

DYNACQ HEALTHCARE INC  
Form 10-Q  
May 29, 2013  
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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 28, 2013

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-21574

**DYNACQ HEALTHCARE, INC.**

(Exact name of registrant as specified in its charter)

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**Nevada**  
(State or other jurisdiction of  
incorporation or organization)

**4301 Vista Road**  
**Pasadena, Texas**  
(Address of principal executive offices)

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

**77504**  
(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
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 May 28, 2013, the number of shares outstanding of the registrant's common stock, par value \$.001 per share, was 14,543,626.

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

|                                                                                                                                                | February 28, 2013<br>(Unaudited) | August 31, 2012      |
|------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------|----------------------|
| <b>Assets</b>                                                                                                                                  |                                  |                      |
| Current assets:                                                                                                                                |                                  |                      |
| Cash and cash equivalents                                                                                                                      | \$ 11,125,159                    | \$ 10,638,217        |
| Accounts receivable, net of allowances of approximately \$183,245,000 and \$187,478,000 at February 28, 2013 and August 31, 2012, respectively | 596,699                          | 797,964              |
| Inventories                                                                                                                                    | 288,632                          | 408,961              |
| Trading securities                                                                                                                             | 1,811,910                        | 1,280,518            |
| Interest receivable                                                                                                                            | 106,993                          | 167,229              |
| Prepaid expenses                                                                                                                               | 197,127                          | 423,659              |
| Income tax receivable                                                                                                                          | 569,430                          | 569,430              |
| Assets of discontinued operations                                                                                                              | 5,087,891                        | 5,401,092            |
| <b>Total current assets</b>                                                                                                                    | <b>19,783,841</b>                | <b>19,687,070</b>    |
| Investments available-for-sale                                                                                                                 | 16,441,102                       | 16,828,886           |
| Investment in real estate, net                                                                                                                 |                                  | 1,889,395            |
| Property and equipment, net                                                                                                                    | 6,509,416                        | 6,655,820            |
| Income tax receivable                                                                                                                          | 868,249                          | 868,249              |
| Other assets                                                                                                                                   | 206,082                          | 255,876              |
| <b>Total assets</b>                                                                                                                            | <b>\$ 43,808,690</b>             | <b>\$ 46,185,296</b> |

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

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

|                                                                                                                                  | February 28, 2013<br>(Unaudited) | August 31, 2012      |
|----------------------------------------------------------------------------------------------------------------------------------|----------------------------------|----------------------|
| <b>Liabilities and equity</b>                                                                                                    |                                  |                      |
| Current liabilities:                                                                                                             |                                  |                      |
| Accounts payable                                                                                                                 | \$ 1,683,487                     | \$ 2,271,436         |
| Accrued liabilities                                                                                                              | 11,490,297                       | 11,763,362           |
| Current portion of notes payable                                                                                                 | 39,342                           | 105,735              |
| Current portion of capital lease obligations                                                                                     | 166,814                          | 101,696              |
| <b>Total current liabilities</b>                                                                                                 | <b>13,379,940</b>                | <b>14,242,229</b>    |
| Non-current liabilities:                                                                                                         |                                  |                      |
| Long-term portion of notes payable                                                                                               | 27,103                           | 1,074,187            |
| Long-term portion of capital lease obligations                                                                                   | 83,801                           | 87,465               |
| <b>Total liabilities</b>                                                                                                         | <b>13,490,844</b>                | <b>15,403,881</b>    |
| Commitments and contingencies                                                                                                    |                                  |                      |
| Equity:                                                                                                                          |                                  |                      |
| Dynacq stockholders' equity:                                                                                                     |                                  |                      |
| Preferred stock, \$.01 par value; 5,000,000 shares authorized, none issued or outstanding                                        |                                  |                      |
| Common stock, \$.001 par value; 100,000,000 shares authorized, 14,543,626 shares issued at February 28, 2013 and August 31, 2012 | 14,544                           | 14,544               |
| Additional paid-in capital                                                                                                       | 10,183,574                       | 10,172,794           |
| Accumulated other comprehensive income                                                                                           | 8,387,456                        | 8,419,324            |
| Retained earnings                                                                                                                | 11,668,786                       | 12,108,494           |
| <b>Total Dynacq stockholders' equity</b>                                                                                         | <b>30,254,360</b>                | <b>30,715,156</b>    |
| <b>Non-controlling interest</b>                                                                                                  | <b>63,486</b>                    | <b>66,259</b>        |
| <b>Total equity</b>                                                                                                              | <b>30,317,846</b>                | <b>30,781,415</b>    |
| <b>Total liabilities and equity</b>                                                                                              | <b>\$ 43,808,690</b>             | <b>\$ 46,185,296</b> |

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

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

(Unaudited)

|                                                                         | Three months ended   |                      | Six months ended     |                      |
|-------------------------------------------------------------------------|----------------------|----------------------|----------------------|----------------------|
|                                                                         | February 28,<br>2013 | February 29,<br>2012 | February 28,<br>2013 | February 29,<br>2012 |
| Net patient service revenue                                             | \$ 1,437,822         | \$ 966,716           | \$ 2,955,849         | \$ 2,811,689         |
| Costs and expenses:                                                     |                      |                      |                      |                      |
| Compensation and benefits                                               | 1,394,940            | 2,019,222            | 2,783,764            | 3,696,591            |
| Medical services and supplies                                           | 374,986              | 343,508              | 770,526              | 566,626              |
| Other operating expenses                                                | 1,122,331            | 1,331,511            | 3,694,582            | 2,608,754            |
| Depreciation and amortization                                           | 121,743              | 139,657              | 245,495              | 274,176              |
| Total costs and expenses                                                | 3,014,000            | 3,833,898            | 7,494,367            | 7,146,147            |
| Operating loss                                                          | (1,576,178)          | (2,867,182)          | (4,538,518)          | (4,334,458)          |
| Other income (expense):                                                 |                      |                      |                      |                      |
| Rent and other income                                                   | 561,979              | 1,257,888            | 3,531,070            | 1,265,285            |
| Interest income                                                         | 170,840              | 319,965              | 475,654              | 587,691              |
| Interest expense                                                        | (139,512)            | (143,265)            | (280,773)            | (294,589)            |
| Total other income, net                                                 | 593,307              | 1,434,588            | 3,725,951            | 1,558,387            |
| Loss before income taxes from continuing operations                     | (982,871)            | (1,432,594)          | (812,567)            | (2,776,071)          |
| Provision (benefit) for income taxes                                    |                      |                      |                      |                      |
| Loss from continuing operations                                         | (982,871)            | (1,432,594)          | (812,567)            | (2,776,071)          |
| Discontinued operations, net of income taxes                            | 128,728              | (189,796)            | 370,086              | (817,927)            |
| Loss on disposal of discontinued operations, net of income taxes        |                      | (229,201)            |                      | (229,201)            |
| Net loss                                                                | (854,143)            | (1,851,591)          | (442,481)            | (3,823,199)          |
| Less: Net (income) loss attributable to noncontrolling interest         | (25)                 | 56,005               | 2,773                | 83,520               |
| Net loss attributable to Dynacq Healthcare, Inc.                        | \$ (854,168)         | \$ (1,795,586)       | \$ (439,708)         | \$ (3,739,679)       |
| Basic and diluted income (loss) per common share:                       |                      |                      |                      |                      |
| Loss from continuing operations attributable to Dynacq Healthcare, Inc. | \$ (0.07)            | \$ (0.10)            | \$ (0.06)            | \$ (0.19)            |
| Discontinued operations, net of income taxes                            | 0.01                 | (0.01)               | 0.03                 | (0.06)               |
| Loss on disposal of discontinued operations, net of income taxes        |                      | (0.02)               |                      | (0.02)               |
| Net loss attributable to Dynacq Healthcare, Inc.                        | \$ (0.06)            | \$ (0.13)            | \$ (0.03)            | \$ (0.27)            |
| Basic and diluted average common shares outstanding                     | 14,543,626           | 14,456,127           | 14,543,626           | 14,443,627           |
| Amounts attributable to Dynacq Healthcare, Inc.:                        |                      |                      |                      |                      |
| Loss from continuing operations                                         | \$ (982,896)         | \$ (1,376,589)       | \$ (809,794)         | \$ (2,692,551)       |
| Discontinued operations, net of income taxes                            | 128,728              | (189,796)            | 370,086              | (817,927)            |
| Loss on disposal of discontinued operations, net of income taxes        |                      | (229,201)            |                      | (229,201)            |

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Net loss attributable to Dynacq Healthcare, Inc. \$ (854,168) \$ (1,795,586) \$ (439,708) \$ (3,739,679)

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

**Table of Contents****Dynacq Healthcare, Inc.****Consolidated Statements of Comprehensive Income (Loss)**

(Unaudited)

|                                                                                                                                    | <b>Three months ended</b>    |                              | <b>Six months ended</b>      |                              |
|------------------------------------------------------------------------------------------------------------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
|                                                                                                                                    | <b>February 28,<br/>2013</b> | <b>February 29,<br/>2012</b> | <b>February 28,<br/>2013</b> | <b>February 29,<br/>2012</b> |
| Net loss                                                                                                                           | \$ (854,143)                 | \$ (1,851,591)               | \$ (442,481)                 | \$ (3,823,199)               |
| Other comprehensive income (loss), net of taxes:                                                                                   |                              |                              |                              |                              |
| Net change in foreign currency translation adjustment, net of taxes of \$-0-, \$(394,529), \$(4,414) and \$(514,617), respectively |                              | (723,079)                    | (8,196)                      | (946,099)                    |
| Net change in fair value of available-for-sale securities, net of taxes of \$-0-, \$1,293,508, \$-0- and \$(97,599), respectively  | 976,823                      | 2,402,230                    | (23,672)                     | (181,256)                    |
| Other comprehensive income (loss)                                                                                                  | 976,823                      | 1,679,151                    | (31,868)                     | (1,127,355)                  |
| Comprehensive income (loss)                                                                                                        | 122,680                      | (172,440)                    | (474,349)                    | (4,950,554)                  |
| Less comprehensive (income) loss attributable to noncontrolling interest                                                           | (25)                         | 56,005                       | 2,773                        | 83,520                       |
| Comprehensive income (loss) attributable to Dynacq Healthcare, Inc.                                                                | \$ 122,655                   | \$ (116,435)                 | \$ (471,576)                 | \$ (4,867,034)               |

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



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

(Unaudited)

|                                                                                                         | Six months ended     |                      |
|---------------------------------------------------------------------------------------------------------|----------------------|----------------------|
|                                                                                                         | February 28,<br>2013 | February 29,<br>2012 |
| <b>Cash flows from operating activities</b>                                                             |                      |                      |
| Net loss                                                                                                | \$ (439,708)         | \$ (3,739,679)       |
| Less (income) loss from discontinued operations, net of income taxes                                    | (370,086)            | 1,047,128            |
| Net loss before discontinued operations                                                                 | (809,794)            | (2,692,551)          |
| Adjustments to reconcile net loss before discontinued operations to net cash from operating activities: |                      |                      |
| Depreciation and amortization                                                                           | 245,495              | 274,176              |
| (Gain) loss on sale of investments available-for-sale and trading securities                            | (2,731,173)          | 57,101               |
| Gain on sale of investment in real estate                                                               | (480,108)            |                      |
| Deferred income taxes                                                                                   |                      | (1,655,662)          |
| Noncontrolling interest                                                                                 | (2,773)              | (83,520)             |
| Stock based compensation                                                                                | 10,780               | 149,934              |
| Gain on sale of assets                                                                                  | (27,509)             |                      |
| Charge for non-controlling interest sale and issuance of stock awards                                   |                      | 166,666              |
| Foreign currency exchange (gains) losses                                                                | (94,120)             | 152,435              |
| Changes in operating assets and liabilities:                                                            |                      |                      |
| Accounts receivable                                                                                     | 201,264              | 691,455              |
| Interest receivable                                                                                     | 60,237               | 13,493               |
| Inventories                                                                                             | 120,330              | 76,332               |
| Prepaid expenses                                                                                        | 226,533              | 74,293               |
| Other assets                                                                                            | 49,793               | 5,210                |
| Accounts payable                                                                                        | (587,949)            | (371,967)            |
| Accrued liabilities                                                                                     | (236,445)            | (4,746,921)          |
| Cash from continuing activities                                                                         | (4,055,439)          | (7,889,526)          |
| Cash from discontinued activities                                                                       | 370,086              | (765,170)            |
| Net cash from operating activities                                                                      | (3,685,353)          | (8,654,696)          |
| <b>Cash flows from investing activities</b>                                                             |                      |                      |
| Sale proceeds of investments available-for-sale                                                         | 2,650,000            |                      |
| Sales proceeds of investment in real estate                                                             | 2,365,017            |                      |
| Purchase of equipment                                                                                   | (2,810)              | (157,753)            |
| Sales proceeds of equipment                                                                             | 14,270               |                      |
| Cash from continuing activities                                                                         | 5,026,477            | (157,753)            |
| Cash from discontinued activities                                                                       | 313,201              |                      |
| Net cash from investing activities                                                                      | 5,339,678            | (157,753)            |
| <b>Cash flows from financing activities</b>                                                             |                      |                      |
| Proceeds from notes payable                                                                             |                      | 116,339              |
| Principal payments on notes payable                                                                     | (1,113,477)          | (60,773)             |
| Payments on capital lease                                                                               | (53,906)             | (46,103)             |

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|                                                                        |               |               |
|------------------------------------------------------------------------|---------------|---------------|
| Contributions from, and distributions to, noncontrolling interest, net |               | 100,000       |
| Cash from continuing activities                                        | (1,167,383)   | 109,463       |
| Cash from discontinued activities                                      |               |               |
| Net cash from financing activities                                     | (1,167,383)   | 109,463       |
| Effect of exchange rate changes on cash                                |               | 230,293       |
| Net change in cash and cash equivalents                                | 486,942       | (8,472,693)   |
| Cash at beginning of period                                            | 10,638,217    | 24,315,160    |
| Cash at end of period                                                  | \$ 11,125,159 | \$ 15,842,467 |

Continued.

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

(Unaudited)

|                                                                  | <b>Six months ended</b>      |                              |
|------------------------------------------------------------------|------------------------------|------------------------------|
|                                                                  | <b>February 28,<br/>2013</b> | <b>February 29,<br/>2012</b> |
| <b>Supplemental cash flow disclosures</b>                        |                              |                              |
| Cash paid during the period for:                                 |                              |                              |
| Interest                                                         | \$ 210,788                   | \$ 728,788                   |
| Income taxes                                                     | \$ 0                         | \$ 0                         |
| <b>Non cash investing and financing activities:</b>              |                              |                              |
| Unrealized change in fair value of available-for-sale securities | \$ 23,671                    | \$ 181,256                   |
| Purchase of equipment under capital lease                        | 115,360                      |                              |

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

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**Dynacq Healthcare, Inc.**

**Notes to Consolidated Financial Statements**

**February 28, 2013**

(Unaudited)

**General**

Dynacq Healthcare, Inc., a Nevada corporation (the "Company"), is a holding company that through its subsidiaries in the United States develops and manages general acute care hospitals that principally provide specialized surgeries. The Company through its United States subsidiaries (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 periods ended February 28, 2013 and February 29, 2012 (see Note below on Discontinued Operations). The Company through its subsidiary in Hong Kong also invests in debt and equity securities, including short-term investments in initial public offerings and pre-initial public offerings.

**Basis of Presentation**

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal and recurring nature. The majority of the Company's expenses are cost of revenue items. Costs that could be classified as general and administrative by the Company would include the corporate office costs, including advertising and marketing expenses, which were approximately \$1.0 million and \$1.5 million for the three months ended February 28, 2013 and February 29, 2012, respectively, and \$3.3 million and \$2.7 million for the six months ended February 28, 2013 and February 29, 2012, respectively. These financial statements should be read in conjunction with the audited financial statements as of August 31, 2012. Operating results for the three and six months ended February 28, 2013 are not necessarily indicative of the results that may be expected for the year ending August 31, 2013.

**Reclassification**

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

**Cash and Cash Equivalents**

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

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

The Company has invested in various bonds. These investments are classified as available-for-sale securities, and are carried at fair value as of February 28, 2013 and August 31, 2012, based on the other observable inputs and market data as of that date. These investments are subject to default risk. Unrealized gains in the fair value are reported in accumulated other comprehensive income, net of related income tax effect. The Company regularly monitors its investment portfolio for any decline in fair value that is other than temporary and records any such impairment as an impairment loss. The determination on the gain or loss on the sale of any security is specific identification method.

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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 28, 2013 and August 31, 2012. These investments are subject to fluctuations in the market price. During the six months ended February 28, 2013 and February 29, 2012, the Company had a net gain (loss) of \$531,673 and \$(57,101), respectively, in these securities.

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

In October 2012, the Company sold the apartment in Hong Kong, which was purchased in March 2010 as an investment in real estate. The net proceeds from the sale of the apartment were \$1,273,403, after repayment of the associated note payable, and the gain on the sale was \$480,108. Depreciation expense associated with the apartment was \$0- and \$12,912 for the three months ended February 28, 2013 and February 29, 2012, respectively, and \$4,304 and \$25,824 for the six months ended February 28, 2013 and February 29, 2012, respectively.

In November 2011 and September 2010, the Company borrowed \$116,339 and \$65,000 as notes payable from a financial institution at an interest rate of 4.5% and 6%, which notes are to be repaid in 36 and 24 monthly installments, respectively, and are secured by specific equipment purchased at our Pasadena facility. The \$65,000 note payable was fully repaid during the quarter ended November 30, 2012. The Company paid down \$21,862 during the six months ended February 28, 2013, and the current and long-term portions of the notes payable as of February 28, 2013 are \$39,342 and \$27,103, 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 and an allowance for doubtful accounts. See Revenue Recognition below for further discussion. Actual results could differ materially from those estimates used in the preparation of these financial statements.

### **Discontinued Operations**

Under ASC Topic 360-10-35, *Property, Plant, and Equipment - Subsequent Measurement*, the Company classifies assets to be disposed of as held for sale or, if appropriate, discontinued operations when appropriate approvals for the disposal are made by management or the Board of Directors. Cash flows from discontinued businesses are reflected as discontinued operating, investing, and financing activities in our statement of cash flows.

The Company had \$5,087,891 of assets of discontinued operations and no liabilities of discontinued operations as of February 28, 2013 associated with its Garland facility, which closed on September 30, 2011. The Company signed a commercial contract of sale on March 7, 2013 to sell its Garland facility. The sale is expected to close in June 2013. Based on the sales price, the Company took an impairment charge of approximately \$1.1 million during the quarter ended August 31, 2012.

The Company's operations in China were classified as discontinued operations, and exited completely in August 2012.

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The following is a summary of financial information related to our discontinued operations for the three and six months ended February 28, 2013 and February 29, 2012:

**Discontinued Operations**

|                                                               | Three months ended February 28, 2013 |                  |            | Three months ended February 29, 2012 |                  |              |
|---------------------------------------------------------------|--------------------------------------|------------------|------------|--------------------------------------|------------------|--------------|
|                                                               | Garland Facility                     | China Operations | Total      | Garland Facility                     | China Operations | Total        |
| Net patient service revenue                                   | \$ 191,333                           | \$               | \$ 191,333 | \$ 93,711                            | \$               | \$ 93,711    |
| Costs and expenses:                                           |                                      |                  |            |                                      |                  |              |
| Compensation and benefits                                     | 10,769                               |                  | 10,769     | 11,196                               | 90               | 11,286       |
| Medical services and supplies                                 | 149                                  |                  | 149        | 46,580                               |                  | 46,580       |
| Other operating expenses                                      | 41,307                               |                  | 41,307     | 195,171                              | 17,824           | 212,995      |
| Depreciation and amortization                                 |                                      |                  |            |                                      | 20,630           | 20,630       |
| Total costs and expenses                                      | 52,225                               |                  | 52,225     | 252,947                              | 38,544           | 291,491      |
| Operating income (loss)                                       | 139,108                              |                  | 139,108    | (159,236)                            | (38,544)         | (197,780)    |
| Other income (expense), net                                   | (10,380)                             |                  | (10,380)   | (10,311)                             | 18,295           | 7,984        |
| Income (loss) before income taxes                             | 128,728                              |                  | 128,728    | (169,547)                            | (20,249)         | (189,796)    |
| Provision (benefit) for income taxes                          |                                      |                  |            |                                      |                  |              |
| Income (loss) on discontinued operations, net of income taxes | 128,728                              |                  | 128,728    | (169,547)                            | (20,249)         | (189,796)    |
| Loss on disposal of discontinued assets                       |                                      |                  |            |                                      | (229,201)        | (229,201)    |
| Benefit for income taxes                                      |                                      |                  |            |                                      |                  |              |
| Loss on disposal of discontinued assets, net of income taxes  |                                      |                  |            |                                      | (229,201)        | (229,201)    |
| Total income (loss) on discontinued operations, net of taxes  | \$ 128,728                           | \$               | \$ 128,728 | \$ (169,547)                         | \$ (249,450)     | \$ (418,997) |

|                               | Six months ended February 28, 2013 |                  |            | Six months ended February 29, 2012 |                  |            |
|-------------------------------|------------------------------------|------------------|------------|------------------------------------|------------------|------------|
|                               | Garland Facility                   | China Operations | Total      | Garland Facility                   | China Operations | Total      |
| Net patient service revenue   | \$ 402,158                         | \$               | \$ 402,158 | \$ 318,587                         | \$               | \$ 318,587 |
| Costs and expenses:           |                                    |                  |            |                                    |                  |            |
| Compensation and benefits     | 27,051                             |                  | 27,051     | 166,803                            | 22,601           | 189,404    |
| Medical services and supplies | (8,030)                            |                  | (8,030)    | 267,551                            |                  | 267,551    |
| Other operating expenses      | 33,494                             |                  | 33,494     | 533,115                            | 161,864          | 694,979    |
| Depreciation and amortization |                                    |                  |            |                                    | 41,097           | 41,097     |
| Total costs and expenses      | 52,515                             |                  | 52,515     | 967,469                            | 225,562          | 1,193,031  |
| Operating income (loss)       | 349,643                            |                  | 349,643    | (648,882)                          | (225,562)        | (874,444)  |
| Other income (expense), net   | 20,443                             |                  | 20,443     | (21,056)                           | 77,573           | 56,517     |

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|                                                               |            |    |            |              |              |                |
|---------------------------------------------------------------|------------|----|------------|--------------|--------------|----------------|
| Income (loss) before income taxes                             | 370,086    |    | 370,086    | (669,938)    | (147,989)    | (817,927)      |
| Provision (benefit) for income taxes                          |            |    |            |              |              |                |
| Income (loss) on discontinued operations, net of income taxes | 370,086    |    | 370,086    | (669,938)    | (147,989)    | (817,927)      |
| Loss on disposal of discontinued assets                       |            |    |            |              | (229,201)    | (229,201)      |
| Benefit for income taxes                                      |            |    |            |              |              |                |
| Loss on disposal of discontinued assets, net of income taxes  |            |    |            |              | (229,201)    | (229,201)      |
| Total income (loss) on discontinued operations, net of taxes  | \$ 370,086 | \$ | \$ 370,086 | \$ (669,938) | \$ (377,190) | \$ (1,047,128) |

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|                                          | February 28, 2013   |                  |                     | August 31, 2012     |                  |                     |
|------------------------------------------|---------------------|------------------|---------------------|---------------------|------------------|---------------------|
|                                          | Garland Facility    | China Operations | Total               | Garland Facility    | China Operations | Total               |
| Current assets                           | \$                  | \$               | \$                  | \$                  | \$               | \$                  |
| Property and equipment, net              | 5,087,891           |                  | 5,087,891           | 5,401,092           |                  | 5,401,092           |
| <b>Total assets</b>                      | <b>\$ 5,087,891</b> | <b>\$</b>        | <b>\$ 5,087,891</b> | <b>\$ 5,401,092</b> | <b>\$</b>        | <b>\$ 5,401,092</b> |
| Current liabilities:                     |                     |                  |                     |                     |                  |                     |
| Accounts payable and accrued liabilities | \$                  | \$               | \$                  | \$                  | \$               | \$                  |
| Total liabilities                        | \$                  | \$               | \$                  | \$                  | \$               | \$                  |



**Table of Contents****Net Income (Loss) per Share**

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

|                                                                         | Three months ended   |                      | Six months ended     |                      |
|-------------------------------------------------------------------------|----------------------|----------------------|----------------------|----------------------|
|                                                                         | February 28,<br>2013 | February 29,<br>2012 | February 28,<br>2013 | February 29,<br>2012 |
| <b>Basic and diluted loss per common share:</b>                         |                      |                      |                      |                      |
| Numerator:                                                              |                      |                      |                      |                      |
| Loss from continuing operations                                         | \$ (982,871)         | \$ (1,432,594)       | \$ (812,567)         | \$ (2,776,071)       |
| Less: Net (income) loss attributable to noncontrolling interest         | (25)                 | 56,005               | 2,773                | 83,520               |
| Loss from continuing operations attributable to Dynacq Healthcare, Inc. | (982,896)            | (1,376,589)          | (809,794)            | (2,692,551)          |
| Discontinued operations, net of income taxes                            | 128,728              | (189,796)            | 370,086              | (817,927)            |
| Loss on disposal of discontinued operations, net of income taxes        |                      | (229,201)            |                      | (229,201)            |
| Net loss attributable to Dynacq Healthcare, Inc.                        | \$ (854,168)         | \$ (1,795,586)       | \$ (439,708)         | \$ (3,739,679)       |
| Denominator:                                                            |                      |                      |                      |                      |
| Basic and diluted average common shares outstanding                     | 14,543,626           | 14,456,127           | 14,543,626           | 14,443,627           |
| <b>Basic and diluted loss per common share:</b>                         |                      |                      |                      |                      |
| Loss from continuing operations attributable to Dynacq Healthcare, Inc. | \$ (0.07)            | \$ (0.10)            | \$ (0.06)            | \$ (0.19)            |
| Discontinued operations, net of income taxes                            | 0.01                 | (0.01)               | 0.03                 | (0.06)               |
| Loss on disposal of discontinued operations, net of income taxes        |                      | (0.02)               |                      | (0.02)               |
| Net loss attributable to Dynacq Healthcare, Inc.                        | \$ (0.06)            | \$ (0.13)            | \$ (0.03)            | \$ (0.27)            |

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 2,077,000 shares and 2,367,000 shares for the six months ended February 28, 2013 and February 29, 2012, 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 (the "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 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 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 were canceled before vesting.

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

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. All these grants were canceled before they vested.

As of February 28, 2013, there remain 250,000 shares to be issued upon exercise of outstanding options, and 14,750,000 shares which can be issued under the 2011 Plan after giving effect to shares issued and canceled.

**2000 Incentive Plan**

The Company's 2000 Incentive Plan ( 2000 Plan ) provides for options and other stock-based awards that may be granted to eligible employees, officers, consultants and non-employee directors of the Company or its subsidiaries. The Company had reserved 5,000,000 shares of common stock for future issuance under the 2000 Plan. The 2000 Plan does not have a fixed termination date, provided that no incentive stock option can be granted subsequent to August 29, 2011. As of February 28, 2013, there remain 1,400,066 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 Compensation 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. Currently, however, we do not have a Compensation Committee, and accordingly, the Board of Directors, of which our chief executive officer is the sole member, will administer the Plans until such time as a Compensation Committee is established. 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.

The following table summarizes the stock option activities for the six months ended February 28, 2013 (share amounts in thousands):

|                                | Shares  | Weighted Average<br>Option<br>Exercise<br>Price Per<br>Share | Weighted Average<br>Grant Date<br>Fair<br>Value Per<br>Share | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|---------|--------------------------------------------------------------|--------------------------------------------------------------|---------------------------------|
| Outstanding, August 31, 2012   | 2,791   | \$ 1.92                                                      | \$                                                           | \$                              |
| Granted                        |         |                                                              |                                                              |                                 |
| Exercised                      |         |                                                              |                                                              |                                 |
| Expired or canceled            | (1,141) | 1.35                                                         |                                                              |                                 |
| Outstanding, February 28, 2013 | 1,650   | \$ 2.31                                                      | \$                                                           | \$                              |

For the six months ended February 28, 2013 and February 29, 2012, there were no stock options exercised.



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The following summarizes information related to stock options outstanding as of February 28, 2013, and related weighted average price and life information:

| Range of Exercise Prices | Options Outstanding |                                                                                     |                                 | Options Exercisable |                                 |
|--------------------------|---------------------|-------------------------------------------------------------------------------------|---------------------------------|---------------------|---------------------------------|
|                          | Shares              | Weighted Average Remaining Contractual Life (Years)<br>(Share Amounts In Thousands) | Weighted Average Exercise Price | Shares              | Weighted Average Exercise Price |
| \$ 1.10                  | 250                 | 8.9                                                                                 | \$ 1.10                         | 63                  | \$ 1.10                         |
| \$ 1.86                  | 737                 | 8.4                                                                                 | 1.86                            | 184                 | 1.86                            |
| \$ 2.50 2.75             | 460                 | 0.3                                                                                 | 2.55                            | 460                 | 2.55                            |
| \$ 4.90                  | 203                 | 1.8                                                                                 | 4.90                            | 203                 | 4.90                            |
| <b>Total</b>             | <b>1,650</b>        | <b>5.4</b>                                                                          | <b>\$ 2.31</b>                  | <b>910</b>          | <b>\$ 2.84</b>                  |

For the three months ended February 28, 2013 and February 29, 2012, stock-based compensation expense associated with the Company's stock options was \$44,327 and \$82,244, respectively. For the six months ended February 28, 2013 and February 29, 2012, stock-based compensation expense associated with the Company's stock options was \$10,780 and \$149,934, respectively. The total unrecognized compensation expense for outstanding stock options as of February 28, 2013 was \$477,000, and will be recognized, in general, over 2.4 years. The weighted average time to recognize the compensation expense is 1.3 years.

**Fair Value of Financial Instruments****Fair Value of Financial Instruments**

On September 1, 2008, the Company adopted ASC Topic 820, *Fair Value Measurements and Disclosures* 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.
- Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted price for identical or similar assets and liabilities in markets that are not active; or other input that are observable or can be corroborated by observable market data.
- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

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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 28, 2013, segregated among the appropriate levels within the fair value hierarchy:

|                                | Quoted prices in active<br>markets for<br>identical<br>(Level 1) | Significant other<br>observable inputs<br>(Level 2) | Significant<br>unobservable<br>(Level 3) |
|--------------------------------|------------------------------------------------------------------|-----------------------------------------------------|------------------------------------------|
| <b>Assets</b>                  |                                                                  |                                                     |                                          |
| Investments available-for-sale | \$                                                               | \$ 16,441,102                                       | \$                                       |
| Trading securities             | 1,811,910                                                        |                                                     |                                          |

The Company's investments in Level 1 are in equity stocks at a cost of \$2,047,390. The Company's investments in Level 2 are in perpetual bonds traded on the European markets, at a cost of \$7,984,646.

**Foreign Currency Translation**

The functional currency of the Company as a whole, including Sino Bond in Hong Kong, is the U.S. Dollar. The Company had designated the Chinese Yuan Renminbi as the functional currency for its subsidiaries in mainland China in prior years. Assets and liabilities were translated into U.S. dollars using current exchange rates as of the balance sheet date. Income and expense were translated at average exchange rates prevailing during the period. The effects of foreign currency translation adjustments were included as a component of Accumulated Other Comprehensive Income within Stockholders' Equity.

**Revenue Recognition****Revenue Recognition**

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.

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 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 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 28, 2013 and February 29, 2012:

|                       | Three months ended   |                      | Six months ended     |                      |
|-----------------------|----------------------|----------------------|----------------------|----------------------|
|                       | February 28,<br>2013 | February 29,<br>2012 | February 28,<br>2013 | February 29,<br>2012 |
| Gross billed charges  | \$ 4,488,742         | \$ 3,692,503         | \$ 9,135,745         | \$ 8,746,618         |
| Contractual allowance | 3,050,920            | 2,725,787            | 6,179,896            | 5,934,929            |
| Net revenue           | \$ 1,437,822         | \$ 966,716           | \$ 2,955,849         | \$ 2,811,689         |

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|                                  |     |     |     |     |
|----------------------------------|-----|-----|-----|-----|
| Contractual allowance percentage | 68% | 74% | 68% | 68% |
|----------------------------------|-----|-----|-----|-----|

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.

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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. 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 2013 fiscal year.

Through February 2013, insurance carriers have voluntarily paid the awards in the decisions and orders issued by SOAH, plus interest, in approximately 180 cases, involving approximately \$11 million in claims. In most of these cases, 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 \$4.2 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. The Company 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 \$7.8 million, not including prejudgment interest. As of February 28, 2013, the Company has accrued this amount of \$7.8 million, and an additional amount of \$1.9 million in interest payable, as accrued liabilities. The Company has appealed the judgments requiring a refund to the carriers. The briefs of the parties have been filed with the court of appeals and oral argument has been held, and the Company is now waiting for the court of appeals to act on the appeals. While the appeals are pending, the adjudication of those cases remanded for determinations of whether the services provided were unusually costly and unusually extensive will continue. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers.

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and may 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 many of the underlying stop-loss fee disputes and that payments refunded to the carriers will be recaptured.

Claims regarding payment for ambulatory surgical center and hospital outpatient services remain pending at the TDWC. It is expected that these claims will be adjudicated at SOAH and 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 from 2001 to 2004 as well as all pending cases involving hospital outpatient services provided prior to March 1, 2008, when the Guidelines took effect. Since the Third Court of Appeals unfavorable ruling, collection, if any, in these cases depends on the Company's ability to establish the criteria in this ruling. The Company was given the opportunity to establish the criteria in approximately 80 cases, which were set for hearing on the merits from March through May 2012 and was unsuccessful. Additionally, the Company will have the opportunity to continue to establish the criteria in several thousand cases currently pending at SOAH during the 2013 fiscal year.

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

### *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 and provides full allowance reserves for any accounts receivable deemed uncollectible.

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.

### **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% to 1.75% at February 28, 2013).



**Table of Contents****Other Comprehensive Income (Loss)**

The following table presents information about items reclassified out of accumulated other comprehensive income (loss) by component for the six months ended February 28, 2013 (net of tax):

|                                                                  | Change in Foreign<br>Currency<br>Translation<br>Adjustment | Change in Fair<br>Value of Available<br>for Sale<br>Securities | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|------------------------------------------------------------------|------------------------------------------------------------|----------------------------------------------------------------|--------------------------------------------------------|
| Balance as of August 31, 2012                                    | \$ 8,196                                                   | \$ 8,411,128                                                   | \$ 8,419,324                                           |
| Other comprehensive income before reclassifications              |                                                            | 2,175,828                                                      | 2,175,828                                              |
| Amounts reclassified from accumulated other comprehensive income | (8,196)                                                    | (2,199,500)                                                    | (2,207,696)                                            |
| Net current-period other comprehensive loss                      | (8,196)                                                    | (23,672)                                                       | (31,868)                                               |
| Balance as of February 28, 2013                                  | \$                                                         | \$ 8,387,456                                                   | \$ 8,387,456                                           |

The following table presents a subtotal for each significant reclassification to net income out of accumulated other comprehensive income (loss) and the line item affected in the consolidated statement of operations during the six months ended February 28, 2013:

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

**Contingencies**

Due to the uncertainties associated with the stop-loss fee dispute cases, the Company 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 \$4.2 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. The Company 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 \$7.8 million, not including prejudgment interest. As of February 28, 2013, the Company has accrued this amount of \$7.8 million, and an additional amount of \$1.9 million in interest payable, as accrued liabilities. The Company has appealed the judgments requiring a refund to the carriers. The briefs of the parties have been filed with the court of appeals and oral argument has been held, and the Company is now waiting for the court of appeals to act on the appeals. While the appeals are pending, the adjudication of those cases remanded

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for determinations of whether the services provided were unusually costly and unusually extensive will continue. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and may 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 many of the underlying stop-loss fee disputes and that payments refunded to the carriers will be recaptured.

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

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

## **Recent Accounting Pronouncements**

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 Company adopted this standard on September 1, 2012, and it did not have a material impact on our consolidated financial position or results of operations.

In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update, or ASU, 2013-02, which requires additional disclosures on the effect of significant reclassifications out of accumulated other comprehensive income. The ASU requires a company that reports other comprehensive income to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. For other amounts that are not required to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference to other required disclosures that provide additional details about those amounts. This ASU is effective for fiscal years beginning after December 15, 2012, and was adopted early by us on September 1, 2012. As it only requires additional disclosure, the adoption of this ASU had no impact on our consolidated financial position or results of operations.

## **Industry Segments and Geographic Information**

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

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

### **Corporate Division**

The Company signed a commercial contract of sale on March 7, 2013 to sell its Garland facility. The sale is expected to close in June 2013. Based on the sales price, the Company took an impairment charge of approximately \$1.1 million during the quarter ended August 31, 2012. The Company closed the Garland facility on September 30, 2011, and accordingly its operations are classified as discontinued operations.

The Company has discontinued operations of all its foreign subsidiaries, except for Sino Bond. We have accounted for the operations of our subsidiary in China, Dynacq Huai Bei Healthcare, Inc., as discontinued operations, and have reclassified prior period financial statements to exclude them from continuing operations.

The Company 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.

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The Company invests in various marketable securities. During the six months ended February 28, 2013, one particular security was called on which the Company had a gain of approximately \$2.2 million. As of February 28, 2013, the balance of these securities is valued at approximately \$16.4 million. During the six months ended February 28, 2013 and February 29, 2012, the Company also traded in initial public offerings of equity securities on the Hong Kong Stock Exchange and had a net gain (loss) of \$531,673 and \$(57,101), respectively.

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

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

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

|                                                                      | Three months ended |                   | Six months ended  |                   |
|----------------------------------------------------------------------|--------------------|-------------------|-------------------|-------------------|
|                                                                      | February 28, 2013  | February 29, 2012 | February 28, 2013 | February 29, 2012 |
| <b><u>Revenues from external customers</u></b>                       |                    |                   |                   |                   |
| <b>Net patient service revenues</b>                                  |                    |                   |                   |                   |
| U.S. Division                                                        | \$ 1,437,822       | \$ 966,716        | \$ 2,955,849      | \$ 2,811,689      |
| Corporate                                                            |                    |                   |                   |                   |
| Consolidated                                                         | \$ 1,437,822       | \$ 966,716        | \$ 2,955,849      | \$ 2,811,689      |
| <b><u>Income (loss) before taxes and discontinued operations</u></b> |                    |                   |                   |                   |
| U.S. Division                                                        | \$ (782,269)       | \$ (1,584,878)    | \$ (1,482,777)    | \$ (1,989,527)    |
| Corporate                                                            | (200,602)          | 152,284           | 670,210           | (786,544)         |
| Consolidated                                                         | \$ (982,871)       | \$ (1,432,594)    | \$ (812,567)      | \$ (2,776,071)    |

|                                   | February 28, 2013 | August 31, 2012 |
|-----------------------------------|-------------------|-----------------|
| <b><u>Total Assets</u></b>        |                   |                 |
| U.S. Division                     | \$ 11,220,675     | \$ 8,072,893    |
| Corporate                         | 27,500,124        | 32,711,311      |
| Assets of continuing operations   | 38,720,799        | 40,784,204      |
| Assets of discontinued operations | 5,087,891         | 5,401,092       |
| Consolidated                      | \$ 43,808,690     | \$ 46,185,296   |

**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, 2012. 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

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read the following discussion of the results of our business and our operations and financial condition in conjunction with our consolidated financial statements, including the notes, included in this quarterly report on Form 10-Q and our audited consolidated financial statements, including the notes, included in our Annual Report on Form 10-K for the fiscal year ended August 31, 2012.

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**Update on Critical Accounting Policies and Estimates**

There have been no changes to the critical accounting policies used in our reporting of results of operations and financial position for the quarter ended February 28, 2013. For a discussion of our critical accounting policies see Management's Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the fiscal year ended August 31, 2012.

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

|                                                                              | Three Months Ended February 28, 2013 |              |              | Three Months Ended February 29, 2012 |             |                |
|------------------------------------------------------------------------------|--------------------------------------|--------------|--------------|--------------------------------------|-------------|----------------|
|                                                                              | U.S. Division                        | Corporate    | Total        | U.S. Division                        | Corporate   | Total          |
| Net patient service revenue                                                  | \$ 1,437,822                         | \$           | \$ 1,437,822 | \$ 966,716                           | \$          | \$ 966,716     |
| Costs and expenses:                                                          |                                      |              |              |                                      |             |                |
| Compensation and benefits                                                    | 922,853                              | 472,087      | 1,394,940    | 964,412                              | 1,054,810   | 2,019,222      |
| Medical services and supplies                                                | 374,986                              |              | 374,986      | 343,508                              |             | 343,508        |
| Other operating expenses                                                     | 671,645                              | 450,686      | 1,122,331    | 990,283                              | 341,228     | 1,331,511      |
| Depreciation and amortization                                                | 115,747                              | 5,996        | 121,743      | 115,206                              | 24,451      | 139,657        |
| Total costs and expenses                                                     | 2,085,231                            | 928,769      | 3,014,000    | 2,413,409                            | 1,420,489   | 3,833,898      |
| Operating loss                                                               | (647,409)                            | (928,769)    | (1,576,178)  | (1,446,693)                          | (1,420,489) | (2,867,182)    |
| Other income (expense):                                                      |                                      |              |              |                                      |             |                |
| Rent and other income                                                        | 4,652                                | 557,327      | 561,979      | 2,110                                | 1,255,778   | 1,257,888      |
| Interest income                                                              |                                      | 170,840      | 170,840      |                                      | 319,965     | 319,965        |
| Interest expense                                                             | (139,512)                            |              | (139,512)    | (140,295)                            | (2,970)     | (143,265)      |
| Total other income (expense), net                                            | (134,860)                            | 728,167      | 593,307      | (138,185)                            | 1,572,773   | 1,434,588      |
| Income (loss) before income taxes from continuing operations                 | \$ (782,269)                         | \$ (200,602) | (982,871)    | \$ (1,584,878)                       | \$ 152,284  | (1,432,594)    |
| Benefit for income taxes                                                     |                                      |              |              |                                      |             |                |
| Loss from continuing operations                                              |                                      |              | (982,871)    |                                      |             | (1,432,594)    |
| Discontinued operations, net of income taxes                                 |                                      |              | 128,728      |                                      |             | (189,796)      |
| Loss on disposal of discontinued operations, net of income taxes             |                                      |              |              |                                      |             | (229,201)      |
| Net loss                                                                     |                                      |              | (854,143)    |                                      |             | (1,851,591)    |
| Less: Net (income) loss attributable to noncontrolling interest              |                                      |              | (25)         |                                      |             | 56,005         |
| Net loss attributable to Dynacq Healthcare, Inc.                             |                                      |              | \$ (854,168) |                                      |             | \$ (1,795,586) |
| Operational statistics (Number of medical procedures) for Pasadena facility: |                                      |              |              |                                      |             |                |
| Inpatient:                                                                   |                                      |              |              |                                      |             |                |
| Bariatric                                                                    | 16                                   |              |              | 13                                   |             |                |
| Orthopedic                                                                   | 1                                    |              |              |                                      |             |                |
| Other                                                                        | 9                                    |              |              | 14                                   |             |                |
| Total inpatient procedures                                                   | 26                                   |              |              | 27                                   |             |                |
| Outpatient:                                                                  |                                      |              |              |                                      |             |                |
| Orthopedic                                                                   | 31                                   |              |              | 28                                   |             |                |
| Other                                                                        | 108                                  |              |              | 93                                   |             |                |

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|                             |     |     |
|-----------------------------|-----|-----|
| Total outpatient procedures | 139 | 121 |
| Total procedures            | 165 | 148 |



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|                                                                              | Six Months Ended February 28, 2013 |             |              | Six Months Ended February 29, 2012 |              |                |
|------------------------------------------------------------------------------|------------------------------------|-------------|--------------|------------------------------------|--------------|----------------|
|                                                                              | U.S. Division                      | Corporate   | Total        | U.S. Division                      | Corporate    | Total          |
| Net patient service revenue                                                  | \$ 2,955,849                       | \$          | \$ 2,955,849 | \$ 2,811,689                       | \$           | \$ 2,811,689   |
| Costs and expenses:                                                          |                                    |             |              |                                    |              |                |
| Compensation and benefits                                                    | 1,815,140                          | 968,624     | 2,783,764    | 1,929,426                          | 1,767,165    | 3,696,591      |
| Medical services and supplies                                                | 770,526                            |             | 770,526      | 566,626                            |              | 566,626        |
| Other operating expenses                                                     | 1,398,585                          | 2,295,997   | 3,694,582    | 1,803,519                          | 805,235      | 2,608,754      |
| Depreciation and amortization                                                | 227,988                            | 17,507      | 245,495      | 224,638                            | 49,538       | 274,176        |
| Total costs and expenses                                                     | 4,212,239                          | 3,282,128   | 7,494,367    | 4,524,209                          | 2,621,938    | 7,146,147      |
| Operating loss                                                               | (1,256,390)                        | (3,282,128) | (4,538,518)  | (1,712,520)                        | (2,621,938)  | (4,334,458)    |
| Other income (expense):                                                      |                                    |             |              |                                    |              |                |
| Rent and other income                                                        | 53,105                             | 3,477,965   | 3,531,070    | 11,811                             | 1,253,474    | 1,265,285      |
| Interest income                                                              |                                    | 475,654     | 475,654      |                                    | 587,691      | 587,691        |
| Interest expense                                                             | (279,492)                          | (1,281)     | (280,773)    | (288,818)                          | (5,771)      | (294,589)      |
| Total other income (expense), net                                            | (226,387)                          | 3,952,338   | 3,725,951    | (277,007)                          | 1,835,394    | 1,558,387      |
| Loss before income taxes from continuing operations                          | \$ (1,482,777)                     | \$ 670,210  | (812,567)    | \$ (1,989,527)                     | \$ (786,544) | (2,776,071)    |
| Benefit for income taxes                                                     |                                    |             |              |                                    |              |                |
| Loss from continuing operations                                              |                                    |             | (812,567)    |                                    |              | (2,776,071)    |
| Discontinued operations, net of income taxes                                 |                                    |             | 370,086      |                                    |              | (817,927)      |
| Loss on disposal of discontinued operations, net of income taxes             |                                    |             |              |                                    |              | (229,201)      |
| Net loss                                                                     |                                    |             | (442,481)    |                                    |              | (3,823,199)    |
| Less: Net loss attributable to noncontrolling interest                       |                                    |             | 2,773        |                                    |              | 83,520         |
| Net loss attributable to Dynacq Healthcare, Inc.                             |                                    |             | \$ (439,708) |                                    |              | \$ (3,739,679) |
| Operational statistics (Number of medical procedures) for Pasadena facility: |                                    |             |              |                                    |              |                |
| Inpatient:                                                                   |                                    |             |              |                                    |              |                |
| Bariatric                                                                    | 26                                 |             |              | 30                                 |              |                |
| Orthopedic                                                                   | 3                                  |             |              | 1                                  |              |                |
| Other                                                                        | 21                                 |             |              | 45                                 |              |                |
| Total inpatient procedures                                                   | 50                                 |             |              | 76                                 |              |                |
| Outpatient:                                                                  |                                    |             |              |                                    |              |                |
| Orthopedic                                                                   | 65                                 |             |              | 53                                 |              |                |
| Other                                                                        | 253                                |             |              | 173                                |              |                |
| Total outpatient procedures                                                  | 318                                |             |              | 226                                |              |                |
| Total procedures                                                             | 368                                |             |              | 302                                |              |                |



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*Three Months Ended February 28, 2013 Compared to the Three Months Ended February 29, 2012*

**U.S. Division**

Through February 28, 2013, insurance carriers have voluntarily paid the awards in the decisions and orders issued by SOAH, plus interest, in approximately 180 cases, involving approximately \$11 million in claims. In most of these cases, 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 \$4.2 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. The Company 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 \$7.8 million, not including prejudgment interest. As of February 28, 2013, the Company has accrued this amount of \$7.8 million, and an additional amount of \$1.9 million in interest payable, as accrued liabilities. The Company has appealed the judgments requiring a refund to the carriers. The briefs of the parties have been filed with the court of appeals and the Company is now waiting for the court of appeals to act on the appeals. While the appeals are pending, the adjudication of those cases remanded for determinations of whether the services provided were unusually costly and unusually extensive will continue. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and may 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 payments refunded to the carriers will be recaptured.

Net patient service revenue increased by \$471,106, or 49%, from \$966,716 to \$1,437,822, and total surgical cases increased by 11% from 148 cases for the quarter ended February 29, 2012 to 165 cases for the quarter ended February 28, 2013. While the number of cases increased by 11%, net patient service revenue increased by 49%, primarily due to a change in the surgical mix of cases, and collection on old accounts receivable that were fully reserved for.

Total costs and expenses decreased by \$328,178, or 14%, from \$2,413,409 for the quarter ended February 29, 2012 to \$2,085,231 for the quarter ended February 28, 2013. The following discusses the various changes in costs and expenses:

Compensation and benefits decreased by \$41,559, or 4%, primarily associated with reduction in workforce.

Medical services and supplies expenses increased by \$31,478, or 9%, primarily due to an 11% increase in the number of cases.

Other operating expenses decreased by \$318,638, or 32%, primarily due to efforts made by the Company to reduce costs. Other income (expense) for the quarters ended February 28, 2013 and February 29, 2012 includes interest expense of \$(139,512) and \$(140,295), respectively, primarily associated with the stop-loss cases discussed above.

**Corporate Division**

Compensation and benefits for the Corporate Division includes all corporate personnel compensation and benefits. It also includes \$44,327 and \$82,244 of non-cash compensation expense for the quarters ended February 28, 2013 and February 29, 2012, respectively, related to employees incentive stock options granted in fiscal years 2007, 2011 and 2012. Apart from the stock option expense discussed above, the decrease in 2013, compared to 2012, was 56%. The compensation expense is lower in the current period due to a reduction in the number of corporate staff, including marketing personnel. In addition, the Company had incurred a non-cash compensation charge of \$50,000 in 2012 for issuance of common stock to an employee, and had paid the former chief financial officer an additional compensation of \$77,000.

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Other operating expenses include all corporate general and administrative expenses, including other professional fees such as legal expenses and audit expenses. It increased by \$109,458, from \$341,228 for the quarter ended February 29, 2012 to \$450,686 for the quarter ended February 28, 2013. The increase in other operating expenses is due to an increase in legal and other professional fees by approximately \$107,000 primarily for general corporate affairs and also due to the internal investigation discussed in note 16 to our consolidated financial statements for the fiscal year ended August 31, 2012.

Rent and other income decreased by \$698,451, from \$1,255,778 for the quarter ended February 29, 2012 to \$557,327 for the quarter ended February 28, 2013. Rent and other income for the quarter ended February 28, 2013 includes (a) a gain of \$473,295 in trading securities, (b) an amount of \$24,372 in foreign currency gains, and (c) miscellaneous other income of \$59,660. Rent and other income for the quarter ended February 29, 2012 includes (a) 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 prior 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 quarter ended February 29, 2012 upon the return of investments from the Company's foreign subsidiaries in China.); (b) a gain of \$108,491 in trading securities; (c) foreign currency exchange losses of \$305,181, primarily on investments in Euro bonds; and (d) miscellaneous other income of \$29,878.

Interest income of \$170,840 and \$319,965 for the quarters ended February 28, 2013 and February 29, 2012, respectively, are primarily related to the Company's investments in bonds.

*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 28, 2013, based on the other observable inputs and market data as of that date. As of February 28, 2013, these securities are valued at approximately \$16.4 million. Unrealized gains in these investments of \$8.4 million are included in accumulated other comprehensive income in the Consolidated Balance Sheet as at February 28, 2013. During the quarters ended February 28, 2013 and February 29, 2012, the Company also traded in initial public offerings of equity securities on the Hong Kong Stock Exchange and had gains of \$473,295 and \$108,491, respectively.

*Discontinued Operations*

The Company closed the Garland facility on September 30, 2011, and accordingly its operations for the fiscal year 2012 and the quarter ended February 28, 2013 continues to be classified as discontinued operations. The Company signed a commercial contract of sale on March 7, 2013 to sell its Garland facility. The sale is expected to close in June 2013. Net patient service revenue for the quarter ended February 28, 2013 was \$191,333, due to receipts on old accounts receivable that were fully reserved earlier per the Company's revenue recognition policy. Net patient service revenue for the quarter ended February 29, 2012 was \$93,711.

Total costs and expenses for the Garland facility for the quarters ended February 28, 2013 and February 29, 2012 was \$52,225 and \$252,947, respectively.

In previous years, the Corporate Division included costs and expenses the Company incurred at certain of its subsidiaries in China while pursuing various projects. All of the Company's foreign subsidiaries, except for Sino Bond, have been classified as discontinued operations, and exited completely in August 2012. Loss before income taxes in these subsidiaries was \$20,249 for the quarter ended February 29, 2012. In addition, loss on disposal of discontinued operations in China was \$229,201 for the quarter ended February 29, 2012.

*Income Taxes*

For the quarters ended February 28, 2013 and February 29, 2012, the Company did not recognize a benefit for income taxes due to the uncertainty of the Company's ability to recognize the benefit from the carry forward of net operating losses. The Company has recorded a full valuation allowance against the deferred tax asset.

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*Six Months Ended February 28, 2013 Compared to the Six Months Ended February 29, 2012*

**U.S. Division**

Through February 2013, insurance carriers have voluntarily paid the awards in the decisions and orders issued by SOAH, plus interest, in approximately 180 cases, involving approximately \$11 million in claims. In most of these cases, 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 \$4.2 million, including prejudgment interest, pending remand for a case-by-case determination of whether the services provided were unusually costly and unusually extensive. The Company 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 \$7.8 million, not including prejudgment interest. As of February 28, 2013, the Company has accrued this amount of \$7.8 million, and an additional amount of \$1.9 million in interest payable, as accrued liabilities. The Company has appealed the judgments requiring a refund to the carriers. The briefs of the parties have been filed with the court of appeals and the Company is now waiting for the court of appeals to act on the appeals. While the appeals are pending, the adjudication of those cases remanded for determinations of whether the services provided were unusually costly and unusually extensive will continue. Voluntary payments made pursuant to the Decisions and Orders are premature payments by the carriers and may 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 payments refunded to the carriers will be recaptured.

Net patient service revenue increased by \$144,160, or 5%, from \$2,811,689 to \$2,955,849, and total surgical cases increased by 22% from 302 cases for the six months ended February 29, 2012 to 368 cases for the six months ended February 28, 2013. While the number of cases increased by 22%, net patient service revenue increased by 5%, primarily due to a change in the surgical mix of cases. Marginal increase in net patient revenues is due to lower number of inpatient cases, from 76 to 50, which typically have higher reimbursements.

Total costs and expenses decreased by \$311,970, or 7%, from \$4,524,209 for the six months ended February 29, 2012 to \$4,212,239 for the six months ended February 28, 2013. The following discusses the various changes in costs and expenses:

Compensation and benefits decreased by \$114,286, or 6%, primarily associated with reduction in workforce.

Medical services and supplies expenses increased by \$203,900, or 36%, primarily due to a 22% increase in the number of cases, and also due to write-off of obsolete supplies.

Other operating expenses decreased by \$404,934, or 22%, primarily due to efforts made by the Company to reduce costs.

Other income (expense) for the six months ended February 28, 2013 and February 29, 2012 includes interest expense of \$(279,492) and \$(288,818), respectively, primarily associated with the stop-loss cases discussed above.

**Corporate Division**

Compensation and benefits for the Corporate Division includes all corporate personnel compensation and benefits. It also includes \$10,780 and \$149,934 of non-cash compensation expense for the six months ended February 28, 2013 and February 29, 2012, respectively, related to employees incentive stock options granted in fiscal years 2007, 2011 and 2012. The lower expense during the six months ended February 28, 2013 is the result of

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reversal of expenses for forfeiture of the unvested stock options. Apart from the stock option expense discussed above, the decrease in 2013, compared to 2012, was 41%. The compensation expense is lower in the current period due to a reduction in the number of corporate staff, including marketing personnel. In addition, the Company had incurred a non-cash compensation charge in 2012 of \$50,000 for issuance of common stock to an employee, and had paid the former chief financial officer an additional compensation of \$77,000.

Other operating expenses include all corporate general and administrative expenses, including other professional fees such as legal expenses and audit expenses. It increased by \$1,490,762, from \$805,235 for the six months ended February 29, 2012 to \$2,295,997 for the six months ended February 28, 2013. The increase in other operating expenses is due to a significant increase in legal and other professional fees by approximately \$1,419,000 primarily for the internal investigation discussed in note 16 to our consolidated financial statements for the fiscal year ended August 31, 2012. The Company has incurred significant amounts of fees related to this investigation, and may continue to do so for the remainder of fiscal year 2013.

Rent and other income increased by \$2,224,491, from \$1,253,474 for the six months ended February 29, 2012 to \$3,477,965 for the six months ended February 28, 2013. Rent and other income for the six months ended February 28, 2013 includes (a) a gain of \$2,199,500 on a bond called during the quarter, (b) a gain of \$480,108 on the sale of the apartment in Hong Kong, (c) an amount of \$163,652 in foreign currency gains, (d) a gain of \$531,673 in trading securities, and (e) miscellaneous other income of \$103,031. Rent and other income for the six months ended February 29, 2012 includes (a) 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 prior 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.); (b) a loss of \$57,101 in trading securities; (c) foreign currency exchange losses of \$178,074, primarily on investments in Euro bonds; and (d) miscellaneous other income of \$66,058.

Interest income of \$475,654 and \$587,691 for the six months ended February 28, 2013 and February 29, 2012, respectively, are primarily related to the Company's investments in bonds.

**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 28, 2013, based on other observable inputs and market data as of that date. As of February 28, 2013, these securities are valued at approximately \$16.4 million. Unrealized gains in these investments of \$8.4 million are included in accumulated other comprehensive income in the Consolidated Balance Sheet as at February 28, 2013. During the six months ended February 28, 2013 and February 29, 2012, the Company also traded in initial public offerings of equity securities on the Hong Kong Stock Exchange and had gains (losses) of \$531,673 and \$(57,101), respectively.

**Discontinued Operations**

The Company closed the Garland facility on September 30, 2011, and accordingly its operations for the fiscal year 2012 and the six months ended February 28, 2013 continues to be classified as discontinued operations. The Company signed a commercial contract of sale on March 7, 2013 to sell its Garland facility. The sale is expected to close in June 2013. Net patient service revenue for the six months ended February 28, 2013 was \$402,158, due to receipts on old accounts receivable that were fully reserved earlier per the Company's revenue recognition policy. Net patient service revenue for the six months ended February 29, 2012 was \$318,587.

Total costs and expenses for the Garland facility for the six months ended February 28, 2013 and February 29, 2012 were \$52,515 and \$967,469, respectively.

In previous years, the Corporate Division included costs and expenses the Company incurred at certain of its subsidiaries in China while pursuing various projects. All of the Company's foreign subsidiaries, except for Sino Bond, have been classified as discontinued operations, and exited completely in August 2012. Loss before income taxes in these subsidiaries was \$377,190 for the six months ended February 29, 2012.

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### *Income Taxes*

For the six months ended February 28, 2013 and February 29, 2012, the Company did not recognize a benefit for income taxes due to the uncertainty of the Company's ability to recognize the benefit from the carry forward of net operating losses. The Company has recorded a full valuation allowance against the deferred tax asset.

### **Liquidity and Capital Resources**

Our fiscal year 2012 Annual Report on Form 10-K includes a detailed discussion of our liquidity, contractual obligations and commitments. The information presented below updates and should be read in conjunction with the information disclosed in that Form 10-K.

#### *Cash flow from operating activities*

Cash flow used in operating activities for continuing activities was \$4,055,439 during the six months ended February 28, 2013, primarily due to (a) a net loss before discontinued operations of \$809,794, (b) net gains on one of the available-for-sale securities the Company was holding being called, and on equity securities, of \$2,731,173, (c) gains of \$480,108 on sale of the apartment in Hong Kong, and (d) decreases in accounts payable and accrued liabilities of \$824,394. Partially offsetting these cash outflows were (a) depreciation and amortization of \$245,495, and (b) reduction in prepaid expenses of \$226,533, due to payment of property taxes.

In addition, cash flow provided by operating activities for discontinued operations was \$370,086 during the six months ended February 28, 2013, primarily due to cash receipts on old accounts receivable which were fully reserved for.

Total cash flow used in operating activities for continuing and discontinued operations combined was \$3,685,353 during the six months ended February 28, 2013.

#### *Cash flows from investing activities*

Cash flow provided by investing activities for continuing activities was \$5,026,477, due to (a) sales proceeds of \$2,650,000 on one of the available-for-sale securities the Company was holding being called, and (b) sales proceeds of \$2,365,017 for the apartment in Hong Kong.

In addition, cash flow provided by investing activities for discontinued operations was \$313,201 during the six months ended February 28, 2013, primarily due to sale of equipment.

Total cash flow provided by investing activities for continuing and discontinued operations combined was \$5,339,678 during the six months ended February 28, 2013.

#### *Cash flows from financing activities*

Cash flow used in financing activities for continuing activities was \$1,167,383, of which \$1,100,737 was for repayment of mortgage loan on the apartment in Hong Kong that was sold in the quarter ended November 30, 2012.

The Company had working capital of \$6,403,901 as of February 28, 2013 and maintained a liquid position by a current ratio of approximately 1.5 to 1.

We believe we will be able to meet our ongoing liquidity and cash needs for fiscal year 2013 through the combination of available cash and cash flows from operations.

### **Recent Accounting Pronouncements**

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

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

Not required.

**Item 4. Controls and Procedures.**

**Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation to assess the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, pursuant to Exchange Act Rule 13a-15(e). Based on that evaluation, our principal executive officer and principal financial officer concluded that, as of February 28, 2013, our disclosure controls and procedures were not effective. This conclusion is based on the material weaknesses and significant deficiencies in internal control over financial reporting that existed as of February 28, 2013, as described below, which may have compromised our ability to ensure that information required to be disclosed in reports we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. As further described below, we have determined that as of April 2013, these material weaknesses and significant deficiencies were remediated, but we had not determined as of February 28, 2013 that they were remediated.

**Changes in Internal Control over Financial Reporting.**

As previously described in Management's Report on Internal Control over Financial Reporting in Item 9A of our annual report on Form 10-K for the fiscal year ended August 31, 2012, for the five fiscal years ended on August 31, 2012, we did not maintain effective internal control over financial reporting due to the existence of certain material weaknesses and significant deficiencies, including a material weakness related to a failure of internal controls designed to limit the ability of management to override our system of internal controls, a material weakness related to a former executive officer's misrepresentations of certain information to our previous independent auditor, and a significant deficiency related to a lack of objectivity by our former executive officers with respect to accounting decisions. As also described in the 10-K, we conducted a review of our internal control and compliance policies and procedures, and during November and December of 2012, implemented two changes to these policies and procedures; specifically, for all accounts payable disbursements, both our Chief Executive Officer and Chief Financial Officer (formerly our Corporate Controller) sign all check requests, and for all payroll changes (including new hires, terminations and pay rate changes), both our Chief Executive Officer and Chief Financial Officer sign the approval form for such payroll changes. Based on an assessment performed by management that was completed in April 2013, we believe these two changes to our internal control and compliance policies and procedures have materially affected our internal controls over financial reporting. As of April 2013, we believe these changes, coupled with the previous changes to our internal control described in our 10-K, have remediated the material weaknesses and significant deficiencies described above, but we will continue to monitor the effects of the changes.

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



**Table of Contents****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, 2012, 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, 2012 have not materially changed.

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

None.

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

None.

**Item 4. Mine Safety Disclosures.**

None.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

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

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\*\* 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: May 29, 2013

By: /s/ Eric K. Chan  
Eric K. Chan  
Chief Executive Officer

(duly authorized officer)

Date: May 29, 2013

By: /s/ Hemant Khemka  
Hemant Khemka  
Chief Financial Officer

(principal financial and accounting officer)

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