

PRECISION AUTO CARE INC
Form 10QSB
May 12, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

ý QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE

ACT OF 1934

For the quarterly period ended March 31, 2005

OR

o TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

Commission file number 0-29478

PRECISION AUTO CARE, INC.

(Exact name of registrant as specified in its charter)

Virginia
(State or other jurisdiction of
incorporation or organization)

54-1847851
(I.R.S. Employer
Identification Number)

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748 Miller Drive, S.E., Leesburg, Virginia 20175

(Address of principal executive offices)

(Zip Code)

703-777-9095

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year,

if changed since last report)

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 past 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 the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date 28,362,252 shares of Common Stock as of April 13, 2005.

Transitional Small Business Disclosure Format: Yes No

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FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements within the meaning of the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934. When used in this report, the words anticipate, believe, estimate, expect, intend and plan as they are used by Precision Auto Care, Inc. or its management are intended to identify such forward-looking statements. All statements regarding Precision Auto Care, Inc. or Precision Auto Care, Inc.'s expected future financial position, business strategy, cost savings and operating synergies, projected costs and plans, and objectives of management for future operations are forward-looking statements. Although Precision Auto Care, Inc. believes the expectations reflected in such forward-looking statements are based on reasonable assumptions, no assurance can be given that such expectations will prove to have been correct. Important factors that could cause actual results to differ materially from the expectations reflected in the forward-looking statements herein include, among others, the factors set forth in the Company's 10-KSB filing for the year ending June 30, 2004 under the caption Business Risk Factors, general economic and business and market conditions, changes in federal and state laws, and increased competitive pressure in the automotive aftermarket services business.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	March 31, 2005 (unaudited)	June 30, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,908,559	\$ 1,573,368
Restricted cash		50,200
Accounts receivable, net of allowance of \$138,905 and \$72,815, respectively	765,940	620,761
Notes receivable	256,671	294,243
Deferred tax asset	473,000	473,000
Other assets	412,918	283,244
Total current assets	4,817,088	3,294,816
Property, plant and equipment, at cost	4,198,957	4,147,329
Less: Accumulated depreciation	(4,065,360)	(3,982,924)
	133,597	164,405
Goodwill	8,711,744	8,711,744
Notes receivable, net of allowance of \$255,519 and \$254,832, respectively	71,191	161,685
Deferred tax asset	965,000	
Deposits and other	63,314	27,914
Total assets	\$ 14,761,934	\$ 12,360,564
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 2,086,181	\$ 1,955,430
Notes payable	39,223	75,240
Deferred revenue	323,846	396,150
Total current liabilities	2,449,250	2,426,820
Notes payable, net of current portion	9,522	13,770
Total liabilities	2,458,772	2,440,590
Commitments and contingencies		
Series A redeemable preferred stock, \$.01 par value; 1,000,000 shares authorized; 11,227 and 202,714 shares issued and outstanding	116,312	2,100,117
Stockholders equity:		
Common stock, \$.01 par value; 39,000,000 shares authorized; 28,362,252 and 23,808,602 shares issued and outstanding	283,623	238,086

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Additional paid-in capital	57,909,364	55,873,804
Accumulated deficit	(46,006,137)	(48,292,033)
Total stockholders' equity	12,186,850	7,819,857
Total liabilities and stockholders' equity	\$ 14,761,934	\$ 12,360,564

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended March 31,	
	2005 (unaudited)	2004 (unaudited)
Revenues:		
Franchise royalties	\$ 2,611,141	\$ 2,603,399
Franchise development	76,784	74,573
Other	79,362	163,109
Total revenues	2,767,287	2,841,081
Direct cost:		
Franchise support	1,767,784	1,723,719
Contribution	999,503	1,117,362
General and administrative expense	771,731	720,085
Depreciation expense	28,253	80,212
Operating income	199,519	317,065
Interest expense	(1,328)	(4,527)
Other income	12,293	12,071
Total other income	10,965	7,544
Income before income tax expense	210,484	324,609
(Benefit) provision for income taxes	(428,000)	
Net income	638,484	324,609
Preferred stock dividends	8,154	17,826
Net income applicable to common shareholders	\$ 630,330	\$ 306,783
Net income applicable to common stock per common share- Basic	\$ 0.03	\$ 0.02
Net income applicable to common stock per common share- Diluted	\$ 0.02	\$ 0.01
Weighted average common shares outstanding- Basic	24,938,661	20,423,929
Weighted average common shares outstanding- Diluted	28,542,253	23,351,858

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

	Nine Months Ended March 31,	
	2005 (unaudited)	2004 (unaudited)
Revenues:		
Franchise royalties	\$ 7,954,686	\$ 7,931,997
Franchise development	956,512	402,006
Other	354,747	478,759
Total revenues	9,265,945	8,812,762
Direct cost:		
Franchise support	5,409,249	5,397,066
Contribution	3,856,696	3,415,696
General and administrative expense	2,464,577	2,498,845
Depreciation expense	82,436	237,004
Operating income	1,309,683	679,847
Gain on debt restructuring		192,875
Interest expense	(4,528)	(16,561)
Other income	44,896	77,659
Total other income	40,368	253,973
Income before income tax expense	1,350,051	933,820
(Benefit) provision for income taxes	(965,000)	
Net income	2,315,051	933,820
Preferred stock dividends	29,155	69,626
Net income applicable to common shareholders	\$ 2,285,896	\$ 864,194
Net income applicable to common stock per common share- Basic	\$ 0.09	\$ 0.05
Net income applicable to common stock per common share- Diluted	\$ 0.08	\$ 0.04
Weighted average common shares outstanding- Basic	24,181,149	17,926,438
Weighted average common shares outstanding- Diluted	27,615,308	21,125,142

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended March 31,	
	2005 (unaudited)	2004 (unaudited)
Operating activities:		
Net income applicable to common shareholders	\$ 2,285,896	\$ 864,194
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	82,436	237,004
Decrease in valuation allowance	(965,000)	
Gain on debt restructuring		(192,875)
Gain on disposal of asset		(25,000)
Stock based compensation	81,912	158,861
Changes in assets and liabilities:		
Restricted cash	50,200	
Accounts and notes receivable	(17,113)	234,357
Prepaid expenses, deposits and other	(105,074)	(163,476)
Accounts payable and accrued liabilities	160,727	(469,898)
Deferred revenue and other	(72,304)	(161,727)
Net cash provided by operating activities	1,501,680	481,440
Investing activities:		
Purchases of property and equipment	(51,628)	(86,098)
Net cash used in investing activities	(51,628)	(86,098)
Financing activities:		
Proceeds from issuance of common stock	15,380	
Payment of preferred stock dividends	(29,976)	(73,248)
Repayment of subordinated debt and other notes payable	(100,265)	(574,070)
Net cash used in financing activities	(114,861)	(647,318)
Net change in cash and cash equivalents	1,335,191	(251,976)
Cash and cash equivalents at beginning of year	1,573,368	1,564,110
Cash and cash equivalents at end of period	\$ 2,908,559	\$ 1,312,134
Supplemental schedule of non cash investing and finance activities:		
Preferred stock exchanged for issuance of common stock	\$ 1,983,805	\$ 3,079,883
Fair value of debt and warrants issued in exchange for cancellation of debt	\$	\$ 272,175

See accompanying notes.

Precision Auto Care, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

Note 1 - Interim Financial Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments consisting primarily of recurring accruals considered necessary for a fair presentation have been included. Operating results for such interim periods are not necessarily indicative of the results, which may be expected for a full fiscal year. For further information, refer to the consolidated financial statements and footnotes included in Precision Auto Care Inc. s (the Company) annual report on Form 10-KSB for the year ended June 30, 2004.

Unless the context requires otherwise, all references to the Company herein mean Precision Auto Care, Inc. and those entities owned or controlled by Precision Auto Care, Inc. Significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 Accounting Policy

Goodwill and Intangible Assets

Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Intangible Assets* , requires that goodwill no longer be amortized, but instead be tested for impairment at least annually. The Company engages a valuation expert to assist in estimating the Company s fair value utilizing a discounted future cash flow approach that estimates revenue, driven by assumed market growth rates and appropriate discount rates. These estimates are consistent with the plans and estimates we use to manage the underlying business. In conjunction with management s analysis, the Company determined it has one reporting unit, which is the same as its reporting segment; Automotive Care Franchising. Historically, management has performed its impairment analysis in the first quarter of each fiscal year. The Company obtained a current business enterprise valuation for purposes of supporting its impairment analysis for fiscal year 2005. Based upon this analysis, management determined that goodwill of approximately \$8.7 million was not impaired.

Stock Options

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The Company generally applies Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for stock options and presents pro forma net income and earnings per share data as if the accounting prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation had been applied. The Company also applies the provisions of FIN 44, Accounting for Certain Transactions Involving Stock Compensation, as required when modifications and other provisions cause the application of variable accounting which calls for the periodic measurement of compensation expense based on the difference in the exercise price and the underlying value of the related stock.

During fiscal year 2005, the Company issued 375,000 options to purchase shares of the Company's common stock to certain employees. The options were granted with an exercise price of \$0.62, which was equal to the market price on that date. As such, no compensation expense was required to be recorded. During fiscal year 2004, the Company issued 65,000 options to purchase shares of the Company's common stock which had an exercise price below the market value of the underlying common stock on the date of grant. As a result, approximately \$15,000 of compensation expense is being recognized over the vesting period of these options. The Company also repurchased certain options from employees and issued new options exercisable at a price of \$0.44 in fiscal year 2003, resulting in the newly issued options being treated as a repricing under FIN 44 which triggered variable accounting. As such, the Company recorded compensation expense of approximately \$68,000 and \$23,000 associated with these options during the nine months ended March 31, 2005 and 2004, respectively. In January 2005, 10,000 shares of the repriced options were exercised at a price of \$0.44. The Company recognized an expense of approximately \$11,000 upon the exercise of these options for the three months ended March 31, 2005.

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Had compensation cost for all options been determined based on the fair value at the grant dates during the nine months ending March 31, 2005 and 2004 consistent with the method of SFAS No. 123, the pro forma net income and income per share would have been as follows:

	Nine Months Ended March 31,	
	2005	2004
Net income applicable to common shareholders	\$ 2,285,896	\$ 864,194
Add: Total stock-based compensation expense reported in net income	81,912	158,861
Deduct: Total stock-based compensation expense determined under fair value based method for all awards*	108,443	224,500
Pro forma net income	\$ 2,259,365	\$ 798,555
Earnings per share:		
Basic- as reported	\$ 0.09	\$ 0.05
Diluted- as reported	\$ 0.08	\$ 0.04
Basic- pro forma	\$ 0.09	\$ 0.04
Diluted- pro forma	\$ 0.08	\$ 0.04
Weighted average shares:		
Weighted average common shares outstanding- Basic	24,181,149	17,926,438
Weighted average common shares outstanding- Diluted	27,615,308	21,125,142

* All awards refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994 awards for which the fair value was required to be measured under Statement 123.

Reclassifications

Certain amounts on the prior period financial statements have been reclassified to be in conformity with the current period financial statements.

Note 3 - Master License Agreement

In August 2004, the Company signed a master franchise agreement with Hung Yue Holdings (Hong Kong) Co., Ltd. giving that firm's affiliate, Precision Tune Auto Care (China) Company Limited, a license to open and operate at least 330 Precision Tune Auto Care (PTAC) car care centers in China over the next seven years. Under the terms of the agreement, Hung Yue Holdings is obligated to pay the Company approximately \$2.1 million. A deposit payment of \$50,000 was paid into escrow prior to executing the agreement and \$100,000 was paid on August 31, 2004, upon execution. Additional payments of \$50,000 were to be paid by November 30, 2004 and December 31, 2004, respectively. However, due to unforeseen circumstances Hung Yue Holdings has requested additional time to make these payments. Accordingly, revenue of \$130,000 was recognized through December 31, 2004, in connection with the signing of the master franchising agreement, and \$20,000 was deferred. The revenue was recognized as the Company had substantially fulfilled all required obligations. The Company has received a portion of the remaining installment payments relating to the signing of the master franchise agreement and recognized additional revenue of \$10,000 for the three months ended March 31, 2005. The Company will also receive a \$250,000 payment on the first anniversary of signing the master franchise agreement, and a minimum of \$1.6 million payable in seven annual installments beginning on August 31, 2005, relating to the opening of car care centers in China. No future revenue will be recognized until collection of such amounts is probable. Additionally, revenue from future franchises under the master license agreement will be recognized when the Company's obligations have been satisfied and collection of the franchise fee is probable. No centers were opened as of March 31, 2005.

Note 4 - New Accounting Pronouncements

The Financial Accounting Standards Board has recently issued several new accounting pronouncements:

In December 2004, the FASB issued SFAS 153 Exchanges of Non-monetary Assets - an amendment of APB Opinion No. 29 . This Statement amended APB Opinion 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of this Statement will be effective for the Company beginning with its fiscal year 2006. The adoption of this Standard is not expected to have a material impact on the Company's financial position, results of operations or cash flows since the Company generally does not engage in non-monetary exchange transactions.

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In December 2004, the FASB issued SFAS 123 (revised 2004) *Share-Based Payment*. This Statement requires that the cost resulting from all share-based transactions be recorded in the financial statements. The Statement establishes fair value as the measurement objective in accounting for share-based payment arrangements and requires all entities to apply a fair-value-based measurement in accounting for share-based payment transactions with employees. The Statement also establishes fair value as the measurement objective for transactions in which an entity acquires goods or services from non-employees in share-based payment transactions. The Statement replaces SFAS 123 *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25 *Accounting for Stock Issued to Employees*. The provisions of this Statement will be effective for the Company beginning with its fiscal year 2007. The Company is currently evaluating the impact this revised Standard will have on its financial position and results of operations.

Note 5 Earnings Per Share

The Company reports earnings per share (EPS) in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, *Earnings per Share* which specifies the methods of computation, presentation, and disclosure. SFAS No. 128 requires the presentation of basic EPS and diluted EPS. Basic EPS is calculated by dividing net income available to common shareholders by the weighted average number of shares outstanding during the period. Diluted EPS is calculated by dividing net income available to common shareholders by the weighted average number of shares outstanding during the period plus the dilutive effect of common stock equivalents. The number of shares outstanding related to stock options and warrants at March 31, 2005 and 2004 was 6,767,460 and 12,580,367, respectively. Only stock options and warrants with exercise prices lower than the average market price of the common shares were included in the diluted EPS calculation. For the three months ended March 31, 2005 and 2004, respectively, 157,950 and 182,950 shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive. For the nine months ended March 31, 2005 and 2004, respectively, 182,950 shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive.

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended		Nine Months Ended	
	March 31, 2005	March 31, 2004	March 31, 2005	March 31, 2004
Numerator:				
Net income	\$ 638,484	\$ 324,609	\$ 2,315,051	\$ 933,820
Preferred stock dividends	(8,154)	(17,826)	(29,155)	(69,626)
Net income applicable to common Shareholders	\$ 630,330	\$ 306,783	\$ 2,285,896	\$ 864,194
Denominator:				
Denominator for basic EPS weighted-average-shares	24,938,661	20,423,929	24,181,149	17,926,438
Common stock equivalents- stock options and warrants	3,603,592	2,927,929	3,434,159	3,198,704
Denominator for diluted EPS weighted-average-shares	28,542,253	23,351,858	27,615,308	21,125,142
Basic earnings per share applicable to common shareholders	\$ 0.03	\$ 0.02	\$ 0.09	\$ 0.05
Diluted earnings per share applicable to common shareholders	\$ 0.02	\$ 0.01	\$ 0.08	\$ 0.04

Note 6 - Debt

Debt

On March 1, 2005, the Company renewed the \$250,000 line of credit with Chevy Chase Bank. The interest rate on this line of credit is indexed to the Prime Rate as published in *The Wall Street Journal* (5.75% at March 31, 2005) and the Company has pledged all of its wholly-owned subsidiaries as collateral. The Company has not borrowed against this line of credit.

Debt Restructuring

In October 1998, a subordinated debenture in the amount of \$2.0 million was executed with an LLC composed of certain members of the Company's board of directors (Board LLC). On July 17, 2003, the Company reached an agreement to restructure the Board LLC subordinated debt. The terms of the agreement called for the following:

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Payment of \$200,000 within 3 days of receipt of approval by the Company's Board of Directors.

Issuance of a non-interest bearing note payable in the amount of \$50,000, which was subsequently paid in full in May 2004.

Issuance of warrants to purchase 400,000 shares of the Company's common stock with an exercise price of \$0.44 per share having a fair value of approximately \$222,000.

The Company recognized a gain of approximately \$160,000 from this debt restructuring in the first quarter of fiscal year 2004.

In December 2003, the Company paid approximately \$169,000 in full satisfaction of the \$201,000 of debt owed to Radiant Systems, Inc. The Company recognized a gain of approximately \$32,000 from this transaction in the second quarter of fiscal year 2004.

In January 2004, 2,469,600 warrants were exercised pursuant to an agreement the Company reached with Precision Franchising, L.L.C. and a former board member in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 2,469,600 restricted shares of common stock by surrendering 104,885 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In February 2004, 4,530,169 warrants were exercised pursuant to an agreement the Company reached with Precision Franchising, L.L.C. and a former board member in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 4,530,169 restricted shares of common stock by surrendering 192,401 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In March 2005, 4,472,270 warrants were exercised pursuant to an agreement the Company reached with Precision Franchising, L.L.C. and former board members in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holders purchased 4,472,270 restricted shares of common stock by surrendering 189,942 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In March 2005, 36,380 warrants were exercised pursuant to an agreement the Company reached to restructure the Board LLC subordinated debt. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 36,380 restricted shares of common stock by surrendering 1,545 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In March 2005, 10,000 warrants were exercised pursuant to an agreement the Company reached to restructure the Board LLC subordinated debt. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 10,000 restricted shares of common stock for \$4,400.

Note 7 Contingencies

The Company is subject to litigation that could have a material adverse impact on its liquidity as follows:

Luminivision, S.A. de C.V. v. Praxis Afinaciones, S.A. de C.V., Third Civil Court, First Judicial District, Monterrey, Nuevo Laredo, Mexico.

Luminivision filed suit against Praxis Afinaciones, an indirect wholly owned subsidiary of PACI, seeking payment of 766,000 Mexican Pesos, plus interest at the rate of 5% per month, for services under a contract. Praxis Afinaciones denies the allegations and is defending the allegations in the lawsuit.

United Bank, NA v. C. Eugene Deal, Miracle Partners, Inc., Star Auto Center, Inc., Common Pleas Court of Cuyahoga County, Ohio, Case No. 01-CV0019, Filed January 11, 2001

Miracle Partners, Inc., a wholly-owned subsidiary of the Company, was party to a confessed judgment of approximately \$1.3 million. The subsidiary is currently inactive and has no assets. As such, management believes this judgment will have no material impact on the Company's consolidated results of operations. Furthermore, the Company believes that it has a meritorious claim against Mr. Deal for misrepresentations made in connection with PACI's acquisition of Miracle Partners, Inc. in 1997 for all amounts covered by the judgment.

Puyallup Auto Stop Associates v. PTW, Inc., Superior Court of the State of Washington, County of Pierce, filed March 9, 2005

On March 9, 2005 PTW, a Precision Tune Auto Care, Inc. subsidiary, was provided with a complaint in which Puyallup Auto Stop Associates (PASA) is seeking an amount to be determined at trial and attorney's fees. PASA claims breach of a lease contract due to a nuisance caused by or permitted by PTW. Beginning in 1994, PTW subleased property owned by PASA to a Precision Tune franchisee. PASA alleges that PTW or the franchisee-subtenant contaminated the property, and that PTW is liable for environmental

remediation costs under its lease with PASA. Investigation into the Company's liability is ongoing. No determination of a possible outcome can be made at this time.

Davis Tune, Inc. v. Precision Franchising LLC (PFL), Circuit Court for Escambia County, Florida

On February 15, 2005, PFL was served with a complaint in which franchisee Davis Tune, Inc. is seeking damages in excess of \$30,000. Davis Tune alleges that PFL engaged in deceptive and unfair trade practices by not providing the advanced training necessary for the operation of the franchise, and by delegating the responsibility to provide this training to an Area Developer who operated competing franchises. Davis Tune also alleges that PFL used advertising royalty payments to offset other corporate expenditures, ignored its complaints that the above-mentioned competitor lured away its employees, and prevented Davis Tune from recouping advertising royalty payments in order to improve its physical plant as per a program initiated by PFL. Investigation into the Company's liability is ongoing. No determination of a possible outcome can be made at this time.

Davis Tune, Inc. and its two shareholders, Mr. Donald Roe and Ms. Shirley F. Roe, are also defendants in a related action filed by PFL on November 1, 2004 in the Federal District Court for the Eastern District of Virginia (Precision Franchising LLC v. Davis Tune, Inc., et al., Civil Action No.: 1:04CV1326). PFL alleges trademark infringement and breach of contract.

The Company and its subsidiaries are subject to other litigation in the ordinary course of business, including contract, franchisee and employment-related litigation. In the course of enforcing its rights under existing and former franchisee agreements, the Company is subject to complaints and letters threatening litigation concerning the interpretation and applicability of these agreements, particularly in cases involving defaults and terminations of franchises.

The Company does not believe that any of the above proceedings will result in material judgments against the Company. There can be no assurance, however, that these suits will ultimately be decided in its favor. Any one of these suits may result in a material judgment against the Company, which could cause material adverse consequences to its operations.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Introduction

The following discussion and analysis or plan of operation of Precision Auto Care, Inc. (the Company) should be read in conjunction with the unaudited interim consolidated financial statements and notes thereto included in Item 1. - Financial Statements of this quarterly report and the audited consolidated financial statements and notes thereto and the section titled Item 6. - Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's annual report on Form 10-KSB for the fiscal year ended June 30, 2004 filed with the Securities and Exchange Commission on September 28, 2004. Historical results and percentage relationships set forth herein are not necessarily indicative of future operations.

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The Company is a franchisor of automotive service centers located in the United States and in certain foreign countries. Through its franchised centers, services are provided to automobile owners and focus on those high-frequency items required on a periodic basis to maintain the vehicle properly.

Critical Accounting Estimates

The following is a summary of the Company's critical accounting policies. These critical accounting policies require estimates and assumptions that affect the amounts of assets, liabilities, revenues and expenses reported in the consolidated financial statements. Due to their nature, estimates involve judgments based on available information. Actual results or amounts could differ from estimates and the difference could have a material impact on the consolidated financial statements. Therefore, understanding these policies is important in understanding the reported results of operations and the financial position of the Company.

Revenue Recognition

The Company's royalty revenue is recognized as earned in accordance with the specific terms of each agreement and to the extent no known issues involving collection exist. In the event receivables are not likely to be collected, the Company will record a provision for bad debts. This estimate is based upon our experience working with individual franchises, taking into consideration past payment history, operating performance of the franchisee or other factors that bear on the ultimate collection of such receivables.

Revenue from the sale of a franchise is recognized when all significant obligations have satisfied, which is generally upon the opening of the franchised center.

The Company enters into domestic Area Development agreements and international Master License agreements (Agreements) which grant the area developer and master licensor, respectively, the right to sell, on the Company's behalf, Precision Tune Auto Care

franchises within a specific geographic region. Revenue from the sale of Area Development and international Master License agreements is recognized as all material services or conditions related to the sale are satisfied.

The Company recognized revenues from foreign countries of \$311,000 and \$139,000 for the nine months ended March 31, 2005 and 2004, respectively.

Goodwill and Intangible Assets

Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Intangible Assets*, requires that goodwill no longer be amortized, but instead be tested for impairment at least annually. The Company engages a valuation expert to assist in estimating the Company's fair value utilizing a discounted future cash flow approach that estimates revenue, driven by assumed market growth rates and appropriate discount rates. These estimates are consistent with the plans and estimates we use to manage the underlying business. In conjunction with management's analysis, it determined that the Company has one reporting unit, which is the same as its reporting segment; Automotive Care Franchising. Historically, management has performed its impairment analysis in the first quarter of each fiscal year. The Company obtained a current business enterprise valuation for purposes of supporting its impairment analysis for fiscal year 2005. Based upon this analysis, management determined that goodwill of approximately \$8.7 million was not impaired.

Deferred Tax Valuation Allowance

The Company recognizes deferred income tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax assets and liabilities reflect the effects of tax losses and the future income tax effects of temporary differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases and are measured using enacted tax rates that apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Company recognizes deferred tax assets if it is more likely than not that the asset will be realized in future years.

Management regularly reviews the recoverability of its deferred tax assets and adjusts the valuation allowance as deemed appropriate. As of March 31, 2005, the Company had a valuation allowance of \$6.4 million against deferred tax assets. The Company has demonstrated an ability to utilize net operating losses given recent operating profits, as such management concluded that it was appropriate to release \$965,000 of the valuation allowance during the nine months ended March 31, 2005. Further reduction of the valuation allowance will be made provided that the Company is able to maintain continual profits from operations.

Results of Operations

Comparison of the three months ended March 31, 2005 to the three months ended March 31, 2004

Summary (in thousands)

Results of Operations

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	Three Months Ended March 31,			
	2005	%	2004	%
Automotive care franchising revenue	\$ 2,688	97	\$ 2,678	94
Other	79	3	163	6
Total revenues	\$ 2,767	100%	\$ 2,841	100%
Automotive care franchising direct cost	1,701	62	1,570	55
Other	67	2	154	5
Total direct cost	1,768	64	1,724	60
General and administrative	772	28	720	26
Depreciation expense	28	1	80	3
Operating income	199	7	317	11
Other	11	1	8	
Earnings before taxes	210	8	325	11
(Benefit) provision for income taxes	(428)	(15)		
Net income	638	23	325	11
Preferred stock dividends	8		18	1
Net income applicable to common shareholders	\$ 630	23%	\$ 307	10%

Revenue. Total revenue for the three months ended March 31, 2005 was approximately \$2.8 million, was consistent with total revenue for the three months ended March 31, 2004.

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Automotive care franchising revenue for the three months ended March 31, 2005 was approximately \$2.7 million, was comparable with automotive care revenue of \$2.7 million for the three months ended March 31, 2004.

Other revenue for the three months ended March 31, 2005 was \$79,000, a decrease of approximately \$84,000 or 52%, compared to \$163,000 for the three months ended March 31, 2004. This decrease was due to the fact that the support revenue from the Shell- Mexico transaction ceased as of December 31, 2004.

Direct Cost. Total direct costs for the three months ended March 31, 2005 increased \$44,000 or 3%, compared with direct costs for the three months ended March 31, 2004.

Automotive care franchising direct costs for the three months ended March 31, 2005 totaled approximately \$1.7 million, compared with \$1.6 million for the three months ended March 31, 2004. The majority of this increase relates to the increase in printing revenue.

Other direct costs for the three months ended March 31, 2005 totaled \$67,000, a decrease of \$87,000 or 56%, compared with \$154,000 for the three months ended March 31, 2004. This decrease is due to the termination of the agreement to provide any support to Shell as that agreement was completed as of December 31, 2004.

General and Administrative Expense. General and administrative expense was \$772,000 for the three months ended March 31, 2005, an increase of \$52,000 or 7%, compared with \$720,000 for the three months ended March 31, 2004. In the three months ended March 31, 2005, the Company accrued for legal expenses of \$50,000 associated with enforcing a franchise agreement. Other general and administrative expenses remained consistent with prior year.

Operating Income. The Company recorded operating income for the three months ended March 31, 2005 of approximately \$199,000 compared with operating income of \$317,000 for the three months ended March 31, 2004. The decrease was mainly attributed to decreased margins from printing revenue and higher general and administrative costs from the accrued legal expenses as detailed above.

Other Income. The Company recorded other income of \$11,000 for the three months ended March 31, 2005, which represents an increase in other income of approximately \$3,000 or 38% compared to \$8,000 in other income for the three months ended March 31, 2004.

Income Taxes. The Company has demonstrated an ability to utilize net operating loss carryforwards given recent operating profits. As such management concluded that it was appropriate to release \$428,000 of the valuation allowance during the three months ended March 31, 2005.

Net Income Applicable to Common Shareholders and Earnings Per Share. The Company recorded net income applicable to common shareholders of \$630,000, or \$0.03 per basic share, for the three months ended March 31, 2005 compared to the net income applicable to common shareholders of \$306,000, or \$0.02 per basic share, for the three months ended March 31, 2004.

Results of Operations**Comparison of the nine months ended March 31, 2005 to the nine months ended March 31, 2004**

Summary (in thousands)

	2005		Nine Months Ended March 31,		2004	
		%			%	
Automotive care franchising revenue	\$	8,911	96	\$	8,334	95
Other		355	4		479	5
Total revenues	\$	9,266	100%	\$	8,813	100%
Automotive care franchising direct cost		5,083	55		4,956	56
Other		326	3		441	5
Total direct cost		5,409	58		5,397	61
General and administrative		2,465	27		2,499	28
Depreciation expense		82	1		237	3
Operating income		1,310	14		680	8
Other		40	1		254	3
Earnings before taxes		1,350	15		934	11
Income taxes		(965)	(10)			
Net income		2,315	25		934	11
Preferred stock dividends		29			70	1
Net income applicable to common shareholders	\$	2,286	25%	\$	864	10%

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Revenue. Total revenue for the nine months ended March 31, 2005 was approximately \$9.3 million, an increase of approximately \$453,000 or 5%, compared with total revenue of approximately \$8.8 million for the nine months ended March 31, 2004.

Automotive care franchising revenue for the nine months ended March 31, 2005 was approximately \$8.9 million, an increase of approximately \$577,000 or 7%, compared to revenue of approximately \$8.3 million for the nine months ended March 31, 2004. This increase was primarily due to an increase in franchise development revenue of \$525,000. Franchise development revenue increased due to the Company signing an area development agreement with North Pacific Precision, Inc. for the area rights for the Seattle market. Under the agreement, North Pacific Precision, Inc. paid \$500,000 for the area developer rights for the Seattle market. Such fees were recognized upon execution of the agreement since all significant obligations under the agreement were satisfied at that time. The Company will also receive fifty percent of the income from the sale of franchises and from royalties from franchisees in the area.

Other revenue for the nine months ended March 31, 2005 was \$355,000, a decrease of approximately \$124,000 or 26%, compared to \$479,000 for the nine months ended March 31, 2004. This decrease was due primarily to the fact that the support revenue from the Shell-Mexico transaction ceased as of December 31, 2004. Additionally, other revenue decreased due to the fact training revenue decreased in the amount of \$31,000 and revenue from the point of sale system decreased \$10,000.

Direct Cost. Total direct costs for the nine months ended March 31, 2005 of approximately \$5.4 million, was consistent with direct costs for the nine months ended March 31, 2004.

General and Administrative Expense. General and administrative expense for the nine months ended March 31, 2005 totaled approximately \$2.5 million, which was comparable to the nine months ended March 31, 2004.

Operating Income. The Company recorded operating income for the nine months ended March 31, 2005 of approximately \$1.3 million compared with operating income of \$680,000 for the nine months ended March 31, 2004. This increase was mainly attributed to the revenue recognized from the sale of the area rights for the Seattle market.

Other Income. The Company recorded other income of \$40,000 for the nine months ended March 31, 2005, which represents a decrease in other income of approximately \$214,000 or 84%, compared to \$254,000 in other income for the nine months ended March 31, 2004. This decrease was primarily attributed to the Company's gain from debt restructurings totaling approximately \$193,000 recorded in the nine months ended March 31, 2004 (see Item 1- Note 6).

Income Taxes. The Company has demonstrated an ability to utilize net operating loss carryforwards given recent operating profits. As such management concluded that it was appropriate to release \$965,000 of the valuation allowance during the nine months ended March 31, 2005.

Net Income Applicable to Common Shareholders and Earnings Per Share. The Company recorded net income applicable to common shareholders of approximately \$2.3 million, or \$0.09 per basic share, for the nine months ended March 31, 2005 compared to the net income applicable to common shareholders of \$864,000, or \$0.05 per basic share, for the nine months ended March 31, 2004.

Liquidity and Capital Resources

Sources and Uses of Cash

Cash at March 31, 2005 was approximately \$2.9 million. This represents an increase of approximately \$1.3 million from June 30, 2004. This increase was driven by the sale of the rights to the Seattle market for \$500,000 as well as the master franchise agreement the Company signed with senior executives of Hung Yue Holdings (Hong Kong) Co., Ltd giving that firm's affiliate, Precision Tune Auto Care (China) Company Limited, a license to open and operate at least 330 Precision Tune Auto Care (PTAC) car care centers in China over the next seven years. Upon execution of the agreement, the Company received advanced payments totaling \$150,000. During the period, cash provided by operations was approximately \$1.5 million. The Company generated operating profit in fiscal year 2004 and the nine months ending March 31, 2005 with the expectation it will continue to do so for the remainder of fiscal year 2005.

Cash used in investing activities for the nine months ended March 31, 2005 was \$52,000, resulting from the purchase of property and equipment for use in the Company's franchise operations.

Cash used in financing activities for the nine months ended March 31, 2005 was \$115,000. Cash used in financing activities during the period consisted primarily of payments of dividends on preferred stock and payment of notes payable.

Management believes that the Company's current cash balance, cash generated from operations, and the available \$250,000 credit line will be sufficient to meet the Company's working capital needs, capital expenditures, and contractual obligations for fiscal year 2005. At March 31, 2005, the entire line of credit was available.

Debt Transactions

On March 1, 2005, the Company renewed the \$250,000 line of credit with Chevy Chase Bank. The interest rate on this line of credit is indexed to the Prime Rate as published in *The Wall Street Journal* (5.75% at March 31, 2005) and the Company has pledged all of its wholly-owned subsidiaries as collateral. The Company has not borrowed against this line of credit.

In October 1998, a subordinated debenture in the amount of \$2.0 million was executed with an LLC composed of certain members of the Company's board of directors (Board LLC). On July 17, 2003, the Company reached an agreement to restructure the Board LLC subordinated debt. The terms of the agreement called for the following:

Payment of \$200,000 within 3 days of receipt of approval by the Company's Board of Directors.

Issuance of a non-interest bearing note payable in the amount of \$50,000, which was subsequently paid in full in May 2004.

Issuance of warrants to purchase 400,000 shares of the Company's common stock with an exercise price of \$0.44 per share having a fair value of approximately \$222,000.

The Company recognized a gain of approximately \$160,000 from this debt restructuring in the first quarter of fiscal year 2004.

In December 2003, the Company paid approximately \$169,000 in full satisfaction of the \$201,000 of debt owed to Radiant Systems, Inc. The Company recognized a gain of approximately \$32,000 from this transaction in the second quarter of fiscal year 2004.

In January 2004, 2,469,600 warrants were exercised pursuant to an agreement the Company reached with Precision Franchising, L.L.C. and a former board member in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 2,469,600 restricted shares of common stock by surrendering 104,885 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In February 2004, 4,530,169 warrants were exercised pursuant to an agreement the Company reached with Precision Franchising, L.L.C. and a former board member in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 4,530,169 restricted shares of common stock by surrendering 192,401 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

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In March 2005, 4,472,270 warrants were exercised pursuant to an agreement the Company reached with Precision Franchising, L.L.C. and former board members in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holders purchased 4,472,270 restricted shares of common stock by surrendering 189,942 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In March 2005, 36,380 warrants were exercised pursuant to an agreement the Company reached to restructure the Board LLC subordinated debt. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 36,380 restricted shares of common stock by surrendering 1,545 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In March 2005, 10,000 warrants were exercised pursuant to an agreement the Company reached to restructure the Board LLC subordinated debt. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 10,000 restricted shares of common stock for \$4,400.

Seasonality and Quarterly Fluctuations

Seasonal changes may impact various sectors of the Company's business differently and, accordingly, the Company's operations may be affected by seasonal trends in certain periods. In particular, severe weather in winter months can adversely affect the Company because such weather makes it difficult for consumers in affected parts of the country to travel to Precision Auto Care centers.

ITEM 3. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14(c) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There have not been any

changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is subject to litigation that could have a material adverse impact on its liquidity as follows:

Luminivision, S.A. de C.V. v. Praxis Afinaciones, S.A. de C.V., Third Civil Court, First Judicial District, Monterrey, Nuevo Laredo, Mexico.

Luminivision filed suit against Praxis Afinaciones, an indirect wholly owned subsidiary of PACI, seeking payment of 766,000 Mexican Pesos, plus interest at the rate of 5% per month, for services under a contract. Praxis Afinaciones denies the allegations and is defending the allegations in the lawsuit.

United Bank, NA v. C. Eugene Deal, Miracle Partners, Inc., Star Auto Center, Inc., Common Pleas Court of Cuyahoga County, Ohio, Case No. 01-CV0019, Filed January 11, 2001

Miracle Partners, Inc., a wholly-owned subsidiary of the Company, was party to a confessed judgment of approximately \$1.3 million. The subsidiary is currently inactive and has no assets. As such, management believes this judgment will have no material impact on the Company's consolidated results of operations. Furthermore, the Company believes that it has a meritorious claim against Mr. Deal for misrepresentations made in connection with PACI's acquisition of Miracle Partners, Inc. in 1997 for all amounts covered by the judgment.

Puyallup Auto Stop Associates v. PTW, Inc., Superior Court of the State of Washington, County of Pierce, filed March 9, 2005

On March 9, 2005 PTW, a Precision Tune Auto Care, Inc. subsidiary, was provided with a complaint in which Puyallup Auto Stop Associates (PASA) is seeking an amount to be determined at trial and attorney's fees. PASA claims breach of a lease contract due to a nuisance caused by or permitted by PTW. Beginning in 1994, PTW subleased property owned by PASA to a Precision Tune franchisee. PASA alleges that PTW or the franchisee-subtenant contaminated the property, and that PTW is liable for environmental remediation costs under its lease with PASA. Investigation into the Company's liability is ongoing. No determination of a possible outcome can be made at this time.

Davis Tune, Inc. v. Precision Franchising LLC, Circuit Court for Escambia County, Florida

On February 15, 2005, PFL was served with a complaint in which franchisee Davis Tune, Inc. is seeking damages in excess of \$30,000. Davis Tune alleges that PFL engaged in deceptive and unfair trade practices by not providing the advanced training necessary for the operation of the franchise, and by delegating the responsibility to provide this training to an Area Developer who operated competing franchises. Davis Tune also alleges that PFL used advertising royalty payments to offset other corporate expenditures, ignored its complaints that the above-mentioned competitor lured away its employees, and prevented Davis Tune from recouping advertising royalty payments in order to improve its physical plant as per a program initiated by PFL.

Davis Tune, Inc. and its two shareholders, Mr. Donald Roe and Ms. Shirley F. Roe, are also defendants in a related action filed by PFL on November 1, 2004 in the Federal District Court for the Eastern District of Virginia (Precision Franchising LLC v. Davis Tune, Inc., et al., Civil Action No.: 1:04CV1326). PFL alleges trademark infringement and breach of contract. Investigation into the Company's liability is ongoing. No determination of a possible outcome can be made at this time.

The Company and its subsidiaries are subject to other litigation in the ordinary course of business, including contract, franchisee and employment-related litigation. In the course of enforcing its rights under existing and former franchisee agreements, the Company is subject to complaints and letters threatening litigation concerning the interpretation and applicability of these agreements, particularly in cases involving defaults and terminations of franchises.

The Company does not believe that any of the above proceedings will result in material judgments against the Company. There can be no assurance, however, that these suits will ultimately be decided in its favor. Any one of these suits may result in a material judgment against the Company, which could cause material adverse consequences to its operations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In January 2004, 2,469,600 warrants were exercised pursuant to an agreement the Company reached with Precision Franchising,

L.L.C. and a former board member in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 2,469,600 restricted shares of common stock by surrendering 104,885 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In February 2004, 4,530,169 warrants were exercised pursuant to an agreement the Company reached with Precision Franchising, L.L.C. and a former board member in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 4,530,169 restricted shares of common stock by surrendering 192,401 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

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In March 2005, 36,380 warrants were exercised pursuant to an agreement the Company reached to restructure the Board LLC subordinated debt. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 36,380 restricted shares of common stock by surrendering 1,545 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

In March 2005, 10,000 warrants were exercised pursuant to an agreement the Company reached to restructure the Board LLC subordinated debt. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holder purchased 10,000 restricted shares of common stock for \$4,400.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

- 10.1* Renewal of Promissory Note dated March 1, 2005 between Precision Auto Care, Inc. and Chevy Chase Bank, F.S.B.
- 31.1* Written statement of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2* Written statement of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1* Written statement of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith

(b) Reports on Form 8-K

None.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on May 12, 2005.

Precision Auto Care, Inc.

By: /s/ Louis M. Brown, Jr.
Louis M. Brown, Jr.
Chief Executive Officer and Chairman of the Board
(Duly Authorized Officer)

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

Signature	Title	Date
/s/ Louis M. Brown, Jr. Louis M. Brown, Jr.	Chief Executive Officer and Chairman of the Board (Principal Executive Officer)	May 12, 2005
/s/ Robert R. Falconi Robert R. Falconi	President and Chief Operating Officer (Principal Financial and Accounting Officer)	May 12, 2005