

PRECISION AUTO CARE INC
Form 10QSB
November 10, 2004

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended September 30, 2004

OR

**o TRANSITION REPORT PURSUANT TO 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)

748 Miller Drive, S.E., Leesburg, Virginia 20175
(Address of principal executive offices)

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(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 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 the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date 23,808,602 shares of Common Stock as of October 29, 2004.

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

| | September 30, 2004 (unaudited) | June 30, 2004 |
|-----------------------------------------------------------------------------------------------------------------------------|--------------------------------------|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 2,567,877 | \$ 1,573,368 |
| Restricted cash | | 50,200 |
| Accounts receivable, net of allowance of \$145,805 and \$72,815, respectively | 815,487 | 620,761 |
| Notes receivable | 300,987 | 294,243 |
| Deferred tax asset | 713,000 | 473,000 |
| Other assets | 344,015 | 283,244 |
| Total current assets | 4,741,366 | 3,294,816 |
| Property, plant and equipment, at cost | 4,168,144 | 4,147,329 |
| Less: Accumulated depreciation | (4,009,564) | (3,982,924) |
| | 158,580 | 164,405 |
| Goodwill | 8,711,744 | 8,711,744 |
| Notes receivable, net of allowance of \$283,033 and \$254,832, respectively | 96,137 | 161,685 |
| Deposits and other | 38,635 | 27,914 |
| Total assets | \$ 13,746,462 | \$ 12,360,564 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 2,022,697 | \$ 1,955,430 |
| Notes payable | 20,553 | 75,240 |
| Deferred revenue | 514,150 | 396,150 |
| Total current liabilities | 2,557,400 | 2,426,820 |
| Notes payable, net of current portion | 12,409 | 13,770 |
| Total liabilities | 2,569,809 | 2,440,590 |
| Commitments and contingencies | | |
| Series A redeemable preferred stock, \$.01 par value; 1,000,000 shares authorized; 202,714 shares issued and outstanding | 2,100,117 | 2,100,117 |
| Stockholders equity: | | |
| Common stock, \$.01 par value; 39,000,000 shares authorized; 23,808,602 shares issued and outstanding | 238,086 | 238,086 |
| Additional paid-in capital | 55,875,050 | 55,873,804 |

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| | | |
|--------------------------------------------|---------------|---------------|
| Accumulated deficit | (47,036,600) | (48,292,033) |
| Total stockholders' equity | 9,076,536 | 7,819,857 |
| Total liabilities and stockholders' equity | \$ 13,746,462 | \$ 12,360,564 |

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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| | Three Months Ended September 30, | |
|-----------------------------------------------------------------|-------------------------------------|---------------------|
| | 2004 (unaudited) | 2003 (unaudited) |
| Revenues: | | |
| Franchise royalties | \$ 2,878,013 | \$ 2,847,787 |
| Franchise development | 698,812 | 174,123 |
| Other | 136,702 | 155,398 |
| Total revenues | 3,713,527 | 3,177,308 |
| Direct cost: | | |
| Franchise support | 1,913,288 | 1,909,620 |
| Contribution | 1,800,239 | 1,267,688 |
| General and administrative expense | 767,801 | 1,055,033 |
| Depreciation expense | 26,641 | 77,444 |
| Operating income | 1,005,797 | 135,211 |
| Gain on debt restructuring | | 160,353 |
| Interest expense | (1,975) | (5,832) |
| Other income | 22,112 | 27,131 |
| Total other income | 20,137 | 181,652 |
| Income before income tax expense | 1,025,934 | 316,863 |
| (Benefit) provision for income taxes | (240,000) | |
| Net income | 1,265,934 | 316,863 |
| Preferred stock dividends | 10,501 | 25,900 |
| Net income applicable to common shareholders | \$ 1,255,433 | \$ 290,963 |
| Net income applicable to common stock per common share- Basic | \$ 0.05 | \$ 0.02 |
| Net income applicable to common stock per common share- Diluted | \$ 0.05 | \$ 0.01 |
| Weighted average common shares outstanding Basic | 23,808,602 | 16,558,833 |
| Weighted average common shares outstanding Diluted | 26,399,153 | 21,769,483 |

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Three Months Ended September 30, | |
|-----------------------------------------------------------------------------------------|-------------------------------------|---------------------|
| | 2004 (unaudited) | 2003 (unaudited) |
| Operating activities: | | |
| Net income applicable to common shareholders | \$ 1,255,433 | \$ 290,963 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 26,641 | 77,444 |
| Decrease in valuation allowance | (240,000) | |
| Gain on debt restructuring | | (160,353) |
| Stock issued for compensation | | 132,500 |
| Stock option compensation | 1,246 | 106,070 |
| Changes in assets and liabilities from continuing operations: | | |
| Restricted cash | 50,200 | |
| Accounts and notes receivable | (135,922) | 124,177 |
| Prepaid expenses, deposits and other | (71,492) | (143,410) |
| Accounts payable and accrued liabilities | 77,766 | (41,598) |
| Deferred revenue and other | 118,000 | (76,875) |
| Net cash provided by operating activities | 1,081,872 | 308,918 |
| Investing activities: | | |
| Purchases of property and equipment | (20,815) | (14,978) |
| Net cash used in investing activities | (20,815) | (14,978) |
| Financing activities: | | |
| Payment of preferred stock dividends | (10,500) | (25,900) |
| Repayment of subordinated debt and other notes payable | (56,048) | (264,073) |
| Net cash used in financing activities | (66,548) | (289,973) |
| Net change in cash and cash equivalents | 994,509 | 3,967 |
| Cash and cash equivalents at beginning of year | 1,573,368 | 1,564,110 |
| Cash and cash equivalents at end of period | \$ 2,567,877 | \$ 1,568,077 |
| Supplemental schedule of non cash investing and finance activities: | | |
| Carrying value of debt cancelled in exchange for cash and issuance of debt and warrants | \$ | \$ 632,528 |
| Fair value of cash, debt and warrants issued in exchange for cancellation of debt | \$ | \$ 472,175 |

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. 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 on this valuation, the goodwill impairment testing for the period ending September 30, 2004, did not result in the impairment of recorded goodwill of approximately \$8.7 million.

Stock Options

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

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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.

Generally, no stock-based compensation cost has been reflected in net income, as the majority of options granted had exercise prices equal to the market value of the underlying common stock on the date of grant. The Company issued 375,000 shares of options on September 28, 2004. The options were granted with an exercise price of \$0.62, which was equal to the market price on that date. However, the Company issued 65,000 options in the three months ended September 30, 2003 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 \$0 and \$105,000 associated with these options during the three months ended September 30, 2004 and 2003, respectively.

Had compensation cost for all options been determined based on the fair value at the grant dates during the three months ending September 30, 2004 and 2003 consistent with the method of SFAS No. 123, the pro forma net income and income per share would have been as follows:

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| | Three Months Ended September 30, | |
|--------------------------------------------------------------------------------------------------------|-----------------------------------------|-------------|
| | 2004 | 2003 |
| Net income applicable to common shareholders | \$ 1,255,433 | \$ 290,963 |
| Add: Total stock-based compensation expense reported in net income under the intrinsic value method | 1,246 | 238,570 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards | 4,119 | 170,500 |
| Pro forma net income | \$ 1,252,560 | \$ 359,033 |
| Earnings per share: | | |
| Basic- as reported | \$ 0.05 | \$ 0.02 |
| Diluted- as reported | \$ 0.05 | \$ 0.01 |
| Basic- pro forma | \$ 0.05 | \$ 0.02 |
| Diluted- pro forma | \$ 0.05 | \$ 0.02 |
| Weighted average shares: | | |
| Weighted average common shares outstanding Basic | 23,808,602 | 16,558,833 |
| Weighted average common shares outstanding Diluted | 26,399,153 | 21,769,483 |

Note 3 Net Income 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 September 30, 2004 and 2003 was 7,159,133 and 13,720,195, 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 September 30, 2004 and 2003, respectively, 182,950 shares attributable to outstanding stock options, and 0 shares attributable to outstanding warrants were not included in the computation of diluted income per share as they were anti-dilutive.

The following table sets forth the computation of basic and diluted net loss per share.

| | Three Months Ended | |
|------------------------------------------------------------|---------------------------|----------------------|
| | September 30, | September 30, |
| | 2004 | 2003 |
| Numerator: | | |
| Net income | \$ 1,265,934 | \$ 316,863 |
| Preferred stock dividends | (10,501) | (25,900) |
| Net income applicable to common Shareholders | \$ 1,255,433 | \$ 290,963 |
| Denominator: | | |
| Denominator for basic EPS weighted- average-shares | 23,808,602 | 16,558,833 |
| Common stock equivalent- stock options | 2,590,551 | 5,210,650 |
| Denominator for diluted EPS weighted- average-shares | 26,399,153 | 21,769,483 |
| Basic income applicable to common shareholders per share | 0.05 | 0.02 |
| Diluted income applicable to common shareholders per share | \$ 0.05 | \$ 0.01 |

Note 4 - Debt

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:

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 the cancellation of this debenture in the first quarter of fiscal year 2004.

Note 5 Contingencies

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

Precision Auto Care, Inc. v. Brian J. Ranta, filed September 23, 2003 in the 52nd Judicial District, State of Michigan, Case No. 03C07934-GC

Precision Franchising, LLC (PFL) and Brian J. Ranta were parties to a Franchise Agreement that expired on February 1, 2003. On September 23, 2003, Precision Auto Care, Inc. (PACI) filed suit against Ranta for \$22,963 (plus interest) relating to unpaid operating and advertising fees. Mr. Ranta answered in December 2003, offering several affirmative defenses including breach of the Franchise Agreement due to PACI's lack of support, evidentiary problems, failure to account for monies already paid, and failure to state a claim. In August 2004 the matter was referred to arbitration; in October 2004 the arbitrators decided in PACI's favor, recommending that Mr. Ranta pay PACI \$11,000. Both sides accepted the arbiters' decision, and Mr. Ranta will pay PACI the full \$11,000 (\$4,000 down, and \$250 a month until paid in full).

Rebecca Abdallah v. Volkswagen of America, Inc., et al., District Court of Webb County, Texas, Case No. 2003-CVE-00798-D2

On September 8, 2003, Precision Franchising LLC (PFL) was served with Plaintiff s First Amended Petition seeking damages in excess of \$75,000 from the manufacturer of a vehicle purchased by her husband, the seller of the vehicle, a franchised Precision Tune Auto Care center which conducted a pre-purchase inspection of the vehicle, and against PFL. With respect to PFL, Plaintiff alleges that she suffered personal injuries as a result of PFL s inadequate policies and procedures regarding the pre-purchase inspection; failure to adequately hire, train and supervise employees; failure to investigate the vehicle s history of fuel leaks and ongoing recall investigations; failure to investigate the vehicle s fuel system; and negligent misrepresentations about the condition of the vehicle. In June 2004, the Company filed a motion to dismiss the lawsuit, and in July 2004, the plaintiff voluntarily dismissed the lawsuit against the Company without prejudice.

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.

Threatened Litigation:

Puyallup Auto Stop Associates, Inc. v. PTW, Inc.: By letter dated July 1, 2003, a landlord has asserted a claim against PTW, Inc. for reimbursement of the costs of remediating environmental contamination to the leased premises during the term of the lease, which costs are alleged to exceed \$250,000. Investigation into the Company's liability is ongoing.

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.

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 case when revenues are not likely to be collected, the Company provides for estimated losses. This estimate is based upon our historical experience as well as a detailed review of our receivable balances.

Revenue from the sale of a franchise is recognized 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 and Precision Lube Express franchises within a specific geographic region. Revenue from the sale of Area Development agreements is recognized as all material services or conditions related to the sale are satisfied. Revenue from the sale of master licenses is recognized upon signing the Agreement since the Company is not required to support the international franchises as there is no contractual agreement between the Company and the international franchisees.

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. 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 on this valuation, the goodwill impairment testing for the period ending September 30, 2004, did not result in the impairment of recorded goodwill of approximately \$8.7 million.

Deferred Tax Valuation Allowance

The Company recognizes deferred income tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax liabilities and assets 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.

The Company regularly reviews the recoverability of its tax deferred assets and establishes a valuation allowance as deemed appropriate. As of September 30, 2004, the Company had a valuation allowance of \$5.9 million against deferred tax assets. Given the Company's current operating performance, management released \$240,000 of the valuation allowance during the first quarter of 2005. This adjustment was based upon management's assessment of the recoverability of deferred taxes which included projections of future pretax earnings.

Overview

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.

The Company earned \$.05 per share, compared to \$.02 per share in the first quarter of fiscal 2003. Significant factors impacting the quarter were:

In August 2004, the Company signed 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, and the Company will receive fifty percent of the income from the sale of franchises and from royalties from franchisees in the area. The entire amount paid was recognized as franchise development revenue in the first quarter from the sale as all material services or conditions related to the sale of the area rights were satisfied.

In August 2004, the Company signed a master franchise agreement 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 payments totaling \$150,000 which were recognized as deferred revenue at September 30, 2004. Under the terms of the agreement, Precision Tune Auto Care (China) Company Limited may open up to 330 centers. The Company will earn \$5,000 per center upon opening and a 1.5% royalty fee based on the total gross center sales. No centers were opened as of September 30. The revenue from these centers will be recognized consistent with the current revenue recognition policy.

Results of Operations**Comparison of the three months ended September 30, 2004 to the three months ended September 30, 2003**

Summary (in thousands)

| | Three Months Ended September 30, | | | |
|----------------------------------------------|----------------------------------|------|----------|------|
| | 2004 | % | 2003 | % |
| Automotive care franchising revenue. | \$ 3,577 | 96 | \$ 3,022 | 95 |
| Other | 137 | 4 | 155 | 5 |
| Total revenues | \$ 3,714 | 100% | \$ 3,177 | 100% |
| Automotive care franchising direct cost | 1,784 | 48 | 1,764 | 56 |
| Other | 129 | 3 | 146 | 5 |
| Total direct cost | 1,913 | 51 | 1,910 | 61 |
| General and administrative | 768 | 21 | 1,055 | 33 |
| Depreciation expense | 27 | 1 | 77 | 2 |
| Operating income | 1,006 | 27 | 135 | 4 |
| Other | 20 | 0 | 182 | 6 |
| Earnings before taxes | 1026 | 27 | 317 | 10 |
| Income taxes | (240) | (7) | | |
| Net income | 1,266 | 34 | 317 | 10 |
| Preferred stock dividends | 11 | 0 | 26 | 1 |
| Net income applicable to common shareholders | \$ 1,255 | 34% | \$ 291 | 9% |

Revenue. Total revenues for the three months ended September 30, 2004 was \$3.7 million, an increase of approximately \$536,000, or 17%, compared with total revenues of \$3.2 million for the three months ended September 30, 2003.

Automotive care franchising revenue for the three months ended September 30, 2004 was \$3.6 million, an increase of approximately \$555,000, or 18%, compared with automotive care revenues of \$3.0 million for the three months ended September 30, 2003. This increase was primarily due to an increase in franchise development revenues of \$525,000. Franchise development revenues 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 three months ended September 30, 2004 was \$137,000, a decrease of approximately \$19,000, or 12%, compared to \$155,000 for the three months ended September 30, 2003.

Direct Cost. Total direct costs for the three months ended September 30, 2004 totaled \$1.9 million, which was comparable to the three months ended September 30, 2003.

Automotive care franchising direct costs for the three months ended September 30, 2004 totaled \$1.8 million, which was comparable to the three months ended September 30, 2003.

Other direct costs for the three months ended September 30, 2004 totaled \$129,000, a decrease of \$17,000 or 12%, compared with \$146,000 for the three months ended September 30, 2003.

General and Administrative Expense. General and administrative expense was \$768,000 for the three months ended September 30, 2004, a decrease of \$287,000 or 27%, compared with \$1.1 million for the three months ended September 30, 2003. In the three months ended September 30, 2003, the company incurred compensation costs of approximately \$133,000 associated with stock and option grants to officers of the Company and approximately \$105,000 of compensation costs associated with repurchased options from employees (see Item 1- Note 2). There were no such costs incurred in the three months ended September 30, 2004. Additionally, this decrease was the result of management's on-going cost reduction initiatives in general and administrative costs.

Operating Income From Continuing Operations. The Company recorded operating income for the three months ended September 30, 2004 of approximately \$1.0 million compared with operating income of \$135,000 for the three months ended September 30, 2003. As discussed previously, this increase was primarily due to the sale of the Seattle market and the decrease in the general and administrative expense.

Other Income. The Company recorded a gain in other income of \$20,000 for the three months ended September 30, 2004, which represents a decrease of approximately \$162,000 or 89% compared with \$182,000 for the three months ended September 30, 2003. This decrease is primarily due to the fact the Company recognized a \$160,000 gain from the debt restructuring that was completed in the first quarter of fiscal year 2004 (see Item 1 - Note 4).

Income Taxes. Based on the Company's current operating performance, management released \$240,000 of the valuation allowance during the first quarter of 2005. This adjustment was based upon management's assessment of the recoverability of deferred taxes which included projections of future pretax earnings.

Net Income Applicable to Common Shareholders and Earnings Per Share. The Company recorded Net Income Applicable to Common Shareholders of \$1.3 million, or \$0.05 per share, for the three months ended September 30, 2004 compared to the Net Income Applicable to Common Shareholders of \$291,000, or \$0.02 per share, for the three months ended September 30, 2003.

Liquidity and Capital Resources

Sources and Uses of Cash

Cash at September 30, 2004 was \$2.6 million. This represents an increase of approximately \$1.0 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 has received advanced payments totaling \$150,000. During the period, cash provided by operations was \$1.1 million. The Company generated operating profit in the fiscal year 2004 and the first quarter of 2005 with the expectation it will continue to do so for the remainder of fiscal year 2005.

Cash used in investing activities for the three months ended September 30, 2004 was \$21,000, resulting from the purchase of property and equipment for use in the Company's franchise operations.

Cash used in financing activities for the three months ended September 30, 2004 was \$67,000. Cash used in financing activities during the period consisted primarily of payments of dividends and other notes payable.

Management believes that the Company's current cash balance, cash generated from operations, and the available credit line will be sufficient to meet the Company's working capital needs, capital expenditures, and contractual obligations for fiscal year 2005.

Debt Transactions

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 \$632,528 outstanding on 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 the cancellation of this debenture in the first quarter of fiscal year 2004.

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 and Precision Lube Express centers.

ITEM 3. CONTROLS AND PROCEDURES

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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 were no changes in our internal control over financial reporting during the quarter ended September 30, 2004 that have materially affected, or are reasonably likely to materially affect, our internal controls 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:

Precision Auto Care, Inc. v. Brian J. Ranta, filed September 23, 2003 in the 52nd Judicial District, State of Michigan, Case No. 03C07934-GC

Precision Franchising, LLC (PFL) and Brian J. Ranta were parties to a Franchise Agreement that expired on February 1, 2003. On September 23, 2003, Precision Auto Care, Inc. (PACI) filed suit against Ranta for \$22,962.55 (plus interest) in unpaid operating and advertising fees. Mr. Ranta answered in December 2003, offering several affirmative defenses including breach of the Franchise Agreement due to PACI's lack of support, evidentiary problems, failure to account for monies already paid, and failure to state a claim. In August 2004 the matter was referred to arbitration; in October 2004 the arbitrators decided in PACI's favor, recommending that Mr. Ranta pay PACI \$11,000. Both sides accepted the arbiters' decision, and Mr. Ranta will pay PACI the full \$11,000 (\$4,000 down, and \$250 a month until paid in full).

Rebecca Abdallah v. Volkswagen of America, Inc., et al., District Court of Webb County, Texas, Case No. 2003-CVE-00798-D2

On September 8, 2003, Precision Franchising LLC (PFL) was served with Plaintiff's First Amended Petition seeking damages in excess of \$75,000 from the manufacturer of a vehicle purchased by her husband, the seller of the vehicle, a franchised Precision Tune

Auto Care center which conducted a pre-purchase inspection of the vehicle, and against PFL. With respect to PFL, Plaintiff alleges that she suffered personal injuries as a result of PFL's inadequate policies and procedures regarding the pre-purchase inspection; failure to adequately hire, train and supervise employees; failure to investigate the vehicle's history of fuel leaks and ongoing recall investigations; failure to investigate the vehicle's fuel system; and negligent misrepresentations about the condition of the vehicle. In June 2004, the Company filed a motion to dismiss the lawsuit, and in July 2004, the plaintiff voluntarily dismissed the lawsuit against the Company without prejudice.

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.

Threatened Litigation:

Puyallup Auto Stop Associates, Inc. v. PTW, Inc.: By letter dated July 1, 2003, a landlord has asserted a claim against PTW, Inc. for reimbursement of the costs of remediating environmental contamination to the leased premises during the term of the lease, which costs are alleged to exceed \$250,000. Investigation into the Company's liability is ongoing.

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. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

The information concerning defaults and the subsequent cure thereof with respect to the Company's indebtedness contained in Note 5 to the Company's financial statements and appearing at Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources is incorporated herein by reference.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS OR REPORTS ON FORM 8-K

(a) Exhibits

- 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

- (i) On August 10, 2004, a Form 8-K was filed announcing the Company's agreement with North Pacific Precision, Inc. (NPPI) for the area rights for the Seattle market.
- (ii) On September 2, 2004, a Form 8-K was filed announcing the Company's agreement with Hung Yue Holdings Co., Ltd. giving that firm a license to open and operate at least 330 Precision Tune Auto Care car care centers in China.

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 November 10, 2004.

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) | November 10, 2004 |
| /s/ Robert R. Falconi Robert R. Falconi | President and Chief Operating Officer (Principal Financial Accounting Officer) | November 10, 2004 |