

PRECISION AUTO CARE INC  
Form 10QSB  
November 07, 2003

**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, 2003**

**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**

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(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 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 16,808,833 shares of Common Stock as of October 30, 2003.

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 relate to Precision 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, 2003 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,<br>2003<br>(unaudited) | June 30,<br>2003 |
|--|--------------------------------------|------------------|
| <b>ASSETS</b>  |                                      |                  |
| Current assets:  |                                      |                  |
| Cash and cash equivalents  | \$ 1,568,077                         | \$ 1,564,110     |
| Accounts receivable, net of allowance of \$123,834 and \$184,607, respectively | 632,388                              | 756,565          |
| Other assets   | 417,272                              | 401,079          |
| Assets of discontinued operations  | 5,945                                | 16,759           |
| Total current assets   | 2,623,682                            | 2,738,513        |
| Property, plant and equipment, at cost   | 4,107,201                            | 4,092,222        |
| Less: Accumulated depreciation   | (3,742,267)                          | (3,664,823)      |
|  | 364,934                              | 427,399          |
| Goodwill   | 8,711,744                            | 8,711,744        |
| Deposits and other   | 257,865                              | 130,648          |
| Total assets   | \$ 11,958,225                        | \$ 12,008,304    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                                     |                                      |                  |
| Current liabilities:   |                                      |                  |
| Accounts payable and accrued liabilities                                       | \$ 2,530,911                         | \$ 2,543,945     |
| Board LLC note   | 40,000                               | 116,163          |
| Other notes payable- current   | 183,527                              | 174,267          |
| Liabilities from discontinued operations                                       | 8,165                                | 73,443           |
| Deferred revenue   | 307,500                              | 307,500          |
| Total current liabilities  | 3,070,103                            | 3,215,318        |
| Board LLC note   |                                      | 516,365          |
| Other notes payable- non-current   | 159,025                              | 222,357          |
| Deferred revenue and other   | 133,125                              | 210,000          |
| Total liabilities  | 3,362,253                            | 4,164,040        |
| Stockholders equity:   |                                      |                  |

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|  |               |               |
|--|---------------|---------------|
| Preferred stock, \$.01 par value; 1,000,000 shares authorized; 500,000 shares issued and outstanding                 | 5,180,000     | 5,180,000     |
| Common stock, \$.01 par value; 39,000,000 shares authorized; 16,808,833 and 16,558,833 shares issued and outstanding | 168,088       | 165,588       |
| Additional paid-in capital   | 52,838,726    | 52,380,481    |
| Accumulated deficit  | (49,590,842)  | (49,881,805)  |
| Total stockholders' equity   | 8,595,972     | 7,844,264     |
| Total liabilities and stockholders' equity   | \$ 11,958,225 | \$ 12,008,304 |

See accompanying notes.

**PRECISION AUTO CARE, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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|   | Three Months Ended<br>September 30, |                     |
|---|-------------------------------------|---------------------|
|   | 2003<br>(unaudited)                 | 2002<br>(unaudited) |
| <b>Revenues:</b>  |                                     |                     |
| Franchise royalties   | \$ 2,847,787                        | \$ 3,077,841        |
| Franchise development   | 174,123                             | 139,310             |
| Company owned centers   |                                     | 73,763              |
| Other   | 155,398                             | 118,748             |
| <b>Total revenues</b>   | <b>3,177,308</b>                    | <b>3,409,662</b>    |
| <b>Direct cost:</b>   |                                     |                     |
| Franchise support   | 1,909,620                           | 2,063,253           |
| <b>Contribution</b>   | <b>1,267,688</b>                    | <b>1,346,409</b>    |
| General and administrative expense  | 1,055,033                           | 1,008,216           |
| Depreciation expense  | 77,444                              | 100,924             |
| Other operating expense   |                                     | 2,716               |
| <b>Operating income</b>   | <b>135,211</b>                      | <b>234,553</b>      |
| Gain on debt restructuring  | 160,353                             |                     |
| Interest expense  | (5,832)                             | (524,223)           |
| Other income  | 6,529                               | 6,138               |
| <b>Total other income (expense)</b>   | <b>161,050</b>                      | <b>(518,085)</b>    |
| <b>Income (loss) before income tax expense</b>                                | <b>296,261</b>                      | <b>(283,532)</b>    |
| Provision for income taxes  |                                     |                     |
| <b>Income (loss) from continuing operations</b>                               | <b>296,261</b>                      | <b>(283,532)</b>    |
| <b>Discontinued operations:</b>   |                                     |                     |
| Income (loss) from discontinued operations                                    | 20,602                              | (149,856)           |
| <b>Net income (loss)</b>  | <b>316,863</b>                      | <b>(433,388)</b>    |
| Preferred stock dividends   | 25,900                              |                     |
| <b>Net income (loss) applicable to common shareholders</b>                    | <b>\$ 290,963</b>                   | <b>\$ (433,388)</b> |
| <b>Income (loss) from continued operations per common share- Basic</b>        | <b>\$ 0.02</b>                      | <b>\$ (0.02)</b>    |
| <b>Gain (loss) from discontinued operations per common share- Basic</b>       | <b>0.00</b>                         | <b>(0.01)</b>       |
| <b>Net income (loss) applicable to common stock per common share- Basic</b>   | <b>\$ 0.02</b>                      | <b>\$ (0.03)</b>    |
| <b>Income (loss) from continued operations per common share- Diluted</b>      | <b>\$ 0.01</b>                      | <b>\$ (0.02)</b>    |
| <b>Gain (loss) from discontinued operations per common share- Diluted</b>     | <b>0.00</b>                         | <b>(0.01)</b>       |
| <b>Net income (loss) applicable to common stock per common share- Diluted</b> | <b>\$ 0.01</b>                      | <b>\$ (0.03)</b>    |
| <b>Weighted average common shares outstanding Basic</b>                       | <b>16,558,833</b>                   | <b>13,318,030</b>   |



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|  |            |            |
|--|------------|------------|
| Weighted average common shares outstanding Diluted | 21,769,483 | 13,318,030 |
|--|------------|------------|

See accompanying notes.

## PRECISION AUTO CARE, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|  | Three Months Ended<br>September 30, |                     |
|--|-------------------------------------|---------------------|
|  | 2003<br>(unaudited)                 | 2002<br>(unaudited) |
| Operating activities:  |                                     |                     |
| Net income (loss) applicable to common shareholders  | \$ 290,963                          | \$ (433,388)        |
| Net (gain) loss from discontinued operations   | (20,602)                            | 149,856             |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                                     |                     |
| Depreciation   | 77,444                              | 100,924             |
| Amortization of debt discount  |                                     | 56,805              |
| Gain on debt restructuring   | (160,353)                           |                     |
| Stock issued for compensation  | 132,500                             |                     |
| Stock option compensation  | 106,070                             |                     |
| Changes in assets and liabilities from continuing operations:                                      |                                     |                     |
| Accounts receivable  | 124,177                             | (20,020)            |
| Inventory  |                                     | (60,681)            |
| Prepaid expenses, deposits and other   | (143,410)                           | (27,754)            |
| Accounts payable and accrued liabilities   | 12,866                              | 114,451             |
| Deferred revenue and other   | (76,875)                            | (44,839)            |
| Changes in assets and liabilities of discontinued operations                                       | (33,862)                            | (77,751)            |
| Net cash provided by (used in) operating activities  | 308,918                             | (242,397)           |
| Investing activities:  |                                     |                     |
| Purchases of property and equipment  | (14,978)                            | (2,520)             |
| Net cash used in investing activities  | (14,978)                            | (2,520)             |
| Financing activities:  |                                     |                     |
| Payment of preferred stock dividends   | (25,900)                            |                     |
| Repayment of subordinated debt and other notes payable   | (264,073)                           | (188,302)           |
| Net cash used in financing activities  | (289,973)                           | (188,302)           |
| Net change in cash and cash equivalents  | 3,967                               | (433,219)           |
| Cash and cash equivalents at beginning of year   | 1,564,110                           | 1,029,643           |
| Cash and cash equivalents at end of period   | \$ 1,568,077                        | \$ 596,424          |
| 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                          | \$                  |
| Property and equipment acquired under capital lease  | \$                                  | \$ 25,992           |

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, 2003.

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*

In June 2001, the FASB issued SFAS No. 142, *Goodwill and Intangible Assets*, which supercedes Accounting Principles Board ( APB ) Opinion No. 17, *Intangible Assets*. This statement addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. Goodwill will cease to be amortized upon the implementation of the statement and companies must test goodwill at least annually for impairment. The Company adopted SFAS No. 142 effective July 1, 2002 and ceased amortizing goodwill of \$8.7 million.

This statement requires that goodwill be tested for impairment annually unless the underlying reporting unit has not changed significantly, the most recent valuation substantially exceeded the carrying value of goodwill, and events or circumstances have not occurred such that the likelihood of impairment is remote. In June 2002, the Company had a business enterprise valuation conducted of its automotive care franchising reporting unit. This reporting unit, which is primarily comprised of Precision Tune Auto Care®, provides automotive services primarily through franchised operations located in the United States and in certain foreign countries. This income approach based valuation considered the nature of the reporting unit s business, the economic outlook of its industry, underlying assets, financial condition, and future earning capacity. During the three months ended September 30,

2003, management determined that goodwill was not impaired based upon the absence of a significant change in the assets and liabilities that make up the reporting unit since the date of the last valuation, its fair value of approximately \$9.5 million was in excess of its carrying value of approximately \$8.6 million, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit was remote, and there were no significant changes in the business of the reporting unit since the date of the last valuation that would likely reduce the fair value of the reporting unit below its carrying amount.

*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 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.

Historically, no stock-based compensation cost was reflected in net income, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. 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 will be recognized over the vesting period of these options. The

Company also repurchased certain options from employees and issued new options exercisable at an exercise price of \$0.44 in fiscal year 2003, resulting in the newly issued options being treated as a repricing under FIN 44 which triggers variable accounting. As a result, the Company recorded compensation expense of approximately \$105,000 and \$0 associated with these options during the three months ended September 30, 2003 and 2002, 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, 2003 and 2002 under the plan consistent with the method of SFAS No. 123, the pro forma net income (loss) and income (loss) per share would have been as follows:

|   | <b>Three Months Ended September 30,</b> |              |
|---|---|--------------|
|   | <b>2003</b>                             | <b>2002</b>  |
| Net income (loss) applicable to common shareholders   | \$ 290,963                              | \$ (433,388) |
| Add: Total stock-based compensation expense reported in net income (loss)                               | 238,570                                 |              |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards* | 170,500                                 | 52,000       |
| Pro forma net income (loss)   | \$ 359,033                              | \$ (485,388) |
| <b>Earnings per share:</b>  |   |              |
| Basic- as reported  | \$ 0.02                                 | \$ (0.03)    |
| Diluted- as reported  | \$ 0.01                                 | \$ (0.03)    |
| Basic- pro forma  | \$ 0.02                                 | \$ (0.04)    |
| Diluted- pro forma  | \$ 0.02                                 | \$ (0.04)    |
| <b>Weighted average shares:</b>   |   |              |
| Weighted average common shares outstanding Basic  | 16,558,833                              | 13,318,030   |
| Weighted average common shares outstanding Diluted  | 21,769,483                              | 13,318,030   |

\* 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.

Note 3 - New Accounting Pronouncements

In May 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for issuer classification and measurement of certain financial instruments with characteristics of both liabilities and equity. Instruments that fall within the scope of SFAS No. 150 must be classified as a liability. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003. For financial instruments issued on or before May 31, 2003, SFAS No. 150 became effective for the Company in the first quarter of fiscal year 2004. Upon adoption, the Company's redeemable preferred stock was reclassified to stockholders' equity.

Note 4 Discontinued Operations

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The Company disposed of its manufacturing and distribution operating segment as a result of the sale of substantially all of the assets of Worldwide Drying Systems (Worldwide) and Hydro Spray Car Wash Equipment Co. (Hydro Spray) in March 2003 and April 2003, respectively.

As a result of the sale of Hydro Spray and Worldwide, the Company retained the following assets and liabilities. These assets and liabilities are included in the assets and liabilities from discontinued operations at September 30, 2003:

|   | <b>September 30,<br/>2003</b> |              |
|---|-------------------------------|--------------|
| <b>Assets of discontinued operations:</b>           |                               |              |
| Accounts receivable, net                            | \$                            | 5,945        |
| <b>Total assets of discontinued operations</b>      | <b>\$</b>                     | <b>5,945</b> |
| <b>Liabilities of discontinued operations:</b>      |                               |              |
| Accounts payable and accrued liabilities            | \$                            | 8,165        |
| <b>Total liabilities of discontinued operations</b> | <b>\$</b>                     | <b>8,165</b> |

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The following amounts related to the Company's manufacturing operations have been segregated from continuing operations and reflected as discontinued operations for the three months ended September 30, 2003 and 2002:

|  | Three Months Ended<br>September 30, |              |
|--|-------------------------------------|--------------|
|  | 2003                                | 2002         |
| Revenues                                   | \$                                  | \$ 1,318,013 |
| Expenses:                                  |                                     |              |
| Direct costs                               |                                     | 1,103,343    |
| General and administrative expense         | 4,396                               | 327,880      |
| Depreciation expense                       |                                     | 21,590       |
| Other expense (income)                     | (24,998)                            | 15,056       |
| Income (loss) from discontinued operations | \$ 20,602                           | \$ (149,856) |

Note 5 Net Income (Loss) 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 (loss) available to common shareholders by the weighted average number of shares outstanding during the period. Diluted EPS is calculated by dividing net income (loss) available to common shareholders by the weighted average number of shares outstanding during the period plus the dilutive effect of common stock equivalents. The weighted average number of shares outstanding related to stock options at September 30, 2003 and 2002 was 1,918,486 and 1,717,325, respectively. Only stock options with exercise prices lower than the average market price of the common shares were included in the diluted EPS calculation.

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

|   | Three Months Ended    |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2003 | September 30,<br>2002 |
| Numerator:  |                       |                       |
| Income (loss) from continuing operations            | \$ 296,261            | \$ (283,532)          |
| Gain (loss) from discontinued operations            | 20,602                | (149,856)             |
| Preferred stock dividends                           | (25,900)              |                       |
| Net income (loss) applicable to common Shareholders | \$ 290,963            | \$ (433,388)          |
| Denominator:  |                       |                       |
| Denominator for basic EPS weighted-average-shares   | 16,558,833            | 13,318,030            |
| Common stock equivalent-stock options               | 5,210,650             |                       |
| Denominator for diluted EPS weighted-average-shares | 21,769,483            | 13,318,030            |



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|   |    |      |    |        |
|---|----|------|----|--------|
| Basic income (loss) from continued operations per share           | \$ | 0.02 | \$ | (0.02) |
| Basic income (loss) from discontinued operations per share        |    | 0.00 |    | (0.01) |
| Basic income (loss) applicable to common shareholders per share   |    | 0.02 |    | (0.03) |
| Diluted income (loss) from continued operations per share         |    | 0.01 |    | (0.02) |
| Diluted income (loss) from discontinued operations per share      |    | 0.00 |    | (0.01) |
| Diluted income (loss) applicable to common shareholders per share | \$ | 0.01 | \$ | (0.03) |

Note 6 - 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, payable in ten monthly installments of \$5,000 each, commencing one month after the date of approval by the Company's Board of Directors.

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 7 Contingencies

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

#### Previously Reported Cases:

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.

Gulshan Hirji v. Precision Auto Care, Inc., Los Angeles Superior Court, State of California, Case No. BC279492, Filed August 12, 2002

Gulshan Hirji, a stockholder of Paisa, Inc. ( Paisa ), filed suit against PACI alleging that PACI breached a contract between PACI and Paisa entered into in June 1998 and amended in August 1998, and made fraudulent representations and negligent misrepresentations in connection with the alleged contract. The plaintiff seeks damages of \$7,000,000, consequential damages, punitive damages, attorneys' fees, prejudgment interest and such other relief as the Court deems proper. PACI denies the allegations and intends to vigorously defend the allegations in the lawsuit. PACI seeks a judgment against Gulshan Hirji on her guaranty of a promissory note for \$500,000 plus interest and attorneys' fees, and has filed a cross-complaint seeking damages from Hirji in excess of \$1,000,000 based on fraudulent representations made to PACI.

The case has been consolidated into PACI's suit against Hirji on the note for \$500,000. Discovery is ongoing. Mediation is scheduled for November 5, 2003. A settlement conference is scheduled for January 6, 2004, and trial is scheduled to begin January 20, 2004.

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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. The Company believes that it has adequately reserved for a possible adverse judgment in the Hirji matter.

## 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 7. - 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, 2003 filed with the Securities and Exchange Commission on September 29, 2003. Historical results and percentage relationships set forth herein are not necessarily indicative of future operations.

### Significant Accounting Policies

#### *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 issues involving collection exist.

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 sales 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.

Management reviews royalty receivables on a regular basis and establishes reserves as necessary based upon historical payment history and overall operating performance of the franchisee.

#### *Deferred Tax Valuation Allowance*

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Given the Company's history of losses from fiscal years 1999, 2000, 2001 and 2002, management has established a valuation allowance against the entire deferred tax asset.

### Results of Operations

#### Comparison of the three months ended September 30, 2003 to the three months ended September 30, 2002

Summary (in thousands)

|  | Three Months Ended September 30, |             |                 |              |
|--|----------------------------------|-------------|-----------------|--------------|
|  | 2003                             | %           | 2002            | %            |
| Automotive care franchising revenue                        | \$ 3,022                         | 95          | \$ 3,217        | 94           |
| Other  | 155                              | 5           | 193             | 6            |
| <b>Total revenues</b>                                      | <b>\$ 3,177</b>                  | <b>100%</b> | <b>\$ 3,410</b> | <b>100%</b>  |
| Automotive care franchising direct cost                    | 1,764                            | 56          | 1,949           | 57           |
| Other  | 146                              | 5           | 114             | 3            |
| <b>Total direct cost</b>                                   | <b>1,910</b>                     | <b>61</b>   | <b>2,063</b>    | <b>60</b>    |
| General and administrative                                 | 1,055                            | 33          | 1,008           | 30           |
| Depreciation expense                                       | 77                               | 2           | 101             | 3            |
| Other operating expense                                    |                                  | 0           | 3               | 0            |
| <b>Operating income</b>                                    | <b>135</b>                       | <b>4</b>    | <b>235</b>      | <b>7</b>     |
| Other  | 161                              | 5           | (518)           | (15)         |
| Gain (loss) from discontinued operations                   | 21                               | 1           | (150)           | (4)          |
| <b>Net income (loss)</b>                                   | <b>317</b>                       | <b>10</b>   | <b>(433)</b>    | <b>(12)</b>  |
| Preferred stock dividends                                  | 26                               | 1           |                 |              |
| <b>Net income (loss) applicable to common shareholders</b> | <b>\$ 291</b>                    | <b>9%</b>   | <b>\$ (433)</b> | <b>(12)%</b> |

*Revenue.* Total revenues for the three months ended September 30, 2003 was \$3.2 million, a decrease of approximately \$233,000, or 7%, compared with total revenues of \$3.4 million for the three months ended September 30, 2002.

Automotive care franchising revenue for the three months ended September 30, 2003 was \$3.0 million, a decrease of approximately \$195,000, or 6%, compared with automotive care revenues of \$3.2 million for the three months ended September 30, 2002. This decrease was partially the result of system wide store sales for the three months ended September 30, 2003 being slightly lower than sales for the three months ended September 30, 2002. The Company also received fewer settlement payments for delinquent royalties during the three months ended September 30, 2003 than it received during the three months ended September 30, 2002.

Other revenue for the three months ended September 30, 2003 was \$155,000, a decrease of approximately \$38,000, or 20%, compared to \$193,000 for the three months ended September 30, 2002. This decrease was due primarily to the sale of its company operated stores in Mexico during the quarter ended September 30, 2002.

*Direct Cost.* Total direct costs for the three months ended September 30, 2003 totaled \$1.9 million, a decrease of \$153,000 or 7%, compared with \$2.1 million for the three months ended September 30, 2002.

Automotive care franchising direct costs for the three months ended September 30, 2003 totaled \$1.8 million, a decrease of \$185,000 or 9%, compared with \$1.9 million for the three months ended September 30, 2002. This decrease is consistent with lower automotive care franchising revenues.

Other direct costs for the three months ended September 30, 2003 totaled \$146,000, an increase of \$32,000 or 28%, compared with \$114,000 for the three months ended September 30, 2002.

*General and Administrative Expense.* General and administrative expense was \$1.1 million for the three months ended September 30, 2003, an increase of \$47,000 or 5%, compared with \$1.0 million for the three months ended September 30, 2002. 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, 2002. These compensation costs were offset by management's cost reduction initiatives in general and administrative costs for the three months ended September 30, 2003.

*Operating Income (Loss) From Continuing Operations.* The Company recorded operating income for the three months ended September 30, 2003 of approximately \$135,000 compared with operating income of \$235,000 for the three months ended September 30, 2002.

*Other Income (Expense).* The Company recorded a gain in Other Income (Expense) of \$161,000 for the three months ended September 30, 2003, which represents an increase in Other Income (Expense) of approximately \$679,000 or 131% compared to the \$518,000 loss in Other Income (Expense) for the three months ended September 30, 2002. This increase was primarily the result of the approximately \$518,000 reduction in interest expense as a result of the Company's debt restructuring in fiscal year 2003. The Company also recognized a \$160,000 gain from the debt restructuring that was completed in the first quarter of fiscal year 2004 (see Item 1 - Note 6).

*Gain (Loss) From Discontinued Operations.* The Company recorded a gain from discontinued operations for the three months ended September 30, 2003 of \$21,000 compared with a loss from discontinued operations of \$150,000 for the three months ended September 30, 2002 relating to the disposal of its manufacturing operations (see Item 1- Note 4).

*Net Income (Loss) Applicable to Common Shareholders and Earnings Per Share.* The Company recorded Net Income Applicable to Common Shareholders of \$291,000, or \$0.02 per share, for the three months ended September 30, 2003 compared to the Net Loss Applicable to Common Shareholders of \$433,000, or (\$0.03) per share, for the three months ended September 30, 2002.

#### Liquidity and Capital Resources

#### Sources and Uses of Cash

Cash at September 30, 2003 was \$1.6 million. This represents an increase of \$4,000 from June 30, 2003. During the period, cash provided by operations was \$309,000. The Company generated operating profit in the fiscal year 2003 and the first quarter of 2004 with the expectation it will continue to do so for the remainder of fiscal year 2004.

Cash used in investing activities for the three months ended September 30, 2003 was \$15,000, 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, 2003 was \$290,000. Cash used in financing activities during the period consisted primarily of repayments of the subordinated debt and other notes payable.

#### Debt Transactions

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, payable in ten monthly installments of \$5,000 each, commencing one month after the date of approval by the Company's Board of Directors.

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**

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, 2003 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## **PART II - OTHER INFORMATION**

### Results of Operations



**ITEM 1. LEGAL PROCEEDINGS**

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

Previously Reported Cases:

Lumnivision, 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.

Gulshan Hirji v. Precision Auto Care, Inc., Los Angeles Superior Court, State of California, Case No. BC279492, Filed August 12, 2002

Gulshan Hirji, a stockholder of Paisa, Inc. ( Paisa ), filed suit against PACI alleging that PACI breached a contract between PACI and Paisa entered into in June 1998 and amended in August 1998, and made fraudulent representations and negligent misrepresentations in connection with the alleged contract. The plaintiff seeks damages of \$7,000,000, consequential damages, punitive damages, attorneys fees, prejudgment interest and such other relief as the Court deems proper. PACI denies the allegations and intends to vigorously defend the allegations in the lawsuit. PACI seeks a judgment against Gulshan Hirji on her guaranty of a promissory note for \$500,000 plus interest and attorneys fees, and has filed a cross-complaint seeking damages from Hirji in excess of \$1,000,000 based on fraudulent representations made to PACI.

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The case has been consolidated into PACI's suit against Hirji on the note for \$500,000. Discovery is ongoing. Mediation is scheduled for November 5, 2003. A settlement conference is scheduled for January 6, 2004, and trial is scheduled to begin January 20, 2004.

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. The Company believes that it has adequately reserved for a possible adverse judgment in the Hirji matter.

### **ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS**

None.

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

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The information concerning defaults and the subsequent cure thereof with respect to the Company's indebtedness contained in Note 6 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 AND REPORTS ON FORM 8-K

(a) Exhibits

10.1\* Agreement dated July 17, 2003 between the Company and Board L.L.C. terminating the Subordinated Debenture dated October 15, 1998 between the Company and Board L.L.C.

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 pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2\* Written statement of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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\* Filed herewith



(b) Reports on Form 8-K

- (i) On August 22, 2003, a Form 8-K was filed announcing the Company's preliminary fiscal year 2003 results.

**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 7, 2003.

By: Precision Auto Care, Inc.  
/s/ Louis M. Brown, Jr.  
Louis M. Brown, Jr.  
Chief Executive Officer  
(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.

| <b>Signature</b>                               | <b>Title</b>   | <b>Date</b>      |
|--|--|------------------|
| /s/ Louis M. Brown, Jr.<br>Louis M. Brown, Jr. | Chief Executive Officer and<br>Chairman of the Board of Directors<br>(Principal Executive Officer) | November 7, 2002 |
| /s/ Robert R. Falconi<br>Robert R. Falconi     | President<br>(Principal Financial and Accounting Officer)  | November 7, 2002 |