

PRECISION AUTO CARE INC  
Form 10QSB  
February 13, 2006

## 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 December 31, 2005**

**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 28,942,252 shares of Common Stock as of January 18, 2006.

Transitional Small Business Disclosure Format: Yes  No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). 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, 2005 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

	December 31, 2005 (unaudited)	June 30, 2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 3,754,713	\$ 3,279,568
Accounts receivable, net of allowance of \$43,700 and \$60,971, respectively	590,302	640,271
Notes receivable	105,435	251,301
Deferred tax asset	479,824	479,824
Other assets	388,896	344,593
Total current assets	5,319,170	4,995,557
Property and equipment, at cost	4,252,664	4,202,133
Less: Accumulated depreciation	(4,109,663)	(4,093,702)
	143,001	108,431
Goodwill	8,711,744	8,711,744
Notes receivable, net of allowance of \$296,475 and \$412,128, respectively	179,154	36,159
Deferred tax asset	2,820,970	3,143,968
Deposits and other	23,687	24,314
Total assets	\$ 17,197,726	\$ 17,020,173
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Line-of-credit	\$	\$
Notes payable- current	7,340	19,346
Accounts payable and accrued liabilities	1,413,122	1,681,354
Due to related party	135,967	116,073
Deferred revenue	303,087	253,322
Total current liabilities	1,859,516	2,070,095
Notes payable, net of current portion	39,405	7,991
Total liabilities	1,898,921	2,078,086
Commitments and contingencies		
Series A redeemable preferred stock, \$.01 par value; 1,000,000 shares authorized; 11,227 shares issued and outstanding	116,312	116,312
Stockholders equity:	289,423	288,623

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Common stock, \$.01 par value; 39,000,000 shares authorized; 28,942,252 and 28,862,252 shares issued and outstanding				
Additional paid-in capital		67,821,730		67,949,970
Accumulated deficit		(52,928,660)		(53,412,818)
Total stockholders' equity		15,182,493		14,825,775
Total liabilities and stockholders' equity	\$	17,197,726	\$	17,020,173

See accompanying notes.

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

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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	Three Months Ended December 31,	
	2005 (unaudited)	2004 (unaudited)
<b>Revenues:</b>		
Franchise royalties	\$ 2,538,287	\$ 2,465,531
Franchise development	83,501	180,916
Other	95,778	138,682
<b>Total revenues</b>	<b>2,717,566</b>	<b>2,785,129</b>
<b>Direct cost:</b>		
Franchise support	1,713,503	1,728,177
<b>Contribution</b>	<b>1,004,063</b>	<b>1,056,952</b>
General and administrative expense	679,202	925,043
Depreciation expense	15,892	27,543
<b>Operating income</b>	<b>308,969</b>	<b>104,366</b>
Interest expense	(2,465)	(1,225)
Other income	37,093	10,491
<b>Total other income</b>	<b>34,628</b>	<b>9,266</b>
<b>Income before income tax expense</b>	<b>343,597</b>	<b>113,632</b>
Provision (benefit) for income taxes	136,142	(297,000)
<b>Net income</b>	<b>207,455</b>	<b>410,632</b>
Preferred stock dividends	582	10,501
<b>Net income applicable to common shareholders</b>	<b>\$ 206,873</b>	<b>\$ 400,131</b>
Net income per common share- Basic	\$ 0.01	\$ 0.02
Net income per common share- Diluted	\$ 0.01	\$ 0.01
<b>Weighted average common shares outstanding- Basic</b>	<b>28,942,252</b>	<b>23,808,602</b>
<b>Weighted average common shares outstanding- Diluted</b>	<b>29,696,847</b>	<b>27,502,395</b>

See accompanying notes.



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	Six Months Ended December 31,	
	2005 (unaudited)	2004 (unaudited)
Revenues:		
Franchise royalties	\$ 5,349,844	\$ 5,343,544
Franchise development	184,375	879,728
Other	159,327	275,384
Total revenues	5,693,546	6,498,656
Direct cost:		
Franchise support	3,538,078	3,641,465
Contribution	2,155,468	2,857,191
General and administrative expense	1,365,778	1,692,844
Depreciation expense	32,424	54,183
Operating income	757,266	1,110,164
Interest expense	(3,091)	(3,200)
Other income	65,128	32,603
Total other income	62,037	29,403
Income before income tax expense	819,303	1,139,567
Provision (benefit) for income taxes	333,982	(537,000)
Net income	485,321	1,676,567
Preferred stock dividends	1,163	21,001
Net income applicable to common shareholders	\$ 484,158	\$ 1,655,566
Net income per common share- Basic	\$ 0.02	\$ 0.07
Net income per common share- Diluted	\$ 0.02	\$ 0.06
Weighted average common shares outstanding- Basic	28,928,700	23,808,602
Weighted average common shares outstanding- Diluted	29,779,044	27,005,936

See accompanying notes.

## PRECISION AUTO CARE, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended December 31,	
	2005 (unaudited)	2004 (unaudited)
Operating activities:		
Net income applicable to common shareholders	\$ 484,158	\$ 1,655,566
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	32,424	54,183
Bad debt expense	14,342	28,201
Disposal of capital leased asset	9,530	
Decrease in valuation allowance		(537,000)
Stock based compensation (benefit) expense	(147,170)	104,054
Changes in assets and liabilities:		
Restricted cash		50,200
Accounts and notes receivable	38,497	(95,936)
Prepaid expenses, deposits and other	(43,676)	(132,730)
Accounts payable and accrued liabilities	(219,195)	11,179
Due to related party	19,894	1,146
Deferred revenue and other	49,765	(97,696)
Deferred taxes	322,998	
Net cash provided by operating activities	561,567	1,041,167
Investing activities:		
Purchases of property and equipment	(76,523)	(34,783)
Net cash used in investing activities	(76,523)	(34,783)
Financing activities:		
Proceeds from exercise of stock options and warrants	19,730	
Payment of preferred stock dividends	(1,163)	(21,001)
Repayment of notes payable	(28,466)	(79,206)
Net cash used in financing activities	(9,899)	(100,207)
Net change in cash and cash equivalents	475,145	906,177
Cash and cash equivalents at beginning of year	3,279,568	1,573,368
Cash and cash equivalents at end of period	\$ 3,754,713	\$ 2,479,545
Supplemental schedule of non cash investing and finance activities:		
Property and equipment acquired under capital lease	\$ 47,875	\$

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, 2005.

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 Summary of Significant Accounting Policies

*Goodwill and Intangible Assets*

Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Intangible Assets* , requires that goodwill no longer be amortized, but instead be tested for impairment at least annually. The Company engaged a valuation expert in fiscal year 2005 to assist the Company with the test for impairment. The fair value of franchising operations was estimated utilizing a discounted cash flow approach that estimates revenue, driven by assumed market growth rates and appropriate discount rates. These estimates are consistent with the plans and estimates we use to manage the underlying business. The Company carried forward the valuation from fiscal year 2005 for the current year analysis since the fair value of the franchising operations exceeded its carrying value by a substantial margin and the fact that there have been no events and circumstances that have had a material impact on the franchising operations since the most recent fair value determination. As such, management concluded the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit to be remote. Impairment testing is performed in the first quarter of each fiscal year. Based upon the above, management has concluded that the \$8.7 million carrying value of goodwill was not impaired.

*Stock Options*

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The Company applies Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for stock options issued to employees and presents pro forma net income and earnings per share data as if the fair value method prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation had been applied. Compensation expense is recorded when modifications and other provisions cause the application of variable accounting or require a new measurement date.

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

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2005	2004	2005	2004
Net income applicable to common shareholders	\$ 206,873	\$ 400,131	\$ 484,158	\$ 1,655,566
(Deduct) add: Total stock-based compensation (benefit) expense reported in net income under the intrinsic value method	(110,041)	102,808	(147,170)	104,054
Deduct: Total stock-based compensation expense determined under fair value based method for all awards	23,434	53,923	71,076	58,042
Pro forma net income	\$ 73,398	\$ 449,016	\$ 265,912	\$ 1,701,578
Earnings per share:				
Basic- as reported	\$ 0.01	\$ 0.02	\$ 0.02	\$ 0.07
Diluted- as reported	\$ 0.01	\$ 0.01	\$ 0.02	\$ 0.06
Basic- pro forma	\$ 0.00	\$ 0.02	\$ 0.01	\$ 0.07
Diluted- pro forma	\$ 0.00	\$ 0.02	\$ 0.01	\$ 0.06
Weighted average shares:				
Weighted average common shares outstanding- Basic	28,942,252	23,808,602	28,928,700	23,808,602
Weighted average common shares outstanding- Diluted	29,696,847	27,502,395	29,779,044	27,005,936

*Reclassifications*

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

## Note 3 - Master License Agreement

In August 2004, the Company signed a master franchise agreement with Hung Yue Holdings (Hong Kong) Co., Ltd. giving that firm's affiliate, Precision Tune Auto Care (China) Company Limited, a license to open and operate at least 330 Precision Tune Auto Care (PTAC) car care centers in China over the next seven years. Under the terms of the original agreement, Hung Yue Holdings is obligated to pay the Company approximately \$2.1 million. Approximately \$246,000 has been collected under the agreement and \$240,000 has been recognized as income as all substantial obligations under that agreement have been fulfilled. Approximately \$6,000 has been deferred for training related expenses. On January 6, 2006, the Company and Hung Yue Holdings signed an amended payment schedule. The Company will receive \$250,000 in installment payments from January through July 2006, and a minimum of \$1.6 million payable in seven installments beginning January 1, 2007, relating to the opening of car care centers in China. No future revenue will be recognized until collection of such amounts is probable. Additionally, revenue from future franchises under the master license agreement will be recognized when the Company's obligations relating to the opening of such centers have been satisfied and collection of the franchise fee is probable. There were four centers opened as of December 31, 2005. Franchise fees from such centers have not yet been received; as such no revenue was recorded for the six months ending December 31, 2005.

## Note 4 Earnings Per Share

The Company reports earnings per share (EPS) in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, Earnings per Share which specifies the methods of computation, presentation, and disclosure. SFAS No. 128 requires the presentation of basic EPS and diluted EPS. Basic EPS is calculated by dividing net income available to common shareholders by the weighted average number of shares outstanding during the period. Diluted EPS is calculated by dividing net income available to common shareholders by the weighted average number of shares outstanding during the period plus the dilutive effect of common stock equivalents. The number of shares outstanding related to stock options and warrants at December 31, 2005 and 2004 was 2,008,798 and 7,145,302, 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 six months ended December 31, 2005 and 2004, respectively, 182,950 shares attributable to outstanding stock options 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 income per share.

	Three Months Ended		Six Months Ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
<b>Numerator:</b>				
Net income	\$ 207,455	\$ 410,632	\$ 485,321	\$ 1,676,567
Preferred stock dividends	(582)	(10,501)	(1,163)	(21,001)
Net income applicable to common Shareholders	\$ 206,873	\$ 400,131	\$ 484,158	\$ 1,655,566
<b>Denominator:</b>				

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Denominator for basic EPS weighted-average-shares	28,942,252	23,808,602	28,928,700	23,808,602
Common stock equivalents- stock options and warrants	754,595	3,693,793	850,344	3,197,334
Denominator for diluted EPS weighted-average-shares	29,696,847	27,502,395	29,779,044	27,005,936
Basic earnings per share applicable to common shareholders	\$ 0.01	\$ 0.02	\$ 0.02	\$ 0.07
Diluted earnings per share applicable to common shareholders	\$ 0.01	\$ 0.01	\$ 0.02	\$ 0.06

Note 5 Contingencies

The Company is subject to litigation that could have a material adverse impact on its liquidity (see Part II Item 1. Legal Proceedings).

**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, 2005 filed with the Securities and Exchange Commission on September 27, 2005. Historical results and percentage relationships set forth herein are not necessarily indicative of future operations.

**Critical Accounting Policies**

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 issues involving collection exist. In the case when revenues are not likely to be collected, the Company provides for an estimate of bad debt expense. 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 when all the material services and conditions have been satisfied, generally at the opening of the franchised center.

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

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

Product services in the form of equipment and other marketing materials related sales are recognized upon delivery to the 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. The Company engaged a valuation expert in fiscal year 2005 to assist the Company with the test for impairment. The fair value of franchising operations was estimated utilizing a discounted cash flow approach that estimates revenue, driven by assumed market growth rates and appropriate discount rates. These estimates are consistent with the plans and estimates we use to manage the underlying business. The Company carried forward the valuation from fiscal year 2005 for the current year analysis since the fair value of the franchising operations exceeded its carrying value by a substantial margin and the fact that there have been no events and circumstances that have had a material impact on the franchising operations since the most recent fair value determination. As such, management concluded the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit to be remote. Impairment testing is performed in the first quarter of each fiscal year. Based upon the above, management has concluded that the \$8.7 million carrying value of goodwill was not impaired.



*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 deferred tax assets and establishes a valuation allowance as deemed appropriate. As of December 31, 2005, the Company had a valuation allowance of \$2.9 million against deferred tax assets.

**Results of Operations****Comparison of the three months ended December 31, 2005 to the three months ended December 31, 2004**

Summary (in thousands)

	Three Months Ended December 31,			
	2005	%	2004	%
Automotive care franchising revenue	\$ 2,622	96	\$ 2,646	95
Other	96	4	139	5
<b>Total revenues</b>	<b>\$ 2,718</b>	<b>100%</b>	<b>\$ 2,785</b>	<b>100%</b>
Automotive care franchising direct cost	1,650	61	1,598	57
Other	64	2	129	5
<b>Total direct cost</b>	<b>1,714</b>	<b>63</b>	<b>1,727</b>	<b>62</b>
General and administrative	679	25	925	33
Depreciation expense	16		28	1
<b>Operating income</b>	<b>309</b>	<b>12</b>	<b>105</b>	<b>4</b>
Other	35	1	9	
<b>Earnings before taxes</b>	<b>344</b>	<b>13</b>	<b>114</b>	<b>4</b>
Provision (benefit) for income taxes	136	(5)	(297)	(11)
<b>Net income</b>	<b>208</b>	<b>8</b>	<b>411</b>	<b>15</b>
Preferred stock dividends	1		11	1
<b>Net income applicable to common shareholders</b>	<b>\$ 207</b>	<b>8%</b>	<b>\$ 400</b>	<b>14%</b>

*Revenue.* Total revenue for the three months ended December 31, 2005 was approximately \$2.7 million, a decrease of approximately \$67,000, compared with total revenue of approximately \$2.8 million for the three months ended December 31, 2004.

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Automotive care franchising revenue for the three months ended December 31, 2005 was \$2.6 million, which was consistent with the three months ended December 31, 2004

The Company recognized revenue from foreign franchisee operations of \$82,000 and \$178,000 for the three months ended December 31, 2005 and 2004, respectively. This decrease was primarily due to the \$130,000 of revenue recognized from the China master franchise agreement for the three months ended December 31, 2004. The Company recognized revenue of \$10,000 relating to the China master franchise agreement for the three months ended December 31, 2005.

Other revenue for the three months ended December 31, 2005 was \$96,000, a decrease of approximately \$43,000, or 31%, compared to \$139,000 for the three months ended December 31, 2004. The decrease in other revenue was primarily due to the cessation of support revenue from the Shell-Mexico transaction as of December 31, 2004 and related revenue of \$75,000 offset by an increase in revenue from training of \$9,000 and an increase of \$23,000 from support fees associated with the new point of sale system.

*Direct Cost.* Total direct cost for the three months ended December 31, 2005 totaled \$1.7 million, a decrease of \$13,000 or 1%, compared with \$1.7 million for the three months ended December 31, 2004.

Automotive care franchising direct cost for the three months ended December 31, 2005 totaled \$1.6 million, which was comparable to the three months ended December 31, 2004.

Other direct cost for the three months ended December 31, 2005 totaled \$64,000, a decrease of \$65,000 or 50%, compared with \$129,000 for the three months ended December 31, 2004. The decrease is primarily attributed to the termination of the agreement to provide support to Shell-Mexico as that agreement was completed as of December 31, 2004. No comparable expense was incurred during the three months ended December 31, 2005.

*General and Administrative Expense.* General and administrative expense was \$679,000 for the three months ended December 31, 2005, a decrease of \$246,000 or 27%, compared with \$925,000 for the three months ended December 31, 2004. In the three months ended December 31, 2005, the Company incurred a compensation benefit of approximately \$111,000 as a result of applying variable accounting to certain outstanding stock options. Conversely, in the three months ended December 31, 2004, the Company incurred a cost of approximately \$102,000 due to changes in compensation expense as a result of applying variable accounting to certain stock options (see Item 1- Note 2).

*Operating Income.* The Company recorded operating income for the three months ended December 31, 2005 of approximately \$309,00 compared with operating income of \$105,000 for the three months ended December 31, 2004. The increase was mainly attributed to the variable accounting adjustment discussed above in the general and administrative expense.

*Other Income.* The Company recorded Other Income of \$35,000 for the three months ended December 31, 2005, which represents an increase in Other Income of approximately \$26,000 compared to \$9,000 in Other Income for the three months ended December 31, 2004. This increase is primarily due to an increase in interest income in the amount of \$25,000.

*Income Taxes.* Based on the Company's current operating performance, management released \$297,000 of the valuation allowance during the three months ending December 31, 2004. This adjustment was based upon management's assessment of the recoverability of deferred taxes which included projections of future pretax earnings. There was no comparable adjustment to the valuation allowance for the three months ending December 31, 2005.

*Net Income Applicable to Common Shareholders and Earnings Per Share.* The Company recorded Net Income Applicable to Common Shareholders of \$207,000, or \$0.01 per share, for the three months ended December 31, 2005 compared to the Net Income Applicable to Common Shareholders of \$400,000, or \$0.02 per share, for the three months ended December 31, 2004.

## **Results of Operations**

### **Comparison of the six months ended December 31, 2005 to the six months ended December 31, 2004**

Summary (in thousands)

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	Six Months Ended December 31,			
	2005	%	2004	%
Automotive care franchising revenue	\$ 5,534	97	\$ 6,251	96
Other	159	3	275	4
Total revenues	\$ 5,693	100%	\$ 6,526	100%
Automotive care franchising direct cost	3,433	60	3,382	52
Other	105	2	259	4
Total direct cost	3,538	62	3,641	56
General and administrative	1,366	24	1,721	26
Depreciation expense	32	1	54	1
Operating income	757	13	1,110	17
Other	62	1	29	1
Earnings before taxes	819	14	1,139	18
Provision (benefit) for income taxes	334	(6)	(537)	(8)
Net income	485	8	1,676	26
Preferred stock dividends	1		21	
Net income applicable to common shareholders	\$ 484	8%	\$ 1,655	26%

*Revenue.* Total revenue for the six months ended December 31, 2005 was approximately \$5.7 million, a decrease of approximately \$833,000, or 13%, compared with total revenue of approximately \$6.5 million for the six months ended December 31, 2004.

Automotive care franchising revenue for the six months ended December 31, 2005 was approximately \$5.5 million, a decrease of approximately \$717,000, or 11%, compared with automotive care revenue of approximately \$6.3 million for the six months ended December 31, 2004. In fiscal year 2005, the Company sold the Area Development rights to three markets which resulted in franchise development revenue of approximately \$600,000. Specifically, during the first quarter of fiscal year 2005, franchise development revenue increased due to the Company signing an area development agreement with North Pacific Precision, Inc. for the area rights for the Seattle market. Under the agreement, North Pacific Precision, Inc. paid \$500,000 for the area developer rights for the Seattle market. Such fees were recognized upon execution of the agreement since all significant obligations under the agreement were satisfied at that time. The Company also recognized revenue of approximately \$59,000 and \$40,000, respectively, for the sale of the area rights for the San Diego and Colorado markets. Additionally, during the six months ended December 31, 2004, the Company

recognized revenue of \$130,000 in connection with the signing of the China master franchising agreement. The revenue was recognized as the Company had substantially fulfilled all required obligations (see Item 1- Note 3).

The Company recognized revenue from foreign franchisee operations of \$164,000 and \$243,000 for the six months ended December 31, 2005 and 2004, respectively. This decrease was primarily due to the \$130,000 of revenue recognized from the China master franchise agreement during the six months ended December 31, 2004. The Company only recognized revenue of \$48,000 relating to the China master franchise agreement during the six months ended December 31, 2005.

Other revenue for the six months ended December 31, 2005 was \$159,000, a decrease of approximately \$116,000, or 42%, compared to \$275,000 for the six months ended December 31, 2004. The decrease in other revenue was primarily due to the fact that the support revenue from the Shell-Mexico transaction ceased as of December 31, 2004. There was no comparable revenue in the six months ending December 31, 2005.

*Direct Cost.* Total direct cost for the six months ended December 31, 2005 totaled approximately \$3.5 million, a decrease of \$103,000 or 3%, compared with approximately \$3.6 million for the six months ended December 31, 2004.

Automotive care franchising direct cost for the six months ended December 31, 2005 totaled \$3.4 million, which was comparable to the six months ended December 31, 2004.

Other direct cost for the six months ended December 31, 2005 totaled \$105,000, a decrease of \$154,000 or 59%, compared with \$259,000 for the six months ended December 31, 2004. The decrease is primarily attributed to the termination of the agreement to provide support services to Shell-Mexico that ended as of December 31, 2004. No comparable expense was incurred during the six months ended December 31, 2005.

*General and Administrative Expense.* General and administrative expense was approximately \$1.4 million for the six months ended December 31, 2005, a decrease of \$355,000 or 21%, compared with approximately \$1.7 million for the six months ended December 31, 2004. In the six months ended December 31, 2005, the Company incurred a compensation benefit of approximately \$150,000 as a result of applying variable accounting to certain outstanding stock options. Conversely, in the six months ended December 31, 2004, the Company incurred a cost of approximately \$102,000 due to changes in compensation expense as a result of applying variable accounting to certain outstanding stock options (see Item 1- Note 2). The balance of this decrease was the result of management's on-going cost reduction initiatives in general and administrative costs.

*Operating Income.* The Company recorded operating income for the six months ended December 31, 2005 of approximately \$757,000 compared with operating income of \$1.1 million for the six months ended December 31, 2004. As discussed previously, in the six months ending December 31, 2004, the Company recognized revenue of approximately \$750,000 for the signing of various area development agreements as well as the signing of the China master franchising agreement. There were no comparable transactions for the six months ending December 31, 2005. As a result, operating income was lower for the six months ending December 31, 2005.

*Other Income.* The Company recorded Other Income of \$62,000 for the six months ended December 31, 2005, which represents an increase in Other Income of approximately \$33,000 compared to \$29,000 in Other Income for the six months ended December 31, 2004.

*Income Taxes.* Based on the Company's current operating performance, management released \$537,000 of the valuation allowance during the six months ending December 31, 2004. This adjustment was based upon management's assessment of the recoverability of deferred taxes which included projections of future pretax earnings. There was no comparable adjustment to the valuation allowance for the six months ending December 31, 2005.

*Net Income Applicable to Common Shareholders and Earnings Per Share.* The Company recorded Net Income Applicable to Common Shareholders of \$484,000, or \$0.02 per share, for the six months ended December 31, 2005 compared to the Net Income Applicable to Common Shareholders of \$1.7 million, or \$0.07 per share, for the six months ended December 31, 2004.

#### Liquidity and Capital Resources

#### Sources and Uses of Cash

Cash at December 31, 2005 was \$3.8 million. During the period, cash provided by operations was \$562,000.

Cash used in investing activities for the six months ended December 31, 2005 was \$77,000 resulting from the purchase of property and equipment for use in the Company's franchise operations.

Cash used in financing activities for the six months ended December 31, 2005 was \$10,000. Cash used in financing activities during the period consisted primarily of the net impact of proceeds from the exercise of stock options and warrants of \$20,000 and the payments of dividends and notes payable of \$30,000.

Management believes that the Company's current cash balance, cash generated from operations, and the available \$250,000 credit line will be sufficient to meet the Company's working capital needs, capital expenditures, and contractual obligations for fiscal year 2006. At December 31, 2005, the entire line of credit was available.

### **Seasonality and Quarterly Fluctuations**

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

### **ITEM 3. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14(c) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

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

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

Lumnivision 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.

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.

#### **Resolved Matters**

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

On March 9, 2005 PTW, Inc. (PTW), a Precision Tune Auto Care, Inc. subsidiary, was served with a complaint in which plaintiff Puyallup Auto Stop Associates (PASA) sought an amount to be determined at trial and attorney's fees. PASA claimed that PTW



breached a real property lease between the parties and sought to recover from PTW certain environmental remediation costs. Beginning in 1994, PTW subleased the property in question to a Precision Tune Auto Care franchisee, Michael and Catherine Ertman (the Ertmans ). On March 30, 2005, PASA amended its complaint to include two additional third-party defendants. In November 2005, PTW made a payment of \$15,000 to settle this claim.

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

None.

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

None.

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

The Annual Meeting of Shareholders was held on November 16, 2005.

The following proposals were adopted by the margins indicated:

1. To elect the Board of Directors for the coming year.

	Number of Shares	
	For	Withheld
Woodley A. Allen	16,516,443	5,680
Louis M. Brown, Jr.	16,516,643	5,480
Bassam N. Ibrahim	16,445,293	76,830
Peter C. Keefe	16,513,293	8,830
John D. Sanders, Ph.D	16,514,643	7,480

2. To ratify the appointment of Grant Thornton LLP as independent auditors for the fiscal year ending June 30, 2006.

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	Number of Shares
For	16,519,623
Against	1,700
Abstain	800

**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.

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\* Filed herewith

(b) Reports on Form 8-K

None.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on February 6, 2006.

By: Precision Auto Care, Inc.  
/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.

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ Louis M. Brown, Jr. Louis M. Brown, Jr.	Chief Executive Officer and Chairman of the Board (Principal Executive Officer)	February 6, 2006
/s/ Robert R. Falconi Robert R. Falconi	President and Chief Operating Officer (Principal Financial and Accounting Officer)	February 6, 2006