

PRECISION AUTO CARE INC
Form 10QSB
May 15, 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 March 31, 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
(Address of principal executive offices)
(Zip Code)

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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 15,918,030 shares of Common Stock as of April 24, 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 apply to Precision Auto Care, Inc. or its management are intended to identify such forward-looking statements. All statements regarding Precision Auto Care, Inc. or Precision Auto Care, Inc.'s expected future financial position, business strategy, cost savings and operating synergies, projected costs and plans, and objectives of management for future operations are forward-looking statements. Although Precision Auto Care, Inc. believes the expectations reflected in such forward-looking statements are based on reasonable assumptions, no assurance can be given that such expectations will prove to have been correct. Important factors that could cause actual results to differ materially from the expectations reflected in the forward-looking statements herein include, among others, the factors set forth in the Company's 10-K filing for the year ending June 30, 2002 under the caption Business Risk Factors, general economic and business and market conditions, changes in federal and state laws, and increased competitive pressure in the automotive aftermarket services business.

PART I - FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****PRECISION AUTO CARE, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

| | March 31, 2003 | June 30, 2002 |
|--|---------------------------|--------------------------|
| | (unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 952,201 | \$ 1,029,643 |
| Restricted cash in escrow | | 175,000 |
| Accounts receivable, net of allowance of \$779,904 and \$2,371,314, respectively | 672,096 | 1,587,820 |
| Inventory, net of allowance of \$0 and \$410,000, respectively | 70,491 | 837,366 |
| Other assets | 303,982 | 172,915 |
| Assets of discontinued business held for sale | 1,276,262 | |
| Total current assets | 3,275,032 | 3,802,744 |
| Property, plant and equipment, at cost | 4,028,448 | 4,672,177 |
| Less: Accumulated depreciation | (3,559,785) | (3,676,506) |
| | 468,663 | 995,671 |
| Assets of discontinued business held for sale | 352,334 | |
| Goodwill, net of accumulated amortization of \$15,864,825 | 8,711,744 | 8,711,744 |
| Deposits and other | 258,611 | 79,249 |
| Total assets | \$ 13,066,384 | \$ 13,589,408 |
| LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT) | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 4,108,126 | \$ 5,442,544 |
| Board LLC note | 106,596 | 551,700 |
| Other notes payable- current | 166,233 | 342,007 |
| Liabilities from discontinued operations | 1,764,384 | |
| Deferred revenue | 313,750 | 683,489 |
| Total current liabilities | 6,459,089 | 7,019,740 |
| Credit facility with related party | | 10,944,532 |
| Subordinated debt | | 3,586,960 |
| Board LLC note | 520,186 | 253,707 |

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| | | |
|---|----------------------|----------------------|
| Other notes payable- non-current | 245,192 | 95,158 |
| Accrued interest on related party debt | | 2,528,913 |
| Deferred revenue and other | 286,875 | 517,500 |
| Total liabilities | 7,511,342 | 24,946,510 |
| Commitments and contingencies | | |
| Redeemable preferred stock | 5,180,000 | |
| Stockholders' equity (deficit): | | |
| Common stock, \$.01 par value; 39,000,000 and 19,000,000 shares authorized; 15,918,030 and 13,318,030 shares issued and outstanding | 159,180 | 133,180 |
| Additional paid-in capital | 52,124,021 | 49,327,613 |
| Accumulated deficit | (51,908,159) | (60,817,895) |
| Total stockholders' equity (deficit) | 375,042 | (11,357,102) |
| Total liabilities and stockholders' equity (deficit) | \$ 13,066,384 | \$ 13,589,408 |

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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| | Three Months Ended March 31, | |
|---|---------------------------------|-----------------------|
| | 2003 (Unaudited) | 2002 (Unaudited) |
| Revenues: | | |
| Franchise development | \$ 52,925 | \$ 51,465 |
| Royalties | 2,399,828 | 2,459,063 |
| Distribution | 182,958 | 167,383 |
| Company centers | | 315,115 |
| Other | 125,739 | 151,787 |
| Total revenues | 2,761,450 | 3,144,813 |
| Direct cost: | | |
| Royalties | 1,509,254 | 2,216,037 |
| Distribution | 141,699 | 134,902 |
| Total direct costs | 1,650,953 | 2,350,939 |
| Contribution (exclusive of amortization shown separately below) | 1,110,497 | 793,874 |
| General and administrative expense | 915,175 | 1,258,803 |
| Depreciation expense | 101,996 | 162,987 |
| Amortization of goodwill | | 340,950 |
| Other operating expense | 543 | |
| Operating income (loss) | 92,783 | (968,866) |
| Gain on debt restructuring | 2,804,162 | |
| Interest expense | (23,497) | (551,666) |
| Other income (expense) | 186 | (63,541) |
| Total other income (expense) | 2,780,851 | (615,207) |
| Income (loss) before income tax expense | 2,873,634 | (1,584,073) |
| Provision for income taxes | | |
| Income (loss) from continuing operations | 2,873,634 | (1,584,073) |
| Discontinued operations: | | |
| Loss from discontinued operations | (278,088) | (838,278) |
| Gain on disposal | 143,640 | |
| Net income (loss) | 2,739,186 | (2,422,351) |
| Preferred stock dividends | 17,267 | |
| Net income (loss) applicable to common shareholders | \$ 2,721,919 | \$ (2,422,351) |
| Income (loss) from continued operations per common share- Basic and Diluted | \$ 0.18 | \$ (0.15) |
| Loss from discontinued operations per common share- Basic and Diluted | (0.01) | (0.08) |
| Net income (loss) applicable to common stock per common share- Basic and Diluted | \$ 0.17 | \$ (0.23) |
| Weighted average common shares outstanding Basic | 15,901,363 | 10,724,308 |

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| | | |
|--|------------|------------|
| Weighted average common shares outstanding Diluted | 15,915,209 | 10,724,308 |
|--|------------|------------|

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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| | Nine Months Ended March 31, | |
|---|--------------------------------|-----------------------|
| | 2003 | 2002 |
| | (Unaudited) | (Unaudited) |
| Revenues: | | |
| Franchise development | \$ 255,441 | \$ 163,712 |
| Royalties | 7,663,659 | 8,069,748 |
| Distribution | 445,030 | 653,478 |
| Company centers | 73,763 | 1,144,424 |
| Other | 399,728 | 294,143 |
| Total revenues | 8,837,621 | 10,325,505 |
| Direct cost: | | |
| Royalties | 5,017,214 | 7,092,124 |
| Distribution | 328,651 | 556,492 |
| Total direct costs | 5,345,865 | 7,648,616 |
| Contribution (exclusive of amortization shown separately below) | 3,491,756 | 2,676,889 |
| General and administrative expense | 2,967,138 | 3,755,358 |
| Depreciation expense | 304,802 | 530,528 |
| Amortization of goodwill | | 1,022,850 |
| Other operating expense | 5,669 | |
| Impairment charges | | 2,096,644 |
| Operating income (loss) | 214,147 | (4,728,491) |
| Gain on debt restructuring | 9,746,100 | |
| Interest expense | (727,887) | (1,612,278) |
| Other income | 11,663 | (61,378) |
| Total other income (expense) | 9,029,876 | (1,673,656) |
| Income (loss) before income tax expense | 9,244,023 | (6,402,147) |
| Provision for income taxes | | |
| Income (loss) from continuing operations | 9,244,023 | (6,402,147) |
| Discontinued operations: | | |
| Loss from discontinued operations | (460,660) | (1,169,564) |
| Gain on disposal | 143,640 | |
| Net income (loss) | 8,927,003 | (7,571,711) |
| Preferred stock dividends | 17,267 | |
| Net income (loss) applicable to common shareholders | \$ 8,909,736 | \$ (7,571,711) |
| Income (loss) from continued operations per common share- Basic and Diluted | \$ 0.63 | \$ (0.61) |
| Loss from discontinued operations per common share- Basic and Diluted | (0.03) | (0.11) |
| Net income (loss) applicable to common stock per common share- Basic and Diluted | \$ 0.60 | \$ (0.72) |

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| | | |
|--|------------|------------|
| Weighted average common shares outstanding Basic | 14,737,444 | 10,486,671 |
| Weighted average common shares outstanding Diluted | 14,748,244 | 10,486,671 |

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Nine Months Ended March 31, | |
|--|--------------------------------|---------------------|
| | 2003 (Unaudited) | 2002 (Unaudited) |
| Operating activities: | | |
| Net income (loss) | \$ 8,909,736 | \$ (7,571,711) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | |
| Depreciation and amortization | 304,802 | 1,640,379 |
| Amortization of debt discount | 19,391 | 153,148 |
| Gain on debt restructuring | (9,746,100) | |
| Gain on sale of business | (143,640) | |
| Loss from discontinued operations | 460,660 | 1,169,564 |
| Stock issued for compensation | 28,000 | 132,250 |
| Charge for impairment of capitalized software | | 202,909 |
| Charge for impairment of goodwill | | 1,893,735 |
| Services received in exchange for stock | | 48,127 |
| Changes in assets and liabilities from continuing operations: | | |
| Accounts receivable | 117,062 | (166,608) |
| Inventory | (79,080) | 277,643 |
| Prepaid expenses, deposits and other | (374,705) | 122,053 |
| Assets held for sale | | 704,417 |
| Accounts payable and accrued liabilities | (380,348) | 395,162 |
| Deferred revenue and other | (236,071) | 673,834 |
| Net assets of discontinued operations | 1,016,681 | (2,316,175) |
| Net cash used in operating activities | (103,612) | (2,641,273) |
| Investing activities: | | |
| Purchases of property and equipment | (24,761) | (178,466) |
| Proceeds from sale of Mexican subsidiary | 175,000 | 2,410,305 |
| Proceeds from sale of assets | 301,884 | 787,122 |
| Net cash provided by investing activities | 452,123 | 3,018,961 |
| Financing activities: | | |
| Proceeds from exercise of warrants | | 275,000 |
| Proceeds from note payable | | 384,912 |
| Repayments of subordinated debt | (178,625) | (615,910) |
| Repayment of notes payable | (247,328) | (283,726) |
| Net cash used in financing activities | (425,953) | (239,724) |

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| | | |
|---|---------------|------------|
| Net change in cash and cash equivalents | (77,442) | 137,964 |
| Cash and cash equivalents at beginning of year | 1,029,643 | 344,458 |
| Cash and cash equivalents at end of period | \$ 952,201 | \$ 482,422 |
| Supplemental schedule of non cash investing and finance activities: | | |
| Carrying value of debt cancelled in exchange for issuance of common and preferred stock | \$ 17,720,508 | \$ |
| Fair value of common, preferred stock, and warrants issued in exchange for cancellation of debt | \$ 7,974,408 | \$ |
| 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-K for the year ended June 30, 2002.

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. In the year of adoption, this statement requires the completion of a transitional goodwill impairment evaluation, which is a two-step process. The first step, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered impaired, and the second step of the impairment test is not required. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss. The second step compares the implied fair value of goodwill with the carrying amount of the goodwill. If the carrying amount of the goodwill exceeds the implied fair value of the goodwill, an impairment loss shall be recognized in an amount equal to that excess.

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. Based on this valuation, the \$9.5 million fair value of this reporting unit is in excess of its carrying value of \$5.7 million. Since the fair value of this reporting unit is greater than its carrying value, the goodwill of this reporting unit is not deemed to be impaired.

Segment Reporting

The Company adopted the provisions of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information", in the quarter ended September 30, 2001. As a result, the Company evaluated its operations along two business lines: Automotive Care Franchising and Manufacturing and Distribution. In April 2003, the Manufacturing and Distribution segment was disposed of as a result of the Company's decision to discontinue the operations of this business (see Note 4). The Company no longer evaluates its operations along the previously mentioned business lines.

Stock Options

In December 2002, the FASB issued SFAS 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, which amends SFAS 123, *Accounting for Stock-Based Compensation*. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. SFAS 148 is effective for fiscal years ending after December 15, 2002 and interim periods beginning after such date.

Management has elected to continue to account for the Company's stock-based compensation plans under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and disclose pro forma effects of the plans on net income and earnings per share as provided by SFAS No. 123 and SFAS No. 148. Accordingly, because the fair market value on the date of grant was equal to the exercise price, the Company did not recognize any compensation cost. Had compensation cost for these plans been determined based on the fair value at the grant dates during the nine months ending March 31, 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:

| | Nine Months Ended | |
|--|---------------------------|---------------------------|
| | March 31, 2003 | March 31, 2002 |
| Net income (loss) applicable to common shareholders | \$ 8,909,736 | \$ (7,571,711) |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards*, net of related tax effects | (66,429) | (143,407) |
| Pro forma net income (loss) | \$ 8,843,307 | \$ (7,715,118) |
| Earnings per share: | | |
| Basic and diluted- as reported | \$ 0.60 | \$ (0.72) |
| Basic and diluted- pro forma | \$ 0.60 | \$ (0.74) |
| Weighted average shares: | | |
| Weighted average common shares outstanding Basic | 14,737,444 | 10,486,671 |
| Weighted average common shares outstanding Diluted | 14,748,244 | 10,486,671 |

* *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 April 2002, the FASB issued SFAS 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS 145 rescinds certain standards and modifies certain standards related to the extinguishment of debt and sale-leaseback transactions. The provisions of SFAS 145 are generally effective after May 15, 2002. As a result of the adoption of this standard, the \$9.7 million gain from the Company's debt to equity conversion (see Note 9) was recorded in other income in the accompanying financial statements as opposed to being reflected as an extraordinary item.

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In June 2002, the FASB issued SFAS 146 Accounting for Costs Associated with Exit or Disposal Activities. SFAS 146 establishes standards for accounting for costs associated with exit or disposal activities and nullifies EITF 94-3. The provisions of SFAS 146 are effective for exit or disposal activities that are initiated after December 31, 2002. Adoption of this standard did not have a material effect on the Company's financial statements.

In January 2003, the FASB issued Interpretation Number 46, Consolidation of Variable Interest Entities (FIN 46). This interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, addresses consolidation by business enterprises of variable interest entities. Under current practice, two enterprises generally have been included in consolidated financial statements because one enterprise controls the other through voting interests. FIN 46 defines the concept of variable interests and requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among the parties involved. This interpretation applies immediately to variable interest entities created after January 31, 2003. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The interpretation may be applied prospectively with a cumulative-effect adjustment as of the date on which it is first applied or by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated. The Company is assessing, but at this point does not believe the adoption of FIN 46 will have a material impact on its financial position or results of operations.

Note 4 Discontinued Operations

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. The sale of Worldwide for \$300,000 in cash included inventory and manufacturing equipment with a carrying value of \$93,000. The resulting gain of \$144,000, which included \$63,000 in selling expenses associated with this sale, was recognized in March 2003. Substantially all of the assets of Hydro Spray were sold in April 2003 for \$900,000 to a group led by Ernest Malas, a former director and consultant of the Company's manufacturing division. The Company received \$450,000 in cash and a note for \$450,000, payable to the Company in 75 monthly payments of \$6,000. The Company will record a gain as a result of this transaction in the fourth quarter of fiscal year 2003.

The following assets and liabilities associated with Hydro Spray are classified as held for sale at March 31, 2003:

| | March 31, 2003 |
|--|---------------------------|
| Assets of discontinued business held for sale: | |
| Accounts receivable, net | \$ 411,552 |
| Inventory | 787,710 |
| Property, plant and equipment, net | 184,264 |
| Other | 168,070 |
| Total assets of discontinued business held for sale | \$ 1,551,596 |
| Liabilities of discontinued business held for sale: | |
| Accounts payable and accrued liabilities | \$ 860,637 |
| Deferred revenue | 686,832 |
| Total liabilities of discontinued business held for sale | \$ 1,547,469 |

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 March 31, 2003:

| | March 31, 2003 |
|--|---------------------------|
| Assets of discontinued operations: | |
| Accounts receivable, net | \$ 77,000 |
| Total assets of discontinued operations | \$ 77,000 |
| Liabilities of discontinued operations: | |
| Accounts payable and accrued liabilities | \$ 172,902 |
| Note payable | 24,998 |
| Other | 19,015 |
| Total liabilities of discontinued operations | \$ 216,915 |

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The following amounts related to Worldwide and Hydro Spray have been segregated from continuing operations and reflected as discontinued operations for the nine months ended March 31, 2003 and March 31, 2002:

| | Nine Months Ended March 31, | |
|---------------------------------------|--|--------------------|
| | 2003 | 2002 |
| | (Unaudited) | (Unaudited) |
| Revenues | \$ 3,714,810 | \$ 5,038,755 |
| Expenses: | | |
| Direct costs | 3,003,414 | 4,650,254 |
| General and administrative expense | 1,089,748 | 1,472,850 |
| Depreciation expense | 64,060 | 87,001 |
| Other expense (income) | 18,248 | (1,786) |
| Loss from discontinued operations | (460,660) | (1,169,564) |
| Gain on sale of discontinued business | 143,640 | |
| Net loss from discontinued operations | \$ (317,020) | \$ (1,169,564) |

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 March 31, 2003 and 2002 was 1,859,200 and 1,518,633, 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 | | Nine Months Ended | |
|---|--------------------|-------------------|-------------------|-------------------|
| | March 31, 2003 | March 31, 2002 | March 31, 2003 | March 31, 2002 |
| Numerator: | | | | |
| Income (loss) from continuing operations | \$ 2,873,634 | \$ (1,584,073) | \$ 9,244,023 | \$ (6,402,147) |
| Loss from discontinued operations | (134,448) | (838,278) | (317,020) | (1,169,564) |
| Net income (loss) applicable to common shareholders | \$ 2,721,919 | \$ (2,422,351) | \$ 8,909,736 | \$ (7,571,711) |
| Denominator: | | | | |
| Denominator for basic EPS weighted-average-shares | 15,901,363 | 10,724,308 | 14,737,444 | 10,486,671 |
| Common stock equivalent- stock options | 13,846 | | 10,800 | |
| Denominator for diluted EPS weighted-average-shares | 15,915,209 | 10,724,308 | 14,748,244 | 10,486,671 |
| Basic and diluted income (loss) from continued operations per share | \$ 0.18 | \$ (0.15) | \$ 0.63 | \$ (0.61) |
| Basic and diluted loss from discontinued operations per share | (0.01) | (0.08) | (0.03) | (0.11) |
| Basic and diluted income (loss) applicable to common shareholders per share | \$ 0.17 | \$ (0.23) | \$ 0.60 | \$ (0.72) |

Note 6 - Cash Held in Escrow

In October 2002, the Company received \$175,000 previously held in escrow from the sale of its Mexican subsidiary in January 2002.

Note 7 - Inventory

The components of inventory are as follows:

| | March 31, 2003 | June 30, 2002 |
|--|-------------------|------------------|
| Raw materials. | \$ | \$ 822,613 |
| Work-in-process. | | 183,499 |
| Finished goods. | 70,491 | 241,254 |
| Reserve for obsolete and unsaleable inventory | | (410,000) |
| | \$ 70,491 | \$ 837,366 |

Note 8 - Debt

During fiscal year 2001, the Company was successful in obtaining a new source of financing. The term of this debenture with

Precision Funding LLC had been extended to September 30, 2003. Precision Funding LLC had also waived all debt covenants through September 30, 2003.

On October 26, 2001, Precision Funding, L.L.C., assigned its interest in the Company's trademarks and certain other assets relating to the franchising operations to Precision Franchising, LLC, a wholly owned subsidiary of the Company. In connection with this assignment, the Company pledged all of its membership interest in Precision Franchising, LLC to Precision Funding LLC as collateral for the loan dated September 29, 2000. On October 30, 2002, the pledge was cancelled as a result of the agreement reached on October 30, 2002 (see Note 9).

In addition to the credit facility with Precision Funding LLC, the Company had two outstanding subordinated debenture agreements. Under the terms of each subordinated debenture, payments of principal and interest on certain of the subordinated debt may have only been made by the Company if the Company had made all required payments to Precision Funding or was otherwise not in default under that credit facility.

The first subordinated debenture in the amount of \$2.0 million was executed in October 1998 with an LLC composed of certain members of the Company's board of directors (Board LLC). Originally due October 15, 1999, the Board LLC has since agreed to a revised payment plan consisting of interest only payments of approximately \$6,000 paid monthly from November 2002 to April 2003. Monthly payments of \$15,000 will be made beginning in May 2003 and ending in September 2007. The effective interest rate for the new agreement is 8.68% per annum.

The second subordinated debenture in the amount of \$5.0 million was executed in January 1999 directly with one member of the Company's board of directors. \$1.4 million of the original principal amount had been repaid. Originally due May 25, 1999, the term of this subordinated debenture had been extended to September 30, 2003. The holder had also waived all debt covenants through September 30, 2003. This debenture and related accrued interest was converted to equity as a result of the agreement reached on October 30, 2002 (see Note 9).

Note 9 Debt Restructuring

Debt Restructuring

On October 30, 2002, the Company reached an agreement with Precision Funding, L.L.C. and a current board member to convert approximately \$17.6 million of outstanding debt and accrued interest due to them to equity. In exchange for the extinguishment of the approximately \$17.6 million in outstanding debt and accrued interest due, the Company issued Precision Funding, L.L.C. and the current board member the following:

2.5 million shares of the Company's common stock.

500,000 shares of redeemable preferred stock of the Company with a stated value of \$10.36 per share. These shares are redeemable by the shareholder at any time after the 3rd anniversary of the Issue Date, October 30, 2002 on 30 days prior written notice. The holders of these shares are also entitled to receive, when and as declared by the Board of Directors, cumulative preferential cash dividends at the rate of 2% of the liquidation preference of the

preferred stock, \$10.36 per share, per annum payable quarterly in arrears in cash on the last day, or the next succeeding business day, of January, April, July, and October in each year, beginning January 31, 2003. In May 2003, a cumulative preferential cash dividend of approximately \$17,000 for the two months ended March 31, 2003 was paid upon the declaration and approval of the Board of Directors in April 2003.

Warrants to purchase 11,472,039 shares of the Company's common stock with an exercise price of \$0.44 per share.

Issuance of the warrants was subject to shareholder approval of a proposal to amend the Articles of Incorporation to increase the Company's authorized shares of common stock. Such approval was granted at the annual shareholder meeting held on January 15, 2003. As a result, the Company recognized a gain of approximately \$6.9 million from the exchange of debt with a carrying value of \$12.6 million for common and preferred stock with a fair value of \$5.7 million during the 2nd quarter of fiscal year 2003. The remaining \$2.8 million gain from the exchange of warrants valued at \$2.2 million for the remaining debt with a carrying value of \$5.0 million was recognized in January 2003 when shareholder approval was granted to increase the Company's authorized shares of common stock.

Note 10 Contingencies

A 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.

The Company and several national chains and local auto repair stores are subject to a suit alleging that the defendants use of automatic transmission fluid changing equipment manufactured by and purchased from T-Tech Industries infringed upon a patent owned by Transclean Corporation, the plaintiff. The complaint seeks an unspecified amount of damages, injunctive relief, attorneys' fees and court costs. PACI is defending the allegations in the lawsuit.

Praxis Afinaciones, S.A. de C.V., an indirect wholly owned subsidiary of PACI, is subject to a suit filed by one of its vendors seeking payment of 766,000 Mexican Pesos (approximately \$77,000), plus interest at the rate of 5% per month, for services under a contract. Praxis denies the allegations and intends to vigorously defend the allegations in the lawsuit.

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 and 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. On December 30, 2002, the Court sustained PACI's demurrer to the complaint, with leave to amend. The plaintiff amended the complaint, and PACI's demurrer to the amended complaint was overruled on or about April 21, 2003. PACI's answer is due to be filed within 20 days. In a separate action, PACI is seeking judgment against Gulshan Hirji on her guaranty of a promissory note for \$500,000 plus interest and attorneys' fees.

Super Wash Inc. alleges that it is the owner of a federal trademark "Super Wash", that a customer of Hydro Spray Car Wash Equipment Co., Ltd. infringed that mark through the use of the name "superwashfix" and that the customer was acting on behalf of Hydro Spray Car Wash Equipment Co., Ltd. Hydro Spray denies that the customer was acting on its behalf, denies that it has committed any of the alleged violations and denies that the plaintiff had been damaged. The plaintiff seeks injunctive relief, an unspecified amount of monetary damages, costs and reasonable attorneys' fees.

The Company and its subsidiaries are subject to other litigation in the ordinary course of business, including contract, franchise 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 case of defaults and terminations.

The Company does not believe that any of the above pending legal 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. While any 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 any adverse judgments.

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-K for the fiscal year ended June 30, 2002 filed with the Securities and Exchange Commission on October 15, 2002. Historical results and percentage relationships set forth herein are not necessarily indicative of future operations.

Results of Operations

Comparison of the three months ended March 31, 2003 to the three months ended March 31, 2002

Summary (in thousands)

| | Three Months Ended March 31, | | | |
|--|------------------------------|------|------------|-------|
| | 2003 | % | 2002 | % |
| Automotive care franchising revenue | \$ 2,452 | 89 | \$ 2,511 | 80 |
| Distribution revenue | 183 | 7 | 167 | 5 |
| Other | 126 | 4 | 467 | 15 |
| Total revenues | \$ 2,761 | 100% | \$ 3,145 | 100% |
| Automotive care franchising direct cost | 1,458 | 53 | 1,397 | 44 |
| Distribution direct cost | 142 | 5 | 135 | 5 |
| Other | 51 | 2 | 819 | 26 |
| Total direct cost | 1,651 | 60 | 2,351 | 75 |
| General and administrative | 915 | 33 | 1,259 | 40 |
| Depreciation expense | 102 | 4 | 163 | 5 |
| Amortization of franchise rights & goodwill | | 0 | 341 | 11 |
| Impairment charges | | 0 | | 0 |
| Other operating expense | 1 | 0 | | 0 |
| Operating income (loss) | 92 | 3 | (969) | (31) |
| Gain on debt restructuring | 2,804 | 102 | | 0 |
| Other | (23) | (1) | (615) | (20) |
| Loss from discontinued operations | (134) | (5) | (838) | (26) |
| Net income (loss) | 2,739 | 99 | (2,422) | (77) |
| Preferred stock dividends | 17 | | | |
| Net income applicable to common shareholders | \$ 2,722 | 99% | \$ (2,422) | (77)% |

Revenue. Total revenues for the three months ended March 31, 2003 was \$2.7 million, a decrease of approximately \$384,000, or 12%, compared with total revenues of \$3.1 million for the three months ended March 31, 2002.

Automotive care franchising revenue for the three months ended March 31, 2003 was \$2.4 million, a decrease of approximately \$59,000, or 2%, compared with automotive care revenue of \$2.5 million for the three months ended March 31, 2002.

Distribution revenue for the three months ended March 31, 2003 was \$183,000, an increase of approximately \$16,000, or 10%, compared with distribution revenues of \$167,000 for the three months ended March 31, 2002.

Other revenue for the three months ended March 31, 2003 was \$126,000, a decrease of approximately \$341,000, or 73%, compared to \$467,000 for the three months ended March 31, 2002. This decrease was due primarily to the sale of its company operated stores in Mexico.

Direct Cost. Total direct costs for the three months ended March 31, 2003 totaled \$1.6 million, a decrease of \$700,000 or 30%, compared with \$2.3 million for the three months ended March 31, 2002.

Automotive care franchising direct costs for the three months ended March 31, 2003 totaled \$1.5 million, an increase of \$61,000 or 4%, compared with \$1.4 million for the three months ended March 31, 2002.

Distribution direct costs for the three months ended March 31, 2003 totaled \$142,000, an increase of \$7,000 or 5%, compared with \$135,000 for the three months ended March 31, 2002.

Other direct costs for the three months ended March 31, 2003 totaled \$51,000, a decrease of \$768,000 or 94%, compared with \$819,000 for the three months ended March 31, 2002. This decrease was due primarily to the sale its company operated stores in Mexico.

General and Administrative Expense. General and administrative expense was \$915,000 for the three months ended March 31, 2003, a decrease of \$344,000 or 27%, compared with \$1.3 million for the three months ended March 31, 2002. In the three months ended March 31, 2002, the company incurred legal and accounting costs associated with the sale of the Company's Mexican subsidiary. There were no such costs incurred in the three months ended March 31, 2003. Furthermore, management initiated several cost reductions in the general and administrative costs of the Company for the three months ended March 31, 2003. These cost reduction initiatives are expected to further reduce the Company's general and administrative costs in future periods.

Amortization of Goodwill. The Company adopted SFAS 142 on July 1, 2002, the beginning of the new fiscal year. Accordingly, the Company did not recognize any amortization expense for the three months ended March 31, 2003. The Company recognized \$341,000 of amortization expenses for the three months ended March 31, 2002.

Operating Income (Loss) From Continuing Operations. The Company recorded operating income for the three months ended March 31, 2003 of \$92,000 compared with an operating loss of \$969,000 for the three months ended March 31, 2002. The reduction in operating loss is attributed to the fact that there was no goodwill amortization in the current period and the cost reduction initiatives implemented by management.

Gain on Debt Restructuring. The Company recognized a \$2.8 million gain from a debt to equity conversion in the three months ended March 31, 2003 (see Item 1 - Note 9). The Company recognized a gain from this debt to equity conversion relating to the issuance of warrants in January 2003 upon shareholder approval of a proposal to amend the Articles of Incorporation to increase the Company's authorized shares of common stock.

Other Expense. The Company recorded Other Expense, primarily interest expense, of \$23,000 for the three months ended March 31, 2003, which represents a decrease in Other Expense of approximately \$592,000 or 96% compared to the Other Expense for the three months ended March 31, 2002 when other expenses were \$615,000. This was primarily the result of the reduction in interest expense for the three months ended March 31, 2003 compared to the three months ended March 31, 2002 from the Company's debt to equity conversion (see Item 1 - Note 9).

Loss From Discontinued Operations. The Company recorded a loss from discontinued operations for the three months ended March 31, 2003 of \$134,000 compared with a loss from discontinued operations of \$838,000 for the three months ended March 31, 2002 due to the planned 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 \$2.7 million, or \$0.17 per share, for the three months ended March 31, 2003. This represents an increase of \$5.1 million or 212% compared to the Net Loss Applicable to Common Shareholders of \$2.4 million, or (\$0.23) per share, for the three months ended March 31, 2002.

Comparison of the nine months ended March 31, 2003 to the nine months ended March 31, 2002

Summary (in thousands)

| | Nine Months Ended March 31, | | | |
|---|-----------------------------|------|------------|-------|
| | 2003 | % | 2002 | % |
| Automotive care franchising revenue | \$ 7,919 | 90 | \$ 8,233 | 80 |
| Distribution revenue | 445 | 5 | 653 | 6 |
| Other | 473 | 5 | 1,439 | 14 |
| Total revenues | \$ 8,837 | 100% | \$ 10,325 | 100% |
| Automotive care franchising direct cost | 4,773 | 54 | 5,492 | 53 |
| Distribution direct cost | 329 | 4 | 556 | 5 |
| Other | 244 | 3 | 1,600 | 15 |
| Total direct cost | 5,346 | 60 | 7,648 | 73 |
| General and administrative | 2,966 | 34 | 3,755 | 36 |
| Depreciation expense | 305 | 3 | 531 | 5 |
| Amortization of franchise rights & goodwill | | 0 | 1,023 | 11 |
| Impairment charges | | 0 | 2,096 | 21 |
| Other operating expense | 6 | 0 | | 0 |
| Operating income (loss) | 214 | 3 | (4,728) | (46) |
| Gain on debt restructuring | 9,746 | 110 | | 0 |
| Other | (716) | (8) | (1,674) | (16) |
| Loss from discontinued operations | (317) | (4) | (1,170) | (11) |
| Net income (loss) | 8,927 | 101 | (7,572) | (73) |
| Preferred stock dividends | 17 | | | |
| Net income (loss) applicable to common shareholders | \$ 8,910 | 101% | \$ (7,572) | (73)% |

Revenue. Total revenues for the nine months ended March 31, 2003 was \$8.8 million, a decrease of approximately \$1.5 million, or 14%, compared with total revenues of \$10.3 million for the nine months ended March 31, 2002.

Automotive care franchising revenue for the nine months ended March 31, 2003 was \$7.9 million, a decrease of approximately \$314,000, or 4%, compared with automotive care revenues of \$8.2 million for the nine months ended March 31, 2002. This decrease was the result of a decrease in royalty revenues of \$406,000 offset by an increase in franchise development revenues of \$92,000. Franchise development revenues were higher for the nine months ended March 31, 2003 because the Company sold more domestic and international franchise licenses than it did in the nine months ended March 31, 2002. The decrease in royalty revenues was the result of a decrease in international royalties of \$879,000. The decrease in international royalties was the direct result of the Company's sale of its franchise operations in Mexico in January of 2002. This was offset by an increase in domestic royalties of \$473,000.

Distribution revenue for the nine months ended March 31, 2003 was \$445,000, a decrease of approximately \$208,000, or 32%, compared with distribution revenues of \$653,000 for the nine months ended March 31, 2002. The decrease in distribution sales was primarily the result of the sale of the Mexican subsidiary in January 2002.

Other revenue for the nine months ended March 31, 2003 was \$473,000, a decrease of approximately \$966,000, or 67%, compared to \$1.4 million for the nine months ended March 31, 2002. This decrease was due primarily to the sale of its company operated stores in Mexico.

Direct Cost. Total direct costs for the nine months ended March 31, 2003 totaled \$5.3 million, a decrease of \$2.3 million or 30%, compared with \$7.6 million for the nine months ended March 31, 2002.

Automotive care franchising direct costs for the nine months ended March 31, 2003 totaled \$4.8 million, a decrease of \$719,000 or 13%, compared with \$5.5 million for the nine months ended March 31, 2002. This decrease was primarily the result of the Company's sale of its franchise operations in Mexico in January of 2002.

Distribution direct costs for the nine months ended March 31, 2003 totaled \$329,000, a decrease of \$227,000 or 41%, compared with \$556,000 for the nine months ended March 31, 2002. This decrease is consistent with lower distribution revenues.

Other direct costs for the nine months ended March 31, 2003 totaled \$244,000, a decrease of \$1.4 million or 85%, compared with \$1.6 million for the nine months ended March 31, 2002. This decrease was due primarily to the sale its company operated stores in Mexico.

General and Administrative Expense. General and administrative expense was \$2.9 million for the nine months ended March 31, 2003, a decrease of \$789,000 or 21%, compared with \$3.8 million for the nine months ended March 31, 2002. In the nine months ended March 31, 2002, the company incurred legal and accounting costs associated with the sale of the Company's Mexican subsidiary. There were no such costs incurred in the nine months ended March 31, 2003. Furthermore, management initiated several cost reductions in the general and administrative costs of the Company for the nine months ended March 31, 2003. These cost reduction initiatives are expected to further reduce the Company's general and administrative costs in future periods.

Amortization of Goodwill. The Company adopted SFAS 142 on July 1, 2002, the beginning of the new fiscal year. Accordingly, the Company did not recognize any amortization expense for the nine months ended March 31, 2003. The Company recognized \$1.0 million of amortization expenses for the nine months ended March 31, 2002.

Impairment Charges. The Company recognized a \$2.1 million impairment charge to reduce the amount of goodwill attributed to the company's Mexican subsidiary in the nine months ended March 31, 2002. No similar charges were incurred in the nine months ended March 31, 2003.

Operating Income (Loss) From Continuing Operations. The Company recorded operating income for the nine months ended March 31, 2003 of \$214,000 compared with an operating loss of \$4.7 million for the nine months ended March 31, 2002. The reduction in operating loss is attributed to the fact that there were no impairment charges or goodwill amortization in the current period and the cost reduction initiatives implemented by management.

Gain on Debt Restructuring. The Company recognized a \$9.7 million gain from a debt to equity conversion in the nine months ended March 31, 2003 (see Item 1 - Note 9).

Other Expense. The Company recorded Other Expense, primarily interest expense, of \$716,000 for the nine months ended March 31, 2003, which represents a decrease in Other Expense of approximately \$958,000 or 57% compared to the Other Expense for the nine months ended March 31, 2002 when other expenses were \$1.7 million. This was primarily the result of the reduction in interest expense as a result of the Company's debt restructuring (see Item 1 - Note 9).

Loss From Discontinued Operations. The Company recorded a loss from discontinued operations for the nine months ended March 31, 2003 of \$317,000 compared with a loss from discontinued operations of \$1.2 million for the nine months ended March 31, 2002 relating to the planned 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 \$8.9 million, or \$0.60 per share, for the nine months ended March 31, 2003. This represents an increase of \$16.5 million or 218% compared to the Net Loss Applicable to Common Shareholders of \$7.6 million, or (\$0.72) per share, for the nine months ended March 31, 2002.

Liquidity and Capital Resources

Sources and Uses of Cash

Cash at March 31, 2003 was \$952,000. This was decrease of \$77,000 from June 30, 2002. During the period, cash used in operations was \$103,000. The Company expects to be able to meet all of its operating obligations by reductions in operating expenses and improved receivable collections. In the event that the Company has difficulty in meeting obligations, the Company expects that they will be able to borrow money from certain shareholders and/or officers on a short-term basis, although absolute assurance cannot be given that it would be successful in doing so.

Cash provided by investing activities for the nine months ended March 31, 2003 was \$452,000 resulting primarily from the sale of assets in the Company's manufacturing operations.

Cash used in financing activities for the nine months ended March 31, 2003 was \$426,000. Cash used in financing activities during the period consisted of repayments of the subordinated debt and other notes payable.

Debt Transactions

During fiscal year 2001, the Company was successful in obtaining a new source of financing. The term of this debenture with Precision Funding LLC had been extended to September 30, 2003. Precision Funding LLC had also waived all debt covenants through September 30, 2003.

On October 26, 2001, Precision Funding, L.L.C., assigned its interest in the Company's trademarks and certain other assets relating to the franchising operations to Precision Franchising, LLC, a wholly owned subsidiary of the Company. In connection with this assignment, the Company pledged all of its membership interest in Precision Franchising, LLC to Precision Funding LLC as collateral for the loan dated September 29, 2000. On October 30, 2002, the pledge was cancelled as a result of the agreement reached on October 30, 2002 (see below).

In addition to the credit facility with Precision Funding LLC, the Company had two outstanding subordinated debenture agreements. Under the terms of each subordinated debenture, payments of principal and interest on certain of the subordinated debt may have only been made by the Company if the Company had made all required payments to Precision Funding or was otherwise not in default under that credit facility.

The first subordinated debenture in the amount of \$2.0 million was executed in October 1998 with an LLC composed of certain members of the Company's board of directors (Board LLC). Originally due October 15, 1999, the Board LLC has since agreed to a revised payment plan consisting of interest only payments of approximately \$6,000 paid monthly from November 2002 to April 2003. Monthly payments of \$15,000 will be made beginning in May 2003 and ending in September 2007. The effective interest rate for the new agreement is 8.68% per annum.

The second subordinated debenture in the amount of \$5.0 million was executed in January 1999 directly with one member of the Company's board of directors. \$1.4 million of the original principal amount had been repaid. Originally due May 25, 1999, the term of this subordinated debenture had been extended to September 30, 2003. The holder had also waived all debt covenants through September 30, 2003.

On October 30, 2002, the Company reached an agreement with Precision Funding, L.L.C. and a current board member to convert approximately \$17.6 million of outstanding debt and accrued interest due to them to equity. In exchange for the extinguishment of the approximately \$17.6 million in outstanding debt and accrued interest due, the Company issued Precision Funding, L.L.C. and the current board member the following:

2.5 million shares of the Company's common stock.

500,000 shares of redeemable preferred stock of the Company with a stated value of \$10.36 per share. These shares are redeemable by the shareholder at any time after the 3rd anniversary of the Issue Date, October 30, 2002 on 30 days prior written notice. The holders of these shares are also entitled to receive, when and as declared by the Board of Directors, cumulative preferential cash dividends at the rate of 2% of the liquidation preference of the preferred stock, \$10.36 per share, per annum payable quarterly in arrears in cash on the last day, or the next succeeding business day, of January, April, July, and October in each year, beginning January 31, 2003. In May 2003, a cumulative preferential cash dividend of approximately \$17,000 for the two months ended March 31, 2003 was paid upon the declaration and approval of the Board of Directors in April 2003.

Warrants to purchase 11,472,039 shares of the Company's common stock with an exercise price of \$0.44 per share.

Issuance of the warrants was subject to shareholder approval of a proposal to amend the Articles of Incorporation to increase the Company's authorized shares of common stock. Such approval was granted at the annual shareholder meeting held on January 15, 2003. As a result, the Company recognized a gain of approximately \$6.9 million from the exchange of debt with a carrying value of \$12.6 million for common and preferred stock with a fair value of \$5.7 million during the 2nd quarter of fiscal year 2003. The remaining \$2.8 million gain from the exchange of warrants valued at \$2.2 million for the remaining debt with a carrying value of \$5.0 million was recognized in January 2003 when shareholder approval was granted to increase the Company's authorized shares of common stock.

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. Severe winter weather and rainy conditions may also adversely impact the Company's sale and installation of car wash equipment.

ITEM 3. CONTROLS AND PROCEDURES

Within the 90 days prior to the date of this Form 10-QSB, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's President and Chief Executive Officer along with the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Company's President and Chief Executive Officer along with the Company's Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings. There have been no significant changes in the Company's internal controls or in other factors which could significantly affect internal controls subsequent to the date the Company carried out its evaluation.

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:

Previously Reported Cases:

Transclean Corporation et al. v. Ashland, Inc. et al., U. S. District Court, District of Minnesota, Civil No. 02-CV-1138-PAM/JGL, Filed July 8, 2002.

Transclean Corporation filed suit against PACI and several national chains and local auto repair stores alleging that the defendants' use of automatic transmission fluid changing equipment manufactured by and purchased from T-Tech Industries infringed upon a patent owned by Transclean. The complaint seeks an unspecified amount of damages, injunctive relief, attorneys' fees and court costs. PACI denies the allegations and is defending the allegations in the lawsuit.

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 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 and 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. On December 30, 2002, the Court sustained PACI's demurrer to the complaint, with leave to amend. The plaintiff amended the complaint, and PACI's demurrer to the amended complaint was overruled on or about April 21, 2003. PACI's answer is due to be filed within 20 days. In a separate action, PACI is seeking judgment against Gulshan Hirji on her guaranty of a promissory note for \$500,000 plus interest and attorneys' fees.

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.

Super Wash Inc. v. Mike Judge, an individual, d/b/a Super Wash fix, d/b/a Wash Pro LLC and Hydro Spray, Case No. 02-CV-1180, filed in the United States District Court for the Central District of Illinois.

The plaintiff alleges that it is the owner of a federal trademark "Super Wash", that the defendant Judge has infringed that mark through the use of the name "superwashfix" and that Judge was acting on behalf of the Company's subsidiary, Hydro Spray Car Wash Equipment Co., Ltd. ("Hydro Spray"). In addition to trademark infringement (both statutory and common law), the plaintiff has alleged violations of the Lanham Act, the Illinois Uniform Deceptive Trade Practices Act, the Illinois Consumer Fraud and Deceptive Business Practices Act, Tortious Interference and Cyberpiracy based on alleged use of the term "superwashfix" by Judge. The plaintiff seeks injunctive relief, along with an unspecified amount of monetary damages, costs and reasonable attorneys' fees. Hydro Spray denies that Judge was acting on its behalf, denies that it has committed any of the alleged violations and denies that the plaintiff has been damaged. Discovery has been initiated but not completed. The case is presently set for trial beginning December 18, 2003. The defendant Judge has admitted limited use of the term "superwashfix" but claims he made no sales in connection therewith and claims to have immediately ceased all use of the term on demand from the plaintiff.

The Company and its subsidiaries are subject to other litigation in the ordinary course of business, including contract, franchise 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 case of defaults and terminations.

The Company does not believe that any of the above pending legal 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. While any 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 any adverse judgments.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

The information concerning defaults and the subsequent cure thereof with respect to the Company's indebtedness contained in Note 8 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

99.1* Written statement of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith

(b) Reports on Form 8-K

(i) On May 1, 2003, a Form 8-K was filed related to Precision Auto Care, Inc.'s sale of substantially all of the assets of its Hydro Spray Car Wash Equipment Co., Ltd. subsidiary.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on May 15, 2003.

Precision Auto Care, Inc.

By: /s/ Louis M. Brown, Jr.
Louis M. Brown, Jr.
President and 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.

| Signature | Title | Date |
|--|--|--------------|
| /s/ Louis M. Brown, Jr. Louis M. Brown, Jr. | President, Chief Executive Officer and Director (Principal Executive Officer) | May 15, 2003 |
| /s/ Robert R. Falconi Robert R. Falconi | Executive Vice President and Chief Operating Officer and Director (Principal Financial Accounting Officer) | May 15, 2003 |

Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Louis M. Brown, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Precision Auto Care, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

| Signature | Title | Date |
|-------------------------|--|--------------|
| /s/ Louis M. Brown, Jr. | President, Chief Executive Officer and Director | May 15, 2003 |
| Louis M. Brown, Jr. | (Principal Executive Officer) | |

Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Robert R. Falconi, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Precision Auto Care, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

| Signature | Title | Date |
|-----------------------|--|--------------|
| /s/ Robert R. Falconi | Executive Vice President and Chief Operating Officer and Director (Principal Financial Accounting Officer) | May 15, 2003 |
| Robert R. Falconi | | |