

PRECISION AUTO CARE INC
Form 10KSB
September 27, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended June 30, 2005

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 0-29478

PRECISION AUTO CARE, INC.

(Name of small business issuer 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)

703-777-9095
(Issuer's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value \$.01 per share

Check whether the issuer (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

Check if no disclosure of delinquent filers in response to Item 405 of Regulation S-B is contained in this form, and no disclosure will be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

The issuer's revenues for its most recent fiscal year were: \$12,802,979.

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The aggregate market value of Common Stock held by persons not affiliated with the issuer at August 15, 2005 was \$21,627,005 based on the closing price of \$0.90 per share. As of August 15, 2005, 28,932,252 of Common Stock were issued and outstanding.

Transitional Small Business Disclosure Format: Yes No

DOCUMENTS INCORPORATED BY REFERENCE:

Certain portions of Registrant's definitive proxy statement, to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the close of the Corporation's fiscal year, are incorporated by reference under Part III.

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FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements within the meaning of the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934. When used in this report, the words anticipate, believe, estimate, expect, intend and plan as they are used by Precision Auto Care, Inc. or its management are intended to identify such forward-looking statements. All statements regarding Precision Auto Care, Inc. or Precision Auto Care, Inc.'s expected future financial position, business strategy, cost savings and operating synergies, projected costs and plans, and objectives of management for future operations are forward-looking statements. Although Precision Auto Care, Inc. believes the expectations reflected in such forward-looking statements are based on reasonable assumptions, no assurance can be given that such expectations will prove to have been correct. Important factors that could cause actual results to differ materially from the expectations reflected in the forward-looking statements herein include, among others, the factors set forth 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.

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PART I

Item 1. *Business*

OVERVIEW

Precision Auto Care, Inc. (*PACI* or the *Company*) is a franchisor of automotive service centers located in the United States and in certain foreign countries. At June 30, 2005, the Company had 29 total employees of which 26 are full time employees. Through its franchised centers, services are provided to automobile owners and focus on those high-frequency items required on a periodic basis to maintain the vehicle properly.

The Company was incorporated as a Virginia corporation in April 1997, but its predecessors have been in the automotive maintenance services business since 1976. The first Precision Tune was established in 1976 to provide quick, convenient and inexpensive engine tune-ups. Franchising of Precision Tune centers began the next year. As automotive technology changed, Precision Tune expanded its menu of offered automotive maintenance and repair services to include oil changes, fuel injection service, air conditioning service, cooling system service, brake service and more diagnostic services. In September 1996, the Precision Tune brand name was changed to Precision Tune Auto Care to reflect the shift in emphasis.

The Company is the result of the November 1997 combination of WE JAC Corporation (the owner of Precision Tune Auto Care) and nine other automotive maintenance services companies in connection with its initial public offering. With the goal of returning focus on core operations, the Company disposed of ancillary business segments with the result the Company now has one business segment, Automotive Care Franchising. The Automotive Care Franchising business segment, which is comprised of Precision Tune Auto Care (*PTAC*) and Precision Lube Express, provides automotive services primarily through franchised operations located in the United States and in certain foreign countries.

- Through its franchisees, PTAC provides automotive maintenance and repair services, such as engine performance, oil change and lubrication and brake services, which require relatively short service times. At June 30, 2005, these services were provided at 425 Precision Tune Auto Care centers owned and operated by franchisees.
- Precision Lube Express franchisees and licensees provide convenient fast oil change and lube services. At June 30, 2005, there was 1 Precision Lube Express center owned and operated by a franchisee. In the future, the Company does not plan to sell additional Precision Lube Express franchises.

OPERATIONS

Precision Tune Auto Care

Precision Tune Auto Care is a franchisor of automotive service centers that provide specialized quality maintenance and repair services that require relatively short service times. The automotive care services provided by Precision Tune Auto Care centers include the diagnosis, maintenance and repair of ignition systems, fuel systems, computerized engine control systems, cooling systems, starting/charging systems, emissions control systems, engine drive train systems, electrical systems, air conditioning systems, oil and other fluid systems, and brake systems. The Company has recently made the decision to sell tires and tire related services at the centers as well.

Prototype Center. The current prototype Precision Tune Auto Care center is a free-standing building with six to eight service bays, of which two to four are drive-through and include pits to facilitate fast oil change and lubrication services. Franchisees typically develop Precision Tune Auto Care centers either by

entering into a build-to-suit lease, under which the landlord constructs the center and leases it to the franchisee, or by purchasing land and building the facility. The Company typically seeks sites in commercial areas with a minimum population of 50,000 people within a five mile radius. Exclusive of real estate, the estimated capital required to open a prototype Precision Tune Auto Care center ranges from \$123,000 to \$208,075.

Retail Marketing. Precision Tune Auto Care's marketing objectives at the retail level are to increase franchisee sales, enhance first-time customers' experiences, and bolster each franchisee's customer retention efforts. To further these objectives, Precision Tune Auto Care has developed and implemented a marketing plan containing programs and materials for use by Precision Tune Auto Care centers. The plan includes targeted marketing programs designed to reach key market segments, in-store merchandising materials designed to enhance retail sales and first time customer trials, and other local marketing materials (e.g., second car discounts, service reminder cards, and ATM receipt coupons) designed to generate customers and improve customer retention.

Training and Operational Support. A significant element of Precision Tune Auto Care's commitment to service is its training program for franchisees. New franchisees are required to successfully complete over 40 hours of initial training at its national training center in Leesburg, Virginia. The Company also offers a full line of technical training, including courses on engine performance, fuel systems and emissions, automotive electronics, fuel injection, and brake certification. These courses, which include both classroom and hands-on training, are designed to allow franchisees and service center technicians to maintain and update their technical capability to service today's more complex vehicles.

Franchise Marketing. The Company (through a predecessor company) has marketed franchises for Precision Tune Auto Care centers since 1977. Its franchise sales process includes advertising in appropriate franchise and business publications, establishing relationships and working with sales brokers, conducting franchise sales seminars, maintaining a home page on the Internet through which interested parties may submit a franchise inquiry, and advertising on several franchise sales orientated web sites. Prospective franchisees are asked to complete a Confidential Qualifications Report, which serves as the initial screening to determine whether a prospect is qualified. The Company seeks individuals with management experience who will make a full-time commitment to the operation of their franchise and who have a minimum of \$70,000 and \$250,000 in liquid assets and net worth, respectively.

Precision Tune Auto Care's area-development system has played a significant role in its franchise development efforts. Under this system, Precision Tune Auto Care has entered into area-development agreements that grant area developers the right and obligation to develop franchises within specific geographic regions for stated periods of time. Franchise agreements within the area are between the Company and the franchisee. The area developer typically receives up to one-half of the initial franchise fee, one-half of the subsequent royalty revenues and one-half of franchise renewal and transfer fees. After the creation of a franchise, the area developer performs many of Precision Tune Auto Care's franchise support obligations. As of June 30, 2005, 15 area developers and their affiliates had an ownership interest in approximately 29% of the total number of Precision Tune Auto Care centers.

Open Area Development. Precision Tune Auto Care's current strategy is also to pursue new area developers to develop open areas in which current area developers have not been granted rights. To attract new area developers, the company employs strategies similar to those used in marketing unit franchises. However, the net worth requirements for prospective area developers are greater than those required for a unit franchisee. These requirements range from \$250,000 to \$1,000,000 net worth, depending upon the size of the particular area.

FRANCHISING ACTIVITIES

Precision Tune Auto Care. As of June 30, 2005, all of Precision Tune Auto Care domestic and international centers were owned and managed by franchisees. Precision Tune Auto Care's franchises have been sold during the preceding years under franchise agreements that vary in detail as the Precision Tune Auto Care's franchise program has evolved. Royalty rates in existing franchise agreements are 7.5%. Currently, Precision Tune Auto Care's standard franchise agreement requires payment to the Company of an initial franchise fee of \$25,000 and a continuing royalty of 7.5% of weekly gross receipts. In addition, the franchisee is required to contribute to or expend up to 9% of weekly gross receipts on advertising, of which 1.5% is currently paid into the national marketing fund and up to 7.5% of which is spent locally. The current standard form franchise agreement has an initial term of ten years and provides for five-year renewal options.

The Company has implemented a program under which qualified franchisees are eligible to have their royalty rate reduced to as low as 6% if they satisfy certain criteria. Under the program, franchisees are also provided with an incentive to purchase additional Precision Tune Auto Care franchises. Any franchisee that has owned and operated a center for at least one year in accordance with this program will be charged an initial franchise fee of \$15,000 for a second franchise and \$10,000 for each additional franchise purchased, provided certain conditions are met.

Under its current form of franchise agreement, the Company has a continuing obligation to make technical and administrative support available, centralized marketing support, and training and related support available to its franchisees. In areas where there are area developers, the Company has delegated most of these duties to area developers under its area developer system.

Upon non-renewal and transfer, the Company has the first right to purchase the operating assets and obtain an assignment of leased facilities in certain cases. In certain situations, the Company will repurchase franchise rights. The decision to repurchase is made solely at its discretion and is not a contractual obligation. The Company also periodically obtains possession of some franchisees' franchise rights by exchanging for such rights notes payable or other consideration, or by exercising rights outlined in the franchise agreements.

The Company also enters into master franchise agreements to develop international markets. At the present time, the Company has master franchise agreements in Taiwan, Oman, Indonesia, United Arab Emirates, the Dominican Republic, Peru, Brazil, El Salvador, Ecuador, Saudi Arabia, China, Spain and Portugal. Generally, the master franchisee pays a license fee and is required to develop Precision Tune Auto Care centers in accordance with an agreed upon schedule within the defined area. Franchise agreements within the area are between the master franchisee and the unit franchisee. The master franchisee is required to perform all of the obligations of the franchisor including training, administrative and operational support, and the Company generally receives 20% of the initial franchise fee and up to one-third of ongoing royalty fees.

CO-BRANDING

On March 20, 2000, the Company entered into an agreement with Petro USA, Inc., a subsidiary of Getty Petroleum Marketing, Inc., to provide Getty's dealers with the opportunity to host a Precision Tune Auto Care franchise. This co-branding program involves a planned association of two distinct brands, which are typically associated with different business concepts. At June 30, 2005, there were five Getty stores that were hosting Precision Tune Auto Care centers.

The Company is seeking to enter into other similar alliance agreements or other related agreements, where its franchised businesses will be the secondary tenant at the primary tenant's location. The

co-branding program may have separate agreements with the primary tenant's organization or its affiliates to assist Precision Tune Auto Care in the offer of franchises to the primary tenants and the provision of services. The Company expects that these co-branding opportunities will be with other providers of automotive services not similar to its own, like gasoline stations, detail, paint and body work stations, tire shops, glass shops, and muffler shops. Due to the nature of these co-branding relationships, the Company expects to modify its standard form of franchise agreement to reflect the differences or similarities between its businesses. Some of these primary tenants may be in direct competition with the Company and may choose not to franchise their particular location. Additionally, the Company makes the final decision as to entering into a franchise agreement with a primary tenant.

COMPETITION

The Company's franchisees and licensees encounter competition in all aspects of their business, including the sale by Precision Tune Auto Care and Precision Lube Express centers of automotive maintenance and repair services and fast oil and lubrication services. The Company believes that automobile dealerships, including recently emerging national and regional new and used auto dealerships, represent Precision Tune Auto Care's principal competitors. Other Precision Tune Auto Care competitors include tire companies and regional under-the-hood service specialists. National competitors within Precision Tune Auto Care's market include Sears Auto Center and the automotive maintenance centers operated by Goodyear, Midas, Meineke and Firestone, among others. The Company believes that the greater technical complexity of today's vehicles provides a substantial barrier to entry for competitors in the under-the-hood segment of the automotive care services industry.

The Company believes that the Precision Tune Auto Care centers all compete on the basis of customer awareness through advertising, service, convenience and location and, to a lesser extent, on price. The Company believes that the potential ability to offer all of the services provided by each of the operations at one center or in centers in close proximity to one another will be a significant competitive advantage.

GOVERNMENT REGULATION

Franchising Regulation. The Company is subject to federal, international and state laws and regulations, including the regulations of the Federal Trade Commission as well as similar authorities in individual states, in connection with the offer, sale and termination of franchises and the regulation of the franchisor/franchisee relationship. From time to time, the Company experiences periods during which sales are restricted while the Company registers updates of its disclosure material with various states. Such delays may have an adverse effect on its ability to offer and sell franchises. In addition, the Company may become subject to litigation with, or other claims filed with state, federal or international authorities by, franchisees or area developers based on alleged unfair trade practices, implied covenants of good faith and fair dealing or express violations of agreements. The failure by the Company to comply with these laws could subject the Company to liability to franchisees and to fines or other penalties imposed by governmental authorities and could have a material adverse effect on its financial condition and results of operations.

Environmental Regulation. Precision Tune Auto Care and Precision Lube Express centers store new oil and handle large quantities of used automotive oils and fluids. As a result of these activities, the Company, its franchisees and area developers are subject to various federal, state and local environmental laws and regulations dealing with the transportation, storage, presence, use, disposal and handling of hazardous materials and hazardous wastes, and underground fuel storage tanks. If any such substances were improperly released or improperly stored on the property of any franchisee, including leased properties, or if the Company were found to be in violation of applicable environmental laws and

regulations, the Company could be responsible for clean-up costs, property damage and fines or other penalties, any one of which could have a material adverse effect on its financial condition and results of operations.

TRADEMARKS

The Company has registered a number of trademarks and service marks with the United States Patent and Trademark Office, including Precision Tune Auto Care. Its failure to obtain and maintain trademark and service mark registration could have a material adverse effect on its operations. The Company has also registered or made application to register trademarks in foreign countries where master franchise licenses have been granted.

SEASONALITY

Seasonal changes may impact various sectors of the Company's businesses and, accordingly, its operations may be adversely affected by seasonal trends in certain periods. In particular, severe weather in winter months may make it difficult for consumers in affected parts of the country to travel to Precision Tune Auto Care and obtain services.

RISK FACTORS

The Company's business and investment in its Common Stock are subject to certain risks, including the following:

Stock Listing. The Company's common stock trades on the National Association of Securities Dealers, Inc.'s OTC Bulletin Board. Like other stocks traded over this quotation system, its common stock is thinly traded, highly volatile and not followed by analysts.

Penny Stock Regulations. The Company's common stock is subject to the rules promulgated under the Securities Exchange Act of 1934, as amended, relating to penny stocks. These rules require brokers selling securities subject to these rules to persons other than established customers and institutional accredited investors to complete certain documentation, make suitability inquiries of investors, and provide investors with certain information concerning the risks of trading in the security. These rules may restrict the ability of brokers to sell the Company's common stock and thus may have an adverse effect on the liquidity and market price of its common stock.

Resale Restrictions on Common Stock. Because of large broker-dealer spreads, investors may be unable to sell the stock immediately back to the broker-dealer at the same price the broker-dealer sold the stock to the investor. In some cases, the stock may fall quickly in value. The market among broker-dealers may not be active, making it more difficult for investors to sell this stock. Investors in a penny stock often are unable to sell stock back to the dealer that sold them the stock. The mark-ups or commissions charged by the broker-dealers may be greater than any profit a seller may make.

Penny Stock Market. Shareholders should be aware that, according to Securities and Exchange Commission Release No. 34-29093, the market for penny stocks has suffered in recent years from patterns of fraud and abuse which could cause investors to lose their entire investment. Such patterns include:

- control of the market for the security by one or a few broker-dealers that are often related to the promoter or issuer;
- manipulation of prices through prearranged matching of purchases and sales and false and misleading press releases;

- boiler room practices involving high pressure sales tactics and unrealistic price projections by inexperienced sales persons;
- excessive and undisclosed bid-ask differentials and mark-ups by selling broker-dealers; and
- the wholesale dumping of the same securities by promoters and broker-dealers after prices have been manipulated to a desired level, along with the inevitable collapse of those prices with consequent investor losses.

The Company's management is aware of the abuses that have occurred historically in the penny stock market. Although it does not expect to be in a position to dictate the behavior of the market or of broker-dealers who participate in the market, it will strive within the confines of practical limitations to prevent the described patterns from being established with respect to its securities.

Competition. The automotive services industry is highly competitive. The Company believes that automobile dealerships, including recently emerging national and regional new and used auto dealerships, represent the principal competitors for Precision Tune Auto Care and Precision Lube Express service centers; however, these service centers also compete with national and regional fast oil change and lube companies, major oil manufacturers, local service stations and local, regional and national automobile maintenance and repair service providers.

The Company believes the principal competitive factors in the markets serviced by each of its business units are location, name recognition and reputation, and quality of service and price.

The Company also competes with some of those noted above and with other parties in the sale of franchises. Competitive factors include startup costs, royalty rates, franchisee support and the financial performance of existing centers. With respect to the sales of supplies and equipment for franchisees, competition is based on availability, price, ability to provide prompt delivery and the quality of support services.

Certain competitors discussed above have greater financial resources than the Company does. There can be no assurance that the Company or individual Precision centers will be able to compete effectively. *See Business—Competition.*

Reliance on Franchising. Franchise royalties are a significant component of its revenue base. Therefore, the Company depends upon the ability of its franchisees to promote and capitalize upon the Precision brand and the reputation the Company believes the Company enjoys for quality and value. There can be no assurance that the Company or our area developers will be able to recruit and retain franchisees with the business abilities or financial resources necessary to open Precision Tune Auto Care centers on schedule or that the franchisees will conduct operations profitably. In addition, to the extent that franchisees finance their operations with secured indebtedness, the Company's rights to receive franchise royalties would be effectively subordinated to the rights of franchisees' lenders. *See Business—Operations.*

Automotive Technology Advances. The demand for the services offered by its Precision Tune Auto Care and Precision Lube Express centers could be adversely affected by continuing developments in automotive technology. Automotive manufacturers are producing cars that last longer and require service and maintenance at less frequent intervals. For example, some manufacturers now recommend that consumers change oil at 10,000 mile intervals and replace spark plugs and other engine components at 100,000 miles, a significant increase from the mileage intervals recommended for earlier models and those currently recommended by most manufacturers. The demand for its services also could be adversely affected by longer and more comprehensive warranty programs offered by automobile manufacturers and other third parties. The Company believes that a majority of new automobile owners have their cars

serviced by a dealer during the period the car is under warranty. In addition, advances in automotive technology may require the Company to incur additional costs to update its technical training program and upgrade the diagnostic capabilities of its centers.

Labor Availability. The provision of high quality maintenance services by Precision Tune Auto Care centers requires an adequate supply of skilled labor. In addition, the operating costs and operating revenues of such centers may be adversely affected by high turnover in skilled technicians. Trained and experienced automotive technicians are in high demand. Accordingly, a center's ability to increase productivity and revenues could be affected by its inability to maintain the employment of skilled technicians necessary to provide the center's services. There can be no assurance that Precision Tune Auto Care or its franchisees will be able to attract and maintain an adequate skilled labor force necessary to operate these centers efficiently or that labor expenses will not increase as a result of a shortage in the supply of skilled technicians, thereby adversely impacting its financial performance.

Dependence on Management and Key Personnel. The Company's success depends to a significant extent on the performance and continued services of senior management and certain key personnel. The Company believes these individuals possess the necessary experience in financing, operating and managing a company intent on improving its financial performance. The loss of the services of one or more of these key employees could have a material adverse impact on its financial condition and results of operations.

Seasonal Nature of Portions of the Business. Seasonal changes may impact various sectors of its businesses and, accordingly, its operations may be adversely affected by seasonal trends in certain periods. In particular, severe weather in winter months may make it difficult for consumers in affected parts of the country to travel to Precision Tune Auto Care and Precision Lube Express centers and obtain services.

Control by Management and Principal Shareholders. As of August 15, 2005, the Company's directors, executive officers and shareholders beneficially owning more than 5% of its outstanding common stock, in the aggregate, beneficially owned approximately 81% of its outstanding common stock. Accordingly, these persons have substantial influence over its affairs, including the ability to influence the election of directors and appointment of management, the outcome of votes by its shareholders on major corporate transactions, including mergers and the sales of substantial assets and other matters requiring shareholder approval.

Franchising Regulations. The Company is subject to federal, international and state laws and regulations, including the regulations of the Federal Trade Commission as well as similar authorities in individual states, in connection with the offer, sale and termination of franchises and the regulation of the franchisor/franchisee relationship. *See*

Business—Government Regulation. Its failure to comply with these laws could subject the Company to liability to franchisees and to fines or other penalties imposed by governmental authorities. From time to time, the Company experiences periods during which sales are restricted while the Company registers updates of its disclosure material with various states. Such delays may have an adverse effect on its ability to offer and sell franchises. In addition, the Company may become subject to litigation with, or other claims filed with state, federal or international authorities by, franchisees or area developers based on alleged unfair trade practices, implied covenants of good faith and fair dealing or express violations of agreements. Accordingly, its failure to comply with applicable franchise laws and regulations could have a material adverse effect on its financial condition and results of operations.

Environmental Regulation. Precision Tune Auto Care and Precision Lube Express centers store new oil and handle large quantities of used automotive oils and fluids. Precision Auto Wash centers (which were formerly franchise operations under the PACI umbrella) used chemicals in the washing process. These chemicals, along with oils, fluids and other chemicals washed off of the vehicle were collected with the waste water from the car wash process. As a result of these activities, the Company, its franchisees and area developers are subject to various federal, state and local environmental laws and regulations dealing

with the transportation, storage, presence, use, disposal and handling of hazardous materials and hazardous wastes, discharge of storm water, and underground fuel storage tanks. If any such substances were improperly released or improperly stored on its property or the property of any franchisee, including leased properties, or the Company were found to be in violation of applicable environmental laws and regulations, the Company could be responsible for clean-up costs, property damage and fines or other penalties, any one of which could have a material adverse effect on its financial condition and results of operations. See Business—Government Regulation.

EXECUTIVE OFFICERS OF PRECISION AUTO CARE, INC.

Louis M. Brown, Jr., age 62, became Chairman of the Board in October 2003. He also remains Chief Executive Officer. He is Vice Chairman of Micros Systems, Inc. since April 2003 and was Chairman of the Board from January 1987 to April 2003.

Robert R. Falconi, age 51, became President in October 2003. He also remains Chief Operating Officer and Chief Financial Officer. From March 2002 to October 2003, he was Executive Vice President and Chief Operating Officer/Chief Financial Officer. From September 2000 to February 2002, he was the Company's Vice President Finance, Administration and Chief Financial Officer. From August 1998 until September 2000, he was Chief Financial Officer of Apptis, Inc.

Frederick F. Simmons, age 43, became Senior Vice President, General Counsel and Secretary in March 2001. From December 1995 to February 2001, he was Assistant General Counsel and Assistant Secretary of Advantica Restaurant Group, Inc.

John T. Wiegand, age 43, became Senior Vice President Operational Programs and Training in March 2002. From August 2000 to March 2002, he was Senior Vice president of Franchise Operations and from June 1998 to August 2000, he was Vice President of North American Operations. Mr. Wiegand joined WE JAC Corporation, the Company's predecessor, as Director of Field Operations in August 1996.

Kevin Bates, age 43, became Senior Vice President of Marketing in August 2004. From October 1999 to August 2004, Mr. Bates was Vice President Marketing and Advertising. From January 1998 until October 1999, he was our Director of Field Operations.

Joel Burrows, age 48, became Vice President Training/Research and Development in September 1999. From December 1997 until September 1999, he was the PTAC Director of Training/Research and Development.

Glyn D. Massingill, age 59, became Vice President Franchise Services in January 2000. From September 1990 through December 1999, Mr. Massingill was Vice President and General Manager of Precision Automotive Components Manufacturing and Distribution (PAC), a division of the Company.

Mark P. Francis, age 39, became Controller in October 2004. From April 2004 until October 2004, Mr. Francis was the Assistant Controller of the Company. From December 1999 until April 2004, he was an accounting manager of REHAU, Inc.

Item 2. Properties

The Company's corporate headquarters are located in approximately 18,000 square feet of leased office space in Leesburg, Virginia pursuant to a lease that expires in 2009.

In the opinion of management, the Company's current space is adequate for its operating needs.

Item 3. *Legal Proceedings*

From time to time, the Company and its subsidiaries are subject to 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. As of the date hereof, there are no such lawsuits pending against the Company.

Previously Reported Cases:

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 Puyallup Auto Stop Associates (PASA) seeks an amount to be determined at trial and attorney's fees. PASA claims PTW breached a real property lease between the parties and seeks 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). Under the terms of the sublease and a consent judgment between PTW and the Ertmans, the Ertmans have an obligation to indemnify PTW in the event PTW incurs any liability in this matter. On March 30, 2005, PASA amended its complaint to include two other, third-party, defendants. PTW has not yet filed an answer in this matter. However, on April 14, 2005 PTW provided to PASA an offer to settle this matter for a lump-sum payment of \$10,000. PASA has not responded to PTW's settlement offer. Trial is scheduled for March 20, 2006.

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.

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

Precision Franchising LLC v. Davis Tune, Inc. et al., Federal District Court for the Eastern District of Virginia

On February 15, 2005, PFL was served with a complaint in which franchisee Davis Tune, Inc. sought damages in excess of \$30,000. Davis Tune, Inc. and its two shareholders, Mr. Donald Roe and Ms. Shirley F. Roe, were also defendants in a related action filed by PFL on November 1, 2004.

On June 10, 2005, the parties entered into a settlement agreement resolving both matters. Under the terms of the settlement Davis Tune, Inc. agreed to: (1) renew one of its Franchise Agreements that had expired and to re-brand the associated location as a Precision Tune Auto Care center; (2) pay

approximately \$11,000 in delinquent fees, and (3) pay PFL \$75,000 in the event it fails to comply with all agreements between the parties.

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

Item 4. *Submission of Matters to a Vote of Security Holders*

None.

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PART II**Item 5. Market for Common Equity and Related Stockholder Matters**

The Company's common stock, par value \$.01 per share (Common Stock) is publicly traded on the National Association of Security Dealers Inc.'s OTC Bulletin Board and is quoted under the symbol PACI.

The following table sets forth the high and low sales prices on NASD OTC Bulletin Board for the Common Stock during the fiscal years ended June 30, 2005, and June 30, 2004, respectively. To date, the Company has not paid any Common Stock dividends and does not anticipate paying any Common Stock dividends in the foreseeable future; however dividends are currently being paid on the Company's Series A redeemable preferred stock (see Management's Discussion and Analysis or Plan of Operation Liquidity and Capital Resources).

These over the counter market quotations reflect inter-dealer prices, without retail mark-up, markdown, or commission, and may not necessarily represent actual transactions.

Fiscal Year Ended June 30, 2005

| Quarter | High | Low |
|---------|---------|---------|
| First | \$ 0.90 | \$ 0.55 |
| Second | 1.17 | 0.62 |
| Third | 1.30 | 0.95 |
| Fourth | 1.10 | 0.90 |

Fiscal Year Ended June 30, 2004

| Quarter | High | Low |
|---------|---------|---------|
| First | \$ 0.85 | \$ 0.55 |
| Second | 1.25 | 0.68 |
| Third | 0.91 | 0.60 |
| Fourth | 0.95 | 0.60 |

As of August 15, 2005, there were approximately 189 record holders of Common Stock and approximately 1,200 beneficial owners of the Company's Common Stock.

Equity Compensation Plan Information

| Plan category | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted average exercise price of outstanding options, warrants and rights (b) | Number of securities remaining available for future issuance (c) |
|--|--|--|---|
| Equity compensation plans approved by security holders | 1,541,700 | 0.85 | 871,997 |
| Equity compensation plans not approved by security holders | 0 | 0 | 0 |
| Total | 1,541,700 | 0.85 | 871,997 |

Item 6. *Management's Discussion and Analysis or Plan of Operation*

Introduction

The following discussion should be read in conjunction with the Financial Statements of the Company and related notes thereto included elsewhere herein.

Overview

Precision Auto Care is a global franchisor of auto care centers. Company revenues are derived from three primary areas: franchise development, royalties, and product sales. Franchise development revenues include sales of franchises and master licenses. Royalty revenues are derived from royalty fees paid by individual franchisees to the Company based on qualified retail sales by the franchisee. Product revenues are derived from the sale of automotive related supplies and equipment to individual franchisees.

Direct costs consist of fees paid to area developers for the sale of new franchises and for supporting franchisees on an ongoing basis, other costs associated with directly supporting the franchise system, and the cost of automotive related supplies. General and administrative expenses include all legal, accounting, general overhead, information technology and corporate staff expenses. Other income and expense items include interest income and expense which are included within the non-operating income/expense category on the Statement of Operations.

The Company has one business segment, Automotive Care Franchising. The Automotive Care Franchising business segment provides automotive services primarily through franchised operations located in the United States and in certain foreign countries.

The Company's core auto care and franchising business continues to benefit from an improved focus on unit economics, offering certain product services to the franchisees such as equipment and other marketing related materials as well as in the field training programs. Additionally, the Company is seeking growth through co-branding. This strategy is designed to permit the Company to partner with other retailers and service providers who are also seeking to improve cash flows through complementary brands.

Critical Accounting Policies

The following is a summary of the Company's critical accounting policies. For a full description of these and other accounting policies, see Note 1 of the Notes to the Consolidated Financial Statements. These critical accounting policies require estimates and assumptions that affect the amounts of assets, liabilities, revenues and expenses reported in the consolidated financial statements. Due to their nature, estimates involve judgments based on available information. Actual results or amounts could differ from estimates and the difference could have a material impact on the consolidated financial statements. Therefore, understanding these policies is important in understanding the reported results of operations and the financial position of the Company.

Revenue Recognition

The Company's royalty revenue is recognized as earned in accordance with the specific terms of each agreement and to the extent no known issues involving collection exist. In the case when revenues are not likely to be collected, the Company provides for estimated losses. This estimate is based upon our historical experience as well as a detailed review of our receivable balances.

Revenue from the sale of a franchise is recognized when all 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 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 franchisee.

The Company recognized revenues from foreign franchisee operations of \$614,000 and \$204,000 for the fiscal years ended June 30, 2005 and 2004, respectively.

Goodwill and Intangible Assets

Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Intangible Assets", requires that goodwill no longer be amortized, but instead be tested for impairment at least annually. The Company engages a valuation expert to assist in estimating the fair value of franchising operations utilizing a discounted future cash flow approach that estimates revenue, driven by assumed market growth rates and appropriate discount rates. These estimates are consistent with the plans and estimates we use to manage the underlying business. Impairment testing is performed in the first quarter of each fiscal year. Based upon the current year analysis, management 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 tax deferred assets and establishes a valuation allowance as deemed appropriate. As of June 30, 2005, the Company had a valuation allowance of \$2.9 million against deferred tax assets. Given the Company's current operating performance, management released approximately \$3.5 million and 629,000 of the valuation allowance during 2005 and 2004, respectively. This adjustment was based upon management's assessment of the recoverability of deferred taxes which included projections of future pretax earnings.

Results of Operations**Comparison of the year ended June 30, 2005 to the year ended June 30, 2004****Summary**

| | Twelve Months Ended June 30, | | | |
|---|-------------------------------------|--------------|------------------|--------------|
| | 2005 | % | 2004 | % |
| | (in thousands) | | | |
| Automotive care franchising revenue | \$ 12,347 | 96 | \$ 11,192 | 94 |
| Other | 456 | 4 | 658 | 6 |
| Total revenues | \$ 12,803 | 100 % | \$ 11,850 | 100 % |
| Automotive care franchising direct cost | 7,181 | 57 | 6,616 | 56 |
| Other | 395 | 3 | 611 | 5 |
| Total direct cost | 7,576 | 60 | 7,227 | 61 |
| General and administrative | 3,486 | 26 | 3,366 | 28 |
| Depreciation expense | 111 | 1 | 318 | 3 |
| Operating income | 1,630 | 13 | 939 | 8 |
| Gain on debt restructuring | | | 193 | 2 |
| Other income | 58 | 0 | 65 | 0 |
| Earnings before taxes | 1,688 | 13 | 1,197 | 10 |
| Income taxes | (2,967) | (23) | (473) | (4) |
| Net income | 4,655 | 36 | 1,670 | 14 |
| Preferred stock dividends | 30 | | 80 | |
| Net income applicable to common shareholders | \$ 4,625 | 36 % | \$ 1,590 | 14 % |

Revenue. Total revenue for the year ended June 30, 2005 was \$12.8 million, an increase of approximately \$953,000, or 8%, compared with total revenue of \$11.9 million for the year ended June 30, 2004.

Automotive care franchising revenue for the year ended June 30, 2005 was \$12.3 million, an increase of approximately \$1.1 million, or 10%, compared with automotive care revenues of \$11.2 million for the year ended June 30, 2004. This increase was primarily due to an increase in franchise development revenue of approximately \$833,000. Franchise development revenue increased due to the Company signing an area development agreement with North Pacific Precision, Inc. for the area rights for the Seattle market. Under the agreement, North Pacific Precision, Inc. paid \$500,000 for the area developer rights for the Seattle market. Such fees were recognized upon execution of the agreement since all significant obligations under the agreement were satisfied at that time. The Company will receive fifty percent of the income from the sale of franchises and from royalty payments from franchisees in that region. Franchise development revenue also increased due to the Company signing two master franchise agreements. The Company also signed a master franchise agreement with Hung Yue Holdings (Hong Kong) Co., Ltd. giving that firm's affiliate, Precision Tune Auto Care (China) Company Limited, a license to open and operate at least 330 Precision Tune Auto Care (PTAC) car care centers in China over the next seven years. Under the terms of the agreement, Hung Yue Holdings is obligated to pay the Company approximately \$2.1 million. The Company recognized revenue of \$193,000 through June 30, 2005 in connection with the signing of the master franchise agreement, and \$13,000 was deferred for travel expenses. The revenue was recognized as the Company had substantially fulfilled all required obligations (see Note 3 of the Consolidated Financial Statements). Additionally, the Company signed a master franchise agreement with Precision Sociedade Gestora de Franchising S.A. de C.V. giving that corporation a license to operate and open at least 180 Precision Tune Auto Care (PTAC) car care centers in Spain over the next five years. Under the terms of the agreement, Precision Sociedade Gestora de Franchising S.A. de C.V. is obligated to pay the

Company approximately \$750,000. The Company recognized revenue of \$150,000 in connection with the signing of the master franchise agreement for the twelve months ended June 30, 2005 (see Note 3 of the Consolidated Financial Statements). The automotive care franchising revenue also increased approximately \$200,000 due to equipment sales for the year ended June 30, 2005. There were no comparable equipment sales for the year ended June 30, 2004.

Other revenue for the year ended June 30, 2005 was \$456,000, a decrease of approximately \$202,000, or 31%, compared to \$658,000 for the year ended June 30, 2004. This decrease was due to the fact that the support revenue from the Shell-Mexico transaction ceased as of December 31, 2004 as well as a decrease in revenue derived from training and rebate programs.

Direct Cost. Total direct cost for the year ended June 30, 2005 totaled \$7.6 million, an increase of approximately \$342,000 or 5%, compared with \$7.2 million for the year ended June 30, 2004.

Automotive care franchising direct cost for the year ended June 30, 2005 totaled \$7.2 million, an increase of \$565,000 or 9%, compared with \$6.6 million for the year ended June 30, 2004. This increase is directly attributable to the fact that nine more centers opened during fiscal year 2005 compared to fiscal year 2004. Also, the equipment revenue comprised a greater percentage of the total revenue mix in fiscal year 2005. The increased equipment revenue had a lower margin compared to the revenue associated with royalties.

Other direct cost for the year ended June 30, 2005 totaled \$395,000, a decrease of \$216,000, compared with \$611,000 for the year ended June 30, 2004. This decrease is primarily due to the termination of the agreement to provide support to Shell-Mexico as that agreement was completed as of December 31, 2004.

General and Administrative Expense. General and administrative expense was \$3.5 million for the year ended June 30, 2005, an increase of approximately \$120,000 or 4%, compared with \$3.4 million for the year ended June 30, 2004. This increase was primarily the result of increased legal expenses associated with enforcing franchise agreements. Other general and administrative expenses remained consistent with prior year. The general and administrative expenses also include a charge of \$97,000 and \$127,000, respectively, due to variable accounting for certain employee stock options in 2005 and 2004 (see Note 10 of the Consolidated Financial Statements).

Operating Income From Continuing Operations. The Company recorded operating income for the year ended June 30, 2005 of approximately \$1.6 million, an increase of \$691,000, or 74%, compared with an operating income of \$939,000 for the year ended June 30, 2004.

Gain on Debt Restructuring. The Company recognized a gain from debt restructuring in the amount of \$193,000 for the year ended June 30, 2004, primarily as a result of restructuring the Board LLC debt (see Note 7 of the Consolidated Financial Statements).

Other Income. The Company recorded Other Income of \$58,000 for the year ended June 30, 2005, compared with Other Income of \$65,000 for the year ended June 30, 2004.

Income Taxes. The Company recorded an income tax benefit of \$3.0 million for the year ended June 30, 2005, an increase of \$2.5 million or 527%, compared with \$473,000 for the year ended June 30, 2004. These adjustments were based upon management's assessment of the recoverability of deferred taxes which included projections of future pretax earnings.

Net Income Applicable to Common Shareholders and Earnings Per Share. The Company recorded Net Income Applicable to Common Shareholders of \$4.6 million, or \$0.18 per share, for the year ended June 30, 2005 compared to \$1.6 million, or \$0.08 per share, for the year ended June 30, 2004.

Liquidity and Capital Resources

Sources and Uses of Cash

Cash at June 30, 2005 was \$3.3 million. During the period, cash provided by operations was \$1.7 million.

Cash used in investing activities for the twelve months ended June 30, 2005 was \$55,000 resulting primarily from the purchase of property and equipment.

Cash provided by financing activities for the twelve months ended June 30, 2005 was \$25,000. Cash provided by financing activities during the period consisted of proceeds from issuance of the Company's stock net of the payments of other notes payable and preferred stock dividends.

Management believes that the Company's current cash balance, cash generated from operations, and available credit line will be sufficient to meet the Company's working capital needs, capital expenditures, and contractual obligations for fiscal year 2006.

Debt Transactions

In October 1998, a subordinated debenture in the amount of \$2.0 million was executed with an LLC composed of certain members of the Company's board of directors (Board LLC). On July 17, 2003, the Company reached an agreement to restructure the remaining \$633,000 due to the Board LLC. The terms of the agreement called for the following:

- Payment of \$200,000 within 3 days of receipt of approval by the Company's Board of Directors.
- Issuance of a non-interest bearing note payable in the amount of \$50,000, payable in ten monthly installments of \$5,000 each, commencing one month after the date of approval by the Company's Board of Directors.
- Issuance of warrants to purchase 400,000 shares of the Company's common stock with an exercise price of \$0.44 per share having a fair value of approximately \$222,000.

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

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

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

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

In March 2005, 4,472,270 warrants were exercised pursuant to an agreement the Company reached with Precision Funding, L.L.C. and former board members in October 2002. Upon the exercise of these warrants at the previously agreed to exercise price of \$0.44 per share, the holders purchased 4,472,270

restricted shares of common stock by surrendering 189,942 shares of Series A Preferred Stock to the Company, therefore, there were no cash proceeds received by the Company from this transaction.

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

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

Seasonality and Quarterly Fluctuations

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

Item 7. *Financial Statements*

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Stockholders of Precision Auto Care, Inc.

We have audited the accompanying consolidated balance sheets of Precision Auto Care, Inc. (the Company) and subsidiaries as of June 30, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above, present fairly, in all material respects, the consolidated financial position of Precision Auto Care, Inc. and subsidiaries as of June 30, 2005 and 2004, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

Vienna, Virginia
September 7, 2005

PRECISION AUTO CARE, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | June 30, 2005 | June 30, 2004 |
|---|------------------|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,279,568 | \$ 1,573,368 |
| Restricted cash | | 50,200 |
| Accounts receivable, net of allowance of \$60,971 and \$72,815, respectively | 640,271 | 545,133 |
| Notes receivable | 251,301 | 211,243 |
| Deferred tax asset | 479,824 | 473,000 |
| Other assets | 344,593 | 283,244 |
| Total current assets | 4,995,557 | 3,136,188 |
| Property and equipment, at cost | 4,202,133 | 4,147,329 |
| Less: Accumulated depreciation | (4,093,702) | (3,982,924) |
| | 108,431 | 164,405 |
| Goodwill | 8,711,744 | 8,711,744 |
| Notes receivable, net of allowance of \$412,128 and \$254,832, respectively. | 36,159 | 161,685 |
| Deferred tax asset | 3,143,968 | |
| Deposits and other | 24,314 | 27,914 |
| Total assets | \$ 17,020,173 | \$ 12,201,936 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Line-of-credit | \$ | \$ |
| Notes payable - current | 19,346 | 75,240 |
| Accounts payable and accrued liabilities | 1,681,354 | 1,705,376 |
| Due to related party | 116,073 | 91,426 |
| Deferred revenue | 253,322 | 396,150 |
| Total current liabilities | 2,070,095 | 2,268,192 |
| Notes payable, net of current portion | 7,991 | 13,770 |
| Total liabilities | 2,078,086 | 2,281,962 |
| Commitments and contingencies | | |
| Series A redeemable preferred stock, \$.01 par value; 1,000,000 shares authorized; 11,227 and 202,714 shares issued and outstanding | 116,312 | 2,100,117 |
| Stockholders' equity: | | |
| Common stock, \$.01 par value; 39,000,000 shares authorized; 28,862,252 and 23,808,602 shares issued and outstanding | 288,623 | 238,086 |
| Additional paid-in capital | 67,949,970 | 65,619,904 |
| Accumulated deficit | (53,412,818) | (58,038,133) |
| Total stockholders' equity | 14,825,775 | 7,819,857 |
| Total liabilities and stockholders' equity | \$ 17,020,173 | \$ 12,201,936 |

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

| | For The Years Ended | |
|--|---------------------|---------------|
| | June 30, | |
| | 2005 | 2004 |
| Revenues: | | |
| Franchise royalties | \$ 11,015,897 | \$ 10,701,034 |
| Franchise development | 1,330,768 | 490,826 |
| Other | 456,314 | 658,029 |
| Total revenues | 12,802,979 | 11,849,889 |
| Direct cost: | | |
| Franchise support and other | 7,576,301 | 7,227,399 |
| Contribution | 5,226,678 | 4,622,490 |
| General and administrative expense | 3,486,448 | 3,365,833 |
| Depreciation expense | 110,778 | 318,101 |
| Operating income | 1,629,452 | 938,556 |
| Gain on debt restructuring | | 192,875 |
| Interest expense | (5,508) | (19,611) |
| Other income | 63,337 | 85,079 |
| Total other income | 57,829 | 258,343 |
| Income before income tax expense | 1,687,281 | 1,196,899 |
| Benefit for income taxes | 2,967,771 | 473,000 |
| Net income | 4,655,052 | 1,669,899 |
| Preferred stock dividends | 29,737 | 80,127 |
| Net income applicable to common shareholders | \$ 4,625,315 | \$ 1,589,772 |
| Net income applicable to common stock per common share Basic | \$ 0.18 | \$ 0.08 |
| Net income applicable to common stock per common share Diluted | \$ 0.16 | \$ 0.07 |
| Weighted average common shares outstanding Basic | 25,253,897 | 19,392,950 |
| Weighted average common shares outstanding Diluted | 28,186,206 | 22,549,311 |

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

| | Common Shares | Common Stock | Additional Paid-in Capital | Accumulated Deficit | Total |
|--|--------------------------|-------------------------|---|--------------------------------|--------------|
| Balance at June 30, 2003 | 16,558,833 | \$165,588 | \$62,126,581 | \$(59,627,905) | \$2,664,264 |
| Issuance of common stock | 6,999,769 | 69,998 | 3,009,885 | | 3,079,883 |
| Common stock issued as compensation | 250,000 | 2,500 | 130,000 | | 132,500 |
| Debt to equity conversion | | | 222,175 | | 222,175 |
| Stock option compensation | | | 131,263 | | 131,263 |
| Net income | | | | 1,589,772 | 1,589,772 |
| Balance at June 30, 2004 | 23,808,602 | \$238,086 | \$65,619,904 | \$(58,038,133) | \$7,819,857 |
| Issuance of common stock | 5,053,650 | 50,537 | 2,113,648 | | 2,164,185 |
| Tax benefit from exercise of stock options | | | 114,072 | | 114,072 |
| Stock based compensation | | | 102,346 | | 102,346 |
| Net income | | | | 4,625,315 | 4,625,315 |
| Balance at June 30, 2005 | 28,862,252 | \$288,623 | \$67,949,970 | \$(53,412,818) | \$14,825,775 |

See accompanying notes.

PRECISION AUTO CARE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | For The Years Ended | |
|---|----------------------------|--------------|
| | June 30, | |
| | 2005 | 2004 |
| Operating activities: | | |
| Net income applicable to common shareholders | \$ 4,625,315 | \$ 1,589,772 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 110,778 | 318,101 |
| Bad debt expense | 147,296 | 76,036 |
| Decrease in valuation allowance | (3,526,000) | (629,000) |
| Gain on debt restructuring | | (192,875) |
| Gain on sale of assets | | (25,000) |
| Stock issued for compensation | | 132,500 |
| Tax benefit from exercise of stock options | 114,072 | |
| Stock based compensation | 102,346 | 131,263 |
| Changes in assets and liabilities: | | |
| Restricted cash | 50,200 | (50,200) |
| Accounts and notes receivable | (156,966) | (88,222) |
| Prepaid expenses, deposits and other | 2,251 | 19,323 |
| Accounts payable and accrued liabilities | 9,186 | (570,961) |
| Due to related party | 24,647 | 91,426 |
| Deferred revenue and other | (142,828) | (121,350) |
| Deferred taxes | 375,208 | 156,000 |
| Net cash provided by operating activities | 1,735,505 | 836,813 |
| Investing activities: | | |
| Purchases of property and equipment | (54,804) | (100,107) |
| Net cash used in investing activities | (54,804) | (100,107) |
| Financing activities: | | |
| Proceeds from issuance of parent company stock | 180,380 | |
| Payment of preferred stock dividends | (33,208) | (85,560) |
| Repayment of subordinated debt and other notes payable | (121,673) | (641,888) |
| Net cash provided by (used in) financing activities | 25,499 | (727,448) |
| Net change in cash and cash equivalents | 1,706,200 | 9,258 |
| Cash and cash equivalents at beginning of year | 1,573,368 | 1,564,110 |
| Cash and cash equivalents at end of period | \$ 3,279,568 | \$ 1,573,368 |
| Supplemental schedule of non cash investing and finance activities: | | |
| Fair value of preferred stock exchanged for issuance of common stock | \$ 1,983,805 | \$ 3,079,883 |
| Fair value of common, preferred stock, and warrants issued in exchange for cancellation of debt | \$ | \$ 272,175 |

See accompanying notes.

Precision Auto Care, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

Note 1 Business Description and Financial Statement Presentation

Precision Auto Care, Inc. (the Company) is a franchisor of automotive maintenance service centers which provide specialized automotive care services, and fast oil change and lube services. These franchisee owned centers operate primarily under the Precision Tune Auto Care and Precision Lube Express brand names.

Note 2 Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries.

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 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 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 sales are satisfied.

Product services in the form of equipment and other marketing materials related sales are recognized upon delivery to the franchisees.

The Company recognized revenues from foreign franchisee operations of \$614,000 and \$204,000 for the fiscal years ended June 30, 2005 and 2004, respectively.

Cash and Cash Equivalents

Cash and cash equivalents are comprised of highly liquid debt instruments with original maturities of three months or less. Cash balances may exceed insured amounts.

Precision Auto Care, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 2 Summary of Significant Accounting Policies (Continued)

Property and Equipment

Property and equipment are stated at cost and depreciated on a straight-line basis for book purposes and accelerated methods for tax purposes over the estimated useful lives of the related assets. The estimated useful lives are as follows:

| | Years |
|------------------------|---------------|
| Furniture and fixtures | 5-7 |
| Equipment | 3-10 |
| Other items | 3-7 |
| Leasehold improvements | Life of lease |

Income Taxes

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. A valuation allowance is established when management is not able to conclude more likely than not that the assets will be realized in future years.

Impairment of Long-Lived Assets

The Company evaluates the carrying amount of long-lived assets to be held and used, including goodwill and other intangible assets, when events and circumstances warrant such a review. The carrying amount of a long lived asset is considered impaired when the estimated undiscounted cash flow from each asset is less than its carrying amount. In that event, the Company would record a loss equal to the amount by which the carrying amount exceeds the fair market value of the long-lived asset.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash, trade accounts receivable and notes receivable. The Company's cash is held at FDIC insured financial institutions, however, cash balances may exceed insured amounts. The trade receivable balances are dispersed among a wide customer and franchisee base. The Company routinely assesses the financial strength of its franchisees. The Company maintains reserves for credit losses, and such losses have been within management's expectations.

Advertising Costs

The Company expenses all advertising costs as incurred. The Company incurred \$60,000 and \$85,000 in advertising costs for the years ended June 30, 2005 and 2004, respectively.

Precision Auto Care, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 2 Summary of Significant Accounting Policies (Continued)

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and 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.

Goodwill and Intangible Assets

Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Intangible Assets*, requires that goodwill no longer be amortized, but instead be tested for impairment at least annually. The Company engages a valuation expert to assist in estimating the fair value of franchising operations utilizing a discounted future cash flow approach that estimates revenue, driven by assumed market growth rates and appropriate discount rates. These estimates are consistent with the plans and estimates we use to manage the underlying business. Impairment testing is performed in the first quarter of each fiscal year. Based upon the current year analysis, management concluded that the \$8.7 million carrying value of goodwill was not impaired.

Segment Reporting

The Company operates in one business segment; Automotive Care Franchising.

Stock Options

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

Generally, the Board of Directors has granted stock options with exercise prices equal to the fair market value of the Company's common stock on the grant date. However, the Company issued 65,000 options on July 30, 2003 which had an exercise price below the fair market value of the underlying common stock on that date. As a result, approximately \$15,000 of compensation expense will be recognized over the option's vesting period. The Company granted stock to an officer with a fair value of \$212,500 during fiscal year 2003, and recognized compensation expense of \$132,500 and \$80,000 as of June 30, 2004 and 2003, respectively. The Company also repurchased certain options from employees and issued new options exercisable at an exercise price of \$0.44 in fiscal year 2003, resulting in the newly issued options being treated as a repricing under FIN 44, which triggered variable accounting. As a result, the Company recorded compensation expense of approximately \$87,000 and \$127,000 associated with these options as of June 30, 2005 and 2004, respectively. In January of 2005, 15,000 shares of the repriced options were exercised and the Company recorded compensation expense of approximately \$11,000 in that period.

Precision Auto Care, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 2 Summary of Significant Accounting Policies (Continued)

Had compensation expense for all options been determined based on the fair value at the grant dates during the years ending June 30, 2005 and 2004 consistent with the fair value method of SFAS No. 123, the pro forma net income and income per share would have been as follows:

| | Year ended June 30, | |
|---|----------------------------|--------------|
| | 2005 | 2004 |
| Net income applicable to common shareholders | \$ 4,625,315 | \$ 1,589,772 |
| Add: Total stock-based compensation expense reported in net income | 102,346 | 263,763 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards* | 163,407 | 243,500 |
| Pro forma net income | \$ 4,564,254 | \$ 1,610,035 |
| Earnings per share: | | |
| Basic as reported and pro forma | \$ 0.18 | \$ 0.08 |
| Diluted as reported and pro forma | \$ 0.16 | \$ 0.07 |
| Weighted average shares: | | |
| Weighted average common shares outstanding Basic | 25,253,897 | 19,392,950 |
| Weighted average common shares outstanding Diluted | 28,186,206 | 22,549,311 |

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. 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 June 30, 2005 and 2004 was 5,682,022 and 11,142,095, 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 fiscal year 2005 and 2004. For the years ended June 30, 2005 and 2004, respectively 182,950 shares attributable to outstanding stock options were not included in the computation of diluted earnings per share because their inclusion would have been anti-dilutive.

Precision Auto Care, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 2 Summary of Significant Accounting Policies (Continued)

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

| | For The Years Ended June 30, | |
|--|-------------------------------------|--------------|
| | 2005 | 2004 |
| Numerator: | | |
| Net income | \$ 4,655,052 | \$ 1,669,899 |
| Preferred stock dividends | (29,737) | (80,127) |
| Net income applicable to common Shareholders | \$ 4,625,315 | \$ 1,589,772 |
| Denominator: | | |
| Denominator for basic EPS weighted- average-shares | 25,253,897 | 19,392,950 |
| Common stock equivalents- stock options and warrants | 2,932,309 | 3,156,361 |
| Denominator for diluted EPS weighted- average-shares | 28,186,206 | 22,549,311 |
| Basic earnings per share applicable to common shareholders | \$ 0.18 | \$ 0.08 |
| Diluted earnings per share applicable to common shareholders | \$ 0.16 | \$ 0.07 |

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 Agreements

In August 2004, the Company signed a master franchise agreement with Hung Yue Holdings (Hong Kong) Co., Ltd. giving that firm's affiliate, Precision Tune Auto Care (China) Company Limited, a license to open and operate at least 330 Precision Tune Auto Care (PTAC) car care centers in China over the next seven years. Under the terms of the agreement, Hung Yue Holdings is obligated to pay the Company approximately \$2.1 million. A deposit payment of \$50,000 was paid into escrow prior to executing the agreement and \$100,000 was paid on August 31, 2004, upon execution. Additional payments of \$50,000 were to be paid by November 30, 2004 and December 31, 2004, respectively. However, due to unforeseen circumstances Hung Yue Holdings requested additional time to make these payments. The Company has received \$56,000 of the remaining installment payments relating to the signing of the master franchise agreement and recognized revenue of \$193,000 in connection with the signing of the master franchising agreement for the year ended June 30, 2005 and \$13,000 was deferred for travel expenses for on-site training. The revenue was recognized as the Company had substantially fulfilled all required obligations. The Company will also receive a \$250,000 payment on the first anniversary of signing the master franchise agreement, and a minimum of \$1.6 million payable in seven annual installments beginning on August 31, 2005, relating to the opening of car care centers in China. No future revenue will be recognized until collection of such amounts is probable. Additionally, revenue from future franchises under the master license agreement will be recognized when the Company's obligations have been satisfied and collection of the franchise fee is probable. There was one center opened as of June 30, 2005.

In May 2005, the Company signed a master franchise agreement with Precision Sociedade Gestora de Franchising S.A. de C.V. giving that corporation a license to open and operate at least 180 Precision Tune Auto Care (PTAC) car care centers in Spain over the next five years. Under the terms of the agreement, Precision Sociedade Gestora de Franchising S.A. de C.V. is obligated to pay the Company \$750,000. The Company received \$150,000 upon the signing of the master franchising agreement and will

Precision Auto Care, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 3 Master License Agreements (Continued)

receive \$150,000 on January 1 for the subsequent four years. The Company recognized revenue of \$150,000 for the year ended June 30, 2005 as the Company had substantially fulfilled all required obligations. Additionally, future revenue will not be recognized until collection of such amounts is probable. No centers were opened as of June 30, 2005.

Note 4 New Accounting Pronouncements

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

Note 5 Property and Equipment

The components of property and equipment are as follows:

| | June 30, | |
|-------------------------------|-----------------|--------------|
| | 2005 | 2004 |
| Furniture and fixtures | \$ 1,065,575 | \$ 1,052,854 |
| Equipment | 2,652,799 | 2,498,685 |
| Equipment under capital lease | 79,459 | 79,459 |
| Leasehold improvements | 61,590 | 46,809 |
| Other items | 342,710 | 469,522 |
| | 4,202,133 | 4,147,329 |
| Accumulated depreciation | (4,093,702) | (3,982,924) |
| Property and equipment, net | \$ 108,431 | \$ 164,405 |

Precision Auto Care, Inc and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 6 Income Taxes

The provision (benefit) for income taxes consisted of the following items:

| | Years Ended June 30, | |
|-------------------------------|-----------------------------|--------------|
| | 2005 | 2004 |
| Current tax expense: | | |
| Federal | \$ 51,000 | \$ |
| State | | |
| Total current tax expense | 51,000 | |
| Deferred tax expense: | | |
| Federal | 415,000 | 129,000 |
| State | 92,000 | 27,000 |
| Total deferred tax expense | 507,000 | 156,000 |
| Change in valuation allowance | (3,526,000) | (629,000) |
| Total income tax (benefit) | \$(2,968,000) | \$(473,000) |

The effective tax rate differed from the statutory rate as follows:

| | Years Ended June 30, | |
|-----------------------------------|-----------------------------|-------------|
| | 2005 | 2004 |
| Statutory federal rate | 34 % | 34 % |
| State taxes | 5 | 5 |
| Nondeductible expenses | | 5 |
| Adjustment to deferred tax assets | (7) | (31) |
| Change in valuation allowance | (209) | (51) |
| Other | 1 | |
| Effective tax rate | (176)% | (38)% |

Deferred tax assets and liabilities reflect the effects of tax losses and the future income tax effects of temporary differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases and are measured using enacted tax rates that apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. During fiscal year 2005 and 2004, the Company made an adjustment of \$115,000 and \$974,000, respectively, to the deferred tax assets primarily to adjust cumulative temporary balances and the net operating loss carryforwards. This adjustment had no effect on the income statement as the valuation allowance was adjusted by the same amount.

Precision Auto Care, Inc and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 6 Income Taxes (Continued)

Significant components of the Company's deferred tax liabilities and assets are as follows:

| | June 30, 2005 | 2004 |
|---|------------------|--------------|
| Deferred tax assets: | | |
| Net operating loss | \$ 5,726,000 | \$ 6,824,000 |
| Other | 797,000 | 74,000 |
| | 6,523,000 | 6,898,000 |
| Valuation allowance for deferred tax assets | (2,899,000) | (6,425,000) |
| Net deferred taxes | \$ 3,624,000 | \$ 473,000 |

As of June 30, 2004, the Company had net operating loss carryforwards for federal tax purposes of approximately \$14.8 million, which expire from 2019 through 2022. The Company regularly reviews the recoverability of its tax deferred assets and establishes a valuation allowance as deemed appropriate. As of June 30, 2005, the Company had a valuation allowance of \$2.9 million against deferred tax assets. Given the Company's current operating performance, management released approximately \$3.5 million of the valuation allowance during 2005. This adjustment was based upon management's assessment of the recoverability of deferred taxes which included projections of future pretax earnings.

Note 7 Debt

Line of Credit

On March 1, 2005, the Company renewed the \$250,000 line of credit with Chevy Chase Bank. The interest rate on this line of credit is indexed to the Prime Rate as published in *The Wall Street Journal* (6.25% at June 30, 2005) and the Company has pledged all of its wholly-owned subsidiaries as collateral. As of June 30, 2005, the Company has not borrowed against this line of credit. Under this agreement, the Company must meet financial covenants relating to profitability, debt service coverage and a maximum leverage ratio. The Company was in compliance with all such covenants as of June 30, 2005 and 2004, respectively.

Debt Restructuring

In October 1998, a subordinated debenture in the amount of \$2.0 million was executed with an LLC composed of certain members of the Company's board of directors (Board LLC). On July 17, 2003, the Company reached an agreement to restructure the remaining \$633,000 due to the Board LLC. The terms of the agreement called for the following:

- Payment of \$200,000 within 3 days of receipt of approval by the Company's Board of Directors.
- Issuance of a non-interest bearing note payable in the amount of \$50,000, payable in ten monthly installments of \$5,000 each, commencing one month after the date of approval by the Company's Board of Directors.
- Issuance of warrants to purchase 400,000 shares of the Company's common stock with an exercise price of \$0.44 per share having a fair value of approximately \$222,000.

Precision Auto Care, Inc and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 7 Debt (Continued)

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

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

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

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

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

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

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

During the years ended June 30, 2005 and 2004, the Company incurred interest expense of approximately \$6,000 and \$20,000, respectively.

Long-term debt consists of the following:

| | June 30, | |
|---|-----------------|-------------|
| | 2005 | 2004 |
| Various notes and obligations payable in monthly installments | \$ 13,567 | \$ 62,117 |
| Lease obligations | 13,770 | 26,893 |
| | 27,337 | 89,010 |
| Less: current maturities | (19,346) | (75,240) |
| Long-term portion | \$ 7,991 | \$ 13,770 |

Precision Auto Care, Inc and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 7 Debt (Continued)

The future debt obligations with maturities in excess of one year as of June 30, 2005 are as follows:

| | Future Debt Maturities |
|------|-----------------------------------|
| 2006 | 19,346 |
| 2007 | 6,758 |
| 2008 | 1,233 |
| | \$ 27,337 |

Note 8 Lease Commitments

At June 30, 2005, the Company has lease commitments for office space, a training center, and a number of service center locations as well as office equipment under operating and capital leases. These leases expire between 2006 and 2009, with renewal options in certain of the leases. Most of the service center location leases are subleased to franchisees. Rent expense for office space and warehouse facilities of approximately \$361,000 and \$284,000 is included in operating expenses for the year ended June 30, 2005 and 2004 respectively. Rent expense for service center locations of approximately \$47,000 and \$6,000 is recorded net of sublease income of \$26,000 and \$0 for the years ended June 30, 2005 and 2004, respectively.

The future minimum lease payments and related sublease payments for operating leases with terms in excess of one year as of June 30, 2005, are as follows:

| | Future Minimum Lease Payments | Sublease Income | Net |
|------------|--|----------------------------|--------------|
| 2006 | 499,000 | 154,000 | 344,000 |
| 2007 | 485,000 | 161,000 | 325,000 |
| 2008 | 491,000 | 156,000 | 335,000 |
| 2009 | 245,000 | 47,000 | 198,000 |
| Thereafter | | | |
| | \$ 1,720,000 | \$ 518,000 | \$ 1,202,000 |

The future minimum lease payments for capital leases with terms in excess of one year as of June 30, 2005, are as follows:

| | Future Minimum Lease Payments |
|-------------------------------------|--|
| 2006 | 7,543 |
| 2007 | 7,543 |
| 2008 | 1,258 |
| Total lease payments | \$ 16,344 |
| Less amounts representing interest | 2,574 |
| Present value of net lease payments | \$ 13,770 |

Precision Auto Care, Inc and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 9 Related Party Transactions

The Company manages the operation of PTAC Marketing Fund, Inc. (PMF), the national advertising fund for Precision Tune Auto Care Centers, pursuant to a Management Agreement approved by the Board of Directors of PMF, which is comprised of franchisee and Company personnel. The Company charged PMF \$741,000 for administrative and other expenses incurred on behalf of PMF, for the years ended June 30, 2005 and 2004, respectively. Based on the timing of receipts and disbursements, it is common for amounts to be due to and from the Company and PMF. At June 30, 2005 and 2004, the net amount due from PMF was \$61,417. This amount is included in accounts receivable.

Bassam N. Ibrahim, a director of the Company, is a partner in Burns, Doane, Swecker & Mathis LLP, an Alexandria, Virginia law firm that performs legal services for the Company related to intellectual property protection. Fees paid in the amount of approximately \$46,000 and \$23,000 to the firm by the Company in the fiscal years ended June 30, 2005 and 2004, respectively, did not exceed five percent of the firm's gross revenues.

Note 10 Stockholders' Equity

During the year ended June 30, 2004, 250,000 shares of common stock were issued to an officer of the Company in September 2003. Compensation expense of \$132,500 and \$80,000 was recorded for the earned portion of these shares for the fiscal years ended June 30, 2004 and June 30, 2003, respectively.

Common Stock Option Plan

In 1999, the Company's Board of Directors and the Company's stockholders approved the 1999 Employee Stock Option Plan (the Option Plan) and reserved 600,000 shares for issuance under the Plan. On March 21, 2001 the Company's stockholders approved an amendment to increase the authorized shares under this plan to 1,600,000. On January 15, 2003 the Company's stockholders approved an amendment to increase the authorized shares under this plan to 2,600,000. Options available for future grants under this plan were 257,000 and 560,000 at June 30, 2005 and 2004, respectively.

Options reserved for issuance under predecessor plans consist of 400,000 related to the 1997 Employee Stock Option Plan, 175,000 related to the 1996 Employee Stock Option Plan, and 75,000 related to the 1998 Director's Stock Option Plan. Options available for future grant at June 30, 2004, under these plans were 327,500, 175,000 and 75,000, respectively. The Compensation Committee of the Company's Board of Directors determines the recipients of the award to be granted, exercise price, vesting period, and number of shares underlying the options.

The Company repurchased 704,000 shares of common stock options (exercise prices of these options range from \$0.75 to \$1.00 per share) for \$0.001 per share in the first quarter of fiscal year 2003. The Company in turn granted the same participants options for the purchase of 704,000 shares. These options are exercisable at an exercise price of \$0.44 per share at the same vesting schedule as the participant's repurchased options. The repurchase of such shares was deemed a repricing under FIN 44 and as such, the Company applies variable accounting during the remaining life of these options and in doing so, measures compensation expense periodically based upon the change in the fair market value of the underlying common stock. As a result, the Company recorded compensation expense of approximately \$97,000 and \$127,000 associated with these options as of June 30, 2005 and 2004, respectively. In fiscal year 2005, 15,000 shares of the repriced options were exercised and the Company recognized an expense of approximately \$11,000 at that date.

Precision Auto Care, Inc and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 10 Stockholders Equity (Continued)

A summary of the Company's stock option activity for the years ended June 30, are as follows:

| | Shares Under Option | Weighted-Average Exercise Price |
|-------------------|------------------------|------------------------------------|
| June 30, 2003 | 1,874,200 | 0.75 |
| Options granted | 65,000 | 0.44 |
| Options exercised | | |
| Options forfeited | | |
| June 30, 2004 | 1,939,200 | 0.74 |
| Options granted | 375,000 | 0.62 |
| Options exercised | (535,000) | 0.33 |
| Options forfeited | (57,500) | 0.44 |
| June 30, 2005 | 1,721,700 | 0.85 |

At June 30, 2005 and 2004, options for 1,198,000 and 1,438,000 shares, respectively, were exercisable. The weighted average grant date fair value per option for options granted in 2005 and 2004 was \$0.62 and \$0.66, respectively. The exercise price of options outstanding at June 30, 2005 ranged from \$0.22 to \$10.00 per share.

The Company applies Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for stock based compensation and presents pro forma net income and earnings per share data as if the accounting prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation had been applied (see Note 2).

The following table summarizes the assumptions used by the Company in estimating compensation expense as of the date the options were granted using a binomial model.

| | 2005 | | 2004 | |
|--|--------|---|--------|---|
| Risk free interest rate | 2.80 | % | 2.19 | % |
| Volatility factors | 191.38 | % | 283.52 | % |
| Weighted-average expected life of the option (years) | 3 | | 3 | |
| Dividend yield | 0.00 | % | 0.00 | % |

Because option valuation models require the input of highly subjective assumptions, such as expected volatility, and because changes in these subjective input assumptions can materially affect the fair value estimate, the existing model may not necessarily provide a reliable single measure of the fair value of its stock options.

Outside Director's Stock Plan

In 2000, the Company's Board of Directors and the Company's stockholders approved the 2000 Outside Directors' Stock Plan and reserved 50,000 shares for issuance under the Plan. Shares available for future grants at June 30, 2005, under this plan were 37,000.

Precision Auto Care, Inc and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 11 Employees Savings Plan

The Company maintains a 401(k) plan under which the Company may contribute up to 25% of an employee's first 6% of compensation deferred under the plan. Employees become eligible after attaining the age of 21 and completing six months of employment with the Company. The employees may elect to have no contribution limitation on their annual compensation subject to limitations set forth in the Internal Revenue Code. Employees' contributions vest immediately. The employee matching contribution is discretionary and vests 20% after one year and in increments of 20% each additional year. The employee matching contributions for each of the years ended June 30, 2005 and 2004 were \$36,000 and \$28,500, respectively.

Note 12 Contingencies

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

Previously Reported Cases:

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 Puyallup Auto Stop Associates (PASA) seeks an amount to be determined at trial and attorney's fees. PASA claims PTW breached a real property lease between the parties and seeks 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). Under the terms of the sublease and a consent judgment between PTW and the Ertmans, the Ertmans have an obligation to indemnify PTW in the event PTW incurs any liability in this matter. On March 30, 2005, PASA amended its complaint to include two other, third-party, defendants. PTW has not yet filed an answer in this matter. However, on April 14, 2005 PTW provided to PASA an offer to settle this matter for a lump-sum payment of \$10,000. PASA has not responded to PTW's settlement offer. Trial is scheduled for March 20, 2006.

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.

Precision Auto Care, Inc and Subsidiaries
Notes to Consolidated Financial Statements (Continued)

Note 12 Contingencies (Continued)

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

Precision Franchising LLC v. Davis Tune, Inc. et al., Federal District Court for the Eastern District of Virginia

On February 15, 2005, PFL was served with a complaint in which franchisee Davis Tune, Inc. sought damages in excess of \$30,000. Davis Tune, Inc. and its two shareholders, Mr. Donald Roe and Ms. Shirley F. Roe, were also defendants in a related action filed by PFL on November 1, 2004.

On June 10, 2005, the parties entered into a settlement agreement resolving both matters. Under the terms of the settlement Davis Tune, Inc. agreed to: (1) renew one of its Franchise Agreements that had expired and to re-brand the associated location as a Precision Tune Auto Care center; (2) pay approximately \$11,000 in delinquent fees, and (3) pay PFL \$75,000 in the event it fails to comply with all agreements between the parties.

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

Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

None.

Item 8A. Controls and Procedures

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14(c) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the year ended June 30, 2005 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Item 8B. Other Information

None.

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PART III

Item 9. *Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act*

The required information on directors will be contained in the Company's Proxy Statement, and reference is expressly made to the Proxy Statement for the specific information incorporated in the Form 10-KSB. The required information on executive officers is set forth in Part I of this Form 10-KSB under an unnumbered item captioned "Executive Officers of Precision Auto Care, Inc."

The code of ethics that applies to the Company's Chief Executive Officer, Chief Financial Officer, Corporate Controller and all other employees is attached as an exhibit in Item 13 of this report. If the Company makes any substantive amendments to the code of ethics or grant any waiver, including any implicit waiver, from a provision of the code to our Chief Executive Officer, Chief Financial Officer or Corporate Controller, the Company will disclose the nature of such amendment or waiver in a report on Form 8-K.

Item 10. *Executive Compensation*

The required information will be set forth under "Executive Compensation" and "Report of the Organization and Compensation Committee on Executive Compensation" in the Company's Proxy Statement, and reference is expressly made to the Proxy Statement for the specific information incorporated in the Form 10-KSB.

Item 11. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

The required information will be set forth under "Security Ownership of Certain Beneficial Owners and Management" in the Company's Proxy Statement, and reference is expressly made to the Proxy Statement for the specific information incorporated in the Form 10-KSB. Except as otherwise stated in the Proxy Statement, the address of each of the persons owning more than 5% of the Company's Common Stock is 748 Miller Drive, S. E., Leesburg, VA 20175.

Item 12. *Certain Relationships and Related Transactions*

The required information will be set forth under "Certain Relationships and Related Transactions" in the Company's Proxy Statement, and reference is expressly made to the Proxy Statement for the specific information incorporated in the Form 10-KSB.

Item 13. *Exhibits*

(a) The following documents are filed as part of this report:

1. Financial Statements

The following financial statements appear in Part II, Item 7 of this report:

Report of Independent Auditors

Audited Financial Statements

Consolidated Balance Sheets

Consolidated Statements of Operations

Consolidated Statements of Stockholders' Equity

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

(b) Exhibits

- 2.1 Plan of Reorganization and Agreement for Combination of Business dated as of August 27, 1997, by and among the Company, WE JAC Corporation, Miracle Industries, Inc., Lube Ventures, Inc., Rocky Mountain Ventures, Inc., Rocky Mountain Ventures II, Inc., Miracle Partners, Inc., Prema Properties, LLC, Ralston Car Wash, LLC and KBG LLC, included as an Exhibit to the Company's Registration Statement on Form S-1 (No. 333-34439) filed August 27, 1997, is incorporated herein by reference.
- 3.1 Articles of Incorporation of the Company included as an exhibit to the Company's Registration Statement on Form S-1 (No. 333-34439) filed August 27, 1997, are incorporated herein by reference.
- 3.2 Bylaws of the Company as amended August 18, 2004 are incorporated herein by reference.
- 3.3 Articles of Amendment to the Articles of Incorporation of Precision Auto Care, Inc. dated October 28, 2002 to create a new series of preferred stock designated as Series A Cumulative Redeemable Preferred Stock, included as an exhibit to the Company's Quarterly Report on Form 10-QSB, filed November 14, 2002, is incorporated herein by reference.
- 3.4 Articles of Amendment to the Articles of Incorporation of Precision Auto Care, Inc. dated January 15, 2003 to increase the number of authorized shares, amend the required number of Board of Directors, and amend the terms of the Board of Directors, included as an exhibit to the Company's Quarterly Report on Form 10-QSB, filed February 14, 2003, is incorporated herein by reference.
- 4.1 Warrant to Purchase Shares of Common Stock of Precision Auto Care, Inc. dated October 30, 2002 (Warrant No. 2002-01) between the Company and Desarrollo Integrado, S. A. de C. V., included as an exhibit to the Company's Quarterly Report on Form 10-QSB, filed November 14, 2002, is incorporated herein by reference.
- 4.2 Warrant to Purchase Shares of Common Stock of Precision Auto Care, Inc. dated October 30, 2002 (Warrant No. 2002-02) between the Company and Arthur C. Kellar, included as an exhibit to the Company's Quarterly Report on Form 10-QSB, filed November 14, 2002, is incorporated herein by reference.
- 10.1 Precision Auto Care, Inc. 1998 Employee Stock Purchase Plan, included as an exhibit to the Company's Registration Statement on Form S-8 (No. 333-49097), filed April 1, 1998, is incorporated herein by reference.
- 10.2 Precision Auto Care, Inc. 2000 Outside Directors' Stock Plan, included as an exhibit to the Company's Registration Statement on Form S-8 (No. 333-39226), filed June 14, 2000, is incorporated herein by reference.
- 10.3 Precision Auto Care, Inc. 1998 Outside Directors' Stock Option Plan, included as an exhibit to the Company's Registration Statement on Form S-8 (No. 333-85877), filed August 25, 1999, is incorporated herein by reference.
- 10.4 Precision Auto Care, Inc. 1999 Employee Stock Option and Restricted Stock Plan, included as an exhibit to the Company's Registration Statement on Form S-8 (No. 333-85879), filed August 25, 1999, is incorporated herein by reference.
- 10.5 Precision Tune Stock Option Plan, included as an exhibit to the Company's Registration Statement on Form S-8 (No. 333-47165), filed March 2, 1998, is incorporated herein by reference.

- 10.6 Precision Auto Care Employee Stock Option Plan, included as an exhibit to the Company's Registration Statement on Form S-8 (No. 333-47169), filed March 2, 1998, is incorporated herein by reference.
- 10.7 Precision Auto Care, Inc. Director Stock Option Plan, included as an exhibit to the Company's Registration Statement on Form S-8 (No. 333-47171), filed March 2, 1998, is incorporated herein by reference.
- 10.8 Subordinated Debenture Agreement with Board LLC, dated October 15, 1998, included as an exhibit to the Company's Amended Quarterly Report on Form 10-Q/A, filed November 20, 1998, is incorporated herein by reference.
- 10.9 Agreement dated August 3, 2000 between the Company and Louis M. Brown, Jr., included as an Exhibit to the Company's Annual Report on Form 10-K, filed October 13, 2000, is incorporated herein by reference.
- 10.10 Lease dated December 3, 2001 between Leesburg Airpark III, LLC and Precision Tune Auto Care, Inc., included as an Exhibit to the Company's Annual Report on Form 10-K, filed October 15, 2002, is incorporated herein by reference.
- 10.11 Agreement dated July 17, 2003 between the Company and Board L.L.C. terminating the Subordinated Debenture dated October 15, 1998 between the Company and Board L.L.C. is incorporated herein by reference.
- 10.12 Renewal of Promissory Note dated March 1, 2005 between Precision Auto Care, Inc. and Chevy Chase Bank, F.S.B. is incorporated herein by reference.
- 21 * Significant Subsidiaries of the Company.
- 23.1* Consent of Grant Thornton LLP, Independent Auditors.
- 31.1* Written statement of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2* Written statement of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1* Written statement of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith

Item 14. *Principal Accountant Fees and Services*

The required information will be set forth under "Principal Accountant Fees and Services" in the Company's Proxy Statement, and reference is expressly made to the Proxy Statement for the specific information incorporated in the Form 10-KSB.

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 September 26, 2005.

PRECISION AUTO CARE, INC.

By:

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

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

| Signature | Title | Date |
|--|---|--------------------|
| /s/ LOUIS M. BROWN, JR. Louis M. Brown, Jr. | Chief Executive Officer and Chairman of the Board | September 26, 2005 |
| /s/ ROBERT R. FALCONI Robert R. Falconi | President and Chief Operating Officer (Principal Financial Accounting Officer) | September 26, 2005 |
| /s/ WOODLEY A. ALLEN Woodley A. Allen | Director | September 26, 2005 |
| /s/ BASSAM N. IBRAHIM Bassam N. Ibrahim | Director | September 26, 2005 |
| /s/ JOHN D. SANDERS John D. Sanders | Director | September 26, 2005 |
| /s/ PETER C. KEEFE Peter C. Keefe | Director | September 26, 2005 |