PRIVATE MEDIA GROUP INC
Form 10-Q
May 16, 2005

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended March 31, 2005

OR

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

For the transition period from __________ to __________

Commission file number 000-25067

PRIVATE MEDIA GROUP, INC.

(Exact Name of Registrant as Specified in its Charter)

Nevada	**87-0365673**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

3230 Flamingo Road, Suite 156, Las Vegas, Nevada 89121

(Registered office)

Carretera de Rubí 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain

(European headquarters and address of principal executive offices)

34-93-590-7070

Registrant s telephone number

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act):

Yes_¨ No x

State the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date

Class	Outstanding at May 9, 2005
Common Stock, par value $.001	52,159,312

PART I.

Item 1. Financial Statements

PRIVATE MEDIA GROUP, Inc.

CONSOLIDATED BALANCE SHEETS

	December 31,	March 31, (Unaudited)	
	2004	2005	2005
	EUR	EUR (in thousands)	USD
ASSETS			
Cash and cash equivalents	3,261	2,035	2,643
Trade accounts receivable	8,397	9,176	11,917
Receivable from sale of building (Note 3)		6,611	8,586
Related party receivable (Note 4)	4,220	5,725	7,435
Inventories - net (Note 5)	9,978	10,387	13,489
Deferred income tax asset	2,350	2,350	3,052
Prepaid expenses and other current assets	2,288	2,377	3,087
TOTAL CURRENT ASSETS	30,494	38,661	50,209
Library of photographs and videos - net	15,146	15,584	20,239
Property, plant and equipment net	10,910	2,591	3,365
Other intangible assets	3,467	3,436	4,463
Goodwill	2,425	2,425	3,149
Note Receivable	541	380	494
Other assets	297	300	390
TOTAL ASSETS	63,281	63,378	82,309
LIABILITIES AND SHAREHOLDERS EQUITY			
Short-term borrowings	3,442	3,523	4,576
Current portion of long-term borrowings (Note 3)	1,313	3,185	4,136
Accounts payable trade	6,099	6,461	8,390
Income taxes payable	265	186	242
Deferred income taxes	65	65	84
Accrued other liabilities	1,068	1,187	1,542
TOTAL CURRENT LIABILITIES	12,253	14,607	18,970
Long-term borrowings (Note 3)	3,109	883	1,146
Related party payable (Note 4)	728		
Convertible notes	1,164	1,267	1,645
TOTAL LIABILITIES	17,254	16,756	21,761
SHAREHOLDERS EQUITY			
	883	885	1,148

Common Stock, $.001 par value, 100,000,000 shares authorized, 50,162,176 and 52,159,312 issued and outstanding at December 31, 2004 and March 31, 2005, respectively			
Additional paid-in capital	17,321	19,056	24,748
Common stock to be issued	1,752		
Retained earnings	28,213	28,884	37,511
Accumulated other comprehensive income	(2,143)	(2,202)	(2,860)
TOTAL SHAREHOLDERS EQUITY	46,026	46,622	60,548
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	63,281	63,378	82,310

See accompanying notes to consolidated statements.

PRIVATE MEDIA GROUP, INC.

CONSOLIDATED STATEMENTS OF INCOME

AND COMPREHENSIVE INCOME

	Three-months ended March 31, (unaudited)		
	2004	**2005**	**2005**
	EUR	**EUR**	**USD**
		(in thousands)	
Net sales	9,951	7,438	9,660
Cost of sales	4,676	4,473	5,809
Gross profit	5,275	2,965	3,850
Selling, general and administrative expenses	4,532	3,518	4,568
Gain on sale of building (Note 3)		1,279	1,661
Operating profit	743	726	943
Interest expense	174	184	239
Interest income	49	37	48
Income before income tax	618	579	752
Income tax expense (benefit)	(167)	(91)	(118)
Net income	784	670	870
Other comprehensive income:			
Foreign currency translation adjustments	(654)	(59)	(76)
Comprehensive income	130	611	794
Net income (loss) per share:			
Basic	0.02	0.01	0.02
Diluted	0.01	0.01	0.02

See accompanying notes to consolidated statements.

PRIVATE MEDIA GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three-months ended March 31, (unaudited)		
	2004	**2005**	**2005**
	EUR	**EUR** (in thousands)	**USD**
Cash flows from operating activities:			
Net income	784	670	870
Adjustment to reconcile net income to net cash flows from operating activities:			
Depreciation	472	296	385
Bond adjustment	82	15	20
Bad debt provision	345	31	41
Amortization of other intangible assets	31	31	40
Amortization of photographs and videos	1,700	1,522	1,976
Gain on sale of building		(1,279)	(1,661)
Effects of changes in operating assets and liabilities:			
Trade accounts receivable	(909)	(810)	(1,052)
Related party receivable	132	(39)	(51)
Inventories	(275)	(408)	(530)
Prepaid expenses and other current assets	(52)	(50)	(65)
Accounts payable trade	173	361	469
Income taxes payable	(167)	(79)	(103)
Accrued other liabilities	(213)	119	155
Net cash provided by operating activities	2,104	380	493
Cash flows from investing activities:			
Investment in library of photographs and videos	1,173	1,960	2,545
Capital expenditures	682	11	15
Cash received from sale of building		(511)	(664)
Investments in (sale of) other assets	(4)	3	4
Note receivable		(190)	(247)
Net cash used in investing activities	1,851	1,273	1,654
Cash flow from financing activities:			
Short-term borrowings repayments	(389)		
Long-term borrowings repayments	(250)	(388)	(503)
Long-term loan additions	798	33	43
Short-term borrowings additions	99	81	105
Net cash (used in) provided by financing activities	257	(274)	(355)
Foreign currency translation adjustment	(654)	(59)	(76)
Net (decrease) increase in cash and cash equivalents	(144)	(1,226)	(1,592)
Cash and cash equivalents at beginning of the period	856	3,261	4,235
Cash and cash equivalents at end of the period	712	2,035	2,643

Cash paid for interest	122	132	172
Cash paid for taxes			
Conversion of bond principal into common stock	236		

See accompanying notes to consolidated statements.

PRIVATE MEDIA GROUP, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Common stock		Additional paid-in capital	Common stock to be issued	Retained earnings	Accumulated other comprehensive income	Total shareholders equity
	Shares	Amounts					
		EUR	EUR	EUR	EUR	EUR	EUR
Balance at January 1, 2004	49,955,057	883	17,124		27,976	(1,826)	44,157
Repurchase of common stock	(116,051)		(253)				(253)
Conversion of bond principal into common stock	153,438		236				236
Conversion of bond interest into common stock	66,245		124				124
Cash received for conversion of options				1,752			1,752
Conversion of options	19,500		23				23
Conversion of series A warrants	45,000		67				67
Cashless Conversion of series A warrants	38,987						
Translation adjustment						(319)	(319)
Net income (loss)					238		238
Balance at December 31, 2004	50,162,176	883	17,321	1,752	28,213	(2,145)	46,024
Repurchase of common stock	(10,873)		(40)				(40)
Conversion of bond interest into common stock	7,259		25				25
Conversion of options	2,000,750	2	1,750	(1,752)			
Translation adjustment						(59)	(59)
Net income (loss)					670		670
Balance at March 31, 2005	52,159,312	885	19,058		28,884	(2,202)	46,622

See accompanying notes to consolidated statements.

PRIVATE MEDIA GROUP, INC.

NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (U.S. GAAP) for interim financial information. Accordingly they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of financial position and results of operations have been included. Operating results for the three months period ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ended December 31, 2005. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on form 10-K for the year ended December 31, 2004.

Solely for the convenience of the reader, the accompanying consolidated financial statements as of March 31, 2005 and for the three months then ended have been translated into United States dollars (USD) at the rate of EUR 0.77 per USD 1.00 the interbank exchange rate on March 31, 2005. The translations should not be construed as a representation that the amounts shown could have been, our could be, converted into US dollars at that or any other rate.

2. Stock-Based Compensation

On December 16, 2004, the Financial Accounting Standards Board issued SFAS No. 123 (revised 2004), (SFAS 123(R)), which is a revision of SFAS 123. SFAS 123(R) supersedes APB 25, and amends SFAS No. 95, Statement of Cash Flows . Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS 123(R) will be effective for the Company on January 1, 2006 and the Company expects to adopt SFAS 123(R) using the modified-prospective method as proscribed in SFAS 123(R). The adoption of SFAS 123(R) s fair value method will have an impact on the Company s results of operations, although it will have no impact on its overall financial position. While the Company cannot estimate the level of share-based payments to be issued in the future, based on the stock options that are currently outstanding, the Company expects that the adoption of SFAS 123(R) will not result in any significant charges to operations in 2006.

As permitted by Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation, the Company currently follows Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees, and related Interpretations for measurement and recognition of stock-based transactions with employees and adopted the disclosure-only provisions of SFAS No. 123. Under APB 25, generally no compensation expense is recognized since at the date of grant, the exercise price of stock options is set: a) at, or above, current price at closing of market or, b) at the price at closing of market on a pre-determined future date.

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NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

Had compensation cost for the Company s stock based compensation issued to employees been determined based upon the fair value at the grant date consistent with the methodology prescribed under SFAS 123, the Company s pro forma net income (loss) for 2004 and 2005 would have been as per the following table:

	Three-months ended March 31, (unaudited)	
	2004	**2005**
	EUR	**EUR**
	(in thousands)	
Net income, as reported	784	670
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards net of related tax effects	(20)	(117)
Pro forma net income	764	553
Earnings per share:		
Basic as reported	0.02	0.01
Basic pro forma	0.02	0.01
Diluted as reported	0.01	0.01
Diluted pro forma	0.01	0.01

3. Transaction

Sale of building

On February 4, 2005, we entered into an agreement with Local i Serveis Sant Cugat, S.L. to sell our real estate property located in Barcelona, Spain. The consideration under the agreement was 6.9 million euro, of which a 10% down payment was received upon signature. The balance of the consideration due amounting to 6.2 million euro is included in receivable from sale of building and will be received in two installments which are expected to take place no later than June and November of 2005, with the first installment to be not less than 2.85 million euro. The amount due is secured by the title to the property which will revert back to us in case of non-payment. Part of the proceeds from the sale will be used to repay the outstanding balance on the loan related to the building. The outstanding loan balance of EUR 2.3 million is included in current portion of long-term borrowings. Repayments on the loan will be made in proportion to cash received from the sale.

4. Related party receivable and payable

In January 2005, the Company presented a claim to the previous owner of our real estate property located in Barcelona, Spain. Under the claim the Company was awarded EUR 2.2 million. The increase in related party receivable of EUR 1.5 million, together with the reduction of EUR 0.7 million in related party

PRIVATE MEDIA GROUP, INC.

NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

payable, reflects this claim. The full value of the claim has been applied as a reduction to the value of the property.

5. Inventories

Inventories consist of the following:

	December 31,	March 31,
	2004	2005
	EUR	EUR
	(in thousands)	
Magazines for sale and resale	3,955	4,133
Video cassettes	733	484
DVDs	5,049	5,445
Other	241	324
	9,978	10,387

6. Earnings per share

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

	Three-months ended March 31,	
	2004	2005
Numerator:		
Net income (EUR in thousands)	784	670
Denominator:		
Denominator for basic earnings per share Weighted average shares	50,084,407	50,382,898
Effect of dilutive securities:		
Convertible Note Weighted average outstanding	997,152	971,562
Common stock warrants, options and other dilutive securities	1,306,562	1,802,804

Denominator for diluted earnings per share weighted average shares and assumed conversions	52,388,120	53,157,264
Earnings (loss) per share (EUR)		
Basic	0.02	0.01
Diluted	0.01	0.01

PRIVATE MEDIA GROUP, INC.

NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

7. Contingent Liability

In December 1999 the Company received final notification from the Swedish Tax Authority assessing its subsidiary in Cyprus for the tax years 1995-1998 for a total amount of SEK 42,000,000 (approx. EUR 4.5 million) plus fines amounting to SEK 16,800,000 (approx. EUR 1.8 million) plus interest. The Swedish Tax Authority has taken the position that the subsidiary carried on business in Sweden from a permanent establishment during the period in question and should therefore be taxed on the income attributable to the permanent establishment. The case is under litigation and the Company believes the circumstances supporting the Tax Authority s claim are without merit. However, the County Court has decided that a permanent establishment is at hand. The Court has only made a principle statement and the question how to calculate any eventual profit that can be allocated to the permanent establishment is not decided by the Court at this stage. The Company has appealed against the decision. The final outcome of this litigation will not be known for several years. Due to the early stages of this matter and the uncertainty regarding the ultimate decision, no amounts have been provided in the Company s financial statements for this dispute.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

You should read this section together with the consolidated financial statements and the notes and the other financial data in this Report. The matters that we discuss in this section, with the exception of historical information, are forward-looking statements within the meaning of the Private Securities Reform Act of 1995. Such forward-looking statements are subject to risks, uncertainties and other factors which could cause our actual results to differ materially from those expressed or implied by such forward-looking statements. Potential risks and uncertainties relate to factors such as (1) the timing of the introduction of new products and services and the extent of their acceptance in the market; (2) our expectations of growth in demand for our products and services; (3) our ability to successfully implement expansion and acquisition plans; (4) the impact of expansion on our revenue, cost basis and margins; (5) our ability to respond to changing technology and market conditions; (6) the effects of regulatory developments and legal proceedings with respect to our business; (7) the impact of exchange rate fluctuations; and (8) our ability to obtain additional financing.

The following discussion should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this Report.

References in this report to we, us, the Company and Private refer to Private Media Group, Inc., a Nevada corporation, including its consolidated subsidiaries.

Overview

We are an international provider of adult media content. We acquire still photography and motion pictures from independent directors and process these images into products suitable for popular media formats such as print publications, DVDs, video cassettes and digital media content for Broadcasting, Broadband and Internet distribution. In addition to media content, we also market and distribute branded leisure and novelty products oriented to the adult entertainment lifestyle and generate additional sales through the licensing of our *Private* trademark to third parties.

We operate in a highly competitive, service-oriented market and are subject to changes in business, economic and competitive conditions. Nearly all of our products compete with other products and services that utilize adult leisure time and disposable income.

We generate revenues primarily through:

- sales of movies on DVD;
- sales of adult feature magazines;
- Internet subscriptions and licensing;
- broadcasting content through cable, satellite, broadband and hotel television programming; and

content, brand name and trademark licensing.

Over time, we expect net sales from magazines and videocassettes to continue to decline as a percentage of net sales in relation to total net sales from DVDs, the Internet and broadcasting. We expect net sales from DVDs, the Internet and broadcasting to grow during the coming years.

We released 104 titles on DVD during 2004, 111 titles during 2003 and 120 titles during 2002, including both new and archival material. We plan to release approximately 120 proprietary titles on DVDs in 2005. In addition, in 2004 we signed an exclusive three year Agreement with US-based Pure Play Media, Inc. for content distribution in Europe. Under the agreement, we will distribute approximately six to ten newly produced movie titles per month in Europe, our main market for DVDs. The content controlled by Pure Play Media features top US producers and directors such as Michael Ninn, Seymore Butts, and Cousin Stevie. The arrangement is based on a split of gross profit and does not require any up-front or future investment in content by Private. We will start releasing titles on DVD under the agreement in the second quarter of 2005.

In 2004 we restructured our US operations and our US subsidiary outsourced its distribution of physical products, inclusive of Internet shop fulfillment. The restructuring started September 30, 2004 and was completed during the first quarter of 2005. We expect the impact of the restructuring to increase operating profit in 2005 compared to 2004, however, the restructuring will reduce sales from the US compared to 2004 since we are reporting sales net of agent s commission as from January 1, 2005.

We recognize net sales on delivery (for further information, see Critical Accounting Estimates).

Even though we recognize net sales upon delivery, we generally provide extended payment terms to our distributors of between 90 and 180 days. Although our extended payment terms increase our exposure to accounts receivable write-offs, we believe our risk is minimized by our generally long-term relationships with our distributors. In addition, we view our extended payment terms as an investment in our distribution channels which are important to the growth of our business.

Our primary expenses include:

- acquisition of content for our library of photographs and videos;
- printing, processing and duplication costs; and
- selling, general and administrative expenses.

Our magazines and DVD and videocassette covers are printed by independent third-party printers in Spain. We introduced DVDs as a motion picture medium in 1999. The production of each DVD master disc, prior to duplication, costs approximately $10,000. DVDs have a relatively low cost of duplication, inclusive of box and packaging, of approximately $2.00 per unit. Our DVDs are duplicated on an all region format, playable on both NTSC and PAL with multiple languages and sub-titles.

Over the years, our cost of sales has been fluctuating relative to net sales due to our use of new mediums for our products, such as the Internet, DVD and broadcasting. Internet and broadcasting sales has historically not carried any cost of sales and variations in these areas affect the overall cost of sales percentage in relation to sales. These new media provide us with additional sales of our existing content

We also incur significant intangible expenses in connection with the amortization of our library of photographs and movies and capitalized development costs, which include the Internet. We amortize these tangible and intangible assets on a straight-line basis for periods of between three and five years.

Critical Accounting Estimates

General

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities revenues and expenses. On an ongoing basis, we evaluate our estimates, including those related to impairment of the library of photographs and videos and other long lived assets, allowances for bad debt, income taxes and contingencies and litigation. Accounts receivable and sales related to certain products are, in accordance with industry practice, subject to distributors right of return to unsold items. We base our estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily available from other sources. Management periodically reviews such estimates. Actual results may differ from these estimates as a result of unexpected changes in trends.

We believe the following critical accounting policies are significantly affected by judgments and estimates used in the preparation of our consolidated financial statements.

Recognition of Revenue

Revenues from the sale of magazines, videocassettes, DVD s and other related products where distributors are not granted rights-of-return are recognized upon transfer of title, which generally occurs upon delivery.

The Company sells magazines to wholesalers on firm sale basis and via national newsstand distributors with the right to return. Our magazines are multi-lingual and the principal magazine market is in Europe.

Revenues from the sale of magazines under agreements that grant distributors rights-of-return are recognized upon transfer of title, which generally occurs on delivery, net of an allowance for returned magazines. Distributors with the right to return are primarily national newsstand distributors. Most of our magazines are bi-monthly (six issues per year) and remain on sale at a newsstand for a period of two months. Normally, all unsolds are reported to us within a period of four to six months from delivery. There are normally two to four national newsstand distributors for all newspapers and periodicals in each country. A majority of our national newsstand distributors are members of Distripress, the international organization for publishers and distributors, and carry out the distribution of the largest national and international newspapers and periodicals, including: Financial Times, Herald Tribune, Time, Newsweek, Vogue, etc.

The Company uses specific return percentages per title and distributor based on estimates and historical data. The percentages vary from 50-80%. Higher percentages generally reflect newer markets and/or products. Percentages are reviewed on an on-going basis.

The magazines have an approximate retail price of EUR 11.50 (USD 15.00) per copy and are printed on glossy high-quality paper at a cost of EUR 1.25 (USD 1.60). They are often shrink-wrapped in order to comply with local regulation or guidance for the sale of adult publications. In view of the high retail price, the margin and the physical quality of the magazines and the fact that the content has a very

long shelf-life since it is not particularly linked to time, trends, fashion or current events, the Company has always collected the returns from newsstands in order to make them available for sale again.

The Company has scheduled re-distribution of the returned magazines, via national newsstand distributors, as Megapacks or Superpacks (three different copies per pack) where the retail price is EUR 14.95 (USD 19.50). As the national newsstand distributors have the right to return, the packs come back to us and are then broken up in individual copies in order to be sent out in DVD packs, see below, or sold on firm sale basis to wholesalers as back numbers at a lower price than new issues.

The Company recently started scheduled re-distribution of returned magazines, via national newsstand distributors, together with DVDs as Magazine/DVD packs as a way of increasing DVD distribution. Since the national newsstand distributors have the right to return, the DVD packs are returned and the magazines are broken out in order to be sold on firm sale basis to wholesalers as back numbers at a lower price than new issues. The Company has historically sold all copies printed at an average price higher than, or equal, to cost.

Revenues from the sale of videocassette and DVD products under consignment agreements with distributors are recognized based upon reported sales by the Company s distributors. Revenues from the sale of subscriptions to the Company s internet website are deferred and recognized ratably over the subscription period. Revenues from licensing of broadcasting rights to the Company s video and film library are recognized upon delivery when the following conditions have been met (i) license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale (ii) the arrangement fee is fixed or determinable and (iii) collection of the arrangement fee is reasonably assured. Revenues from satellite & cable broadcasting are recognized based on sales reported each month by its cable and satellite affiliates. The affiliates do not report actual monthly sales for each of their systems until approximately 60 90 days after the month of service ends. This practice requires management to make monthly revenue estimates based on historical experience for each affiliated system. Revenue is subsequently adjusted to reflect the actual amount earned upon receipt. Adjustments made to adjust revenue from estimated to actual have historically been immaterial.

Accounts receivable

We are required to estimate the collectibility of our trade receivables and notes receivable. A considerable amount of judgment is required in assessing the ultimate realization of these receivables including the current credit-worthiness of each customer. Significant changes in required reserves have been recorded in the past and may occur in the future due to the current market environment.

Management reviews the allowance for doubtful accounts on at least a quarterly basis and adjusts the balance based on their estimate of the collectibility of specific accounts as well as a reserve for a portion of other accounts which have been outstanding for more than 180 days. This estimate is based on historical losses and information about specific customers. After collection attempts have failed, the Company writes off the specific account.

Goodwill and Other Intangible Assets

On January 1, 2002 the Company adopted Financial Accounting Standards Board Statement (SFAS) No. 142, Goodwill and Other Intangible Assets . Under SFAS 142, goodwill and indefinite lived

intangible assets will no longer be amortized but will be reviewed annually for impairment (or more frequently if indicators of impairment arise).

During 2002, the Company performed an initial impairment test of goodwill and indefinite lived intangible assets as of January 1, 2002. This generally required us to assess these assets for recoverability when events or circumstances indicate a potential impairment by estimating the undiscounted cash flows to be generated from the use of these assets. There was no effect of on the earnings and financial position of the Company as a result of the impairment testing.

Impairment of Long-Lived Assets

The Company periodically evaluates the carrying value of long-lived assets including its library of photographs and videos for potential impairment. Upon indication of impairment, the company will record a loss on its long-lived assets if the undiscounted cash flows that are estimated to be generated by those assets are less than the related carrying value of the assets. An impairment loss is then measured as the amount by which the carrying value of the asset exceeds the estimated discounted future cash flows. Management s estimated future revenues are based upon assumptions about future demand and market conditions and additional write downs may be required if actual conditions are less favorable than those assumed.

Inventories

Inventories are valued at the lower of cost or market, with cost principally determined on an average basis. Inventories principally consist of DVD s, videocassettes and magazines held for sale or resale. The inventory is written down to the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional write-downs may be required.

Results of Operations

Three months ended March 31, 2005 compared to the three months ended March 31, 2004

Net sales. For the three months ended March 31, 2005, we had net sales of EUR 7.4 million compared to net sales of EUR 10.0 million for the three months ended March 31, 2004, a decrease of EUR 2.6 million or 25%.

DVD sales decreased EUR 1.1 million, or 22%, to EUR 4.1 million. The decrease in DVD sales was primarily attributable to one month s loss of sales of new releases equal to approximately EUR 1.0 million. The loss of sales was the result of our DVD duplicator suffering a logistics and delivery breakdown in February 2005. In addition DVD sales were affected by our outsourcing in the US where we now report sales net of agent s commission (see discussion under *Overview* above). The negative impact of reporting US sales net of agent s commission was EUR 0.5 million. Video sales decreased EUR 0.7 million, or 86%, to EUR 0.1 million. The decrease in video sales was the result of a general industry decrease in video sales due to the migration from video to DVD. Magazine sales decreased EUR 0.2 million, or 14% to EUR 1.3 as a result of fewer issues released during the three month period. Internet sales decreased EUR 0.3 million, or 20%, to EUR 1.0 million as a result of the closing down of our third party payment processor for

US transactions. Subsequently, we temporarily transferred our US transactions to our payment processor for European transactions, however, this did not compensate sales. As of May 2005 we have a new payment processor for US transactions online and we expect sales to increase. Broadcasting sales decreased EUR 0.2 million, or 17%, to EUR 1.0 million as a result of lower content licensing sales in the period.

Easter, which took place during the first quarter of the year compared to the second quarter of the year in 2004, had an overall negative impact on sales of magazines and DVDs.

Cost of Sales. Our cost of sales was EUR 4.5 million for the three months ended March 31, 2005 compared to EUR 4.7 million for the three months ended March 31, 2004, a decrease of EUR 0.2 million, or 4%.

Included in cost of sales is printing, processing and duplication, amortization of library and broadcasting costs. Printing, processing and duplication cost was EUR 2.8 million for the three months ended March 31, 2005 compared to EUR 2.7 million for the three months ended March 31, 2004. Printing, processing and duplication cost as a percentage of sales was 37% for the three months ended March 31, 2005, which represents an increase of 9%. The increase was the result of sales mix. Amortization of library was EUR 1.5 million for the three months ended March 31, 2005 compared to EUR 1.7 million for the three months ended March 31, 2004, a decrease of EUR 0.2 million. Amortization of library does not vary with sales since it reflects the amortization of our investments in content which has been available for sale for a period of three to five years. The decrease was the result of lower amounts invested in content released during the period subject to amortization in 2005 compared to 2004. Broadcasting cost was EUR 0.2 million for the three months ended March 31, 2005 compared to EUR 0.2 million for the three months ended March 31, 2004. Broadcasting cost represents programming and transmission cost.

Gross Profit. In the three months ended March 31, 2005, we realized a gross profit of EUR 3.0 million, or 40% of net sales compared to EUR 5.3 million, or 53% of net sales for the three months ended March 31, 2004. The decrease in gross profit as a percentage of sales was the result of sales mix and the effect of amortization of library which does not vary with sales.

Selling, general and administrative expenses. Our selling, general and administrative expenses were EUR 3.5 million for the three months ended March 31, 2005 compared to EUR 4.5 million for the three months ended March 31, 2004, a decrease of EUR 1.0 million, or 22%. We attribute the decrease primarily to reductions in bad debt expense and depreciation, and the outsourcing of distribution in the United States, offset by non-recurring expenses of EUR 0.5 million related to a weekly publication which was launched and discontinued during the period. We expect selling, general and administrative expenses to continue to decrease in 2005.

Gain on sale of building. We reported gain on sale of building of EUR 1.3 million for the three months ended March 31, 2005.

Operating profit. We reported an operating profit of EUR 0.7 million for the three months ended March 31, 2005 compared to EUR 0.7 million for the three months ended March 31, 2004.

Interest expense. We reported interest expense of EUR 0.2 million for the three months ended March 31, 2005, compared to EUR 0.2 million for the three months ended March 31, 2004.

Income tax benefit. We reported income tax benefit of EUR 0.1 million for the three months ended March 31, 2005, compared to EUR 0.2 million for the three months ended March 31, 2004. The decrease in income tax benefit is a result of lower losses being recorded in jurisdictions with higher corporate tax rates.

Net income/loss. We reported net income of EUR 0.7 million for the three months ended March 31, 2005, compared to EUR 0.8 million for the three months ended March 31, 2004. We attribute this change in net income in 2005 of EUR 0.1 million, to decreased income tax benefit.

Liquidity and Capital Resources

We reported a working capital surplus of EUR 24.1 million at March 31, 2005, an increase of EUR 5.9 million compared to the year ended December 31, 2004. The increase is principally attributable to the sale of our real estate property in Barcelona.

Operating Activities

Net cash provided by operating activities was EUR 0.4 million for the three months ended March 31, 2005, and was primarily the result of net income, as adjusted for non-cash transactions, offset by uses of cash related to changes in operating assets and liabilities. The net income of EUR 0.7 million was adjusted to reconcile net income to net cash flows from operating activities, representing depreciation of EUR 0.3 million and amortization of photographs and videos of EUR 1.5 million making a total of EUR 2.6 million which was offset by gain on sale of building of EUR 1.3 million, providing a net balance of EUR 1.3 million. The total of EUR 1.3 million was then reduced by changes in trade accounts receivable, related party receivable, inventories, prepaid expenses and other current assets and income taxes payable totaling EUR 1.4 million offset by EUR 0.5 million from accounts payable trade and accrued other liabilities. Net cash provided by operating activities was EUR 2.1 million for the three months ended March 31, 2004. The decrease in cash provided by operating activities for the three months ended March 31, 2005 compared to the same period last year is the result of adjustment to reconcile net income to net cash flows from operating activities.

Investing Activities

Net cash used in investing activities for the three months ended March 31, 2005 was EUR 1.3 million. The investing activities were principally investment in library of photographs and videos of EUR 2.0 million, which was carried out in order to maintain the 2005 release schedules for both magazines and DVD offset by EUR 0.7 million from part-payment on sale of building and note receivable. Despite the increase in investment in library of photographs and videos of EUR 0.8 million, or 67%, net cash used in investing activities decreased EUR 0.6 million over the same period last year. The decrease is principally due to cash received from part-payment on sale of building and note receivable.

Financing Activities

Net cash used in financing activities for the three-month period ended March 31, 2005 was EUR 0.3 million, represented primarily by EUR 0.4 million in repayments on short- and long-term borrowings offset by EUR 0.1 million in cash provided by short- and long-term borrowings. We attribute the change of EUR

0.5 million in net cash used in financing activities over the comparable three-month 2004 period to lower additional borrowings. The main movements during the three-month period ended March 31, 2005 are described as follows:

The $3.0 million loan from Beate Uhse AG was reduced by EUR 0.2 million, inclusive of exchange rate changes. As of March 31, 2005 the remaining balance on the loan was EUR 0.5 million. The $4.0 million Note held by Consipio Holding b.v. increased by EUR 0.1 million inclusive of exchange rate changes. As of December 31, 2004 the remaining balance on the Note was EUR 2.3 million.

In May 2003, Euro 1.65 million of the related party note payable to Luthares was re-financed by an institutional lender at the same interest rate as on the note payable, EURIBOR + 1%. The loan is repayable in equal monthly installments over a four year period starting June 29, 2004. During the three months ended March 31, 2005, the Company repaid Euro 0.1 million and subsequently the remaining balance was Euro 1.3 million.

Non-Cash Transaction

In January 2005, the Company presented a claim to the previous owner of our real estate property located in Barcelona, Spain. Under the claim the Company was awarded EUR 2.2 million. The increase in related party receivable of EUR 1.5 million, together with the reduction of EUR 0.7 million in related party payable, reflects this claim.

Contractual obligations

During the three-month period ended March 31, 2005, we have not experienced any material changes in our contractual obligations compared to what was reported in our Form 10-K for the year ended December 31, 2004.

Outlook

We expect growth in 2005, particularly in the broadcasting, DVD and Internet segments. During 2005, we expect to increase the release frequency of new movie productions compared to 2004.

We expect that our available cash resources and cash generated from operations and the sale of real estate will be sufficient to meet our presently anticipated working capital and capital expenditure requirements for at least the next 12 months. However, we may need to raise additional funds to support more rapid expansion or respond to unanticipated requirements.

If additional funds are raised through the issuance of equity securities, our shareholders percentage ownership will be reduced, they may experience additional dilution, or these newly issued equity securities may have rights, preferences, or privileges senior to those of our current shareholders. Additional financing may not be available when needed on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to develop or enhance our products and services, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could harm our business.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

We do not use derivative financial instruments for trading purposes and were never a party to any derivative, swap or option contracts. We do not hedge our interest rate or foreign currency exchange rate exposures.

As our cash and cash equivalents and short-term investments consist principally of money market securities and investments in short-term debt or equity securities and our borrowings are primarily at fixed rates of interest our market risk related to fluctuations in interest rates is limited. Accordingly, a one percentage change in market interest rates would not have a material impact on our results of operations.

We transact our business in various currencies, principally the Euro and the U.S dollar and certain other European Union currencies. We generally attempt to limit exposure to currency rate fluctuations by matching transaction currencies (revenues/expenses) to the functional currency of its operating subsidiaries. Our exposure to market risk for fluctuations in foreign currency exchange rates relates primarily to fluctuations in the Euro versus the U.S dollar. We translate our consolidated subsidiaries whose functional currency is not the euro into the euro for reporting purposes. Income statement amounts are translated into euros using the average exchange rate for the fiscal year. The balance sheet is translated at the year-end exchange rate. Due to the significance of the results reported in dollars the impact of the euro/dollar exchange rate on our major categories of revenue and expense can be material.

Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the specified time periods. As of the end of the period covered by this report, the Company s Chief Executive Officer and Chief Financial Officer evaluated, with the participation of the Company s management, the effectiveness of the Company s disclosure controls and procedures. Based on the evaluation, which disclosed no significant deficiencies or material weaknesses, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective. There were no changes in the Company s internal control over financial reporting that occurred during the Company s most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

In the fall of 2003 we sold convertible notes to four accredited institutional investors in the aggregate principal amount of $2.25 million. Interest on the convertible notes accrues at the rate of 7%, and is payable quarterly in cash or common stock, at the election of the Company, based upon a weighted average market price during the 15 trading days preceding payment. The notes are convertible at the option of the holder at a fixed conversion price of $2.00.

In March 2005 we issued an aggregate of 7,258 shares of common stock in payment of $33,658 of accrued interest under the notes. The issuance of the common stock is deemed to be exempt from the registration requirement of the Securities Act of 1933, as amended, in reliance on Section 4(2) of the Securities Act and Regulation D promulgated thereunder, as it was sold to institutional investors believed to be accredited investors and was made without general solicitation or advertising.

Item 6. Exhibits and Reports on Form 8-K

a. Exhibits:

31.1 Certifications pursuant to Rule 13a-14 under the Securities Exchange Act of 1934.

31.2 Certifications pursuant to Rule 13a-14 under the Securities Exchange Act of 1934.

32.1 Certification of CEO and CFO Pursuant to 18 U.S.C. § 1350, as Adopted Pursuant to § 906 of the Sarbanes-Oxley Act of 2002.

b. Reports on Form 8-K:

On February 10, 2005, we filed a Current Report on Form 8-K under Item 1.01 to report that on February 4, 2005, we entered into an agreement with Local i Serveis Sant Cugat, S.L. to sell the remaining part of our real estate property located in Barcelona, Spain.

SIGNATURES

Pursuant to the requirements 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.

PRIVATE MEDIA GROUP, INC.
(Registrant)

Date: May 16, 2005

/s/ Johan Gillborg
Johan Gillborg, Chief Financial Officer