PRIVATE MEDIA GROUP INC
Form 10-Q
August 14, 2003

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.. June 30, 2003

OR

o **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 o

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

Yes o 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 August 8, 2003
Common Stock, par value $.001	49,854,934

PART I.

Item 1. Financial Statements

PRIVATE MEDIA GROUP, INC.
CONSOLIDATED BALANCE SHEETS

	December 31,	June 30, (Unaudited)	
	2002	2003	2003
	EUR	EUR (in thousands)	USD
ASSETS			
Cash and cash equivalents	1,694	1,142	1,298
Short-term investment	2,850	2,850	3,239
Trade accounts receivable	12,472	12,514	14,220
Related party receivable	4,228	4,488	5,100
Inventories - net (Note 4)	8,808	10,698	12,156
Deferred income tax asset	396	396	450
Prepaid expenses and other current assets	3,630	4,624	5,254
TOTAL CURRENT ASSETS	34,078	36,712	41,718
Library of photographs and videos - net	16,929	17,682	20,093
Property, plant and equipment - net	14,890	15,448	17,554
Goodwill and other intangible assets (Note 5)	2,851	3,560	4,045
Other assets	240	239	271
TOTAL ASSETS	68,989	73,640	83,682
LIABILITIES AND SHAREHOLDERS EQUITY			
Short-term borrowings	9,739	2,850	3,238
Accounts payable trade	6,929	9,972	11,331
Income taxes payable	753	387	440
Deferred income taxes	31	31	35
Accrued other liabilities	1,339	1,494	1,698
TOTAL CURRENT LIABILITIES	18,791	14,733	16,742
Long-term borrowings	178	9,642	10,957
Related party payable	6,569	4,920	5,591
TOTAL LIABILITIES	25,538	29,295	33,289
SHAREHOLDERS EQUITY			
$4.00 Series A Convertible Preferred Stock 10,000,000 shares authorized, 7,000,000 and 1,650,000 issued and outstanding at December 31, 2002 and			

June 30, 2003, respectively			
Common Stock, $.001 par value, 100,000,000 shares authorized, 28,608,609 and 44,904,934 issued and outstanding at December 31, 2002 and June 30, 2003, respectively	863	878	998
Additional paid-in capital	15,668	16,359	18,590
Stock dividends to be distributed	692	148	168
Retained earnings	28,695	29,080	33,046
Accumulated other comprehensive loss	(2,467)	(2,120)	(2,409)
TOTAL SHAREHOLDERS EQUITY	43,451	44,345	50,392
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	68,989	73,640	83,682

PRIVATE MEDIA GROUP, INC.
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	Three-months ended June 30, (unaudited)		Six-months ended June 30, (unaudited)		
	2002	2003	2002	2003	2003
	EUR	EUR	EUR (in thousands)	EUR	USD
Net sales	11,027	10,078	20,289	19,669	22,351
Cost of sales	4,592	4,880	8,109	9,179	10,430
Gross profit	6,435	5,198	12,180	10,490	11,921
Selling, general and administrative expenses	4,457	4,907	10,226	9,966	11,325
Offering expenses			1,401		
Operating profit (loss)	1,978	291	553	524	596
Interest expense	74	204	353	406	461
Interest income	13	37	175	80	91
Income before income tax	1,917	124	375	198	225
Income taxes (benefit)	(47)	(155)	(372)	(337)	(383)
Net income	1,964	279	746	535	608
Other comprehensive income:					
Foreign currency adjustments	(257)	262	1,343	347	395
Comprehensive income	1,707	542	2,089	883	1,003
Income applicable to common shares	1,611	207	(7)	387	440
Net income per share:					
Basic	0.06	0.00	0.00	0.01	0.01
Diluted	0.04	0.00	0.00	0.01	0.01

See accompanying notes to consolidated statements.

PRIVATE MEDIA GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six-months ended June 30, (unaudited)		
	2002	**2003**	**2003**
	EUR	**EUR** (in thousands)	**USD**
Cash flows from operating activities:			
Net income	746	535	608
Adjustment to reconcile net income to net cash flows from operating activities:			
Depreciation	309	515	585
Bad debt provision	686	150	170
Provision for offering expenses	134		
Amortization of other intangible assets		25	28
Amortization of photographs and videos	2,808	3,474	3,948
Effects of changes in operating assets and liabilities:			
Trade accounts receivable	(329)	(926)	(1,052)
Related party receivable	(3,251)	(260)	(296)
Inventories	(902)	(1,889)	(2,147)
Prepaid expenses and other current assets	(732)	(993)	(1,129)
Accounts payable trade	1,619	3,043	3,458
Income taxes payable	(1,047)	(366)	(416)
Accrued other liabilities	34	155	176
Net cash provided by operating activities	77	3,462	3,934
Cash flows from investing activities:			
Investment in library of photographs and videos	5,304	4,228	4,804
Capital expenditures	869	1,060	1,204
Investments in (sale of) other assets	(11)	(2)	(2)
Net cash used in investing activities	6,163	5,286	6,006
Cash flow from financing activities:			
Conversion of warrants	232		
Related party note payable		(1,649)	(1,874)
Long-term loan (repayments on loan)	(12)	9,464	10,755
Short-term borrowings (repayments)	(494)	(6,890)	(7,829)
Net cash (used in) provided by financing activities	(274)	925	1,051
Foreign currency translation adjustment	1,343	347	395
Net (decrease) increase in cash and cash equivalents	(5,017)	(551)	(626)
Cash and cash equivalents at beginning of the period	6,408	1,694	1,925
Cash and cash equivalents at end of the period	1,391	1,142	1,298

Cash paid for interest	247	219	249
Cash paid for taxes	675	320	364

See accompanying notes to consolidated statements.

PRIVATE MEDIA GROUP, INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Common stock		Preferred stock		Additional paid-in capital	Stock dividends to be distributed	Retained earnings	Accumulated other comprehensive income	Total shareholder's equity
	Shares	Amounts	Shares	Amounts					
		EUR		EUR	EUR	EUR	EUR	EUR	EUR
Balance at January 1, 2002	28,370,857	863	7,000,000		14,285	396	29,802	(3,066)	42,280
Translation Adjustment								666	666
Unrealized loss on short-term investment								(67)	(67)
Conversion of warrants and options	55,295				232				232
Stock dividends	182,457				1,150	(1,150)			
Stock dividends to be distributed						1,446	(1,446)		
Net income							340		340
Balance at December 31, 2002	28,608,609	863	7,000,000		15,668	692	28,695	(2,467)	43,450
Translation Adjustment								348	348
Conversion of preferred stock to common stock	16,050,000	15	(5,350,000)						15
Stock dividends	246,325				692	(692)			
Stock dividends to be distributed						148	(148)		
Net income							533		533
Balance at June 30, 2003	44,904,934	878	1,650,000		16,359	148	29,080	(2,120)	44,345

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 six months period ended June 30, 2003 are not necessarily indicative of the results that may be expected for the year ended December 31, 2003. 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, 2002.

Solely for the convenience of the reader, the accompanying consolidated financial statements as of June 30, 2003 and for the six months then ended have been translated into United States dollars (USD) at the rate of EUR 0.88 per USD 1.00 the Interbank Exchange Rate on June 30, 2003. The translations should not be construed as a representation that the amounts shown could have been, or could be, converted into US dollars at that or any other rate.

2. Conversion of Preferred Stock

We are authorized to issue up to 10,000,000 shares of preferred stock under our Articles of Incorporation, of which 7,000,000 million have been issued as Series A Preferred Stock.. On March 18, 2003 Slingsby Enterprises Limited, the record owner of the outstanding Series A Preferred Stock, converted 5,350,000 of the 7,000,000 shares of $4.00 Series A Preferred Stock into 16,050,000 shares of common stock in accordance with the terms of the Series A Preferred Stock. Accordingly, as of March 18, 2003, 1,650,000 shares of Series A Preferred Stock remained outstanding.

3. Stock-Based Compensation

As permitted by Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation, the Company has elected to continue following 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 because the exercise price of the options equals the fair value of the stock at the vesting date.

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 2002 and 2003 would have been as per the following table:

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PRIVATE MEDIA GROUP, INC.
NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

	Three-months ended June 30, (unaudited)		Six-months ended June 30, (unaudited)	
	2002	2003	2002	2003
	EUR	EUR	EUR	EUR
	(in thousands)		(in thousands)	
Net income, as reported	1,964	279	746	535
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards net of related tax effects	(417)	(1,606)	(678)	(2,321)
Pro forma net income	1,547	(1,327)	68	(1,786)
Net income applicable to common shares, as reported	1,611	207	(7)	387
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards net of related tax effects	(417)	(1,606)	(678)	(2,321)
Pro forma net income applicable to common shares	1,194	(1,399)	(685)	(1,934)
Earnings (loss) per share:				
Basic as reported	0.06	0.00	0.00	0.01
Basic pro forma	0.04	(0.03)	(0.02)	(0.05)
Diluted as reported	0.04	0.00	0.00	0.01
Diluted pro forma	0.03	(0.03)	(0.02)	(0.05)

4. Inventories

Inventories consist of the following:

	December 31,	June 30,
	2002	2003
	EUR	EUR
	(in thousands)	

Magazines for sale and resale	2,634	2,970
Video cassettes	2,874	3,002
DVDs	3,231	4,651
Other	69	75
	8,808	10,698

5. Goodwill and Other Intangible Assets

On May 30, 2003 the Company entered into an Asset Purchase Agreement to acquire certain assets, including governmental film board approvals and distribution rights from its former Canadian distributor, Software Entertainment Ltd. The transaction closed on May 30, 2003. The consideration for the transaction was EUR 734,091 and the transaction has been accounted for as the acquisition of an intangible asset which is being amortized on a straight line basis over 10 years.

PRIVATE MEDIA GROUP, INC.
NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

6. Earnings per share

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

	Three-months ended June 30,		Six-months ended June 30,	
	2002	**2003**	**2002**	**2003**
Numerator: (EUR in thousands)				
Net income (numerator diluted EPS)	1,964	279	746	535
Less: Dividends on preferred stock	353	72	754	148
Income applicable to common shares (numerator basic EPS)	1,611	207	(7)	387
Denominator:				
Denominator for basic earnings per share Weighted average shares	28,566,982	44,983,761	28,535,966	38,153,326
Effect of dilutive securities:				
Preferred stock	21,000,000	N/A	N/A	11,726,667
Common stock warrants and options	166,533	N/A	N/A	331,376
Denominator for diluted earnings per share weighted average shares and assumed conversions	49,733,515	N/A	N/A	50,211,369
Earnings per share (EUR)				
Basic	0.06	0.00	0.00	0.01
Diluted	0.04	0.00	0.00	0.01

For the six month period ended June 30, 2002 and the three month period ended June 30, 2003 the impact of potentially dilutive securities (convertible preferred shares and outstanding options and warrants for common shares) is anti-dilutive therefore reported diluted and basic income (loss) per share are EUR 0.00.

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

PRIVATE MEDIA GROUP, INC.
NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

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.

8. Subsequent Event

On August 8, 2003 Slingsby Enterprises Limited, the record owner of the outstanding Series A Preferred Stock, see Note 2, converted the remaining 1,650,000 of the 7,000,000 shares of $4.00 Series A Preferred Stock into 4,950,000 shares of common stock in accordance with the terms of the Series A Preferred Stock. Accordingly, as of August 8, 2003, no shares of Series A Preferred Stock remained outstanding.

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.

Critical Accounting Policies

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.

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.

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. 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.

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.

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.

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 recent periods and may occur in the future due to the current market environment.

Results of Operations

Three months ended June 30, 2003 compared to the three months ended June 30, 2002

Net sales. For the three months ended June 30, 2003, we had net sales of EUR 10.1 million compared to net sales of EUR 11.0 million for the three months ended June 30, 2002, a decrease of EUR 0.9 million, or 9%. We attribute this change to a decrease in Video and Magazine, Internet and Broadcasting sales. Video and Magazine sales decreased 18% to EUR 3.5 million, primarily as a result of DVD taking over from video in the marketplace. Internet sales decreased 32% to EUR 1.1 million as a result of a weaker US dollar and lower license sales. Broadcasting sales decreased 61% to EUR 0.6 million as a result of a decrease in license sales. The reduction in Broadcasting license sales is a result of the Company s strategy to start operating its own TV channel in the United States. The launch of this channel requires the Company to refrain from selling its broadcast rights to third parties for the period leading up to the launch. The decrease in Video and Magazine, Internet and Broadcasting sales was offset by a increase in DVD sales of 33% to EUR 4.9 million. We attribute the growth in sales of DVDs to the increasing number of DVD players being sold in all of our markets. We believe that the growth in DVD sales will continue through the remainder of 2003.

Net sales in general were affected by unfavorable changes in exchange rates.

Cost of Sales. Our cost of sales was EUR 4.9 million for the three months ended June 30, 2003 compared to EUR 4.6 million for the three months ended June 30, 2002, an increase of EUR 0.3 million, or 6%. Cost of sales as a percentage of sales was 48% for the three months ended June 30, 2003, compared to 42% for the three months ended June 30, 2002. The increase in cost of sales as a percentage of sales was primarily the result of sales mix, see *Gross Profit*.

Gross Profit. In the three months ended June 30, 2003, we realized a gross profit of EUR 5.2 million, or 52% of net sales compared to EUR 6.4 million, or 58% of net sales for the three months ended June 30, 2002, a decrease of EUR 1.2 million, or 19%. The decrease in gross profit was primarily the result of sales mix, with higher sales volume in products generating cost of sales, such as Videos, Magazines and DVDs combined, and lower sales in products not generating cost of sales, such as Internet and Broadcasting sales.

Selling, general and administrative expenses. Our selling, general and administrative expenses were EUR 4.9 million for the three months ended June 30, 2003 compared to EUR 4.5 million for the three months ended June 30, 2002, an increase of EUR 0.4 million, or 10%. The increase is primarily the result of increased marketing efforts and EUR 0.15 million in increased bad debt provision.

Operating profit. We reported an operating profit of EUR 0.3 million for the three months ended June 30, 2003 compared to an operating profit of EUR 2.0 million for the three months ended June 30, 2002, a decrease of EUR 1.7 million, or 85%. The decrease was primarily the result of lower gross profit.

Interest expense. We reported interest expense of EUR 0.2 million for the three months ended June 30, 2003, compared to EUR 0.1 million for the three months ended June 30, 2002, an increase of EUR 0.1 million. We attribute this increase to higher short-term and long-term borrowings outstanding during the three months ended June 30, 2003, compared to the three months ended June 30, 2002.

Income tax expense/benefit. We reported income tax benefit of EUR 0.2 million for the three months ended June 30, 2003, compared to no income tax for the three months ended June 30, 2002.

Net income. We reported net income of EUR 0.3 million for the three months ended June 30, 2003, compared to net income of EUR 2.0 million for the three months ended June 30, 2002. We attribute the decrease in net income in 2003 of EUR 1.7 million to lower operating profit.

Six months ended June 30, 2003 compared to the six months ended June 30, 2002

Net sales. For the six months ended June 30, 2003, we had net sales of EUR 19.7 million compared to net sales of EUR 20.3 million for the six months ended June 30, 2002, a decrease of EUR 0.6 million, or 3%. We attribute this change to a decrease in Video and Magazine, Internet and Broadcasting sales. Video and Magazine sales decreased 14% to EUR 6.5 million, primarily as a result of DVD taking over from video in the marketplace. Internet sales decreased 25% to EUR 2.4 million as a result of a weaker US dollar and lower license sales. Broadcasting sales decreased 43% to EUR 1.3 million as a result of a decrease in license sales. The reduction in Broadcasting license sales is a result of the Company s strategy to start operating its own TV channel in the United States. The launch of this channel requires the Company to refrain from selling its broadcast rights to third parties for the period leading up to the launch. The decrease in Video and Magazine, Internet and Broadcasting sales was offset by a increase in DVD sales of 30% to EUR 9.5 million. We attribute the growth in sales of DVDs to the increasing number of DVD players being sold in all of our markets. We believe that the growth in DVD sales will continue through the remainder of 2003.

Net sales in general were affected by unfavorable changes in exchange rates.

Cost of Sales. Our cost of sales was EUR 9.2 million for the six months ended June 30, 2003 compared to EUR 8.1 million for the six months ended June 30, 2002, an increase of EUR 1.1 million, or 13%. Cost of sales as a percentage of sales was 47% for the six months ended June 30, 2003, compared to 40% for the six months ended June 30, 2002. The increase in cost of sales as a percentage of sales was primarily the result of sales mix, see *Gross Profit.*

Gross Profit. In the six months ended June 30, 2003, we realized a gross profit of EUR 10.5 million, or 53% of net sales compared to EUR 12.2 million, or 60% of net sales for the six months ended June 30, 2002, a decrease of EUR 1.7 million, or 14%. The decrease in gross profit was primarily the result of sales mix, with higher sales volume in products generating cost of sales, such as Videos, Magazines and DVDs combined, and lower sales in products not generating cost of sales, such as Internet and Broadcasting sales.

Selling, general and administrative expenses. Our selling, general and administrative expenses were EUR 10.0 million for the six months ended June 30, 2003 compared to EUR 10.2 million for the six months ended June 30, 2002, a decrease of EUR 0.2 million, or 3%. Discounting non-recurring charges of EUR 0.7 million made in 2002, our selling, general and administrative expenses have increased by EUR 0.5 million which is primarily the result of increased marketing efforts and EUR 0.15 million in increased bad debt provision.

Operating profit. We reported an operating profit of EUR 0.5 million for the six months ended June 30, 2003 compared to an operating profit of EUR 0.6 million for the six months ended June 30, 2002, a decrease of EUR 0.1 million, or 5%. Discounting non-recurring charges of EUR 1.4 million in offering expenses made in 2002, the decrease was EUR 1.5 million. The decrease was primarily the result of lower gross profit.

Interest expense. We reported interest expense of EUR 0.4 million for the six months ended June 30, 2003, compared to EUR 0.4 million for the six months ended June 30, 2002.

Income tax expense/benefit. We reported income tax benefit of EUR 0.3 million for the six months ended June 30, 2003, compared to income tax benefit of EUR 0.4 million for the six months ended June 30, 2002.

Net income. We reported net income of EUR 0.5 million for the six months ended June 30, 2003, compared to net income of EUR 0.7 million for the six months ended June 30, 2002.

Liquidity and Capital Resources

We reported a working capital surplus of EUR 22.0 million at June 30, 2003, an increase of EUR 6.7 million compared to the year ended December 31, 2002. The increase is principally attributable to reductions in short-term borrowings.

Operating Activities

Net cash provided by operating activities was EUR 3.5 million for the six months ended June 30, 2003, and was primarily the result of adjustments to reconcile net income to net cash flows from operating activities. The net income of EUR 0.5 million was adjusted to reconcile net income to net cash flows from operating activities, representing depreciation of EUR 0.5 million, bad debt provision of EUR 0.15 million and amortization of photographs and videos of EUR 3.5 million provided a total of EUR 4.7 million. The total of EUR 4.7 million was then added to by changes in accounts payable trade and accrued other liabilities totaling EUR 3.2 million offset by EUR 4.4 million from trade accounts receivable, related party receivable, inventories, prepaid expenses and other current assets and income taxes payable. There was no net cash provided by operating activities for the six months ended June 30, 2002. The increase in cash provided by operating activities for the six months ended June 30, 2003 compared to the same period last year is primarily the result of changes in operating assets and liabilities.

Investing Activities

Net cash used in investing activities for the six months ended June 30, 2003 was EUR 5.3 million. The investing activities were principally investment in library of photographs and videos of EUR 4.2 million, which was carried out in order to maintain the 2003 and 2004 release schedules for both magazines, video and DVD, and EUR 1.1 million invested in capital expenditures. The decrease over the comparable six-month 2002 period is principally due to decreased investments in library of photographs and videos.

Financing Activities

Net cash provided by financing activities for the six months ended June 30, 2003 was EUR 0.9 million, represented primarily by a loan from an institutional lender in the principal amount of EUR 4.2 million of which EUR 1.75 million was received in March 2003. The loan bears interest at the rate of EURIBOR + 1.5%, repayable over 12 years, including an initial period of 18 months during which only interest is payable. The loan was obtained for the purposes of financing the construction of an office building and is secured by a mortgage on the building. The balance of the loan will be paid out over the remaining period of construction of the building, which is expected to be completed in 2004. The increase over the comparable six-month 2002 period is primarily due to the initial amount received from the loan.

In December 2001 we borrowed USD $ 4.0 million from Commerzbank AG pursuant to a Note originally due on December 20, 2002. The Note bore interest at an annual rate of 7%, payable quarterly, with the entire principal amount and accrued interest originally due on December 20, 2002. In December 2002 Commerzbank AG agreed to extend the maturity date of the Note from December 20, 2002 to March 20, 2003.

In April 2003 the Note was acquired by Consipio Holding b.v. from Commerzbank AG, and the maturity of the Note was extended for five years, with interest on the Note being increased to 9.9% per annum. In addition, Consipio acquired a USD $3.0 million note from the Company to Beate Uhse AG, which Note was due on December 13, 2003, and bore interest at the rate of 5% per annum. This Note has now been restructured to provide for the extension of the maturity date by five years and an interest rate of 9.9% per annum.

In May 2003 Euro 1.65 million of the approximately Euro 6.6 million related party payable to Luthares was re-financed by BPA Bank 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. Thus the remaining balance on the Note Payable to Luthares is Euro 4.9 million.

We expect that our available cash resources and cash generated from operations 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 equivalent 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

As required by SEC Rule 13a-15(b), an evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a - 15(e) and 15d - 15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including cost limitations, judgments used in decision making, assumptions regarding the likelihood of future events, soundness of internal controls, fraud, the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can provide only reasonable, and not absolute, assurance of achieving their control objectives. Based upon and as of the date of the evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective, in all material respects, with respect to the recordings, processing, summarizing and reporting, within the time periods specified in the SEC s rules and forms, of information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934.

There have been no significant changes in our internal controls or in other factors that could significantly affect internal controls subsequent to the date of the evaluation described above.

PART II. OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

Conversion of Preferred Stock

We are authorized to issue up to 10,000,000 shares of preferred stock under our Articles of Incorporation, of which 7,000,000 million have been issued as Series A Preferred Stock.. On March 18, 2003 Slingsby Enterprises Limited, the record owner of the outstanding Series A Preferred Stock, converted 5,350,000 of the 7,000,000 shares of $4.00 Series A Preferred Stock into 16,050,000 shares of common stock in accordance with the terms of the Series A Preferred Stock. On August 8, 2003, the remaining outstanding 1,650,000 shares of Series A Preferred Stock were converted into 4,950,000 shares of common stock. Accordingly, as of August 8, 2003, no shares of Series A Preferred Stock remained outstanding.

Item 6. Exhibits and Reports on Form 8-K

a. Exhibits:

Exhibit 31.1 - Certifications pursuant to Rule 13a-14 under the Securities Exchange Act of 1934
Exhibit 31.2 - Certifications pursuant to Rule 13a-14 under the Securities Exchange Act of 1934
Exhibit 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:

No reports on Form 8-K were filed during the quarter for which this Quarterly Report on Form 10-Q is filed.

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)

/s/ JOHAN GILLBORG

Date: August 12, 2003

Johan Gillborg, Chief Financial Officer