

PRIVATE MEDIA GROUP INC  
Form 10-Q  
November 14, 2006

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**U.S. SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2006

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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

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Large Accelerated Filer  Accelerated Filer  Non-accelerated filer

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

Yes  No

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 November 10, 2006
Common Stock, par value \$.001	53,148,165

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## PART I.

## Item 1. Financial Statements

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

	December 31,	September 30, (Unaudited)	
	2005 EUR	2006 EUR	2006 USD
	(in thousands)		
<b>ASSETS</b>			
Cash and cash equivalents	3,112	2,195	2,778
Trade accounts receivable	8,813	9,636	12,198
Receivable from sale of building	225		
Related party receivable	5,888	6,049	7,657
Inventories - net (Note 2)	9,780	9,073	11,484
Deferred income tax asset	2,836	2,836	3,590
Prepaid expenses and other current assets	2,953	2,440	3,089
<b>TOTAL CURRENT ASSETS</b>	<b>33,607</b>	<b>32,229</b>	<b>40,796</b>
Library of photographs and videos net	17,058	17,242	21,825
Property, plant and equipment net	2,163	2,029	2,568
Other intangible assets	3,343	3,250	4,114
Goodwill	2,425	2,425	3,069
Other assets	304	328	415
<b>TOTAL ASSETS</b>	<b>58,901</b>	<b>57,502</b>	<b>72,788</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>			
Short-term borrowings	3,853	3,530	4,468
Current portion of long-term borrowings	1,511	416	527
Accounts payable trade	5,871	4,772	6,040
Income taxes payable	488	146	185
Deferred income taxes	52	52	66
Accrued other liabilities	1,682	1,236	1,565
<b>TOTAL CURRENT LIABILITIES</b>	<b>13,457</b>	<b>10,152</b>	<b>12,851</b>
Long-term borrowings	555	237	300
<b>TOTAL LIABILITIES</b>	<b>14,012</b>	<b>10,389</b>	<b>13,151</b>
<b>SHAREHOLDERS EQUITY</b>			
Common Stock, \$.001 par value, 100,000,000 shares authorized, 52,478,723 and 53,180,166 issued and outstanding at December 31, 2005 and September 30, 2006, respectively	885	885	1,120
Additional paid-in capital	19,585	20,781	26,305
Retained earnings	27,188	28,183	35,675
Accumulated other comprehensive income	(2,769)	(2,737)	(3,465)
<b>TOTAL SHAREHOLDERS EQUITY</b>	<b>44,889</b>	<b>47,113</b>	<b>59,636</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>58,901</b>	<b>57,502</b>	<b>72,787</b>

See accompanying notes to consolidated statements.



## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF INCOME (LOSS)

## AND COMPREHENSIVE INCOME (LOSS)

	Three-months ended		Nine-months ended		
	September 30,		September 30,		
	(unaudited)		(unaudited)		
	2005 EUR	2006 EUR	2005 EUR	2006 EUR	2006 USD
	(in thousands)				
Net sales	6,295	7,776	20,815	21,907	27,730
Cost of sales	3,131	3,190	11,809	10,808	13,682
Gross profit	3,163	4,586	9,006	11,098	14,048
Selling, general and administrative expenses (Note 4)	3,307	3,587	10,443	10,456	13,236
Gain on sale of building			1,279		
Operating profit (loss)	(144)	999	(157)	642	812
Interest expense	171	183	548	487	617
Interest income	50	54	137	171	217
Income (loss) before income tax	(265)	871	(568)	326	413
Income taxes (benefit)	(192)	(107)	(524)	(669)	(847)
Net income (loss)	(73)	978	(44)	995	1,259
Other comprehensive income:					
Foreign currency adjustments	(11)		(502)	50	63
Comprehensive income (loss)	(84)	978	(546)	1,044	1,322
Net income (loss) per share:					
Basic	0.00	0.02	0.00	0.02	0.02
Diluted	0.00	0.02	0.00	0.02	0.02

See accompanying notes to consolidated statements.

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine-months ended September 30,		
	(unaudited)		
	2005	2006	2006
	EUR	EUR	USD
	(in thousands)		
<b>Cash flows from operating activities:</b>			
Net income (loss)	(44)	995	1,259
<b>Adjustment to reconcile net income to net cash flows from operating activities:</b>			
Depreciation	835	820	1,037
Stock based compensation		53	67
Bond adjustment	68	71	89
Bad debt provision	71	8	10
Amortization of other intangible assets	93	93	118
Amortization of photographs and videos	5,043	4,888	6,187
Gain on sale of building	(1,279)		
<b>Effects of changes in operating assets and liabilities:</b>			
Trade accounts receivable	(630)	(831)	(1,052)
Related party receivable	(185)	(161)	(204)
Inventories	(749)	707	895
Prepaid expenses and other current assets	(625)	(80)	(101)
Accounts payable trade	215	(1,099)	(1,391)
Income taxes payable	(225)	(342)	(433)
Accrued other liabilities	183	(446)	(565)
Net cash provided by operating activities	2,771	4,676	5,918
<b>Cash flows from investing activities:</b>			
Investment in library of photographs and videos	(6,062)	(5,072)	(6,421)
Capital expenditures	(248)	(688)	(871)
Cash received from sale of building	3,412	225	285
Investments in sale of other assets	18	(23)	(30)
Note receivable	578	592	750
Net cash (used in) investing activities	(2,301)	(4,966)	(6,286)
<b>Cash flow from financing activities:</b>			
Conversion of stock options		79	100
Short-term borrowings repayments		(323)	(409)
Long-term borrowings repayments	(2,066)	(415)	(525)
Long-term loan additions	54		
Short-term borrowings - additions	187		
Net cash (used in) provided by financing activities	(1,825)	(659)	(835)
Foreign currency translation adjustment	(502)	32	41
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(1,857)</b>	<b>(918)</b>	<b>(1,162)</b>
<b>Cash and cash equivalents at beginning of the period</b>	<b>3,261</b>	<b>3,112</b>	<b>3,940</b>
<b>Cash and cash equivalents at end of the period</b>	<b>1,404</b>	<b>2,195</b>	<b>2,778</b>
Cash paid for interest	411	400	506

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Cash paid for taxes	72	
Conversion of bond principal into common stock	1,057	1,337

See accompanying notes to consolidated statements.

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Common stock				Retained earnings EUR	Accumulated other comprehensive income EUR	Total share- holders equity EUR
	Shares	Amounts EUR	paid-in capital EUR	to be issued EUR			
Balance at January 1, 2005	50,162,176	883	17,321	1,752	27,138	(2,145)	44,951
Repurchase of common stock	(46,479)		(127)				(127)
Conversion of bond principal into common stock	312,500		529				529
Conversion of bond interest into common stock	49,776		113				113
Conversion of options	2,000,750	2	1,750	(1,752)			
Translation adjustment						(626)	(626)
Net income (loss)					50		50
Balance at December 31, 2005	52,478,723	885	19,585		27,188	2,769	44,889
Repurchase of common stock	(10,933)		(32)				(32)
Conversion of bond principal into common stock	662,500		1,057				1,057
Conversion of bond interest into common stock	16,128		39				39
Conversion of stock options	33,750		79				79
Stock based compensation			53				53
Translation adjustment						32	32
Net income (loss)					995		995
Balance at September 30, 2006	53,180,166	885	20,781		28,183	(2,737)	47,112

See accompanying notes to consolidated statements.



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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 nine months period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006. 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, 2005.

Solely for the convenience of the reader, the accompanying consolidated financial statements as of September 30, 2006 and for the nine months then ended have been translated into United States dollars ( USD ) at the rate of EUR 0.79 per USD 1.00 the interbank exchange rate on September 30, 2006. 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.

*Stock-based compensation*

On January 1, 2006, the Company adopted the Statement of Financial Accounting Standards No. 123 (revised 2004) Share Based Payment , ( 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 consolidated income statement based on their fair values. The Company adopted SFAS 123(R) using the modified-prospective method as proscribed in SFAS 123(R). Our consolidated financial statements as of and for the nine months ending September 30, 2006 reflect the impact of adopting SFAS 123(R). In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R).

Stock-based compensation cost recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest. Stock-based compensation cost recognized in the consolidated financial statements during the nine months ending September 30, 2006 included compensation cost for stock-based compensation granted prior to, but not yet vested, as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 148 and compensation cost for the stock-based payment awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with FAS 123(R). As stock-based compensation cost recognized in the consolidated statement of income for the nine months ending September 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information required under SFAS 148 for the periods prior to 2006, the Company accounted for forfeitures as they occurred.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

## (UNAUDITED)

Prior to January 1, 2006, and as permitted by Statement of Financial Accounting Standards No. 123 ( SFAS No. 123 ), Accounting for Stock-Based Compensation , the Company followed Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees ( APB 25 ) 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 was recognized since at the date of grant, the exercise price of stock options was 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. As of January 1, 2006, the accounting under APB 25 and the disclosure-only provisions of SFAS No. 123 are no longer an alternative.

The following table illustrates the effect on net income after taxes and net income per common share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation during the three and nine month periods ended September 30, 2005 (in thousands, except per share amounts):

	Three-months ended September 30, (unaudited) 2005 EUR	Nine-months ended September 30, (unaudited) 2005 EUR
	(in thousands)	
Net income, as reported	(73)	(44)
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards net of related tax effects	(27)	(245)
Pro forma net income	(100)	(289)
Earnings per share:		
Basic as reported	0.00	0.00
Basic pro forma	0.00	0.00
Diluted as reported	0.00	0.00
Diluted pro forma	0.00	0.00

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

**2. Inventories**

Inventories consist of the following:

	December 31, 2005 EUR	September 30, 2006 EUR
	(in thousands)	
Magazines for sale and resale	3,534	3,600
Video cassettes	299	119
DVDs	5,484	4,887
Other	463	467
	9,780	9,073

**3. Earnings (loss) per share**

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

	Three-months ended September 30,		Nine-months ended September 30,	
	2005	2006	2005	2006
<b>Numerator: (EUR in thousands)</b>				
Net income (loss)	(73)	978	(44)	995
<b>Denominator:</b>				
Denominator for basic earnings per share	Weighted average shares		52,152,232	53,037,036
Effect of dilutive securities:			51,587,713	52,759,267
Convertible Note	Weighted average outstanding		n/a	140,750
Common stock warrants and options			n/a	372,040
Denominator for diluted earnings per share	weighted average shares and assumed conversions		n/a	53,549,826
			n/a	53,471,492
<b>Earnings (loss) per share in EUR</b>				
Basic	0.00	0.02	0.00	0.02
Diluted	0.00	0.02	0.00	0.02

For the three months and the nine months ended September 30, 2005 diluted impact of potentially dilutive securities is anti-dilutive therefore diluted and basic loss per share is EUR 0.00. The equivalent of 1,105,197 and 1,573,654 common shares derived from dilutive securities such as options, warrants and convertible notes are excluded from the diluted earnings per share for the three months and nine months ended September 30, 2005, respectively, as they are anti-dilutive.



## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

**4. Stock-based compensation**

The Company has an Employee Stock Option Plan as described below. On adoption, the Company reviewed the Employee Stock Option Plan for potential forfeitures and estimated that out of the nonvested options outstanding at September 30, 2006 there would be none. The compensation cost charged against income for the three and nine month periods ended September 30, 2006 was EUR 15 thousand and EUR 53 thousand, respectively, which is included in selling, general and administrative expense. The charge of compensation cost had no impact on tax since none of the option beneficiaries are taxable in the U.S. and tax rules are different in the beneficiaries respective tax jurisdictions.

*Employee Stock Option Plan*

The 1999 Employee Stock Option Plan ( the Plan ), which is shareholder approved, allows the Company to grant options to purchase common stock to designated employees, executive officers, directors, consultants, advisors and other corporate and divisional officers of Private Media Group. The Plan authorizes the Company to grant stock options exercisable for up to an aggregate of 7,200,000 shares of common stock. No stock options may be granted under the Plan, after the Plan expires, on March 1, 2009. The purchase price (exercise price) of option shares must be at least equal to the fair market value of such shares on the date the stock option is granted or such later date the Company may specify. The stock option is exercisable for a period of ten years from the date of grant or such shorter period as is determined by the Company. Each stock option may provide that it is exercisable in full or in cumulative or non-cumulative installments, and each stock option is exercisable from the date of grant or any later date specified in the option. Unless otherwise provided by the Company, an optionee may not exercise a stock option unless from the date of grant to the date of exercise the optionee remains continuously in the Company's employ.

The Company calculates the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The following general assumptions are used: a) expected volatility is based on historical volatility of our stock, b) expected life is determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior, c) risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and d) dividend yield is zero based on the Company's current dividend policy.

During the nine-month periods ended September 30, 2005 and 2006 grants for 8,000 shares, respectively, were made. The following assumptions were used in calculating the fair value:

	Nine-months ended	
	September 30, 2005	2006
Expected volatility	70.0%	61.8%
Expected term (in years)	2.5	2.5
Risk-free rate	4.00%	5.05%

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

A summary of stock option activity for the nine month period ended September 30, 2006 is as follows:

	Number of Shares	Weighted- Average Exercise Price in USD	Weighted- Average Remaining Contractual Term in Years	Aggregate Intrinsic Value <sup>1</sup> in Thousands of USD
Outstanding January 1, 2006	2,740,186	5.22		
Granted	8,000	4.73		
Exercised	33,750	2.91		
Forfeited	15,500	2.16		
Outstanding September 30, 2006	2,698,936	5.23	2.46	754
Exercisable September 30, 2006	2,517,936	5.27	2.48	678

During the nine months ended September 30, 2005 and 2006, the aggregate intrinsic value of options exercised under our stock option plan was USD 6.5 million and USD 42 thousand, respectively, determined as of the date of option exercise.

A summary of the status of the Company's nonvested shares as of September 30, 2006, and changes during the nine month period then ended, is presented below:

	Number of Shares	Weighted- Average Grant-Date Fair Value in USD
<b>Nonvested Shares</b>		
Nonvested January 1, 2006	181,000	0.92
Granted	8,000	1.96
Vested	50,000	1.16
Forfeited	8,000	1.23
Nonvested September 30, 2006	131,000	1.09

As of September 30, 2006, there was USD 37 thousand of total unrecognized compensation cost related to nonvested option granted under the Plan. The cost is expected to be recognized over a weighted-average period of 0.51 years. The total fair value of all shares vested and outstanding at September 30, 2005 and 2006, was USD 6.6 million and USD 6.6 million, respectively.

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<sup>1</sup> The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for the options that were in-the-money at September 30, 2006.

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**(UNAUDITED)**

**5. 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 Administrative Court of Appeal 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.

**6. Recent Accounting Pronouncements**

In March 2006, the FASB's Emerging Issues Task Force (EITF) issued Issue 06-3, How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (EITF 06-3). A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes and the amounts of taxes. The guidance is effective beginning on January 1, 2007. The Company is currently evaluating the impact of adopting EITF 06-3 but it is not expected to have a material impact to the Company's results of operations and net income.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Tax Positions- an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainties in tax positions. This Interpretation requires that the Company recognize in its financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit, based on technical merits of the position. The provisions of FIN 48 are effective beginning on January 1, 2007. The Company is currently evaluating the impact of adopting FIN 48 on its financial statements but it is not expected to have a material impact.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements, (FAS 157). FAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. We are required to adopt FAS 157 effective at the beginning of 2008. The Company is currently evaluating the impact of adopting FAS 157 on its financial statements but it is not expected to have a material impact.



**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 and digital media content for Broadcasting, Wireless 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 DVDs;

sales of adult feature magazines;

Internet subscriptions and licensing;

broadcasting movies through cable, satellite, IPTV and hotel television programming;

sales of adult mobile content (wireless); and

content, brand name and trademark licensing.

Over time, we expect net sales from magazines to continue to decline as a percentage of net sales in relation to total net sales from DVDs, the Internet, wireless and broadcasting. We expect net sales from the Internet, wireless and broadcasting to grow during the coming years and eventually become our main source of income.

We released 113 titles on DVD during 2005, 104 titles during 2004 and 111 titles during 2003, including both new and archival material. We plan to release approximately 120 proprietary titles on DVDs in 2006.

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 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 production, 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, wireless and broadcasting. Internet, wireless and broadcasting sales has historically not carried any material 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, 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 DVDs 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) persuasive evidence of a sale or licensing arrangement with a customer exists, (ii) the film is complete and has been delivered or is available for immediate and unconditional delivery (in accordance with the terms of the arrangement), (iii) the license period has begun and the customer can begin its exploitation, exhibition, or sale, (iv) the fee is fixed or determinable and (v) collection of the 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 90 - 120 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.

Revenues from wireless are recognized based on sales reported each month by aggregators. The aggregators do not report actual monthly sales for each of their systems until approximately 90 - 120 days after the month of service ends. This practice requires management to make monthly revenue estimates based on historical experience for each aggregator. Revenue is subsequently adjusted to reflect the actual amount earned upon receipt.

#### *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 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 September 30, 2006 compared to the three months ended September 30, 2005***

*Net sales.* For the three months ended September 30, 2006, we had net sales of EUR 7.8 million compared to net sales of EUR 6.3 million for the three months ended September 30, 2005, an increase of EUR 1.5 million or 24%. The increase was attributed to an increase in Internet, broadcasting and wireless sales of EUR 1.8 million, or 79%, which was offset by a reduction in sales of magazines and video of EUR 0.4 million, or 9%.

Broadcasting sales increased EUR 1.3 million to EUR 2.4 million primarily as a result of additional IPTV/VOD and licensing sales, (see discussion under *Outlook* below). Wireless sales increased EUR 0.3 million to EUR 0.6 million as a result our content being available with more operators. Internet sales increased EUR 0.1 million to EUR 1.2 million. DVD sales did not change and remained on EUR 3.1 million. Magazine sales decreased EUR 0.3 million to EUR 0.6 as a result of lower quantities sold through certain retail channels during the three month period.

Going forward, we expect broadcasting, Internet and wireless sales to increase (see discussion under *Outlook* below).

*Cost of Sales.* Our cost of sales was EUR 3.2 million for the three months ended September 30, 2006 compared to EUR 3.1 million for the three months ended September 30, 2005, an increase of EUR 0.1 million, or 2%.

Included in cost of sales is printing, processing and duplication, amortization of library and broadcasting costs. Printing, processing and duplication cost was EUR 1.4 million for the three months ended September 30, 2006 compared to EUR 1.2 million for the three months ended September 30, 2005. Printing, processing and duplication cost as a percentage of sales was 22% for the three months ended September 30, 2006, which represents an increase of 3%. The increase was the result of reduced margins on sales of physical products. Amortization of library was EUR 1.6 million for the three months ended September 30, 2006 compared to EUR 1.7 million for the three months ended September 30, 2005, which represents a slight change. 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 compared to the same period last year. Broadcasting cost was EUR 0.2 million for the three months ended September 30, 2006 compared to EUR 0.2 million for the three months ended September 30, 2005. Broadcasting cost represents programming and transmission cost.

*Gross Profit.* In the three months ended September 30, 2006, we realized an increase in gross profit of EUR 1.4 million, or 45% compared to the same period last year. Gross profit for the three months ended September 30, 2006 was EUR 4.6 million, or 59% of net sales compared to EUR 3.2 million, or 50% of net sales for the three months ended September 30, 2005. The increase in gross profit both in money and as a percentage of sales was the result of increased sales of non-physical products.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses were EUR 3.6 million for the three months ended September 30, 2006 compared to EUR 3.3 million for the three months ended September 30, 2005, an increase of EUR 0.3 million, or 8%, which was primarily related to payroll and depreciation.

*Operating profit (loss).* We reported an operating profit of EUR 1.0 million for the three months ended September 30, 2006 compared to an operating loss of EUR 0.1 million for the three months ended September 30, 2005. The increase in operating profit was primarily related to the increase in gross profit offset by an increase in selling, general and administrative expenses

*Interest expense.* We reported interest expense of EUR 0.2 million for the three months ended September 30, 2006, compared to EUR 0.2 million for the three months ended September 30, 2005.

*Income tax benefit.* We reported income tax benefit of EUR 0.1 million for the three months ended September 30, 2006, compared to EUR 0.2 million for the three months ended September 30, 2005.

*Net income/loss.* We reported net income of EUR 1.0 million for the three months ended September 30, 2006, compared to a net loss of EUR 0.1 million for the three months ended September 30, 2005. The increase was primarily related to an increase in operating profit.

*Nine months ended September 30, 2006 compared to the nine months ended September 30, 2005*

*Net sales.* For the nine months ended September 30, 2006, we had net sales of EUR 21.9 million compared to net sales of EUR 20.8 million for the nine months ended September 30, 2005, an increase of EUR 1.1 million or 5%. The increase was attributed to an increase in Internet, broadcasting and wireless sales of EUR 4.7 million, or 77%, which was offset by a reduction in sales of magazines, DVDs and video of EUR 3.6 million, or 25%.

Broadcasting sales increased EUR 3.7 million to EUR 6.2 million as a result of a new Pay-TV licensing agreement for German speaking Europe and an increase in video on demand sales offset by a temporary decrease in channel licensing sales due to the switchover to new channel licensing partners (see discussion under *Outlook* below). Wireless sales increased EUR 0.8 million to EUR 1.3 million as a result our content being available with more operators. Internet sales increased EUR 0.2 million to EUR 3.3 million compared to the same period last year. DVD sales decreased EUR 2.0 million to EUR 9.3 million. The decrease in DVD sales was attributable to a reduction in points of sales carrying our DVD products and an industry wide decrease in DVD consumer prices. The reduction of points of sales occurred during the second half of 2005 as a result of the Company's decrease in releases of new movie productions. Currently, and going forward, the Company is releasing the optimal level of new movie productions and subsequently, during the remainder of 2006, we expect to regain points of sales and improve our margins as a result of having more higher priced new movie productions on sale. The industry wide drop in DVD consumer prices is partly the result of offline sales/rental competing with online sales/rental. Video sales decreased EUR 0.2 million to EUR 0.0 million since the Company no longer sells video cassettes. Magazine sales decreased EUR 1.3 million, to EUR 1.7 million as a result of lower quantities sold through certain retail channels during the nine month period.

Going forward, we expect Broadcasting, Internet and wireless sales to increase (see discussion under *Outlook* below).

*Cost of Sales.* Our cost of sales was EUR 10.8 million for the nine months ended September 30, 2006 compared to EUR 11.8 million for the nine months ended September 30, 2005, a decrease of EUR 1.0 million, or 8%.

Included in cost of sales is printing, processing and duplication, amortization of library and broadcasting costs. Printing, processing and duplication cost was EUR 5.3 million for the nine months ended September 30, 2006 compared to EUR 6.2 million for the nine months ended September 30, 2005. Printing, processing and duplication cost as a percentage of sales was 26% for the nine months ended September 30, 2006, which represents a decrease of 4%. The decrease was primarily the result of an increase in sales of non-physical products such as Internet, broadcasting and wireless which carries no printing, processing and duplication cost. Amortization of library was EUR 4.9 million for the nine months ended September 30, 2006 compared to EUR 5.0 million for the nine months ended September 30, 2005, which represents 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 compared to the same period last year. Broadcasting cost was EUR 0.6 million for the nine months ended September 30, 2006 compared to EUR 0.5 million for the nine months ended September 30, 2005. Broadcasting cost represents programming and transmission cost.

*Gross Profit.* In the nine months ended September 30, 2006, we realized an increase in gross profit of EUR 2.1 million, or 23% compared to the same period last year. Gross profit for the nine months ended September 30, 2006 was EUR 11.1 million, or 51% of net sales compared to EUR 9.0 million, or 43% of net sales for the nine months ended September 30, 2005. The increase in gross profit in both money and as a percentage of sales was primarily the result of sales mix, i.e. the increase in sales of non-physical products carrying no printing, processing and duplication cost and the decrease in sales of physical products carrying printing, processing and duplication cost.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses were EUR 10.5 million for the nine months ended September 30, 2006 compared to EUR 10.4 million for the nine months ended September 30, 2005. The increase is primarily related to payroll.

*Gain on sale of building.* We reported gain on sale of building of EUR 1.3 million for the nine months ended September 30, 2005.

*Operating profit (loss).* We reported an operating profit of EUR 0.6 million for the nine months ended September 30, 2006 compared to an operating loss of EUR 0.2 million for the nine months ended September 30, 2005. The increase in operating profit of EUR 0.8 million was primarily the result of an increase in gross profit offset by the absence of gain on sale of building we had in 2005. Discounting the non-recurring effect of gain on sale of building of EUR 1.3 million in 2005, operating profit improved by EUR 2.1 million in the period.

*Interest expense.* We reported interest expense of EUR 0.5 million for the nine months ended September 30, 2006, compared to EUR 0.5 million for the nine months ended September 30, 2005.

*Income tax benefit.* We reported income tax benefit of EUR 0.7 million for the nine months ended September 30, 2006, compared to EUR 0.5 million for the nine months ended September 30, 2005. The increase in income tax benefit is a result of higher losses being recorded in jurisdictions with higher corporate tax rates.

*Net income/loss.* We reported net income of EUR 1.0 million for the nine months ended September 30, 2006, compared to net income of EUR 0.0 million for the nine months ended September 30, 2005. Discounting the non-recurring effect of gain on sale of building in 2005, net income improved by EUR 2.3 million in the period.

#### **Liquidity and Capital Resources**

We reported a working capital surplus of EUR 22.1 million at September 30, 2006, an increase of EUR 1.9 million compared to the year ended December 31, 2005. The increase is principally attributable to a decrease in current liabilities.



*Operating Activities*

Net cash provided by operating activities was EUR 4.7 million for the nine months ended September 30, 2006, 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. Net income of EUR 1.0 million was adjusted to reconcile net income to net cash flows from operating activities including some minor adjustments, depreciation of EUR 0.8 million and amortization of photographs and videos of EUR 4.9 million making a total of EUR 6.9 million. The total of EUR 6.9 million was then reduced by changes in trade accounts receivable, related party receivable, prepaid expenses and other current assets, accounts payable trade, income taxes payable and accrued other liabilities totaling EUR 3.0 million offset by EUR 0.7 million from inventories. Net cash provided by operating activities was EUR 2.8 million for the nine months ended September 30, 2005. The increase in cash of EUR 1.9 million provided by operating activities for the nine months ended September 30, 2006 compared to the same period last year is primarily 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 nine months ended September 30, 2006 was EUR 5.0 million. The investing activities were principally investment in library of photographs and videos of EUR 5.1 million, which was carried out in order to maintain the 2006/2007 release schedules for both magazines and DVDs and capital expenditure of EUR 0.7 million offset by EUR 0.8 million from the last payment on sale of building and note receivable. Net cash used in investing activities increased EUR 2.7 million over the same period last year. The increase is principally due to less cash received from sale of building.

*Financing Activities*

Net cash used in financing activities for the nine-month period ended September 30, 2006 was EUR 0.7 million, represented by repayments on short- and long-term borrowings, which included the final payment on the loan related to the building, offset by cash received from conversion of stock options. Net cash used in financing activities for the nine-month period ended September 30, 2006 decreased by EUR 1.1 million as a result of reduced requirements on repayments on borrowings.

*Non-Cash Transaction*

During the nine month period ending September 30, 2006 three convertible note holders converted a total of \$1,325,000 of principal into common stock. As of September 30, 2006, the \$2,250,000 convertible note was fully converted and subsequently all debt related to the note was repaid.

**Contractual obligations**

During the nine-month period ended September 30, 2006, 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, 2005.

## Outlook

During the nine months ending September 30, 2006, the combined increase in broadcasting, wireless and Internet sales was 77% compared to the same period last year, and represented 49% of total sales. We expect aggressive growth in this area going forward and subsequently it will significantly affect the overall growth and operating profit of the Company's business. Below follows a discussion highlighting some important factors which we expect to contribute to the growth:

### *Broadcasting*

During the past twelve months we have seen evidence of a new source of significant future profits in the IPTV based True Video on Demand (TVOD<sup>2</sup>) market in Europe. Revenues from our initial distributors on this type of platform have increased steadily, in line with subscriber growth.

In response to the development and rollout of IPTV based TVOD, the Company is aggressively targeting all major TVOD platforms and we are currently in the process of contracting with several platforms. During the fourth quarter of 2006 we expect to add a total of ten new TVOD platforms, represented by seven in Western Europe, two in Canada and one in Taiwan. By the end of 2007, the Company expects to reach a subscription base of at least 16 million TVOD enabled subscribers on a minimum of 27 new platforms in Western Europe(16), North America(6), the Far East(4) and Australia(1). We have reason to believe that our revenue from TVOD platforms will grow in line with the addition of platforms and their subscriber growth and consequently we expect a significant contribution to operating profit going forward.

In order to increase growth and profitability in broadcasting, we have restructured our trademark and content licensing business with respect to the operation and distribution of Private branded TV channels carrying our content in Europe and Latin America. The restructuring included finding new partners in these markets and subsequently we entered into agreements with Playboy TV Latin America, The Portland Television Group and Playboy TV International. During the switchover phase we were not fully operational in these markets and the third quarter of 2006 was the first full quarter since the end of 2005 in which all Private branded TV channels were in place. With the restructuring completed, we expect revenues and operating profit to grow going forward.

An additional feature of the restructuring discussed above was the release back to the Company of previously exclusive content rights held by third parties. Subsequently, in May 2006, the Company entered into a five-year Pay-TV content licensing agreement with Erotic Media AG for the territory of German Speaking Europe. Under the terms of the agreement, Private Media Group will receive 6 million euro during the licensing period in return for the access to a certain number of titles in its library. The agreement is highly profitable and it is making a substantial contribution to operating profit. During the second quarter of 2006 the Company recorded EUR 2.0 million in sales and EUR 0.35 million in marketing expense from this agreement, and during the third quarter of 2006 the Company recorded EUR 1.2 million in sales and EUR 0.1 million in marketing expense. The Company expects to be able to do additional deals based on the same concept going forward.

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<sup>2</sup> True Video On Demand - (TVOD) - TVOD is the ideal VOD service where individual users get immediate responses when interacting with the VOD system. With TVOD, the user can not only get instant access to the program online and watch it on TV, but also be able to do any VCR or DVD-like commands on the VOD system with the same quick response time as it is when working a VCR or DVD.

*Wireless Adult Mobile Content*

As of September 30, 2006 Private's mobile content was available to over 500 million handsets via 59 operators in 28 countries, of which 33 operators went live since September 2005. We are scheduled to go live with 20 additional operators in the fourth quarter and the Company is expecting to grow steadily with at least 10 additional operators each quarter during 2007. Asia and the Americas are currently unexplored and do therefore represent an enormous growth potential to us. Moreover, mobile data usage is still in the early days. More distribution channels and new technologies such as Mobile-TV and age verification systems, offering the ability to show explicit content, will provide us with significant growth in 2007 and beyond.<sup>3</sup>

*Internet*

Traffic to our sites has been growing steadily during the last 12 months and in the third quarter we experienced a new record of 2.8 million unique visits. Driving the growth in traffic is the development of our affiliate program Private Cash, which has continued to attract increasing traffic thanks to its promotion across our webmaster base. Although our affiliate program is still in its infancy it has proved that it works, and as the number of webmasters signing up grows we expect traffic and sales to increase.

In the second quarter we contracted with a third-party in order to employ DivX technology on our sites. DivX is among the world's most popular video technologies and has been downloaded over 200 million times. DivX enables consumers to both stream and/or download to own and play highly-compressed, high-quality video content on their PCs and TV sets. Since August 2006, visitors to the Private-to-Own section of our online shop can download to own videos and we expect this new feature to generate growth going forward.

**Liquidity**

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 twelve 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.

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<sup>3</sup> Juniper Research estimates in its white paper *Adult to Mobile: Personal Services - Third Edition (September 2006)* that the global mobile adult content market will more than double over the next five years, to nearly US\$3.3 billion by 2011.

**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.

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**PART II. OTHER INFORMATION**
**Item 2. Unregistered Sales of Securities and Use of Proceeds***Convertible Notes*

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 the third quarter of 2006 we issued an aggregate of 3,512 shares of common stock in payment of \$7,601 of accrued interest under the notes and 231,652 shares in exchange for the conversion of principal 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.

*Purchases of Equity Securities*

The following table sets forth information with respect to shares of common stock of the Company purchased by the Company during the nine months ended September 30, 2006

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number	(d) Maximum
			of Shares Purchased as Part of Publicly Announced Plans or Programs	Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Programs (1)
January, 2006	10,935	\$ 3.57		
February, 2006				
March, 2006				
April, 2006				
May, 2006				
June, 2006				
July, 2006				
August, 2006				
September, 2006				
<b>Total (1)</b>	<b>10,935</b>	<b>\$ 3.57</b>		

- (1) We have an arrangement with a non-affiliated shareholder whereby we sell our products in exchange for shares of common stock valued at market price at the time of repurchase. We may repurchase up to an additional 34,999 shares of common stock under this arrangement.

**Item 6. 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.

**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: November 14, 2006

/s/ Johan Gillborg  
Johan Gillborg, Chief Financial Officer

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