

NETFLIX INC  
Form 10-Q  
July 31, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2009

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: 000-49802

**Netflix, Inc.**

(Exact name of Registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**77-0467272**  
(I.R.S. Employer  
Identification Number)

**100 Winchester Circle, Los Gatos, California 95032**  
(Address and zip code of principal executive offices)

**(408) 540-3700**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). Yes  No

As of June 30, 2009, there were 57,415,726 shares of the registrant's common stock, par value \$0.001, outstanding.

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**PART I. FINANCIAL INFORMATION**

***Item 1.* Condensed Consolidated Financial Statements**  
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**Table of Contents****Netflix, Inc.****Condensed Consolidated Statements of Operations****(unaudited)****(in thousands, except per share data)**

|   | <b>Three Months Ended</b> |                 | <b>Six Months Ended</b> |                 |
|---|---------------------------|-----------------|-------------------------|-----------------|
|   | <b>June 30,</b>           | <b>June 30,</b> | <b>June 30,</b>         | <b>June 30,</b> |
|   | <b>2009</b>               | <b>2008</b>     | <b>2009</b>             | <b>2008</b>     |
| Revenues  | \$ 408,509                | \$ 337,614      | \$ 802,607              | \$ 663,797      |
| Cost of revenues:   |                           |                 |                         |                 |
| Subscription  | 224,858                   | 193,769         | 440,157                 | 380,925         |
| Fulfillment expenses *  | 44,385                    | 36,318          | 88,354                  | 71,967          |
| Total cost of revenues  | 269,243                   | 230,087         | 528,511                 | 452,892         |
| Gross profit  | 139,266                   | 107,527         | 274,096                 | 210,905         |
| Operating expenses:   |                           |                 |                         |                 |
| Technology and development *                                      | 27,119                    | 22,186          | 51,319                  | 42,453          |
| Marketing *   | 46,231                    | 39,984          | 108,473                 | 94,879          |
| General and administrative *                                      | 13,252                    | 13,419          | 26,266                  | 27,158          |
| Gain on disposal of DVDs  | (118)                     | (2,263)         | (1,215)                 | (3,096)         |
| Total operating expenses  | 86,484                    | 73,326          | 184,843                 | 161,394         |
| Operating income  | 52,782                    | 34,201          | 89,253                  | 49,511          |
| Other income (expense):   |                           |                 |                         |                 |
| Interest expense on lease financing obligations                   | (674)                     | (681)           | (1,344)                 | (1,104)         |
| Interest and other income (expense)                               | 866                       | 2,404           | 2,476                   | 10,064          |
| Income before income taxes  | 52,974                    | 35,924          | 90,385                  | 58,471          |
| Provision for income taxes  | 20,531                    | 9,345           | 35,579                  | 18,548          |
| Net income  | \$ 32,443                 | \$ 26,579       | \$ 54,806               | \$ 39,923       |
| Net income per share:   |                           |                 |                         |                 |
| Basic   | \$ 0.56                   | \$ 0.43         | \$ 0.94                 | \$ 0.64         |
| Diluted   | \$ 0.54                   | \$ 0.42         | \$ 0.91                 | \$ 0.62         |
| Weighted average common shares outstanding:                       |                           |                 |                         |                 |
| Basic   | 57,872                    | 61,782          | 58,301                  | 62,262          |
| Diluted   | 59,660                    | 63,857          | 60,182                  | 64,341          |
| <b>* Stock-based compensation included in expense line items:</b> |                           |                 |                         |                 |
| Fulfillment expenses  | \$ 102                    | \$ 108          | \$ 222                  | \$ 214          |
| Technology and development  | 1,190                     | 849             | 2,261                   | 1,845           |

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|                            |       |       |       |       |
|----------------------------|-------|-------|-------|-------|
| Marketing                  | 458   | 455   | 901   | 964   |
| General and administrative | 1,528 | 1,493 | 3,026 | 3,012 |

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents****Netflix, Inc.****Condensed Consolidated Balance Sheets****(unaudited)****(in thousands, except share and par value data)**

|  | June 30,<br>2009  | As of<br>December 31,<br>2008 |
|--|-------------------|-------------------------------|
| <b>Assets</b>  |                   |                               |
| Current assets:  |                   |                               |
| Cash and cash equivalents  | \$ 87,471         | \$ 139,881                    |
| Short-term investments   | 167,498           | 157,390                       |
| Prepaid expenses   | 11,430            | 8,122                         |
| Prepaid revenue sharing expenses   | 14,671            | 18,417                        |
| Current content library, net   | 33,519            | 18,691                        |
| Deferred tax assets  | 5,594             | 5,617                         |
| Other current assets   | 22,381            | 13,329                        |
| <b>Total current assets</b>  | <b>342,564</b>    | <b>361,447</b>                |
| Content library, net   | 100,316           | 98,547                        |
| Property and equipment, net  | 120,346           | 124,948                       |
| Deferred tax assets  | 17,225            | 22,409                        |
| Other assets   | 11,542            | 10,595                        |
| <b>Total assets</b>  | <b>\$ 591,993</b> | <b>\$ 617,946</b>             |
| <b>Liabilities and Stockholders' Equity</b>  |                   |                               |
| Current liabilities:   |                   |                               |
| Accounts payable   | \$ 101,634        | \$ 100,344                    |
| Accrued expenses   | 27,782            | 31,394                        |
| Current portion of lease financing obligations   | 1,275             | 1,152                         |
| Deferred revenue   | 80,495            | 83,127                        |
| <b>Total current liabilities</b>   | <b>211,186</b>    | <b>216,017</b>                |
| Lease financing obligations, excluding current portion   | 37,301            | 37,988                        |
| Other liabilities  | 19,135            | 16,786                        |
| <b>Total liabilities</b>   | <b>267,622</b>    | <b>270,791</b>                |
| Commitments and contingencies  |                   |                               |
| Stockholders' equity:  |                   |                               |
| Common stock, \$0.001 par value; 160,000,000 shares authorized at June 30, 2009 and December 31, 2008; 57,415,726 and 58,862,478 issued and outstanding at June 30, 2009 and December 31, 2008, respectively | 64                | 62                            |
| Additional paid-in capital   | 375,574           | 338,577                       |
| Treasury stock at cost (6,295,073 and 3,491,084 shares at June 30, 2009 and December 31, 2008, respectively)   | (215,250)         | (100,020)                     |
| Accumulated other comprehensive income, net  | 725               | 84                            |
| Retained earnings  | 163,258           | 108,452                       |
| <b>Total stockholders' equity</b>  | <b>324,371</b>    | <b>347,155</b>                |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$ 591,993</b> | <b>\$ 617,946</b>             |

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See accompanying notes to the condensed consolidated financial statements.



**Table of Contents****Netflix, Inc.****Condensed Consolidated Statements of Cash Flows****(unaudited)****(in thousands)**

|   | <b>Three Months Ended</b> |                 | <b>Six Months Ended</b> |                 |
|---|---------------------------|-----------------|-------------------------|-----------------|
|   | <b>June 30,</b>           | <b>June 30,</b> | <b>June 30,</b>         | <b>June 30,</b> |
|   | <b>2009</b>               | <b>2008</b>     | <b>2009</b>             | <b>2008</b>     |
| <b>Cash flows from operating activities:</b>                                      |                           |                 |                         |                 |
| Net income  | \$ 32,443                 | \$ 26,579       | \$ 54,806               | \$ 39,923       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |                 |                         |                 |
| Depreciation and amortization of property, equipment and intangibles              | 9,013                     | 8,188           | 18,188                  | 14,772          |
| Amortization of content library   | 53,235                    | 57,012          | 102,539                 | 114,582         |
| Amortization of discounts and premiums on investments                             | 119                       | 177             | 313                     | 316             |
| Stock-based compensation expense  | 3,278                     | 2,905           | 6,410                   | 6,035           |
| Excess tax benefits from stock-based compensation                                 | (3,815)                   | (2,554)         | (7,499)                 | (3,374)         |
| Loss on disposal of property and equipment  | 110                       |                 | 254                     |                 |
| Loss (gain) on sale of short-term investments                                     | 101                       | 78              | (471)                   | (4,242)         |
| Gain on disposal of DVDs  | (506)                     | (4,059)         | (2,539)                 | (6,651)         |
| Deferred taxes  | 5,404                     | (2,502)         | 4,781                   | (3,361)         |
| Changes in operating assets and liabilities:                                      |                           |                 |                         |                 |
| Prepaid expenses and other current assets   | (8,845)                   | (10,947)        | (9,236)                 | (8,197)         |
| Content library   | (9,343)                   | (7,982)         | (31,434)                | (31,394)        |
| Accounts payable  | (6,549)                   | 7,092           | 2,023                   | 15,772          |
| Accrued expenses  | (234)                     | (14,551)        | 4,097                   | (6,724)         |
| Deferred revenue  | (128)                     | (489)           | (2,632)                 | (3,779)         |
| Other assets and liabilities  | 1,019                     | 8,433           | 1,335                   | 7,764           |
| Net cash provided by operating activities   | 75,302                    | 67,380          | 140,935                 | 131,442         |
| <b>Cash flows from investing activities:</b>                                      |                           |                 |                         |                 |
| Purchases of short-term investments   | (28,769)                  | (65,937)        | (81,153)                | (157,891)       |
| Proceeds from sale of short-term investments                                      | 7,832                     | 21,017          | 44,765                  | 195,436         |
| Proceeds from maturities of short-term investments                                | 26,175                    | 665             | 27,505                  | 1,565           |
| Purchases of property and equipment   | (6,933)                   | (14,662)        | (13,505)                | (27,093)        |
| Acquisition of intangible assets  |                           | (1,000)         | (200)                   | (1,000)         |
| Acquisitions of content library   | (43,224)                  | (44,410)        | (89,723)                | (95,726)        |
| Proceeds from sale of DVDs  | 1,159                     | 5,379           | 3,885                   | 9,886           |
| Investment in business  |                           |                 |                         | (6,000)         |
| Other assets  | 11                        | 20              | 9                       | 28              |
| Net cash used in investing activities   | (43,749)                  | (98,928)        | (108,417)               | (80,795)        |
| <b>Cash flows from financing activities:</b>                                      |                           |                 |                         |                 |
| Principal payments of lease financing obligations                                 | (295)                     | (230)           | (564)                   | (352)           |
| Proceeds from issuance of common stock  | 9,778                     | 4,524           | 23,367                  | 13,066          |
| Excess tax benefits from stock-based compensation                                 | 3,815                     | 2,554           | 7,499                   | 3,374           |
| Repurchases of common stock   | (72,511)                  |                 | (115,230)               | (99,885)        |
| Net cash (used in) provided by financing activities                               | (59,213)                  | 6,848           | (84,928)                | (83,797)        |

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|  |           |            |           |            |
|--|-----------|------------|-----------|------------|
| Net decrease in cash and cash equivalents      | (27,660)  | (24,700)   | (52,410)  | (33,150)   |
| Cash and cash equivalents, beginning of period | 115,131   | 168,989    | 139,881   | 177,439    |
| Cash and cash equivalents, end of period       | \$ 87,471 | \$ 144,289 | \$ 87,471 | \$ 144,289 |

See accompanying notes to the condensed consolidated financial statements.

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**Table of Contents****Netflix, Inc.****Notes to Condensed Consolidated Financial Statements****1. Basis of Presentation and Summary of Significant Accounting Policies**

The accompanying condensed consolidated interim financial statements of Netflix, Inc. and its wholly owned subsidiary (the Company) have been prepared in conformity with accounting principles generally accepted in the United States (U.S.) and are consistent in all material respects with those applied in the Company's Annual Report on Form 10-K for the year ended December 31, 2008. The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and judgments that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Examples include the estimates of useful lives and residual value of the Company's content library, the valuation of stock-based compensation and the recognition and measurement of income tax assets and liabilities. The actual results experienced by the Company may differ from management's estimates.

The interim financial information is unaudited, but reflects all normal recurring adjustments that are, in the opinion of management, necessary to fairly present the information set forth herein. The interim financial statements should be read in conjunction with the audited financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission (the SEC) on February 25, 2009. Interim results are not necessarily indicative of the results for a full year.

The Company has evaluated subsequent events through July 31, 2009, the date which these financial statements were both available to be issued and were issued.

There have been no material changes in our significant accounting policies, except for the adoption of the Financial Accounting Standards Board (FASB) Staff Positions (FSP) No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability has Significantly Decreased and Identifying Transactions That Are Not Orderly*, No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* and No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, as compared to the significant accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

**Recent Accounting Pronouncements**

In June 2009, the FASB issued Statement of Financial Accounting Standard (SFAS) No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162*. SFAS No. 168 replaces SFAS No. 162 and establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in accordance with GAAP. All guidance included in the Codification will be considered authoritative at that time, even guidance that comes from what is currently deemed to be a non-authoritative section of a standard. Once the Codification becomes effective, all non-grandfathered, non-SEC accounting literature not included in the Codification will become non-authoritative. SFAS No. 168 is applicable for interim and annual periods ending after September 15, 2009. The Company does not expect the adoption of this standard to have a material effect on its financial position or results of operations.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*. SFAS No. 167 eliminates Interpretation 46(R)'s exceptions to consolidating qualifying special-purpose entities, contains new criteria for determining the primary beneficiary of a variable interest entity, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a variable interest entity. SFAS No. 167 also contains a new requirement that any term, transaction, or arrangement that does not have a substantive effect on an entity's status as a variable interest entity, a company's power over a variable interest entity, or a company's obligation to absorb losses or its right to receive benefits of an entity must be disregarded in applying Interpretation 46(R)'s provisions. SFAS No. 167 is applicable for annual periods beginning after November 15, 2009 and interim periods thereafter. The Company does not expect the adoption of this standard to have a material effect on its financial position or results of operations.

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*. SFAS No. 166 eliminates the concept of a qualifying special-purpose entity, creates more stringent conditions for reporting a transfer of a portion of a financial asset as a sale, clarifies other sale-accounting criteria, and changes the initial measurement of a transferor's interest in transferred financial assets. SFAS No. 166 is applicable for annual periods beginning after November 15, 2009 and interim periods therein and thereafter. The Company does not expect the adoption of this standard to have a material effect on its financial position or results of operations.



**Table of Contents****2. Net Income Per Share**

Basic net income per share is computed using the weighted-average number of outstanding shares of common stock during the period. Diluted net income per share is computed using the weighted-average number of outstanding shares of common stock and, when dilutive, potential common shares outstanding during the period. Potential common shares consist primarily of incremental shares issuable upon the assumed exercise of stock options and shares currently purchasable pursuant to the Company's employee stock purchase plan using the treasury stock method. The computation of net income per share is as follows:

|  | Three months ended                    |                  | Six months ended |                  |
|--|---------------------------------------|------------------|------------------|------------------|
|  | June 30,<br>2009                      | June 30,<br>2008 | June 30,<br>2009 | June 30,<br>2008 |
|  | (in thousands, except per share data) |                  |                  |                  |
| <b>Basic earnings per share:</b>                               |                                       |                  |                  |                  |
| Net income   | \$ 32,443                             | \$ 26,579        | \$ 54,806        | \$ 39,923        |
| <b>Shares used in computation:</b>                             |                                       |                  |                  |                  |
| Weighted-average common shares outstanding                     | 57,872                                | 61,782           | 58,301           | 62,262           |
| <b>Basic earnings per share</b>                                | <b>\$ 0.56</b>                        | <b>\$ 0.43</b>   | <b>\$ 0.94</b>   | <b>\$ 0.64</b>   |
| <b>Diluted earnings per share:</b>                             |                                       |                  |                  |                  |
| Net income   | \$ 32,443                             | \$ 26,579        | \$ 54,806        | \$ 39,923        |
| <b>Shares used in computation:</b>                             |                                       |                  |                  |                  |
| Weighted-average common shares outstanding                     | 57,872                                | 61,782           | 58,301           | 62,262           |
| Employee stock options and employee stock purchase plan shares | 1,788                                 | 2,075            | 1,881            | 2,079            |
| <b>Weighted-average number of shares</b>                       | <b>59,660</b>                         | <b>63,857</b>    | <b>60,182</b>    | <b>64,341</b>    |
| <b>Diluted earnings per share</b>                              | <b>\$ 0.54</b>                        | <b>\$ 0.42</b>   | <b>\$ 0.91</b>   | <b>\$ 0.62</b>   |

Employee stock options with exercise prices greater than the average market price of the common stock were excluded from the diluted calculation as their inclusion would have been anti-dilutive. The following table summarizes the potential common shares excluded from the diluted calculation:

|                        | Three months ended |                  | Six months ended |                  |
|------------------------|--------------------|------------------|------------------|------------------|
|                        | June 30,<br>2009   | June 30,<br>2008 | June 30,<br>2009 | June 30,<br>2008 |
|                        | (in thousands)     |                  |                  |                  |
| Employee stock options | 79                 | 355              | 82               | 409              |

**3. Short-Term Investments and Fair Value Measurement**

On April 1, 2009, the Company adopted FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability has Significantly Decreased and Identifying Transactions That Are Not Orderly*, No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* and No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. FSP FAS No. 157-4 provides additional guidance for estimating fair value in accordance with SFAS No. 157, *Fair Value Measurements*, when the volume and level of activity for the asset or liability have significantly decreased. FSP No. FAS 115-2 and FAS 124-2 modifies the requirements for recognizing other-than-temporary impairments of debt securities, changes the existing impairment model for those securities, and modifies the presentation and frequency of related disclosures. FSP No. FAS 107-1 and APB 28-1 amends FAS No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This FSP also amends APB Opinion No. 28, *Interim Financial*

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*Reporting*, to require those disclosures in summarized financial information at interim reporting periods. The adoption of these standards did not have a material effect on the Company's financial position or results of operations.

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The Company's investment policy is consistent with the definition of available-for-sale securities. The Company does not buy and hold securities principally for the purpose of selling them in the near future. The Company's policy is focused on the preservation of capital, liquidity and return. From time to time, the Company may sell certain securities but the objectives are generally not to generate profits on short-term differences in price. Short-term investments are therefore classified as available-for-sale securities and are reported at fair value as follows:

|                                      | June 30, 2009     |                              |                               | Estimated<br>Fair<br>Value |
|--------------------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
|                                      | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                            |
|                                      |                   | (in thousands)               |                               |                            |
| Corporate debt securities            | \$ 76,442         | \$ 1,120                     | \$ (35)                       | \$ 77,527                  |
| Government and agency securities     | 78,097            | 703                          | (43)                          | 78,757                     |
| Asset and mortgage backed securities | 11,807            | 184                          | (777)                         | 11,214                     |
|                                      | \$ 166,346        | \$ 2,007                     | \$ (855)                      | \$ 167,498                 |

|                                      | December 31, 2008 |                              |                               | Estimated<br>Fair<br>Value |
|--------------------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
|                                      | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                            |
|                                      |                   | (in thousands)               |                               |                            |
| Corporate debt securities            | \$ 45,482         | \$ 440                       | \$ (727)                      | \$ 45,195                  |
| Government and agency securities     | 92,378            | 1,812                        | (244)                         | 93,946                     |
| Asset and mortgage backed securities | 19,446            | 15                           | (1,212)                       | 18,249                     |
|                                      | \$ 157,306        | \$ 2,267                     | \$ (2,183)                    | \$ 157,390                 |

The following tables show the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position:

|                                      | As of June 30, 2009    |                      |                         |                      |               |                      |
|--------------------------------------|------------------------|----------------------|-------------------------|----------------------|---------------|----------------------|
|                                      | Less Than<br>12 Months |                      | 12 Months<br>or Greater |                      | Total         |                      |
|                                      | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value           | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
|                                      | (in thousands)         |                      |                         |                      |               |                      |
| Corporate debt securities            | \$ 6,729               | \$ (32)              | \$ 822                  | \$ (3)               | \$ 7,551      | \$ (35)              |
| Government and agency securities     | 12,483                 | (43)                 |                         |                      | 12,483        | (43)                 |
| Asset and mortgage backed securities | 596                    | (150)                | 2,054                   | (627)                | 2,650         | (777)                |
|                                      | \$ 19,808              | \$ (225)             | \$ 2,876                | \$ (630)             | \$ 22,684     | \$ (855)             |

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|                                      | As of December 31, 2008 |                      |                         |                      |               |                      |
|--------------------------------------|-------------------------|----------------------|-------------------------|----------------------|---------------|----------------------|
|                                      | Less Than<br>12 Months  |                      | 12 Months<br>or Greater |                      | Total         |                      |
|                                      | Fair<br>Value           | Unrealized<br>Losses | Fair<br>Value           | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| Corporate debt securities            | \$ 22,806               | \$ (692)             | \$ 1,316                | \$ (35)              | \$ 24,122     | \$ (727)             |
| Government and agency securities     | 12,128                  | (244)                |                         |                      | 12,128        | (244)                |
| Asset and mortgage backed securities | 15,511                  | (1,212)              |                         |                      | 15,511        | (1,212)              |
|                                      | \$ 50,445               | \$ (2,148)           | \$ 1,316                | \$ (35)              | \$ 51,761     | \$ (2,183)           |

Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, the Company does not consider those investments with an unrealized loss to be other-than-temporarily impaired at June 30, 2009. There were no material other-than-temporary impairments or credit losses related to available-for-sale securities in 2009 or 2008. There were no material gross realized gains or losses from the sales of available-for-sale securities in the three or six months ended June 30, 2009. In addition, there were no material gross realized gains or losses from the sale of available-for-sale securities in the three months ended June 30, 2008. The Company recognized gross realized gains of \$4.4 million and gross realized losses of \$0.2 million during the six months ended June 30, 2008 from the sales of available-for-sale securities. Realized gains and losses and interest income are included in interest and other income (expense).

The estimated fair value of short-term investments by contractual maturity as of June 30, 2009 is as follows:

|  | (in thousands)    |
|--|-------------------|
| Due within one year                    | \$ 59,856         |
| Due after one year and through 5 years | 102,803           |
| Due after 5 years and through 10 years |                   |
| Due after 10 years                     | 4,839             |
| <b>Total short-term investments</b>    | <b>\$ 167,498</b> |

The Company measures certain financial assets at fair value on a recurring basis, including cash equivalents and available-for-sale securities. In accordance with SFAS No. 157, fair value is a market-based measurement that should be determined based on the assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS No. 157 establishes a three-level hierarchy which prioritizes the inputs used in measuring fair value. The three hierarchy levels are defined as follows:

**Level 1** Valuations based on unadjusted quoted prices in active markets for identical assets. The fair value of available-for-sale securities included in the Level 1 category is based on quoted prices that are readily and regularly available in an active market. The Level 1 category includes money market funds of \$23.0 million, which are included in cash and cash equivalents in the condensed consolidated balance sheets.

**Level 2** Valuations based on observable inputs (other than Level 1 prices), such as quoted prices for similar assets at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, either directly or indirectly. The fair value of available-for-sale securities included in the Level 2 category is based on the market values obtained from an independent pricing service that were evaluated using pricing models that vary by asset class and may incorporate available trade, bid and other market information and price quotes from well established independent pricing vendors and broker-dealers. The Level 2 category includes short-term investments of \$167.5 million and cash equivalents of \$8.8 million, which are comprised of corporate debt securities, government and agency securities and asset and mortgage-backed securities.

**Level 3** Valuations based on inputs that are unobservable and involve management judgment and the reporting entity's own assumptions about market participants and pricing. The Company has no material Level 3 financial assets measured at fair value on the condensed consolidated balance sheets as of June 30, 2009.

The hierarchy level assigned to each security in the Company's available-for-sale portfolio and cash equivalents is based on its assessment of the transparency and reliability of the inputs used in the valuation of such instrument at the measurement date. The Company did not have any



material financial liabilities that were covered by SFAS No. 157 as of June 30, 2009.

**Table of Contents****4. Content Library**

Content library and accumulated amortization are as follows:

|                                    | June 30,<br>2009 | As of<br>December 31,<br>2008 |
|------------------------------------|------------------|-------------------------------|
|                                    | (in thousands)   |                               |
| Content library, gross             | \$ 676,611       | \$ 637,336                    |
| Less accumulated amortization      | (542,776)        | (520,098)                     |
|                                    | 133,835          | 117,238                       |
| Less: Current content library, net | 33,519           | 18,691                        |
| Content library, net               | \$ 100,316       | \$ 98,547                     |

**5. Other Comprehensive Income**

The Company reports comprehensive income or loss in accordance with the provisions of SFAS No. 130, *Reporting Comprehensive Income*, which establishes standards for reporting comprehensive income and its components in the financial statements. Other comprehensive income consists of unrealized gains and losses on available-for-sale securities, net of tax. The components of comprehensive income are as follows:

|   | Three months ended<br>June 30,<br>2009    2008 |           | Six months ended<br>June 30,<br>2009    2008 |           |
|---|--|-----------|--|-----------|
|   | (in thousands)                                 |           | (in thousands)                               |           |
| Net income  | \$ 32,443                                      | \$ 26,579 | \$ 54,806                                    | \$ 39,923 |
| Other comprehensive income:   |  |           |  |           |
| Change in unrealized gain (loss) on available-for-sale securities, net of tax | 1,172  | (1,124)   | 641  | (2,425)   |
| Comprehensive income  | \$ 33,615                                      | \$ 25,455 | \$ 55,447                                    | \$ 37,498 |

**Table of Contents****6. Stockholders Equity***Stock Repurchases*

On January 26, 2009, the Company announced that its Board of Directors authorized a stock repurchase program for 2009. Under this program, the Company is authorized to repurchase up to \$60 million during the third and fourth quarters of 2009. The timing and actual number of shares repurchased will depend on various factors including price, corporate and regulatory requirements, alternative investment opportunities and other market conditions. During the three months ended June 30, 2009, under this program, the Company repurchased 1,627,446 shares of common stock at an average price of approximately \$45 per share for an aggregate amount of approximately \$73 million. During the six months ended June 30, 2009, under this program, the Company repurchased 2,803,989 shares of common stock at an average price of approximately \$41 per share for an aggregate amount of approximately \$115 million. Shares repurchased under this program are held as treasury stock and accordingly repurchases were accounted for at cost under the treasury method.

There were no unsettled share repurchases at June 30, 2009.

*Stock-Based Compensation*

A summary of option activity during the six months ended June 30, 2009 is as follows:

|   | Shares Available<br>for Grant | Options Outstanding |                                       | Weighted-Average                            |  |
|---|-------------------------------|---------------------|---------------------------------------|---|--|
|   |                               | Number of<br>Shares | Weighted-Average<br>Exercise<br>Price | Remaining<br>Contractual Term<br>(in Years) | Aggregate<br>Intrinsic Value<br>(in Thousands) |
| Balances as of December 31, 2008        | 3,192,515                     | 5,365,016           | \$ 18.81                              |   |  |
| Granted                                 | (329,765)                     | 329,765             | 37.51                                 |   |  |
| Exercised                               |                               | (1,204,962)         | 16.88                                 |   |  |
| Canceled                                | 417                           | (417)               | 31.89                                 |   |  |
| Balances as of June 30, 2009            | 2,863,167                     | 4,489,402           | \$ 20.70                              | 6.37  | \$ 92,865                                      |
| Vested and exercisable at June 30, 2009 |                               | 4,489,402           | \$ 20.70                              | 6.37  | \$ 92,865                                      |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the Company's closing stock price on the last trading day of the second quarter of 2009 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2009. This amount changes based on the fair market value of the Company's common stock. Total intrinsic value of options exercised for the three months ended June 30, 2009 and 2008 was \$11.2 million and \$6.6 million, respectively. Total intrinsic value of options exercised for the six months ended June 30, 2009 and 2008 was \$27.5 million and \$13.2 million, respectively.

Cash received from option exercises and purchases under the ESPP for the three months ended June 30, 2009 and 2008 was \$9.8 million and \$4.5 million, respectively. Cash received from option exercises and purchases under the ESPP for the six months ended June 30, 2009 and 2008 was \$23.4 million and \$13.1 million, respectively.

The following table summarizes the assumptions used to value option grants using the lattice-binomial model:

|                            | Three Months Ended June 30, |           | Six Months Ended June 30, |             |
|----------------------------|-----------------------------|-----------|---------------------------|-------------|
|                            | 2009                        | 2008      | 2009                      | 2008        |
| Dividend yield             | 0%                          | 0%        | 0%                        | 0%          |
| Expected volatility        | 52%                         | 51%       | 52% - 56%                 | 51% - 54%   |
| Risk-free interest rate    | 3.01%                       | 3.69%     | 2.60%-3.01%               | 3.69%-3.86% |
| Suboptimal exercise factor | 1.74-1.94                   | 1.77-1.92 | 1.73-1.94                 | 1.77-2.04   |

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In the first and second quarters of 2009, the Company used a suboptimal exercise factor of 1.87 and 1.94, respectively, for executives and 1.73 and 1.74, respectively, for non-executives, which resulted in a calculated expected life of the option grants of four years for executives and three years for non-executives. In the first and second quarters of 2008, the Company used a suboptimal exercise factor of 2.04 and 1.92, respectively, for executives and 1.77 for non-executives, which resulted in a calculated expected life of four years for executives and three years for non-executives.

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The weighted-average fair value of employee stock options granted during the three months ended June 30, 2009 and 2008 was \$18.34 and \$14.06 per share, respectively. The weighted-average fair value of employee stock options granted during the six months ended June 30, 2009 and 2008 was \$15.99 and \$13.14 per share, respectively.

The following table summarizes the assumptions used to value employee stock purchase rights using the Black Scholes option pricing model:

|                          | <b>Three Months Ended June 30,</b> |             |
|--------------------------|------------------------------------|-------------|
|                          | <b>2009</b>                        | <b>2008</b> |
| Dividend yield           | 0%                                 | 0%          |
| Expected volatility      | 55%                                | 55%         |
| Risk-free interest rate  | 0.35%                              | 1.58%       |
| Expected life (in years) | 0.5                                | 0.5         |

The following table summarizes stock-based compensation expense, net of tax, related to stock option plans and employee stock purchases for the three and six months ended June 30, 2009 and 2008 which was allocated as follows:

|  | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             |
|--|------------------------------------|-------------|----------------------------------|-------------|
|  | <b>2009</b>                        | <b>2008</b> | <b>2009</b>                      | <b>2008</b> |
|  | <b>(in thousands)</b>              |             |                                  |             |
| Fulfillment expense                                  | \$ 102                             | \$ 108      | \$ 222                           | \$ 214      |
| Technology and development                           | 1,190                              | 849         | 2,261                            | 1,845       |
| Marketing  | 458                                | 455         | 901                              | 964         |
| General and administrative                           | 1,528                              | 1,493       | 3,026                            | 3,012       |
| Stock-based compensation expense before income taxes | 3,278                              | 2,905       | 6,410                            | 6,035       |
| Income tax benefit                                   | (1,272)                            | (755)       | (2,531)                          | (2,032)     |
| Total stock-based compensation after income taxes    | \$ 2,006                           | \$ 2,150    | \$ 3,879                         | \$ 4,003    |

**7. Income Taxes**

The provision for income taxes for the three months ended June 30, 2009 was \$20.5 million. The effective tax rate for the three months ended June 30, 2009 and 2008 is 38.8% and 26.0%, respectively. The effective tax rate for the six months ended June 30, 2009 and 2008 is 39.4% and 31.7%, respectively. The increase in the effective tax rates for the three and six months ended June 30, 2009 as compared to the same prior-year period was primarily attributable to the absence of a cumulative benefit for prior period R&D tax credits that is reflected in the prior year.

As of January 1, 2009, the Company had \$10.9 million gross unrecognized tax benefits. During the six months ended June 30, 2009, the Company had an increase in gross unrecognized tax benefits of approximately \$1.2 million. The gross uncertain tax positions, if recognized by the Company, will result in a reduction of approximately \$9.7 million to the tax provision which will favorably impact the Company's effective tax rate. The Company anticipates settling \$0.3 million of its unrecognized tax benefits over the next twelve months. As a result, this amount was included in the current income taxes payable.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense.

The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is subject to U.S. federal or state income tax examinations by tax authorities for years after 1997. Due to the Company's loss position for tax purposes in prior years, all tax years are open to examination in the U.S. and state jurisdictions. The Company is also open to examination in various state jurisdictions for tax years 2000 and forward, none of which are individually material.

**8. Commitments and Contingencies**

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The Company accounts for streaming content in accordance with SFAS No. 63, *Financial Reporting by Broadcasters*, which requires classification of streaming content as either a current or non-current asset in the consolidated balance sheets based on the estimated time of usage after certain criteria have been met including availability of the streaming content for its first showing. The Company has \$88.5 million of commitments at June 30, 2009 related to streaming content license agreements that have been executed but for which the streaming content does not meet the asset recognition criteria in SFAS No. 63.

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**Table of Contents*****Litigation***

From time to time, in the normal course of its operations, the Company is a party to litigation matters and claims, including claims relating to employee relations and business practices. Litigation can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict and we cannot reasonably estimate the likelihood or potential dollar amount of any adverse results. The Company expenses legal fees as incurred. Listed below are material legal proceedings to which the Company is a party. An unfavorable outcome of any of these matters could have a material adverse effect on the Company's financial position, liquidity or results of operations.

On April 1, 2009, Jay Nunez, individually and on behalf of others similarly situated in California, filed a purported class action lawsuit against the Company in California Superior Court, County of Orange. The complaint asserts claims of unlawful, unfair and deceptive business practices and violation of the California Consumer Legal Remedies Act relating to certain of the Company's marketing statements. The complaint seeks restitution, injunction and other relief.

In January through April of 2009, a number of purported anti-trust class action suits were filed against the Company. Wal-Mart Stores, Inc. and Walmart.com USA LLC (collectively, Wal-Mart) were also named as defendants in these suits. Most of the suits were filed in the United States District Court for the Northern District of California and other federal district courts around the country. A number of suits were filed in the Superior Court of the State of California, Santa Clara County. The plaintiffs, who are current or former Netflix customers, generally allege that Netflix and Wal-Mart entered into an agreement to divide the markets for sales and online rentals of DVD's in the United States, which resulted in higher Netflix subscription prices. The complaints, which assert violation of federal and/or state antitrust laws, seek injunctive relief, costs (including attorneys' fees) and damages in an unspecified amount. On April 10, 2009, the Judicial Panel on Multidistrict Litigation ordered all cases pending in federal court transferred to the Northern District of California to be consolidated or coordinated for pre-trial purposes. These cases have been assigned the multidistrict litigation number MDL-2029. The cases pending in the Superior Court of the State of California, Santa Clara County have been consolidated. In addition, in May of 2009, three additional lawsuits were filed—two in the Northern District of California and one in the Superior Court of the State of California, San Mateo County—alleging identical conduct and seeking identical relief. In these three cases, the plaintiffs are current or former subscribers to the online DVD rental service offered by Blockbuster Inc. The two cases filed in federal court on behalf of Blockbuster subscribers have been related to MDL-2029.

On December 26, 2008, Quito Enterprises, LLC filed a complaint for patent infringement against the Company in the United States District Court for the Southern District of Florida, captioned *Quito Enterprises, LLC v. Netflix, Inc., et al*, Civil Action No. 1:08-cv-23543-AJ. The complaint alleges that the Company infringed U.S. Patent No. 5,890,152 entitled "Personal Feedback Browser for Obtaining Media Files" issued on March 30, 1999. The complaint seeks unspecified damages, interest, and seeks to permanently enjoin the Company from infringing the patent in the future.

On October 24, 2008, Media Queue, LLC filed a complaint for patent infringement against the Company in the United States District Court for the Eastern District of Oklahoma, captioned *Media Queue, LLC v. Netflix, Inc., et al*, Civil Action No. CIV 08-402-KEW. The complaint alleges that the Company infringed U.S. Patent No. 7,389,243 entitled "Notification System and Method for Media Queue" issued on June 17, 2008. The complaint seeks unspecified compensatory and enhanced damages, interest and fees, and seeks to permanently enjoin the Company from infringing the patent in the future. On February 24, 2009, the case was transferred to the Northern District of California.

On December 28, 2007, Parallel Networks, LLC filed a complaint for patent infringement against the Company in the United States District Court for the Eastern District of Texas, captioned *Parallel Networks, LLC v. Netflix, Inc., et al*, Civil Action No 2:07-cv-562-LED. The complaint alleges that the Company infringed U.S. Patent Nos. 5,894,554 and 6,415,335 B1 entitled "System For Managing Dynamic Web Page Generation Requests by Intercepting Request at Web Server and Routing to Page Server Thereby Releasing Web Server to Process Other Requests" and "System and Method for Managing Dynamic Web Page Generation Requests", issued on April 13, 1999 and July 2, 2002, respectively. The complaint seeks unspecified compensatory and enhanced damages, interest and fees, and seeks to permanently enjoin the Company from infringing the patent in the future.

On January 3, 2007, Lycos, Inc. filed a complaint for patent infringement against the Company, TiVo, Inc. and Blockbuster, Inc. in the United States District Court for the Eastern District of Virginia. The complaint alleges that the Company infringed U.S. Patents Nos. 5,867,799 and 5,983,214, entitled "Information System and Method for Filtering a Massive Flow of Information Entities to Meet User Information Classification Needs" and "System and Method Employing Individual User Content-Based Data and User Collaboration Feedback Data to Evaluate the Content of an Information Entity in a Large Information Communication Network", respectively. The complaint seeks unspecified compensatory and enhanced damages, interest and fees and seeks to permanently enjoin the defendants from infringing the patents in the future. On August 6, 2007, the case was transferred to the District of Massachusetts. On November 21, 2008, the Company filed a motion for summary judgment of non-infringement and on June 18, 2009, the Court granted Netflix's motion for summary judgment.





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### ***Indemnifications***

In the ordinary course of business, the Company enters into contractual arrangements under which it has agreed to provide indemnification of varying scope and terms to business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of the Company's breach of such agreements and out of intellectual property infringement claims made by third parties. In these circumstances, payment may be conditional on the other party making a claim pursuant to the procedures specified in the particular contract. Further, the Company's obligations under these agreements may be limited in terms of time and/or amount, and, in some instances, the Company may have recourse against third parties for certain payments. In addition, the Company has entered into indemnification agreements with its directors and certain of its officers that will require it, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. The terms of such obligations vary.

It is not possible to make a reasonable estimate of the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the unique facts and circumstances involved in each particular agreement. No amount has been accrued in the accompanying condensed consolidated financial statements with respect to these indemnification obligations.

### ***Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations*** **Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of the federal securities laws. These forward-looking statements include, but are not limited to: statements regarding the breadth of content choices available to us, our competitive advantage, increasing content choices for streaming, the availability of electronic equipment that will enable streamed content, the continued popularity of the DVD format, expectations on the growth of Internet delivery of content, and our liquidity. These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission on February 25, 2009, in the Quarterly Report on Form 10-Q filed with the SEC on May 8, 2009, and in the other Quarterly Reports on Form 10-Q to be filed by us in 2009.

We assume no obligation to revise or publicly release any revision to any forward-looking statements contained in this Quarterly Report on Form 10-Q.

### **Overview**

#### ***Our Business***

With more than 10 million subscribers, we are the largest online movie rental subscription service in the United States. We offer a variety of subscription plans, with no due dates, no late fees, no shipping fees and no pay-per-view fees. We provide subscribers access to over 100,000 DVD and Blu-ray titles and more than 12,000 streaming content choices. Subscribers select titles at our Web site aided by our proprietary recommendation service and merchandising tools. Subscribers can:

Receive DVD's by U.S. mail and return them to us at their convenience using our prepaid mailers. After a DVD has been returned, we mail the next available DVD in a subscriber's queue.

Watch streaming content without commercial interruption on personal computers (PCs), Intel-based Macintosh computers (Macs) and televisions (TVs). The viewing experience is enabled by Netflix controlled software that can run on a variety of devices. These devices include PCs, Macs, Internet connected Blu-ray players, such as those manufactured by LG Electronics and Samsung, set-top boxes, such as TiVo and the Roku Player, game consoles, such as Microsoft's Xbox 360, and TVs from Sony and LG Electronics.

Our core strategy is to grow a large subscription business consisting of DVD by mail and streaming content. We offer over 100,000 titles on DVD. In comparison, the 12,000 content choices available for streaming are relatively limited. We expect to substantially broaden the content choices as more content becomes available to us. Until such time, by bundling DVD and streaming as part of the Netflix subscription, we are able to offer subscribers a uniquely comprehensive selection of movies for one low monthly price. We believe this creates a competitive

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advantage as compared to a streaming only subscription service. This advantage will diminish over time as more content becomes available over the Internet from competing services, by which time we expect to have further developed our other advantages such as brand, distribution, and our proprietary merchandising platform. Despite the growing popularity of Internet delivered content, we expect that standard definition DVD, along with its high definition successor, Blu-ray (collectively referred to in this Quarterly Report as DVD ), will continue to be the primary means by which most Netflix subscribers view content for the foreseeable future. However, at some point in the future, we expect that Internet delivery of content directly to the home will surpass DVD.

**Table of Contents****Key Business Metrics**

Management periodically reviews certain key business metrics within the context of our articulated performance goals in order to evaluate the effectiveness of our operational strategies, allocate resources and maximize the financial performance of our business. The key business metrics include the following:

*Churn:* Churn is a monthly measure defined as customer cancellations in the quarter divided by the sum of beginning subscribers and gross subscriber additions, then divided by three months. Management reviews this metric to evaluate whether we are retaining our existing subscribers in accordance with our business plans.

*Subscriber Acquisition Cost:* Subscriber acquisition cost is defined as total marketing expense divided by total gross subscriber additions. Management reviews this metric to evaluate how effective our marketing programs are in acquiring new subscribers on an economical basis in the context of estimated subscriber lifetime value.

*Gross Margin:* Management reviews gross margin to monitor variable costs and operating efficiency.

Management believes it is useful to monitor these metrics together and not individually as management does not make business decisions based upon any single metric. Please see Results of Operations below for further discussion on these key business metrics.

**Performance Highlights**

The following represents our performance highlights for the three months ended June 30, 2009, March 31, 2009 and June 30, 2008 and the six months ended June 30, 2009 and June 30, 2008:

|                                    | Three Months Ended  |                   |                  | Change             |                    |
|------------------------------------|---|-------------------|------------------|--------------------|--------------------|
|                                    | June 30,<br>2009  | March 31,<br>2009 | June 30,<br>2008 | Q2 09 vs.<br>Q2 08 | Q2 09 vs.<br>Q1 09 |
|                                    | (in thousands, except per share data,<br>percentages and subscriber acquisition cost) |                   |                  |                    |                    |
| Revenues                           | \$ 408,509  | \$ 394,098        | \$ 337,614       | 21.0%              | 3.7%               |
| Net income                         | 32,443  | 22,363            | 26,579           | 22.1%              | 45.1%              |
| Net income per share - diluted     | \$ 0.54   | \$ 0.37           | \$ 0.42          | 28.6%              | 45.9%              |
| Total subscribers at end of period | 10,599  | 10,310            | 8,411            | 26.0%              | 2.8%               |
| Churn                              | 4.5%  | 4.2%              | 4.2%             | 7.1%               | 7.1%               |
| Subscriber acquisition cost        | \$ 23.88  | \$ 25.79          | \$ 28.89         | (17.3)%            | (7.4)%             |
| Gross margin                       | 34.1%   | 34.2%             | 31.8%            | 7.2%               | (0.3)%             |

|                                | Six Months Ended  |                  | Change<br>YTD 09 vs<br>YTD 08 |
|--------------------------------|---|------------------|-------------------------------|
|                                | June 30,<br>2009  | June 30,<br>2008 |                               |
|                                | (in thousands, except per share data,<br>percentages and subscriber acquisition cost) |                  |                               |
| Revenues                       | \$ 802,607  | \$ 663,797       | 20.9%                         |
| Net income                     | 54,806  | 39,923           | 37.3%                         |
| Net income per share - diluted | \$ 0.91   | \$ 0.62          | 46.8%                         |

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|                                    |          |          |         |
|------------------------------------|----------|----------|---------|
| Total subscribers at end of period | 10,599   | 8,411    | 26.0%   |
| Churn*                             | 4.3%     | 4.1%     | 4.9%    |
| Subscriber acquisition cost        | \$ 24.94 | \$ 29.23 | (14.7)% |
| Gross margin                       | 34.2%    | 31.8%    | 7.5%    |

\* Churn for the six months ended June 30, 2009 and 2008 is the average of Churn for the two quarters of the respective period.

### **Critical Accounting Policies and Estimates**

There have been no significant changes during the six months ended June 30, 2009 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2008.

### **Results of Operations**

The following table sets forth, for the periods presented, the line items in our condensed consolidated statements of operations as a percentage of total revenues. The information contained in the table below should be read in conjunction with the condensed consolidated financial statements, notes to the condensed consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q.

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|   | Three Months Ended |                   |                  | Six Months Ended |                  |
|---|--------------------|-------------------|------------------|------------------|------------------|
|   | June 30,<br>2009   | March 31,<br>2009 | June 30,<br>2008 | June 30,<br>2009 | June 30,<br>2008 |
| Revenues  | 100.0%             | 100.0%            | 100.0%           | 100.0%           | 100.0%           |
| Cost of revenues:                               |                    |                   |                  |                  |                  |
| Subscription                                    | 55.0%              | 54.6%             | 57.4%            | 54.8%            | 57.4%            |
| Fulfillment expenses                            | 10.9%              | 11.2%             | 10.8%            | 11.0%            | 10.8%            |
| Total cost of revenues                          | 65.9%              | 65.8%             | 68.2%            | 65.8%            | 68.2%            |
| Gross profit                                    | 34.1%              | 34.2%             | 31.8%            | 34.2%            | 31.8%            |
| Operating expenses:                             |                    |                   |                  |                  |                  |
| Technology and development                      | 6.6%               | 6.1%              | 6.6%             | 6.4%             | 6.4%             |
| Marketing                                       | 11.3%              | 15.8%             | 11.8%            | 13.5%            | 14.3%            |
| General and administrative                      | 3.2%               | 3.3%              | 4.0%             | 3.3%             | 4.1%             |
| Gain on disposal of DVDs                        |                    | (0.2)%            | (0.7)%           | (0.2)%           | (0.5)%           |
| Total operating expenses                        | 21.1%              | 25.0%             | 21.7%            | 23.0%            | 24.3%            |
| Operating income                                | 13.0%              | 9.2%              | 10.1%            | 11.2%            | 7.5%             |
| Other income (expense):                         |                    |                   |                  |                  |                  |
| Interest expense on lease financing obligations | (0.2)%             | (0.2)%            | (0.2)%           | (0.2)%           | (0.2)%           |
| Interest and other income (expense)             | 0.2%               | 0.5%              | 0.7%             | 0.3%             | 1.5%             |
| Income before income taxes                      | 13.0%              | 9.5%              | 10.6%            | 11.3%            | 8.8%             |
| Provision for income taxes                      | 5.0%               | 3.8%              | 2.8%             | 4.4%             | 2.8%             |
| Net income                                      | 8.0%               | 5.7%              | 7.8%             | 6.9%             | 6.0%             |

**Revenues**

We currently generate all of our revenues in the United States. We derive substantially all of our revenues from monthly subscription fees and recognize subscription revenues ratably over each subscriber's monthly subscription period. We record refunds to subscribers as a reduction of revenues.

We offer a variety of subscription plans for DVD rental and streaming service. The price per plan varies based on the number of DVD's that a subscriber has out at any given point and based on whether the service has limited or unlimited usage. All of our unlimited plans allow the subscriber unlimited streaming to their computer or Netflix ready device. The vast majority of our subscriber base has chosen a 1, 2 or 3-out Unlimited plan. Customers electing access to the high definition Blu-ray discs in addition to standard definition DVD's pay a surcharge of \$1 to \$4 for our most popular plans. Pricing of our plans is as follows:

|                           | Price per<br>month |
|---------------------------|--------------------|
| 1-out Limited             | \$ 4.99            |
| 1-out Unlimited           | 8.99               |
| 2-out Unlimited           | 13.99              |
| 3-out Unlimited           | 16.99              |
| All other Unlimited Plans | 23.99 to 47.99     |

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The following table presents our ending subscriber information:

|                                      | June 30,<br>2009                   | As of<br>March 31,<br>2009 | June 30,<br>2008 |
|--------------------------------------|------------------------------------|----------------------------|------------------|
|                                      | (in thousands, except percentages) |                            |                  |
| Free subscribers                     | 224                                | 194                        | 176              |
| As a percentage of total subscribers | 2.1%                               | 1.9%                       | 2.1%             |
| Paid subscribers                     | 10,375                             | 10,116                     | 8,235            |
| As a percentage of total subscribers | 97.9%                              | 98.1%                      | 97.9%            |
| Total subscribers                    | 10,599                             | 10,310                     | 8,411            |

Three months ended June 30, 2009 as compared to the three months ended June 30, 2008

|   | Three Months Ended<br>June 30,<br>2009   | June 30,<br>2008 | Change<br>Q2 09 vs.<br>Q2 08 |
|---|--|------------------|------------------------------|
|   | (in thousands except percentages and<br>average monthly revenue per paying subscriber) |                  |                              |
| Revenues                                      | \$ 408,509   | \$ 337,614       | 21.0%                        |
| Other data:                                   |  |                  |                              |
| Average number of paying subscribers          | 10,246   | 8,169            | 25.4%                        |
| Average monthly revenue per paying subscriber | \$ 13.29   | \$ 13.78         | (3.6)%                       |

The \$70.9 million increase in our revenues was primarily a result of the 25.4% growth in the average number of paying subscribers. This increase was partially offset by a 3.6% decline in the average monthly revenue per paying subscriber to \$13.29, resulting from the growing popularity of our lower priced subscription plans. The total number of average paying subscribers in our 1 and 2-out plans grew by 41.5% year over year as compared to a 3.5% growth in all other plans.

Six months ended June 30, 2009 as compared to the six months ended June 30, 2008

|   | Six Months Ended<br>June 30,<br>2009   | June 30,<br>2008 | Change<br>YTD 09 vs.<br>YTD 08 |
|---|--|------------------|--------------------------------|
|   | (in thousands except percentages and<br>average monthly revenue per paying subscriber) |                  |                                |
| Revenues                                      | \$ 802,607   | \$ 663,797       | 20.9%                          |
| Other data:                                   |  |                  |                                |
| Average number of paying subscribers          | 9,943  | 7,942            | 25.2%                          |
| Average monthly revenue per paying subscriber | \$ 13.45   | \$ 13.93         | (3.4)%                         |

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The \$138.8 million increase in our revenues was primarily a result of the 25.2% growth in the average number of paying subscribers. This increase was partially offset by a 3.4% decline in the average monthly revenue per paying subscriber, resulting from the growing popularity of our lower priced subscription plans. The total number of average paying subscribers in our 1 and 2-out plans grew by 40.0% year over year as compared to a 5.5% growth in all other plans.

*Three months ended June 30, 2009 as compared to the three months ended March 31, 2009*

|  | <b>Three Months Ended</b> |                  | <b>Change</b>    |
|--|---------------------------|------------------|------------------|
|  | <b>June 30,</b>           | <b>March 31,</b> | <b>Q2 09 vs.</b> |
|  | <b>2009</b>               | <b>2009</b>      | <b>Q1 09</b>     |

(in thousands except percentages and average monthly revenue per paying subscriber)

|   |            |            |        |
|---|------------|------------|--------|
| Revenues                                      | \$ 408,509 | \$ 394,098 | 3.7%   |
| Other data:                                   |            |            |        |
| Average number of paying subscribers          | 10,246     | 9,640      | 6.3%   |
| Average monthly revenue per paying subscriber | \$ 13.29   | \$ 13.63   | (2.5)% |

The \$14.4 million increase in our revenues was primarily a result of the 6.3% growth in the average number of paying subscribers. This increase was partially offset by a 2.5% decline in the average monthly revenue per paying subscriber, resulting from the growing popularity of our lower priced subscription plans. The total number of average paying subscribers in our 1 and 2-out plans grew by 10.5% quarter over quarter as compared to a 0.7% decline in all other plans.

Until the average price of gross new additions is equal to the average price of existing subscribers, we expect our average monthly revenue per paying subscriber will continue to decline, as the lower priced plans grow as a percentage of our subscriber base. Our revenues and average monthly revenue per paying subscriber could be impacted by future changes to our pricing structure which may result from competitive effects that we are unable to predict.

**Cost of Revenues****Subscription**

*Three months ended June 30, 2009 as compared to the three months ended June 30, 2008*

|  | <b>Three Months Ended</b> |                 | <b>Change</b>    |
|--|---------------------------|-----------------|------------------|
|  | <b>June 30,</b>           | <b>June 30,</b> | <b>Q2 09 vs.</b> |
|  | <b>2009</b>               | <b>2008</b>     | <b>Q2 08</b>     |

(in thousands except percentages)

|                             |            |            |       |
|-----------------------------|------------|------------|-------|
| Subscription                | \$ 224,858 | \$ 193,769 | 16.0% |
| As a percentage of revenues | 55.0%      | 57.4%      |       |

The \$31.1 million increase in cost of subscription revenues was due to the following factors:

Postage and packaging expenses increased \$21.0 million due to an 18.3% increase in the number of DVD s mailed to paying subscribers and to a two cent (4.8%) increase in the rates of first class postage in May 2009. The increase in the number of DVD s mailed was driven by a 25.4% increase in the number of average paying subscribers, partially offset by a 5.7% decline in monthly DVD rentals per average paying subscriber attributed to the growing popularity of our lower priced plans.

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Content expenses increased by \$10.1 million due to increased investments in our content library, particularly related to additions to our streaming content.



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Six months ended June 30, 2009 as compared to the six months ended June 30, 2008

|                             | Six Months Ended                  |                  | Change                |
|-----------------------------|-----------------------------------|------------------|-----------------------|
|                             | June 30,<br>2009                  | June 30,<br>2008 | YTD '09 vs<br>YTD '08 |
|                             | (in thousands except percentages) |                  |                       |
| Subscription                | \$ 440,157                        | \$ 380,925       | 15.5%                 |
| As a percentage of revenues | 54.8%                             | 57.4%            |                       |

The \$59.2 million increase in cost of subscription revenues was due to the following factors:

Postage and packaging expenses increased \$40.1 million due to a 17.6% increase in the number of DVD s mailed to paying subscribers. The increase in the number of DVD s mailed was driven by a 25.2% increase in the number of average paying subscribers, partially offset by a 6.1% decline in monthly DVD rentals per average paying subscriber attributed to the growing popularity of our lower priced plans

Content expenses increased by \$19.1 million due to increased investments in our content library, particularly related to additions to our streaming content.

Three months ended June 30, 2009 as compared to the three months ended March 31, 2009

|                             | Three Months Ended                |                   | Change              |
|-----------------------------|-----------------------------------|-------------------|---------------------|
|                             | June 30,<br>2009                  | March 31,<br>2009 | Q2 '09 vs<br>Q1 '09 |
|                             | (in thousands except percentages) |                   |                     |
| Subscription                | \$ 224,858                        | \$ 215,299        | 4.4%                |
| As a percentage of revenues | 55.0%                             | 54.6%             |                     |

The \$9.6 million increase in cost of subscription revenues was due to the following factors:

Postage and packaging expenses slightly increased by \$3.0 million. The number of DVD s mailed to paying subscribers remained flat despite a 6.3% increase in the number of average paying subscribers, consistent with similar historical sequential patterns of lower DVD shipments per average paying subscriber.

Content expenses increased by \$6.6 million due to increased investments in our content library.

**Fulfillment Expenses**

Three months ended June 30, 2009 as compared to the three months ended June 30, 2008

|                             | Three Months Ended                |                  | Change              |
|-----------------------------|-----------------------------------|------------------|---------------------|
|                             | June 30,<br>2009                  | June 30,<br>2008 | Q2 '09 vs<br>Q2 '08 |
|                             | (in thousands except percentages) |                  |                     |
| Fulfillment expenses        | \$ 44,385                         | \$ 36,318        | 22.2%               |
| As a percentage of revenues | 10.9%                             | 10.8%            |                     |

The \$8.1 million increase in fulfillment expenses was due to the following:

Delivery centers and customer service related costs increased \$6.0 million primarily due to a 15.9% increase in headcount to support the higher volume of content delivery.

Credit card fees increased \$2.1 million as a result of the 21.0% growth in revenues.

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Six months ended June 30, 2009 as compared to the six months ended June 30, 2008

|                             | Six Months Ended                  |                  | Change                |
|-----------------------------|-----------------------------------|------------------|-----------------------|
|                             | June 30,<br>2009                  | June 30,<br>2008 | YTD '09 vs<br>YTD '08 |
|                             | (in thousands except percentages) |                  |                       |
| Fulfillment expenses        | \$ 88,354                         | \$ 71,967        | 22.8%                 |
| As a percentage of revenues | 11.0%                             | 10.8%            |                       |

The \$16.4 million increase in fulfillment expenses was due to the following:

Delivery centers and customer service related costs increased \$12.2 million primarily due to a 14.6% increase in headcount to support the higher volume of content delivery.

Credit card fees increased \$4.2 million as a result of the 20.9% growth in revenues.

Three months ended June 30, 2009 as compared to the three months ended March 31, 2009

|                             | Three Months Ended                |                   | Change              |
|-----------------------------|-----------------------------------|-------------------|---------------------|
|                             | June 30,<br>2009                  | March 31,<br>2009 | Q2 '09 vs<br>Q1 '09 |
|                             | (in thousands except percentages) |                   |                     |
| Fulfillment expenses        | \$ 44,385                         | \$ 43,969         | 0.9%                |
| As a percentage of revenues | 10.9%                             | 11.2%             |                     |

Fulfillment expenses for the three months ended June 30, 2009 as compared to the three months ended March 31, 2009 were relatively flat as costs related to delivery centers and customer service decreased slightly as the number of DVD s shipped to paying subscribers remained flat quarter over quarter. This decrease was offset by a 3.8% increase in the credit card fees consistent with the increase in revenues.

**Gross Margin**

Three months ended June 30, 2009 as compared to the three months ended June 30, 2008

|  | Three Months Ended  |                  | Change               |
|--|---|------------------|----------------------|
|  | June 30,<br>2009  | June 30,<br>2008 | Q2 '09 vs.<br>Q2 '08 |
|  | (in thousands except percentages and<br>average monthly gross profit per paying subscriber) |                  |                      |
| Gross profit                                       | \$ 139,266  | \$ 107,527       | 29.5%                |
| Gross margin                                       | 34.1%   | 31.8%            |                      |
| Average monthly gross profit per paying subscriber | \$ 4.53   | \$ 4.39          | 3.2%                 |

The 2.3% increase in gross margin was due to a decline in the average revenue per paying subscriber of 3.6% offset by a larger decrease in the cost of subscription per average paying subscriber of 7.5%. This is primarily attributable to the growing popularity of our lower priced plans evidenced by the increase in average gross profit per paying subscriber. This increase is due to the fact that the decrease in revenue per average paying subscriber is proportionally lower than the decrease in the DVD rentals per average paying subscriber, offset slightly by higher content expense associated with our investment in streaming. In addition, our gross margins continue to benefit from increased utilization of catalog titles resulting from ongoing improvements in our merchandising and recommendation systems.



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Six months ended June 30, 2009 as compared to the six months ended June 30, 2008

|  | Six Months Ended |                  | Change                |
|--|------------------|------------------|-----------------------|
|  | June 30,<br>2009 | June 30,<br>2008 | YTD '09 vs<br>YTD '08 |

(in thousands except percentages and average monthly gross profit per paying subscriber)

|  |            |            |       |
|--|------------|------------|-------|
| Gross profit                                       | \$ 274,096 | \$ 210,905 | 30.0% |
| Gross margin                                       | 34.2%      | 31.8%      |       |
| Average monthly gross profit per paying subscriber | \$ 4.59    | \$ 4.43    | 3.6%  |

The 2.4% increase in gross margin was due to a decline in the average revenue per paying subscriber of 3.4% offset by a larger decrease in the cost of subscription per average paying subscriber of 7.7%. This is primarily attributable to the growing popularity of our lower priced plans evidenced by the increase in average gross profit per paying subscriber. This increase is due to the fact that the decrease in revenue per average paying subscriber is proportionally lower than the decrease in the DVD rentals per average paying subscriber, offset slightly by higher content expense associated with our investments in streaming. In addition, our gross margins continue to benefit from increased utilization of catalog titles resulting from ongoing improvements in our merchandising and recommendation systems.

Three months ended June 30, 2009 as compared to the three months ended March 31, 2009

|  | Three Months Ended |                   | Change              |
|--|--------------------|-------------------|---------------------|
|  | June 30,<br>2009   | March 31,<br>2009 | Q2 '09 vs<br>Q1 '09 |

(in thousands except percentages and average monthly gross profit per paying subscriber)

|  |            |            |        |
|--|------------|------------|--------|
| Gross profit                                       | \$ 139,266 | \$ 134,830 | 3.3%   |
| Gross margin                                       | 34.1%      | 34.2%      |        |
| Average monthly gross profit per paying subscriber | 4.53       | 4.66       | (2.8%) |

The gross margin was relatively flat. Average monthly gross profit per paying subscriber decreased due to the fact that the decrease in DVD shipments per average paying subscriber was outpaced by higher content investments.

**Technology and Development**

Three months ended June 30, 2009 as compared to the three months ended June 30, 2008

|  | Three Months Ended |                  | Change               |
|--|--------------------|------------------|----------------------|
|  | June 30,<br>2009   | June 30,<br>2008 | Q2 '09 vs.<br>Q2 '08 |

(in thousands, except percentages)

|                             |           |           |       |
|-----------------------------|-----------|-----------|-------|
| Technology and development  | \$ 27,119 | \$ 22,186 | 22.2% |
| As a percentage of revenues | 6.6%      | 6.6%      |       |

The \$4.9 million increase in technology and development expenses was primarily attributable to a \$4.8 million increase in personnel-related costs due to growth in headcount related to the development of solutions for streaming content and continued improvements in our service.

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*Six months ended June 30, 2009 as compared to the six months ended June 30, 2008*

|                             | <b>Six Months Ended<br/>June 30,<br/>2009</b> | <b>June 30,<br/>2008</b> | <b>Change<br/>YTD 09 vs.<br/>YTD 08</b> |
|-----------------------------|---|--------------------------|---|
|                             | (in thousands, except percentages)            |                          |   |
| Technology and development  | \$ 51,319                                     | \$ 42,453                | 20.9%                                   |
| As a percentage of revenues | 6.4%  | 6.4%                     |   |

The \$8.9 million increase in technology and development expenses was primarily attributable to a \$7.5 million increase in personnel-related costs due to growth in headcount related to the development of solutions for streaming content and continued improvements in our service.

*Three months ended June 30, 2009 as compared to the three months ended March 31, 2009*

|                             | <b>Three Months Ended<br/>June 30,<br/>2009</b> | <b>March 31,<br/>2009</b> | <b>Change<br/>Q2 09 vs.<br/>Q1 09</b> |
|-----------------------------|---|---------------------------|---------------------------------------|
|                             | (in thousands, except percentages)              |                           |                                       |
| Technology and development  | \$ 27,119                                       | \$ 24,200                 | 12.1%                                 |
| As a percentage of revenues | 6.6%  | 6.1%                      |                                       |

The \$2.9 million increase in technology and development expenses was primarily attributable to a \$2.2 million increase in personnel-related costs due to growth in headcount.

**Marketing**

*Three months ended June 30, 2009 as compared to the three months ended June 30, 2008*

|                             | <b>Three Months Ended<br/>June 30,<br/>2009</b>                       | <b>June 30,<br/>2008</b> | <b>Change<br/>Q2 09 vs.<br/>Q2 08</b> |
|-----------------------------|---|--------------------------|---------------------------------------|
|                             | (in thousands, except percentages and<br>subscriber acquisition cost) |                          |                                       |
| Marketing                   | \$ 46,231   | \$ 39,984                | 15.6%                                 |
| As a percentage of revenues | 11.3%   | 11.8%                    |                                       |
| Other data:                 |   |                          |                                       |
| Gross subscriber additions  | 1,936   | 1,384                    | 39.9%                                 |
| Subscriber acquisition cost | \$ 23.88  | \$ 28.89                 | (17.3)%                               |

The \$6.2 million increase in marketing expenses was primarily attributable to a \$4.8 million increase in marketing program spending, resulting from the growth in our consumer electronic partner programs.

Subscriber acquisition cost decreased for the three months ended June 30, 2009 as compared to the same prior-year period primarily due to strong performance in all marketing channels coupled with strong organic subscriber growth.

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Six months ended June 30, 2009 as compared to the six months ended June 30, 2008

**Six Months Ended**  
**June 30,**      **June 30,**      **Change**  
**2009**      **2008**      **YTD 09 vs.**  
**(in thousands, except percentages and subscriber**  
**acquisition cost)**      **YTD 08**

|                             |            |           |         |
|-----------------------------|------------|-----------|---------|
| Marketing                   | \$ 108,473 | \$ 94,879 | 14.3%   |
| As a percentage of revenues | 13.5%      | 14.3%     |         |
| <b>Other data:</b>          |            |           |         |
| Gross subscriber additions  | 4,349      | 3,246     | 34.0%   |
| Subscriber acquisition cost | \$ 24.94   | \$ 29.23  | (14.7)% |

The \$13.6 million increase in marketing expenses was primarily attributable to an \$11.0 million increase in marketing program spending, resulting from the growth in our consumer electronic partner programs.

Subscriber acquisition cost decreased for the six months ended June 30, 2009 as compared to the same prior-year period primarily due to strong performance in all marketing channels coupled with strong organic subscriber growth.

Three months ended June 30, 2009 as compared to the three months ended March 31, 2009

**Three Months Ended**  
**June 30,**      **March 31,**      **Change**  
**2009**      **2009**      **Q2 09 vs.**  
**(in thousands, except percentages and**  
**subscriber acquisition cost)**      **Q1 09**

|                             |           |           |         |
|-----------------------------|-----------|-----------|---------|
| Marketing                   | \$ 46,231 | \$ 62,242 | (25.7)% |
| As a percentage of revenues | 11.3%     | 15.8%     |         |
| <b>Other data:</b>          |           |           |         |
| Gross subscriber additions  | 1,936     | 2,413     | (19.8)% |
| Subscriber acquisition cost | \$ 23.88  | \$ 25.79  | (7.4)%  |

The \$16.0 million decrease in marketing expenses was primarily attributable to a \$14.9 million decrease in marketing program spending, due to lower online advertising.

Subscriber acquisition cost decreased for the three months ended June 30, 2009 as compared to the three months ended March 31, 2009 primarily due to strong performance in all marketing channels coupled with strong organic subscriber growth.

**General and Administrative**

Three months ended June 30, 2009 as compared to the three months ended June 30, 2008

**Three Months Ended**  
**June 30,**      **June 30,**      **Change**  
**2009**      **2008**      **Q2 09 vs.**  
**(in thousands, except percentages)**      **Q2 08**

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|                             |           |           |        |
|-----------------------------|-----------|-----------|--------|
| General and administrative  | \$ 13,252 | \$ 13,419 | (1.2)% |
| As a percentage of revenues | 3.2%      | 4.0%      |        |

General and administrative expenses for the three months ended June 30, 2009 as compared to the same prior-year period were relatively flat attributable to a \$1.4 million increase in costs related to legal proceedings offset by a \$1.4 million decrease in costs related to our subsidiary, Red Envelope Entertainment.



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*Six months ended June 30, 2009 as compared to the six months ended June 30, 2008*

|                             | <b>Six Months Ended</b>                   |                 | <b>Change</b>     |
|-----------------------------|---|-----------------|-------------------|
|                             | <b>June 30,</b>                           | <b>June 30,</b> | <b>YTD 09 vs.</b> |
|                             | <b>2009</b>                               | <b>2008</b>     | <b>YTD 08</b>     |
|                             | <b>(in thousands, except percentages)</b> |                 |                   |
| General and administrative  | \$ 26,266                                 | \$ 27,158       | (3.3)%            |
| As a percentage of revenues | 3.3%                                      | 4.1%            |                   |

General and administrative expenses were relatively flat, due to a \$2.1 million increase in costs related to legal proceedings offset by a \$2.4 million decrease in costs related to our subsidiary, Red Envelope Entertainment.

*Three months ended June 30, 2009 as compared to the three months ended March 31, 2009*

|                             | <b>Three Months Ended</b>                 |                  | <b>Change</b>    |
|-----------------------------|---|------------------|------------------|
|                             | <b>June 30,</b>                           | <b>March 31,</b> | <b>Q2 09 vs.</b> |
|                             | <b>2009</b>                               | <b>2009</b>      | <b>Q1 09</b>     |
|                             | <b>(in thousands, except percentages)</b> |                  |                  |
| General and administrative  | \$ 13,252                                 | \$ 13,014        | 1.8%             |
| As a percentage of revenues | 3.2%                                      | 3.3%             |                  |

General and administrative expenses were relatively flat.

**Interest and Other Income (Expense)**

*Three months ended June 30, 2009 as compared to the three months ended June 30, 2008*

|                                     | <b>Three Months Ended</b>                 |                 | <b>Change</b>    |
|-------------------------------------|---|-----------------|------------------|
|                                     | <b>June 30,</b>                           | <b>June 30,</b> | <b>Q2 09 vs.</b> |
|                                     | <b>2009</b>                               | <b>2008</b>     | <b>Q2 08</b>     |
|                                     | <b>(in thousands, except percentages)</b> |                 |                  |
| Interest and other income (expense) | \$ 866                                    | \$ 2,404        | (64.0)%          |
| As a percentage of revenues         | 0.2%                                      | 0.7%            |                  |

The decrease in interest and other income (expense) was primarily attributable to 52.3% lower interest and dividends earned on our cash and short-term investments, due to lower cash balances resulting from the repurchase of our common stock.

*Six months ended June 30, 2009 as compared to the six months ended June 30, 2008*

|  | <b>Six Months Ended</b>                   |                 | <b>Change</b>     |
|--|---|-----------------|-------------------|
|  | <b>June 30,</b>                           | <b>June 30,</b> | <b>YTD 09 vs.</b> |
|  | <b>2009</b>                               | <b>2008</b>     | <b>YTD 08</b>     |
|  | <b>(in thousands, except percentages)</b> |                 |                   |

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|                                     |          |           |         |
|-------------------------------------|----------|-----------|---------|
| Interest and other income (expense) | \$ 2,476 | \$ 10,064 | (75.4)% |
| As a percentage of revenues         | 0.3%     | 1.5%      |         |

The decrease in interest and other income (expense) was primarily attributable to 60.5% lower interest and dividends earned on our cash and short-term investments, due to lower cash balances resulting from the repurchase of our common stock, coupled with a \$3.8 million decrease in realized gains recognized as compared to the same prior year period.

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Three months ended June 30, 2009 as compared to the three months ended March 31, 2009

|                                     | Three Months Ended<br>June 30,<br>2009 | March 31,<br>2009 | Change<br>Q2 09 vs.<br>Q1 09 |
|-------------------------------------|--|-------------------|------------------------------|
|                                     | (in thousands, except percentages)     |                   |                              |
| Interest and other income (expense) | \$ 866                                 | \$ 1,610          | (46.2)%                      |
| As a percentage of revenues         | 0.2%                                   | 0.5%              |                              |

The decrease in interest and other income (expense) during was primarily attributable to gains of \$0.6 million realized from the sale of short-term investments in the first quarter of 2009.

**Income Taxes**

Three months ended June 30, 2009 as compared to the three months ended June 30, 2008

|                            | Three Months Ended<br>June 30,<br>2009 | June 30,<br>2008 | Change<br>Q2 09 vs<br>Q2 08 |
|----------------------------|--|------------------|-----------------------------|
|                            | (in thousands, except percentages)     |                  |                             |
| Provision for income taxes | \$ 20,531                              | \$ 9,345         | 119.7%                      |
| Effective tax rate         | 38.8%                                  | 26.0%            |                             |

Our effective tax rate for the second quarter of 2009 was 38.8% and differed from the federal statutory rate due primarily to state taxes offset by the Federal and California R&D tax credit recorded during the quarter. The increase in our effective tax rate for the three months ended June 30, 2009 as compared to the same prior-year periods was primarily attributable to the absence of a cumulative benefit for prior period R&D tax credits that is reflected in the three months ended June 30, 2008. This cumulative benefit resulted in an 8.5% reduction to the effective tax rate.

Six months ended June 30, 2009 as compared to the six months ended June 30, 2008

|                            | Six Months Ended<br>June 30,<br>2009 | June 30,<br>2008 | Change<br>YTD 09 vs<br>YTD 08 |
|----------------------------|--------------------------------------|------------------|-------------------------------|
|                            | (in thousands, except percentages)   |                  |                               |
| Provision for income taxes | \$ 35,579                            | \$ 18,548        | 91.8%                         |
| Effective tax rate         | 39.4%                                | 31.7%            |                               |

Our effective tax rate for the six months ended June 30, 2009 was 39.4% and differed from the federal statutory rate due primarily to state taxes offset by the Federal and California R&D tax credit recorded during the quarter. The increase in our effective tax rate for the six months ended June 30, 2009 as compared to the same prior-year periods was primarily attributable to the absence of a cumulative benefit for prior period R&D tax credits that is reflected in the six months ended June 30, 2008. This cumulative benefit resulted in an 8.5% reduction to the effective tax rate.

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Three months ended June 30, 2009 as compared to the three months ended March 31, 2009

|  | <b>Three Months Ended<br/>June 30,<br/>2009</b> | <b>March 31,<br/>2009</b> | <b>Change<br/>Q2 09 vs<br/>Q1 09</b> |
|--|---|---------------------------|--------------------------------------|
|--|---|---------------------------|--------------------------------------|

(in thousands, except percentages)

|                            |           |           |       |
|----------------------------|-----------|-----------|-------|
| Provision for income taxes | \$ 20,531 | \$ 15,048 | 36.4% |
| Effective tax rate         | 38.8%     | 40.2%     |       |

The effective tax rate for the three months ended June 30, 2009 decreased 1.4% from the effective tax rate for the period ended March 31, 2009 due to a discrete tax benefit recorded for Federal and State tax credits.

**Liquidity and Capital Resources**

We have generated net cash from operations during each quarter since the second quarter of 2001. Many factors will impact our ability to continue to generate and grow cash from our operations including, but not limited to, the number of subscribers who sign up for our service and the growth or reduction in our subscriber base. In addition, we may have or otherwise choose to lower our prices and increase our marketing expenses in order to grow faster or respond to competition. Although we currently anticipate that cash flows from operations, together with our available funds, will be sufficient to meet our cash needs for the foreseeable future, we may require or choose to obtain additional financing. Our ability to obtain financing will depend on, among other things, our development efforts, business plans, operating performance and the condition of the capital markets at the time we seek financing.

Our primary source of liquidity has been cash from operations, which consists mainly of net income adjusted for non-cash items such as amortization of our content library, depreciation of property and equipment and stock-based compensation related to the issuance of common stock. Our primary uses of cash include our stock repurchase programs, postage and packaging expenses, the acquisition of content, capital expenditures related to information technology and automation equipment for operations, marketing and fulfillment expenses.

In addition, on January 26, 2009, we announced that our Board of Directors authorized a stock repurchase program allowing us to repurchase our common stock through the end of 2009. Under this program, the Company is authorized to repurchase up to \$60 million during the third and fourth quarters of 2009. The timing and actual number of shares repurchased will depend on various factors, including price, corporate and regulatory requirements, alternative investment opportunities and other market conditions. The following table highlights selected measures of our liquidity and capital resources for the three and six months ended June 30, 2009 and 2008 (in thousands):

|   | <b>Three Months Ended</b> |                          | <b>Six Months Ended</b>  |                          |
|---|---------------------------|--------------------------|--------------------------|--------------------------|
|   | <b>June 30,<br/>2009</b>  | <b>June 30,<br/>2008</b> | <b>June 30,<br/>2009</b> | <b>June 30,<br/>2008</b> |
| Net cash provided by operating activities           | \$ 75,302                 | \$ 67,380                | \$ 140,935               | \$ 131,442               |
| Net cash used in investing activities               | (43,749)                  | (98,928)                 | (108,417)                | (80,795)                 |
| Net cash (used in) provided by financing activities | (59,213)                  | 6,848                    | (84,928)                 | (83,797)                 |

**Operating Activities**

During the three months ended June 30, 2009, our operating activities consisted of net income of \$32.4 million, increased by non-cash adjustments of \$66.9 million offset by a decrease in net changes in operating assets and liabilities of \$24.1 million. The majority of the non-cash adjustments resulted from amortization of the content library of \$53.2 million as we continue to purchase additional titles to support our larger subscriber base. The net changes in operating assets and liabilities were mainly driven by the acquisition of streaming content, as we continued to increase our investments in streaming content in 2009. Cash provided by operating activities increased by \$7.9 million for the three months ended June 30, 2009 as compared to the same prior-year period. This was primarily due to an increase in net income of \$5.9 million and an increase in non-cash adjustments of \$7.7 million offset by a decrease in net changes in operating assets and liabilities of \$5.7 million.

During the six months ended June 30, 2009, our operating activities consisted of net income of \$54.8 million, increased by non-cash adjustments of \$122.0 million offset by a decrease in net changes in operating assets and liabilities of \$35.8 million. The majority of the non-cash

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adjustments resulted from amortization of the content library of \$102.5 million as we continue to purchase additional titles in order to support our larger subscriber base. The net changes in operating assets and liabilities were mainly driven by acquisitions of streaming content, as we continued to increase our investments in streaming content in 2009. Cash provided by

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operating activities increased \$9.5 million for the six months ended June 30, 2009 as compared to the same prior-year period. This was primarily due to an increase in net income of \$14.9 million and an increase in non-cash adjustments of \$3.9 million and a decrease in net changes in operating assets and liabilities of \$9.3 million.

***Investing Activities***

During the three months ended June 30, 2009, our investing activities consisted primarily of purchases and sales of available-for-sale securities, acquisitions of DVD content and purchases of property and equipment. Cash used in investing activities decreased by \$55.2 million for the three months ended June 30, 2009 as compared to the same prior-year period. This is primarily attributable to a decrease of \$37.2 million in the purchases of available-for-sale securities and an increase in the proceeds and maturities of available-for-sale securities of \$12.3 million. In addition, during 2008, we invested in automation equipment for our various shipping centers to achieve operational efficiencies and because such investments were completed prior to 2009, cash flows related to purchases of property and equipment decreased by \$7.7 million as compared to the same prior-year period.

During the six months ended June 30, 2009, our investing activities consisted primarily of purchases and sales of available-for-sale securities, acquisitions of DVD content and purchases of property and equipment. Cash used in investing activities increased \$27.6 million for the six months ended June 30, 2009 as compared to the same prior-year period. This is primarily attributable to a decrease of \$124.7 million in the proceeds from the sales and maturities of available-for-sale securities offset by a decrease in the purchases of available-for-sale securities of \$76.7 million and a decrease in the purchases of property and equipment of \$13.6 million as compared to the same prior-year period.

***Financing Activities***

During the three months ended June 30, 2009, our financing activities consisted primarily of the issuance of common stock and repurchases of our common stock. Cash used in financing activities increased by \$66.1 million for the three months ended June 30, 2009 as compared to the same prior-year period primarily due to an increase in stock repurchases of \$72.5 million offset by an increase in the proceeds from the issuance of common stock of \$5.3 million.

During the six months ended June 30, 2009, our financing activities consisted primarily of the issuance of common stock and repurchases of our common stock. Cash used in financing activities increased by \$1.1 million for the six months ended June 30, 2009 as compared to the same prior-year period primarily due to an increase in stock repurchases of \$15.3 million offset by an increase in the proceeds from the issuance of common stock of \$10.3 million.

**Contractual Obligations*****Off-Balance Sheet Arrangements***

As part of our ongoing business, we do not engage in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities. Accordingly, our operating results, financial condition and cash flows are not subject to off-balance sheet risks.

***Operating Leases***

We have entered into various non-cancelable operating lease agreements for our offices and distribution centers throughout the U.S. with original lease periods expiring through 2016. Certain of these leases have free or escalating rent payment provisions. We recognize rent expense on our operating leases on a straight-line basis at the commencement of the lease.

***Indemnifications***

The information set forth under Note 8 in the notes to the condensed consolidated financial statements under the caption **Indemnifications** is incorporated herein by reference.

**Recent Accounting Pronouncements**

The information set forth under Note 1 in the notes to the condensed consolidated financial statements under the caption **Basis of Presentation and Summary of Significant Accounting Policies** is incorporated herein by reference.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

For financial market risks related to changes in interest rates, reference is made to Item 7A Quantitative and Qualitative Disclosures About Market Risk contained in Part II of our Annual Report on Form 10-K for the year ended December 31, 2008. We started an investment portfolio during the first quarter of 2007 which is comprised of corporate debt securities, government and agency securities and asset and mortgage-backed securities. However, our exposure to market risk has not changed significantly since December 31, 2008.

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**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness 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 amended) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q were effective in providing reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Netflix have been detected.

*Changes in Internal Control Over Financial Reporting*

There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

The information set forth under Note 8 in the notes to the condensed consolidated financial statements under the caption "Litigation" is incorporated herein by reference.

**Item 1A. Risk Factors**

There have been no material changes from risk factors as previously disclosed under the heading "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2008 except as follows:

Reference was made to the possible expiration in late 2009 of the agreement covering the next largest number of devices through which subscribers enjoy streaming content (the largest number being the PC and Mac platforms). This agreement was extended at the partner's option. Nonetheless, our business could be adversely impacted if our consumer electronics partners are not willing to extend agreements so as to continue to provide access to our service or are unwilling to do so on terms acceptable to us.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Stock repurchases during the three months ended June 30, 2009 were as follows:

| Period                         | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Programs | Maximum Dollar Value that May Yet Be Purchased Under the Program (1) |
|--------------------------------|----------------------------------|------------------------------|---|--|
| April 1, 2009 - April 30, 2009 | 265,485                          | \$ 46.26                     | 265,485   | \$ 119,999,374   |
| May 1, 2009 - May 31, 2009     | 1,361,961                        | 44.22                        | 1,361,961   | 59,769,681   |
| June 1, 2009 - June 30, 2009   |                                  |                              |   | 59,769,681   |
| Total                          | 1,627,446                        | \$ 44.56                     | 1,627,446   | \$ 59,769,681  |

- (1) On January 26, 2009, the Company announced that its Board of Directors authorized a stock repurchase program for 2009. Based on the Board's authorization, the Company anticipates repurchasing up to \$60 million during the third and fourth quarters of 2009. The timing and actual number of shares repurchased will depend on various factors including price, corporate and regulatory requirements, alternative investment opportunities and other market conditions.

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

Our Annual Meeting of Stockholders was held on May 28, 2009. The following two proposals were adopted:

*Proposal One:*

Election of Directors:

| Nominees             | Number of Shares |          |
|----------------------|------------------|----------|
|                      | For              | Withheld |
| Richard N. Barton    | 52,588,722       | 385,529  |
| Charles H. Giancarlo | 52,622,371       | 351,880  |

In addition, the term of each of the following directors continued after the annual meeting: Reed Hastings, Jay C. Hoag, A George (Skip) Battle, Timothy Haley, Michael Schuh and Greg Stanger.

*Proposal Two:*

Ratification of the appointment of KPMG LLP as independent auditors for the year ending December 31, 2009:

| For        | Against | Number of Shares |  | Non-Votes |
|------------|---------|------------------|--|-----------|
|            |         | Abstain          |  |           |
| 52,595,094 | 319,514 | 59,643           |  |           |

**Table of Contents****Item 6. Exhibits**

(a) Exhibits:

| Exhibit Number | Exhibit Description   | Form    | Incorporated by Reference |         |                | Filed Herewith |
|----------------|---|---------|---------------------------|---------|----------------|----------------|
|                |   |         | File No.                  | Exhibit | Filing Date    |                |
| 3.1            | Amended and Restated Certificate of Incorporation   | 10-Q    | 000-49802                 | 3.1     | August 2, 2004 |                |
| 3.2            | Amended and Restated Bylaws   | 8-K     | 000-49802                 | 3.1     | March 20, 2009 |                |
| 3.3            | Certificate of Amendment to the Amended and Restated Certificate of Incorporation   | 10-Q    | 000-49802                 | 3.3     | August 2, 2004 |                |
| 4.1            | Form of Common Stock Certificate  | S-1/A   | 333-83878                 | 4.1     | April 16, 2002 |                |
| 10.1           | Form of Indemnification Agreement entered into by the registrant with each of its executive officers and directors  | S-1/A   | 333-83878                 | 10.1    | March 20, 2002 |                |
| 10.2           | 2002 Employee Stock Purchase Plan   | 10-Q    | 000-49802                 | 10.16   | August 9, 2006 |                |
| 10.3           | Amended and Restated 1997 Stock Plan  | S-1/A   | 333-83878                 | 10.3    | May 16, 2002   |                |
| 10.4           | Amended and Restated 2002 Stock Plan  | Def 14A | 000-49802                 | A       | March 31, 2006 |                |
| 10.5           | Amended and Restated Stockholders Rights Agreement  | S-1     | 333-83878                 | 10.5    | March 6, 2002  |                |
| 10.6           | Lease between Sobrato Land Holdings and Netflix, Inc.   | 10-Q    | 000-49802                 | 10.15   | August 2, 2004 |                |
| 10.7           | Lease between Sobrato Interests II and Netflix, Inc.  | 10-Q    | 000-49802                 | 10.16   | August 2, 2004 |                |
| 10.9           | Description of Director Equity Compensation Plan  | 8-K     | 000-49802                 | 10.1    | July 5, 2005   |                |
| 10.10          | Amended and Restated Executive Severance and Retention Incentive Plan   | 10-Q    | 000-49802                 | 10.10   | May 5, 2009    |                |
| 31.1           | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |         |                           |         |                | X              |
| 31.2           | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |         |                           |         |                | X              |
| 32.1*          | Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes - Oxley Act of 2002   |         |                           |         |                | X              |
| 101            | The following financial information from Netflix, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2009 filed with the SEC on July 31, 2009, formatted in XBRL includes: (i) Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2009 and 2008, (ii) Condensed Consolidated Balance Sheets as of June 30, 2009 and December 31, 2008, (iii) Condensed Consolidated Statements of Cash Flows for the Three and Six Months Ended June 30, 2009 and 2008 and (iv) the Notes to Condensed Consolidated Financial Statements, tagged as blocks of text. |         |                           |         |                | X              |

\* These certifications are not deemed filed by the SEC and are not to be incorporated by reference in any filing we make under the Securities Act of 1933 or the Securities Exchange Act of 1934, irrespective of any general incorporation language in any filings. Indicates a management contract or compensatory plan.



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**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.

NETFLIX, INC.

Dated: July 31, 2009

By: */s/ REED HASTINGS*  
**Reed Hastings**  
**Chief Executive Officer**  
  
*(Principal executive officer)*

Dated: July 31, 2009

By: */s/ BARRY MCCARTHY*  
**Barry McCarthy**  
**Chief Financial Officer**  
  
*(Principal financial and accounting officer)*

**Table of Contents****EXHIBIT INDEX**

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