

NETFLIX INC

FORM 10-K (Annual Report)

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Address	100 WINCHESTER CIRCLE . LOS GATOS, CA 95032
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Sector	Services
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 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)

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)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Name of Exchange on which registered</u>
Common stock, \$0.001 par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:

None
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 (§229.405 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definition 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 Smaller reporting company
(do not check if smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes No

As of June 30, 2009, the aggregate market value of voting stock held by non-affiliates of the registrant, based upon the closing sales price for the registrant's common stock, as reported in the NASDAQ Global Select Market System, was \$1,622,014,793. Shares of common stock beneficially owned by each executive officer and director of the Registrant and by each person known by the Registrant to beneficially own 10%

or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for any other purpose.

As of January 31, 2010, there were 53,533,265 shares of the registrant's common stock, par value \$0.001, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the registrant's Proxy Statement for Registrant's 2010 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

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PART I

Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the federal securities laws. These forward-looking statements include, but are not limited to, statements regarding: our core strategy; expected competition and our competitive advantage; the growth of Internet delivery of content; the continued popularity of the DVD format; the growth of streaming content choices available through our service; the expansion of electronic equipment that will enable streamed content; gross margin; liquidity; revenue per average paying subscriber; impacts relating to our pricing strategy; our content library investments; international expansion; and, our stock-based compensation expense for 2010. These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included throughout this filing and particularly in Item 1A: "Risk Factors" section set forth in this Annual Report on Form 10-K. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to revise or publicly release any revision to any such forward-looking statement, except as may otherwise be required by law.

Item 1. Business

With more than 12 million subscribers, we are the world's largest subscription service streaming movies and TV episodes over the Internet and sending DVDs by mail. Our subscribers can instantly watch unlimited movies and TV episodes streamed to their TVs and computers and can receive DVDs delivered quickly to their homes. We offer a variety of subscription plans, with no due dates, no late fees, no shipping fees and no pay-per-view fees. Aided by our proprietary recommendation and merchandising technology, subscribers can select from a growing library of titles that can be watched instantly and a vast array of titles on DVD. On average, approximately 2 million discs are shipped daily from our distribution centers across the United States. Additionally, more than 48% of our subscribers instantly watched more than 15 minutes of streaming content in the fourth quarter of 2009.

Subscribers can:

- Watch streaming content without commercial interruption on their computers and TVs. The viewing experience is enabled by Netflix controlled software that can run on a variety of consumer electronics devices ("Netflix Ready Devices"). These Netflix Ready Devices currently include Blu-ray disc players, Internet-connected TVs, digital video players and game consoles.
- Receive DVDs 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.

Our core strategy is to grow a large subscription business consisting of streaming and DVD-by-mail content. By combining streaming and DVD as part of the Netflix subscription, we are able to offer subscribers a uniquely compelling selection of movies for one low monthly price. We believe this creates a competitive 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 the standard definition DVD, along with its high definition successor, Blu-ray (collectively referred to as "DVD"), will continue to be the primary means by which a majority of Netflix subscribers view content for the foreseeable future. However, at some point in the future, we expect that Internet delivery of content to the home will surpass DVD as the primary means by which most Netflix subscribers view content.

We promote our service to consumers through various marketing programs, including online promotions, TV and radio advertising, package inserts, direct mail and other promotions with third parties. We also engage

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our consumer electronics partners to generate new subscribers for our service. These programs encourage consumers to subscribe to our service and may include a free trial period. At the end of the free trial period, subscribers are automatically enrolled as paying subscribers, unless they cancel their subscription. All paying subscribers are billed monthly in advance. We believe that our paid marketing efforts are significantly enhanced by the benefits of word-of-mouth advertising, our subscriber referrals and our active public relations programs.

We use our proprietary recommendation and merchandising technology to determine which titles are presented to a subscriber. In doing so, we believe we provide our subscribers with a quick and personalized way to find titles they are more likely to enjoy while also effectively managing our inventory utilization. Our merchandising efforts are used throughout our web site and as part of the user interface on many Netflix Ready Devices to determine which titles are displayed to subscribers, including the generation of lists of similar titles. We believe our merchandising efforts create a powerful method for catalog browsing and efficient library utilization.

We obtain content through direct purchases, revenue sharing agreements and license agreements with studios, distributors and other suppliers. DVD content is typically obtained through direct purchases or revenue sharing agreements. Streaming content is generally licensed for a fixed fee for the term of the license agreement.

We ship and receive DVDs throughout the United States and maintain a nationwide network of shipping centers that allows us to provide fast delivery and return service to our subscribers. We also utilize third party content delivery networks to help us efficiently stream movies and TV episodes in high volume to Netflix subscribers over the Internet.

We are focused on growing our subscriber base and revenues and utilizing our proprietary recommendation and merchandising technology to minimize variable and fixed operating costs within the framework of providing a valuable and compelling user experience. Our technology is extensively employed to manage and integrate our business, including our Web site interface, order processing, fulfillment operations and customer service. We believe that our technology also allows us to maximize our library utilization and to run our fulfillment operations in a flexible manner with minimal capital requirements.

We are organized in a single operating segment. We currently generate all our revenues in the United States, although we plan to launch a limited international expansion with a streaming subscription service in 2010. Substantially all our revenues are derived from monthly subscription fees. We have no long-lived assets outside the United States.

Industry and competitive overview

We operate in the subscription segment of the in-home entertainment video market. In 2007, we expanded our DVD-by-mail distribution model to include streaming content over the Internet. This hybrid distribution model expands the consumer appeal of the Netflix subscription service beyond the traditional reach of the DVD rental segment and offers subscribers a uniquely compelling selection of content, both streaming and DVD, for one low monthly price. While the consumer appeal of this hybrid service has grown quickly, the market for Internet delivered video content is still in its formative stages, and we expect competition to be intense.

Currently the market for Internet delivered video consists of three market segments: video-on-demand (“VOD”), ad supported, and subscription. The VOD segment includes competitors like Amazon, Apple, Blockbuster, Cinemanow and Microsoft. The ad supported segment includes competitors like Hulu and YouTube. Currently, Netflix is the primary provider in the subscription segment, but we expect direct and indirect competition to emerge and continue to grow as the consumer appeal for Internet delivery of video continues to expand.

The market for in-home entertainment video is intensely competitive and subject to rapid change. Many consumers maintain simultaneous relationships with multiple in-home entertainment video providers and can

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easily shift spending from one provider to another. For example, consumers may subscribe to cable, rent a DVD from Redbox or Blockbuster, buy a DVD from Wal-Mart or Amazon, download a movie from Apple iTunes, watch a TV show on Hulu.com, and subscribe to Netflix, or some combination thereof, all in the same month. New competitors may be able to launch new businesses at a relatively low cost. DVDs and Internet delivery of content represent only two of many existing and potential new technologies for viewing entertainment video. In addition, the growth in adoption of DVD and Internet delivery of content is not mutually exclusive from the growth of other technologies.

Our principal competitors include:

- DVD rental outlets and kiosk services, such as Blockbuster, Movie Gallery and Redbox;
- video package providers with pay-per-view and VOD content including cable providers, such as Time Warner and Comcast; direct broadcast satellite providers, such as DIRECTV and Echostar; and telecommunication providers such as AT&T and Verizon;
- online DVD subscription rental web sites, such as Blockbuster Online;
- entertainment video retail stores, such as Best Buy, Wal-Mart and Amazon.com; and
- Internet movie and TV content providers, such as Apple's iTunes, Amazon.com, Hulu.com and Google's YouTube.

Studio licensing and movie distribution

Motion pictures, including movies and TV episodes ("entertainment video") are distributed broadly through a variety of channels, including movie theaters, airlines, hotels and in-home. In-home distribution channels include DVD rental, retail outlets and web sites, Internet delivery and cable, satellite and telecommunication providers offering basic and premium TV, pay-per-view and VOD. Currently, studios distribute movies approximately three to six months after theatrical release to the home video market, three to seven months after theatrical release to pay-per-view and VOD, one year after theatrical release to premium TV and two to three years after theatrical release to basic cable and network TV. Internet delivered content is made available typically at the same time as pay-per-view or VOD. However, some content, such as TV episodes, are often made available for Internet viewing shortly after the original airing date. The major studios and TV networks have continued to experiment with shortened release windows, and we anticipate that they will continue to test a variety of modifications or adjustments to the traditional windows, including releasing movies simultaneously on DVD and VOD.

Competitive strengths

We believe that our revenue and subscriber growth are a result of the following competitive strengths:

Iconic brand . Netflix has been highly rated in online retail customer satisfaction by independent surveys from Nielsen Online and in every one of the ten consecutive surveys conducted by ForeSee/FGI Research. Because of the high level of consumer satisfaction with Netflix, over 90 percent of surveyed subscribers say that they would recommend the Netflix service to a friend. We believe that these high levels of customer satisfaction and brand loyalty make it expensive and difficult for competitors to displace Netflix as a subscription segment leader.

Personalized merchandising . We utilize various tools, including our proprietary recommendation technology, to create a custom interface for each subscriber. We believe that this customization enhances the user experience by helping Netflix subscribers discover great movies. Subscribers rate titles through our service, and our recommendation technology compares these ratings to the database of ratings collected from our entire user base. For each subscriber, these comparisons are used to make predictions about specific titles the subscriber may enjoy. These predictions, along with other factors, are used to help merchandise titles to

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subscribers. We believe that our recommendation technology and our other merchandising practices allow us to create broad-based demand for our library and maximize utilization of our library. By creating demand for content, we seek to cost-effectively balance subscriber demand between newer, more expensive titles, and older, less expensive titles. Our ability to generate demand for these older, or “long-tail,” titles while maintaining high levels of customer satisfaction helps us manage and maintain our gross margin, subscriber acquisition cost, churn rate and lifetime subscriber profit. To that end, approximately 70% of the DVDs shipped during 2009 were titles with DVD release dates greater than 13 weeks.

Growing scale. We have achieved a level of scale in our business that provides many operational and competitive advantages. From an operational perspective, for example, we are able to cost effectively automate many of our shipping and receiving processes, helping to drive down unit shipping costs while also providing a better, more consistent experience to our subscribers. Such scale economies also have contributed over time to expanding operating margins which has made it possible for Netflix to aggressively price its service offering at levels difficult for competition to meet.

Convenience, selection and fast delivery. Subscribers can conveniently select titles by building and modifying a personalized queue of titles on our Web site or by selecting titles directly from select Netflix Ready Devices. We create a unique experience for subscribers by generating user interfaces on our Website and Netflix Ready Devices that are tailored to subscribers’ individual rental and ratings history. Subscribers rate approximately 20 million movies a week and Netflix has recorded more than 3 billion ratings to date. Based on each subscriber’s queue, we ship DVDs by first class mail and subscribers return these DVDs to us in prepaid mailers. After receipt of returned DVDs, we mail our subscribers the next available DVD in their queue of selected titles. We have a vast array of titles on DVD and our nationwide network of distribution centers allows us to offer fast delivery. In addition, subscribers can select from a growing number of titles that can be watched instantly on their computers or TVs without commercial interruption. The number of streaming content choices has grown approximately 30% over the year ended December 31, 2009 and is expected to continue to grow rapidly for the foreseeable future.

Growth strategy

Our core strategy to grow a large subscription business consisting of streaming and DVD-by-mail content includes the following key elements:

Providing compelling value for subscribers. For a low fixed monthly fee, we provide subscribers access to a growing library of movies and TV episodes that can be watched instantly and a vast selection of DVD titles. We quickly deliver DVDs to subscribers from our shipping centers located throughout the United States by U.S. mail. Subscribers can, at no additional fee, also stream movies and TV episodes to their computers and TVs. There are no due dates, no late fees, no shipping fees and no pay-per-view fees. We merchandise titles in easy-to-recognize lists including new releases, by genre and other targeted categories. Our recommendation and merchandising technology provides subscribers with individualized recommendations of titles from our library. Our convenient, easy-to-use Web site allows subscribers to quickly select current titles, reserve upcoming releases and build an individual queue for future viewing.

Utilizing technology to enhance subscriber experience and operate efficiently. We utilize proprietary and other technology to manage the processing and distribution of DVDs from our shipping centers and the delivery of streaming content over the Internet. Our software and equipment automate the process of tracking and routing DVDs to and from each of our shipping centers and allocate order responsibilities among them. We continuously monitor, test and seek to improve the efficiency of our distribution, processing and inventory management systems as our subscriber base and shipping volume grows. We operate a nationwide network of shipping centers and continue to develop this network to meet the demands of our operations. We also utilize third party content delivery networks to help us efficiently stream movies and TV episodes in high volume to Netflix subscribers over the Internet.

Building mutually beneficial relationships with entertainment video providers. We have invested substantial resources in establishing strong ties with various entertainment video providers. We maintain an

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office in Beverly Hills, California in order to maintain effective working relationships with the major studios. We obtain content through direct purchases, revenue sharing agreements and license agreements. We work with the content providers to determine which method of acquiring titles is the most beneficial for each party. Our growing subscriber base provides studios with an additional distribution outlet for popular movies and TV episodes, as well as niche titles and programs.

Expanding the number of devices capable of streaming video from Netflix . We have engaged a number of consumer electronics partners to offer instant streaming of content from Netflix to various devices. We currently offer subscribers the ability to stream content through their computers and other devices, including the Xbox 360, PlayStation3, Internet-connected TVs and Blu-ray players, TiVo, and the Roku video digital player. We intend to broaden our partner relationships over time so that more devices, such as the Nintendo Wii game console, are capable of streaming content from Netflix. By providing consumers with a broad array of devices capable of streaming content from Netflix, we believe that we enhance the value of our service to subscribers as well as position ourselves for continued growth as the Internet delivery of content becomes more popular.

Our web site—www.netflix.com

We apply substantial resources to develop and maintain technology to implement the features of our Web site, such as subscription account sign-up and management, personalized movie merchandising, inventory optimization and streaming content. We believe that our Web site provides our subscribers with an easy-to-use interface that enhances the value of our service. We believe that our ability to personally merchandise our content through the Web site optimizes subscriber satisfaction and management of our library by integrating the predictions from our recommendation and merchandising technology, each subscriber's current queue and viewing history, inventory levels and other factors to determine which movies to promote to each subscriber. Subscribers pay for our service by a credit or debit card. We utilize third party services to authorize and process our payment methods. Throughout our Web site, we have extensive measurement and testing capabilities, allowing us to continuously optimize our Web site according to our needs, as well as those of our subscribers. We use random control testing extensively, including testing service levels, plans, promotions and pricing.

Merchandising

We use our proprietary recommendation and merchandising technology along with other data to determine which titles are presented to a subscriber. In doing so, we believe we provide our subscribers with a quick and personalized way to find titles they are more likely to enjoy while also effectively managing our inventory utilization. Our merchandising efforts are used throughout our web site to determine which titles are displayed to subscribers, including the generation of lists of similar titles. We believe our merchandising efforts create a powerful method for catalog browsing and efficient library utilization.

We also provide our subscribers with detailed information about each title in our library which helps them select movies they will enjoy. This information may include:

- factual data, including length, rating, cast and crew, special DVD features and screen formats;
- movie trailers and other editorial perspectives, including plot synopses and reviews written by our editors, third parties and by other Netflix subscribers; and
- data from our recommendation and merchandising technology, including personal rating, average rating and other similar titles the subscriber may enjoy.

Marketing

We use multiple marketing channels through which we attract subscribers to our service. Online advertising is an important channel for acquiring subscribers. We advertise our service online through such vehicles as paid search listings, banner ads, text links and permission based e-mails. In addition, we have an affiliate program

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whereby we make available Web-based banner ads and other advertisements that third parties may retrieve on a self-assisted basis from our Web site and place on their Web sites. We also engage our consumer electronics partners to generate new subscribers for our service. We also advertise our service on various regional and national TV and radio stations. We use targeted, solo direct mail, shared mail and newspaper print advertising to acquire new subscribers. We also participate in a variety of cooperative advertising programs with studios under the terms of which we receive cash consideration in exchange for featuring the studios movies in Netflix promotional advertising. We believe that our paid marketing efforts are significantly enhanced by the benefits of word-of-mouth advertising, our subscriber referrals and our active public relations programs.

Content acquisition

We obtain content through direct purchases, revenue sharing agreements and license agreements. Under our DVD and streaming revenue sharing agreements with studios and distributors, we generally obtain titles for a low initial cost in exchange for a commitment for a defined period of time either to share a percentage of our subscription revenues or to pay a fee based on content utilization. After the revenue sharing period expires for a DVD, we generally have the option of returning the DVD to the studio, destroying the DVD or purchasing the DVD. The principal structure of each agreement is similar in nature but the specific terms are generally unique to each studio. We also purchase DVDs from various studios, distributors and other suppliers on a purchase order basis. Under these arrangements, we typically pay a per disc fee for each of the DVDs we purchase. For titles that are streamed to our subscribers, we generally license the content directly from studios and distributors for a defined period of time. Following expiration of the license term, we remove the content from our service unless we extend or renew the associated license agreement.

Fulfillment operations

We have allocated substantial resources to developing, maintaining and testing the technology that helps us manage fulfillment and the integration of our web site, transaction processing systems, fulfillment operations, inventory levels, content delivery networks and coordination of our shipping centers. We ship and receive DVDs from a nationwide network of shipping centers located throughout the United States. We believe our shipping centers allow us to improve the customer experience for subscribers by shortening the transit time for our DVDs through the U.S. Postal Service. We also utilize third party content delivery networks to help us efficiently stream movies and TV episodes in high volume to our subscribers over the Internet.

Customer service

We believe that our ability to establish and maintain long-term relationships with subscribers depends, in part, on the strength of our customer support and service operations. As such, we work on maintaining and improving the overall quality and level of customer service and support we provide to our subscribers. Our customer service center is located in Hillsboro, Oregon, and primarily handles subscriber inquiries by telephone. In addition, we continue to focus on eliminating the causes of customer support calls and providing certain self-service features on our web site, such as the ability to report and correct most shipping problems. We continue to explore new avenues to deliver efficient problem resolution and feedback channels.

Employees

As of December 31, 2009, we had 1,883 full-time employees. We also utilize part-time and temporary employees, primarily in our fulfillment operations, to respond to the fluctuating demand for DVD shipments. As of December 31, 2009, we had 2,197 part-time and temporary employees. Our employees are not covered by a collective bargaining agreement, and we consider our relations with our employees to be good.

Intellectual property

We use a combination of patent, trademark, copyright and trade secret laws and confidentiality agreements to protect our proprietary intellectual property. We have filed patents in the U.S. and abroad. While our patents

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are an important element of our business, our business as a whole is not materially dependent on any one or a combination of patents. We have registered trademarks and service marks for the Netflix name and have filed applications for additional trademarks and service marks. Our software, the content of our Web site and other material which we create are protected by copyright. We also protect certain details about our business methods, processes and strategies as trade secrets, and keep confidential information that we believe gives us a competitive advantage.

Our ability to protect and enforce our intellectual property rights is subject to certain risks. Enforcement of intellectual property rights is costly and time consuming. To date, we have relied primarily on proprietary processes and know-how to protect our intellectual property. It is uncertain if and when our other patent and trademark applications may be allowed and whether they will provide us with a competitive advantage.

From time to time, we encounter disputes over rights and obligations concerning intellectual property. We cannot assure that we will prevail in any intellectual property dispute.

Other information

We were incorporated in Delaware in August 1997 and completed our initial public offering in May 2002. Our principal executive offices are located at 100 Winchester Circle, Los Gatos, California 95032, and our telephone number is (408) 540-3700. We maintain a Web site at www.netflix.com. The contents of our Web site are not incorporated in, or otherwise to be regarded as part of, this Annual Report on Form 10-K. In this Annual Report on Form 10-K, "Netflix," the "Company," "we," "us," "our" and the "registrant" refer to Netflix, Inc.

Our investor relations Web site is located at <http://ir.netflix.com>. We make available, free of charge, on our investor relations Web site under "SEC Filings," our Annual Reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports as soon as reasonably practicable after electronically filing or furnishing those reports to the Securities and Exchange Commission.

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Item 1A. Risk Factors

If any of the following risks actually occurs, our business, financial condition and results of operations could be harmed. In that case, the trading price of our common stock could decline, and you could lose all or part of your investment.

Risks Related to Our Business

If our efforts to attract subscribers are not successful, our revenues will be adversely affected.

We must continue to attract subscribers to our service. Our ability to attract subscribers will depend in part on our ability to consistently provide our subscribers with a valuable and quality experience for selecting, viewing, receiving and returning DVD and streaming titles, including providing valuable recommendations through our recommendation and merchandising technology. Furthermore, the relative service levels, pricing and related features of competitors to our service may adversely impact our ability to attract subscribers. Competitors include DVD rental outlets and kiosk services, video package providers with pay-per-view and VOD content, online DVD subscription rental web sites, entertainment video retail stores and Internet movie and TV content providers. If consumers do not perceive our service offering to be of value, or if we introduce new services that are not favorably received by them, we may not be able to attract subscribers. In addition, many of our subscribers are rejoining our service or originate from word-of-mouth advertising from existing subscribers. If our efforts to satisfy our existing subscribers are not successful, we may not be able to attract subscribers, and as a result, our revenues will be adversely affected.

If we experience excessive rates of churn, our revenues and business will be harmed.

We must minimize the rate of loss of existing subscribers while adding new subscribers. Subscribers cancel their subscription to our service for many reasons, including a perception that they do not use the service sufficiently, delivery takes too long, the service is a poor value, competitive services provide a better value or experience and customer service issues are not satisfactorily resolved. We must continually add new subscribers both to replace subscribers who cancel and to grow our business beyond our current subscriber base. If too many of our subscribers cancel our service, or if we are unable to attract new subscribers in numbers sufficient to grow our business, our operating results will be adversely affected. If we are unable to successfully compete with current and new competitors in both retaining our existing subscribers and attracting new subscribers, our churn will likely increase and our business will be adversely affected. Further, if excessive numbers of subscribers cancel our service, we may be required to incur significantly higher marketing expenditures than we currently anticipate to replace these subscribers with new subscribers.

Deterioration in the economy could impact our business.

Netflix is an entertainment service, and payment for our service may be considered discretionary on the part of many of our current and potential subscribers. To the extent the overall economy continues to deteriorate, such as in the case of a prolonged recession, our business could be impacted as subscribers choose either to leave our service or reduce their service levels. Also, efforts to attract new subscribers may be adversely impacted.

If the market segment for online DVD rentals saturates, our business will be adversely affected.

The market segment for online DVD rental has grown significantly since inception. Some of the increasing growth can be attributed to changes in our service offering, especially the ability of our subscribers to stream movies and TV episodes on their TVs and computers. A decline in our rate of growth could indicate that the market segment for online DVD rentals is beginning to saturate. While we believe that online DVD rentals will continue to grow for the foreseeable future, if this market segment were to saturate, our business would be adversely affected.

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If we are unable to compete effectively, our business will be adversely affected.

The market for in-home entertainment video is intensely competitive and subject to rapid change. New technologies for delivery of in-home entertainment video, such as VOD and Internet delivery of content, continue to receive considerable media and investor attention. Many of our competitors have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, marketing and other resources than we do. If we are unable to successfully or profitably compete with current and new competitors, programs and technologies, our business will be adversely affected, and we may not be able to increase or maintain market share, revenues or profitability.

Some of our competitors have adopted, and may continue to adopt, aggressive pricing policies and devote substantially more resources to marketing and Web site and systems development than we do. There can be no assurance that we will be able to compete effectively against current or new competitors at our existing pricing levels or at even lower price points in the future. Furthermore, we may need to adjust the level of service provided to our subscribers and/or incur significantly higher marketing expenditures than we currently anticipate. As a result of increased competition, we may see a reduction in operating margins and market share.

If VOD or other technologies are more widely adopted and supported as a method of content delivery, our business could be adversely affected.

Some digital cable providers and Internet content providers have implemented technology referred to as VOD. This technology transmits movies and other entertainment content on demand with interactive capabilities such as start, stop and rewind. In addition, other technologies have been developed that allow alternative means for consumers to receive and watch movies or other entertainment, particularly over the Internet and on devices such as cell phones. Although we are providing our own Internet-based delivery of content, allowing our subscribers to stream certain movies and TV episodes, VOD or other technologies may become more affordable and viable alternative methods of content delivery that are widely supported by studios and distributors and adopted by consumers. If this happens more quickly than we anticipate or more quickly than our own Internet delivery offerings, or if other providers are better able to meet studio and consumer needs and expectations, our business could be adversely affected.

If the popularity of the DVD format decreases, our business could be adversely affected.

While the growth of DVD sales has slowed, we believe that the DVD will be a valuable long-term consumer proposition and studio profit center. However, if DVD sales were to decrease, because of a shift away from movie watching or because new or existing technologies were to become more popular at the expense of DVD enjoyment, studios and retailers may reduce their support of the DVD format. Our subscriber growth will be substantially influenced by the continued popularity of the DVD format, and if such popularity wanes, our subscriber growth may also slow.

If U.S. Copyright law were altered to amend or eliminate the First Sale Doctrine or if studios were to release or distribute titles on DVD in a manner that attempts to circumvent or limit the affects of the First Sale Doctrine, our business could be adversely affected.

Under U.S. Copyright Law, once a copyright owner sells a copy of his work, the copyright owner relinquishes all further rights to sell or otherwise dispose of that copy. While the copyright owner retains the underlying copyright to the expression fixed in the work, the copyright owner gives up his ability to control the fate of the work once it had been sold. As such, once a DVD is sold into the market, those obtaining the DVD are permitted to re-sell it, rent it or otherwise dispose of it. If Congress or the courts were to change or substantially limit this First Sale Doctrine, our ability to obtain content and then rent it could be adversely affected. Likewise, if studios agree to limit the sale or distribution of their content in ways that try to limit the affects of the First Sale Doctrine, our business could be adversely affected. For example, some studios have expressed a desire to delay the availability of new release DVDs for rental for a brief period of time following the DVDs release to the retail

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market and, in connection therewith, would prohibit certain of their wholesalers from selling to various rental outlets, such as us and Redbox. In fact, Universal Studios and Twentieth Century Fox are engaged in litigation brought by Redbox over this practice. Furthermore, certain content owners, from time to time, have established exclusive rental windows with particular outlets. This happened in late 2006 and again in late 2007 when Blockbuster announced arrangements with certain content owners pursuant to which Blockbuster would receive content on DVDs for rental exclusively by Blockbuster. To the extent content is to be distributed exclusively and not to retail vendors or distributors, we could be prevented from obtaining such content. To the extent the content is also sold to retail vendors or distributors, we would not be prohibited from obtaining and renting such content pursuant to the First Sale Doctrine. Nonetheless, to the extent content owners do not distribute to us directly or through their wholesalers or otherwise establish exclusive rental windows, it will impact our ability to obtain such content in the most efficient manner and, in some cases, in sufficient quantity to satisfy demand. If such arrangements were to become more commonplace or if additional impediments to obtaining content were created, our ability to obtain content could be impacted and our business could be adversely affected.

Delayed availability of new release DVDs for rental could adversely affect our business.

We recently entered into a licensing agreement with Warner Bros. whereby we agreed not to rent new release Warner Bros. DVDs until twenty-eight days after such DVDs are first made available for retail sale. We believe that this agreement, and perhaps others like it, will provide us with less expensive content as well as deeper copy depth, thus improving both our business and consumer experience. Nonetheless, it is possible that the delay in obtaining new release content both from Warner Bros. and any other suppliers that may adopt similar licensing strategies could impact consumer perception of our service or otherwise negatively impact subscriber satisfaction. If this were to happen, our business could be adversely impacted.

If studios were to offer new releases of entertainment video to other distribution channels prior to, or on parity with, the release on DVD, our business could be adversely affected.

Except for theatrical release, DVDs currently enjoy a competitive advantage over other distribution channels, such as pay-per-view and VOD, because of the early distribution window on the DVD format. The window for new releases on DVD is generally exclusive against other forms of non-theatrical movie distribution, such as pay-per-view, Internet delivery, premium TV, basic cable and network and syndicated TV. The length of the exclusive window for movie rental and retail sales varies and the order, length and exclusivity of each window for each distribution channel are determined solely by the studio releasing the title. Over the past several years, the major studios have shortened the release windows and several studios have released movies simultaneously on DVD and VOD. If other distribution channels were to receive priority over, or parity with, DVD and such practices are widely adopted, our subscribers might find these other distribution channels of more value than our service and our business could be adversely affected.

We depend on studios and distributors to license us content that we can stream instantly over the Internet.

Streaming content over the Internet involves the licensing of rights which are separate from and independent of the rights we acquire when obtaining DVD content. Our ability to provide our subscribers with content they can watch instantly therefore depends on studios and distributors licensing us content specifically for Internet delivery. The license periods and the terms and conditions of such licenses vary. If the studios and distributors change their terms and conditions or are no longer willing or able to provide us licenses, our ability to stream content to our subscribers will be adversely affected. Unlike DVD, streaming content is not subject to the First Sale Doctrine. As such, we are completely dependent on the studio or distributor providing us licenses in order to access and stream content. Many of the licenses provide for the studios or distributor to withdraw content from our service relatively quickly. Because of these provisions as well as other actions we may take, content available through our service can be withdrawn on short notice. For example, in December 2008, certain content associated with our license from the Starz Play service was withdrawn on short notice. In addition, the studios have great

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flexibility in licensing content. They may elect to license content exclusively to a particular provider or otherwise limit the types of services that can deliver streaming content. For example, HBO licenses content from studios like Warner Bros. and the license provides HBO with the exclusive right to such content against other subscription services, including Netflix. As such, Netflix cannot license certain Warner Bros. content for delivery to its subscribers while Warner Bros. may nonetheless license the same content to transactional VOD providers. If we are unable to secure and maintain rights to streaming content or if we cannot otherwise obtain such content upon terms that are acceptable to us, our ability to stream movies and TV episodes to our subscribers will be adversely impacted, and our subscriber acquisition and retention could also be adversely impacted. During the course of our license relationship, various contract administration issues can arise. To the extent that we are unable to resolve any of these issues in an amicable manner, our relationship with the studios and distributors or our access to content may be adversely impacted.

We rely upon a number of partners to offer instant streaming of content from Netflix to various devices.

We currently offer subscribers the ability to receive streaming content through their PCs, Macs and other devices, including Internet-connected Blu-ray players and TVs, digital video players and game consoles. We intend to broaden our capability to instantly stream movies and TV episodes to other platforms and partners over time. If we are not successful in maintaining existing and creating new relationships, or if we encounter technological, content licensing or other impediments to our streaming content, our ability to grow our business could be adversely impacted. Our agreements with our consumer electronics partners are typically between one and three years in duration and our business could be adversely affected if, upon expiration, our partners do not continue to provide access to our service or are unwilling to do so on terms acceptable to us. Furthermore, devices are manufactured and sold by entities other than Netflix and while these entities should be responsible for the devices' performance, the connection between these devices and Netflix may nonetheless result in consumer dissatisfaction toward Netflix and such dissatisfaction could result in claims against us or otherwise adversely impact our business. In addition, technology changes to our streaming functionality may require that partners update their devices. If partners do not update or otherwise modify their devices, our service and our subscribers use and enjoyment could be negatively impacted.

If we experience increased demand for titles which we are unable to offset with increased subscriber retention or operating margins, our operating results may be adversely affected.

With our unlimited plans, there is no established limit to the number of movies and TV episodes that subscribers may rent on DVD or watch instantly. We are continually adjusting our service in ways that may impact subscriber content usage. Such adjustments include new Web site features and merchandising practices, improvements in the technology that enable subscribers to instantly watch movies and TV episodes, an expanded DVD distribution network and software and process changes. In addition, demand for titles may increase for a variety of reasons beyond our control, including promotion by studios and seasonal variations or shifts in consumer content watching.

If our subscriber retention does not increase or our operating margins do not improve to an extent necessary to offset the effect of any increased operating costs associated with increased usage, our operating results will be adversely affected. In addition, our subscriber growth and retention may be adversely affected if we attempt to alter our service or increase our monthly subscription fees to offset any increased costs of acquiring or delivering titles.

If our subscribers select titles or formats that are more expensive for us to obtain and deliver more frequently, our expenses may increase.

Certain titles cost us more to purchase or result in greater revenue sharing expenses, depending on the source from which they are obtained and the terms on which they are obtained. If subscribers select these titles

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more often on a proportional basis compared to all titles selected, our revenue sharing and other content acquisition expenses could increase, and our gross margins could be adversely affected. In addition, films released on Blu-ray and those released for streaming may be more expensive to obtain than in the standard definition DVD format. The rate of customer acceptance and adoption of these new formats is uncertain. If subscribers select these formats on a proportional basis more often than the existing standard definition DVD format, our content acquisition expenses could increase, and our gross margins could be adversely affected.

If our efforts to build strong brand identity and improve subscriber satisfaction and loyalty are not successful, we may not be able to attract or retain subscribers, and our operating results may be adversely affected.

We must continue to build and maintain strong brand identity. To succeed, we must continue to attract and retain a large number of subscribers who have relied on other rental outlets and persuade them to subscribe to our service. In addition, we may have to compete for subscribers against other brands which have greater recognition than ours. We believe that the importance of brand loyalty will only increase in light of competition, both for online subscription services and other means of distributing titles, such as VOD. From time to time, our subscribers express dissatisfaction with our service, including among other things, our inventory allocation, delivery processing and service interruptions. Furthermore, third party devices that enable instant streaming of movies and TV episodes from Netflix may not meet consumer expectations. To the extent dissatisfaction with our service is widespread or not adequately addressed, our brand may be adversely impacted. If our efforts to promote and maintain our brand are not successful, our operating results and our ability to attract and retain subscribers may be adversely affected.

If we are unable to manage the mix of subscriber acquisition sources, our subscriber levels and marketing expenses may be adversely affected.

We utilize a broad mix of marketing programs to promote our service to potential new subscribers. We obtain new subscribers through our online marketing efforts, including paid search listings, banner ads, text links and permission-based e-mails, as well as our active affiliate program. We also engage our consumer electronics partners to generate new subscribers for our service. In addition, we have engaged in various offline marketing programs, including TV and radio advertising, direct mail and print campaigns, consumer package and mailing insertions. We also acquire a number of subscribers who rejoin our service having previously cancelled their membership. We maintain an active public relations program to increase awareness of our service and drive subscriber acquisition. We opportunistically adjust our mix of marketing programs to acquire new subscribers at a reasonable cost with the intention of achieving overall financial goals. If we are unable to maintain or replace our sources of subscribers with similarly effective sources, or if the cost of our existing sources increases, our subscriber levels and marketing expenses may be adversely affected.

If we are unable to continue using our current marketing channels, our ability to attract new subscribers may be adversely affected.

We may not be able to continue to support the marketing of our service by current means if such activities are no longer available to us, become cost prohibitive or are adverse to our business. If companies that currently promote our service decide to enter our business or a similar business or decide to exclusively support our competitors, we may no longer be given access to such channels. In addition, if ad rates increase, we may curtail marketing expenses or otherwise experience an increase in our cost per subscriber. Laws and regulations impose restrictions on the use of certain channels, including commercial e-mail and direct mail. We may limit or discontinue use or support of e-mail and other activities if we become concerned that subscribers or potential subscribers deem such activities intrusive, which could affect our goodwill or brand. If the available marketing channels are curtailed, our ability to attract new subscribers may be adversely affected.

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If we are not able to manage our growth, our business could be adversely affected.

We have expanded rapidly since we launched our Web site in April 1998. Many of our systems and operational practices were implemented when we were at a smaller scale of operations. Also, as we grow, we have implemented new systems and software to help run our operations. If we are not able to refine or revise our legacy systems or implement new systems and software as we grow, if they fail or, if in responding to any other issues related to growth, our management is materially distracted from our current operations, our business may be adversely affected.

We rely heavily on our proprietary technology to process deliveries and returns of our DVDs and to manage other aspects of our operations, including streaming of movies and TV episodes to our subscribers, and the failure of this technology to operate effectively could adversely affect our business.

We use complex proprietary and other technology to process deliveries and returns of our DVDs and to manage other aspects of our operations, including streaming of movies and TV episodes to our subscribers. We continually enhance or modify the technology used for our distribution operations. We cannot be sure that any enhancements or other modifications we make to our distribution operations will achieve the intended results or otherwise be of value to our subscribers. Future enhancements and modifications to our technology could consume considerable resources. If we are unable to maintain and enhance our technology to manage the processing of DVDs among our shipping centers or the streaming of movies and TV episodes to our subscribers in a timely and efficient manner, our ability to retain existing subscribers and to add new subscribers may be impaired. In addition, if our technology or that of third parties we utilize in our operations fails or otherwise operates improperly, our ability to retain existing subscribers and to add new subscribers may be impaired. Also, any harm to our subscribers' personal computers or other devices caused by software used in our operations could have an adverse effect on our business, results of operations and financial condition.

If we experience delivery problems or if our subscribers or potential subscribers lose confidence in the U.S. mail system, we could lose subscribers, which could adversely affect our operating results.

We rely exclusively on the U.S. Postal Service to deliver DVDs from our shipping centers and to return DVDs to us from our subscribers. We are subject to risks associated with using the public mail system to meet our shipping needs, including delays or disruptions caused by inclement weather, natural disasters, labor activism, health epidemics or bioterrorism. Our DVDs are also subject to risks of breakage and theft during our processing of shipments as well as during delivery and handling by the U.S. Postal Service. The risk of breakage is also impacted by the materials and methods used to replicate our DVDs. If the entities replicating our DVDs use materials and methods more likely to break during delivery and handling or we fail to timely deliver DVDs to our subscribers, our subscribers could become dissatisfied and cancel our service, which could adversely affect our operating results. In addition, increased breakage and theft rates for our DVDs will increase our cost of acquiring titles.

Increases in the cost of delivering DVDs could adversely affect our gross profit.

Increases in postage delivery rates could adversely affect our gross profit if we elect not to raise our subscription fees to offset the increase. The U.S. Postal Service increased the rate for first class postage on May 12, 2008 to 42 cents and again in May 2009 to 44 cents. It is expected that the U.S. Postal Service will raise rates again in subsequent years in accordance with the powers given the U.S. Postal Service in connection with the 2007 postal reform legislation. However, in October 2009, the U.S. Postal Service announced that it would not raise rates in 2010. The U.S. Postal Service continues to focus on plans to reduce its costs and make its service more efficient. If the U.S. Postal Service were to change any policies relative to the requirements of first-class mail, including changes in size, weight or machinability qualifications of our DVD envelopes, such changes could result in increased shipping costs or higher breakage for our DVDs, and our gross margin could be adversely affected. For example, the Office of Inspector General ("OIG") at the U.S. Postal Service issued a report in November 2007 recommending that the U.S. Postal Service revise the machinability qualifications for

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first class mail related to DVDs or to charge DVD mailers who don't comply with the new regulations a 17 cent surcharge on all mail deemed unmachinable. In addition, a by-mail game rental company filed a complaint with the Postal Regulatory Commission alleging that the U.S. Postal Service unreasonably discriminated against it in favor of Netflix and Blockbuster. To the extent this proceeding was to result in operational or regulatory changes impacting our mail processing, our gross margins and business operations could be adversely affected. We do not anticipate any material impact to our operational practices or postage delivery rates arising from the OIG report or the proceeding. Also, if the U.S. Postal Service curtails its services, such as by closing facilities or discontinuing or reducing Saturday delivery service, our ability to timely deliver DVDs could diminish, and our subscriber satisfaction could be adversely affected.

Studios also release films in high definition format on Blu-ray. This high definition format DVD has higher damage rates than we currently experience with standard definition DVDs. If we were to see a significant increase in the number of Blu-ray DVDs we ship or an increase in the percentage of Blu-ray DVDs our subscribers take and the damage rates remained higher than standard definition DVDs, our gross margins, profitability and cash flow could be adversely affected.

If we are unable to effectively utilize our recommendation and merchandising technology, our business may suffer.

Our proprietary recommendation and merchandising technology enables us to predict and recommend titles and effectively merchandise our library to our subscribers. We believe that in order for our recommendation and merchandising technology to function most effectively, it must access a large database of user ratings. We cannot assure that our recommendation and merchandising technology will continue to function effectively to predict and recommend titles that our subscribers will enjoy, or that we will continue to be successful in enticing subscribers to rate enough titles for our database to effectively predict and recommend new or existing titles.

We are continually refining our recommendation and merchandising technology in an effort to improve its predictive accuracy and usefulness to our subscribers. We may experience difficulties in implementing refinements. In addition, we cannot assure that we will be able to continue to make and implement meaningful refinements to our recommendation technology.

If our recommendation and merchandising technology does not enable us to predict and recommend titles that our subscribers will enjoy or if we are unable to implement meaningful improvements, our personal movie recommendation service will be less useful, in which event:

- our subscriber satisfaction may decrease, subscribers may perceive our service to be of lower value and our ability to attract and retain subscribers may be adversely affected;
- our ability to effectively merchandise and utilize our library will be adversely affected; and
- our subscribers may default to choosing titles from among new releases or other titles that cost us more to provide, and our margins may be adversely affected.

If we do not acquire sufficient DVD titles, our subscriber satisfaction and results of operations may be adversely affected.

If we do not acquire sufficient copies of DVDs, either by not correctly anticipating demand or by intentionally acquiring fewer copies than needed to fully satisfy demand, we may not appropriately satisfy subscriber demand, and our subscriber satisfaction and results of operations could be adversely affected. Conversely, if we attempt to mitigate this risk and acquire more copies than needed to satisfy our subscriber demand, our inventory utilization would become less effective and our gross margins would be adversely affected. Our ability to accurately predict subscriber demand as well as market factors such as exclusive distribution arrangements may impact our ability to acquire appropriate quantities of certain DVDs.

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If we are unable to renew or renegotiate our revenue sharing agreements when they expire on terms favorable to us, or if the cost of obtaining titles on a wholesale basis increases, our gross margins may be adversely affected.

We obtain DVDs through a mix of revenue sharing agreements and direct purchases. The type of agreement depends on the economic terms we can negotiate as well as studio preferences. We have entered into numerous revenue sharing arrangements with studios and distributors which typically enabled us to increase our copy depth of DVDs on an economical basis because of a low initial payment with additional payments made only if our subscribers rent the DVD. During the course of our revenue sharing relationships, various contract administration issues can arise. To the extent that we are unable to resolve any of these issues in an amicable manner, our relationship with the studios and distributors or our access to content may be adversely impacted.

As the revenue sharing agreements expire, we must renegotiate new terms or shift to direct purchasing arrangements, under which we must pay the full wholesale price regardless of whether the DVD is rented. If we cannot renegotiate purchasing on favorable terms, the cost of obtaining content could increase and our gross margins may be adversely affected. In addition, the risk associated with accurately predicting title demand could increase if we are required to directly purchase more titles.

If the sales price of DVDs to retail consumers decreases, our ability to attract new subscribers may be adversely affected.

The cost of manufacturing DVDs is substantially less than the price for which new DVDs are generally sold in the retail market. Thus, we believe that studios and other resellers of DVDs have significant flexibility in pricing DVDs for retail sale. If the retail price of DVDs decreases significantly, consumers may choose to purchase DVDs instead of subscribing to our service.

Any significant disruption in our computer systems or those of third parties that we utilize in our operations could result in a loss or degradation of service and could adversely impact our business.

Subscribers and potential subscribers access our service through our Web site or a Netflix Ready Device. Our reputation and ability to attract, retain and serve our subscribers is dependent upon the reliable performance of our computer systems and those of third parties that we utilize in our operations. Interruptions in these systems, or with the Internet in general, including discriminatory network management practices, could make our service unavailable or degraded or otherwise hinder our ability to fulfill DVD selections or deliver streaming content. For example, in August 2008, we suffered a service interruption that impacted our ability to ship and receive DVDs as well as stream movies to our subscribers. Much of our software is proprietary, and we rely on the expertise of our engineering and software development teams for the continued performance of our software and computer systems. Service interruptions, errors in our software or the unavailability of computer systems used in our operations could diminish the overall attractiveness of our subscription service to existing and potential subscribers.

Our servers and those of third parties we use in our operations are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions and delays in our service and operations as well as loss, misuse or theft of data. Our Web site periodically experiences directed attacks intended to cause a disruption in service. Any attempts by hackers to disrupt our service or our internal systems, if successful, could harm our business, be expensive to remedy and damage our reputation. Our insurance does not cover expenses related to direct attacks on our Web site or internal systems. Efforts to prevent hackers from entering our computer systems are expensive to implement and may limit the functionality of our services. In certain instances, we have voluntarily provided affected subscribers with a credit during periods of extended outage. Any significant disruption to our service or internal computer systems could result in a loss of subscribers and adversely affect our business and results of operations.

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We utilize our own communications and computer hardware systems located either in our facilities or in that of a third-party Web hosting provider. We recently have begun utilizing third-party Internet-based or “cloud” computing systems in connection with our business operations. Also, we utilize third-party content delivery networks to help us stream movies and TV episodes in high volume to Netflix subscribers over the Internet. Fires, floods, earthquakes, power losses, telecommunications failures, break-ins and similar events could damage these systems and hardware or cause them to fail completely. As we do not maintain entirely redundant systems, a disrupting event could result in prolonged downtime of our operations and could adversely affect our business. In addition, problems faced by our third party Web hosting, cloud computing, or content delivery network providers, including technological or business-related disruptions, could adversely impact the experience of our subscribers.

In the event of an earthquake or other natural or man-made disaster, our operations could be adversely affected.

Our executive offices and data centers are located in the San Francisco Bay Area. We have shipping centers located throughout the United States, including earthquake and hurricane-sensitive areas. Our business and operations could be adversely affected in the event of these natural disasters as well as from electrical blackouts, fires, floods, power losses, telecommunications failures, break-ins or similar events. We may not be able to effectively shift our fulfillment and delivery operations to handle disruptions in service arising from these events. Because the San Francisco Bay Area is located in an earthquake-sensitive area, we are particularly susceptible to the risk of damage to, or total destruction of, our executive offices and data centers. We are not insured against any losses or expenses that arise from a disruption to our business due to earthquakes and may not have adequate insurance to cover losses and expenses from other natural disasters.

Privacy concerns could limit our ability to leverage our subscriber data and our disclosure of or unauthorized access to subscriber data could adversely impact our business and reputation.

In the ordinary course of business and in particular in connection with providing our personal movie recommendations, we collect and utilize data supplied by our subscribers. We currently face certain legal obligations regarding the manner in which we treat such information. Other businesses have been criticized by privacy groups and governmental bodies for attempts to link personal identities and other information to data collected on the Internet regarding users’ browsing and other habits. Increased regulation of data utilization practices, including self-regulation as well as increased enforcement of existing laws, could have an adverse effect on our business. In addition, if unauthorized access to our subscriber data were to occur or if we were to disclose data about our subscribers in a manner that was objectionable to them, our business reputation could be adversely affected, and we could face potential legal claims that could impact our operating results.

Our reputation and relationships with subscribers would be harmed if our subscriber data, particularly billing data, were to be accessed by unauthorized persons.

We maintain personal data regarding our subscribers, including names and mailing addresses. With respect to billing data, such as credit card numbers, we rely on licensed encryption and authentication technology to secure such information. We take measures to protect against unauthorized intrusion into our subscribers’ data. If, despite these measures, we, or our payment processing service, experience any unauthorized intrusion into our subscribers’ data, current and potential subscribers may become unwilling to provide the information to us necessary for them to become subscribers, we could face legal claims, and our business could be adversely affected. Similarly, if a well-publicized breach of the consumer data security of any other major consumer Web site were to occur, there could be a general public loss of confidence in the use of the Internet for commerce transactions which could adversely affect our business.

In addition, because we obtain subscribers’ billing information on our Web site, we do not obtain signatures from subscribers in connection with the use of credit cards by them. Under current credit card practices, to the extent we do not obtain cardholders’ signatures, we are liable for fraudulent credit card transactions, even when

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the associated financial institution approves payment of the orders. From time to time, fraudulent credit cards are used on our Web site to obtain service and access our DVD inventory and streaming. Typically, these credit cards have not been registered as stolen and are therefore not rejected by our automatic authorization safeguards. While we do have a number of other safeguards in place, we nonetheless experience some loss from these fraudulent transactions. We do not currently carry insurance against the risk of fraudulent credit card transactions. A failure to adequately control fraudulent credit card transactions would harm our business and results of operations.

Increases in payment processing fees or changes to operating rules would increase our operating expenses and adversely affect our business and results of operations.

Our subscribers pay for our subscription services predominately using credit cards and debit cards. Our acceptance of these payment methods requires our payment of certain fees. From time to time, these fees may increase, either as a result of rate changes by the payment processing companies or as a result in a change in our business practices which increase the fees on a cost-per-transaction basis. Such increases may adversely affect our results of operations.

We are subject to rules, regulations and practices governing our accepted payment methods, which are predominately credit cards and debit cards. These rules, regulations and practices could change or be reinterpreted to make it difficult or impossible for us to comply. If we fail to comply with these rules or requirements, we may be subject to fines and higher transaction fees and lose our ability to accept these payment methods, and our business and results of operations would be adversely affected.

If our trademarks and other proprietary rights are not adequately protected to prevent use or appropriation by our competitors, the value of our brand and other intangible assets may be diminished, and our business may be adversely affected.

We rely and expect to continue to rely on a combination of confidentiality and license agreements with our employees, consultants and third parties with whom we have relationships, as well as trademark, copyright, patent and trade secret protection laws, to protect our proprietary rights. We may also seek to enforce our proprietary rights through court proceedings. We have filed and from time to time we expect to file for trademark and patent applications. Nevertheless, these applications may not be approved, third parties may challenge any patents issued to or held by us, third parties may knowingly or unknowingly infringe our patents, trademarks and other proprietary rights, and we may not be able to prevent infringement without substantial expense to us. If the protection of our proprietary rights is inadequate to prevent use or appropriation by third parties, the value of our brand and other intangible assets may be diminished, competitors may be able to more effectively mimic our service and methods of operations, the perception of our business and service to subscribers and potential subscribers may become confused in the marketplace, and our ability to attract subscribers may be adversely affected.

Intellectual property claims against us could be costly and result in the loss of significant rights related to, among other things, our Web site, our recommendation and merchandising technology, title selection processes and marketing activities.

Trademark, copyright, patent and other intellectual property rights are important to us and other companies. Our intellectual property rights extend to our technology, business processes and the content on our Web site. We use the intellectual property of third parties in merchandising our products and marketing our service through contractual and other rights. From time to time, third parties allege that we have violated their intellectual property rights. If we are unable to obtain sufficient rights, successfully defend our use, or develop non-infringing technology or otherwise alter our business practices on a timely basis in response to claims against us for infringement, misappropriation, misuse or other violation of third party intellectual property rights, our business and competitive position may be adversely affected. Many companies are devoting significant

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resources to developing patents that could potentially affect many aspects of our business. There are numerous patents that broadly claim means and methods of conducting business on the Internet. We have not exhaustively searched patents relative to our technology. Defending ourselves against intellectual property claims, whether they are with or without merit or are determined in our favor, results in costly litigation and diversion of technical and management personnel. It also may result in our inability to use our current Web site or our recommendation and merchandising technology or inability to market our service or merchandise our products. As a result of a dispute, we may have to develop non-infringing technology, enter into royalty or licensing agreements, adjust our merchandising or marketing activities or take other actions to resolve the claims. These actions, if required, may be costly or unavailable on terms acceptable to us.

If we are unable to protect our domain names, our reputation and brand could be adversely affected.

We currently hold various domain names relating to our brand, including Netflix.com. Failure to protect our domain names could adversely affect our reputation and brand and make it more difficult for users to find our Web site and our service. The acquisition and maintenance of domain names generally are regulated by governmental agencies and their designees. The regulation of domain names in the United States may change in the near future. Governing bodies may establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. As a result, we may be unable to acquire or maintain relevant domain names. Furthermore, the relationship between regulations governing domain names and laws protecting trademarks and similar proprietary rights is unclear. We may be unable, without significant cost or at all, to prevent third parties from acquiring domain names that are similar to, infringe upon or otherwise decrease the value of our trademarks and other proprietary rights.

If we become subject to liability for content that we distribute through our service, our results of operations would be adversely affected.

As a distributor of content, we face potential liability for negligence, copyright, patent or trademark infringement or other claims based on the nature and content of materials that we distribute. We also may face potential liability for content uploaded from our users in connection with our community-related content or movie reviews. If we become liable, then our business may suffer. Litigation to defend these claims could be costly and the expenses and damages arising from any liability could harm our results of operations. We cannot assure that we are adequately insured or indemnified to cover claims of these types or liability that may be imposed on us.

If government regulations relating to the Internet or other areas of our business change or if consumer attitudes toward use of the Internet change, we may need to alter the manner in which we conduct our business, or incur greater operating expenses.

The adoption or modification of laws or regulations relating to the Internet or other areas of our business could limit or otherwise adversely affect the manner in which we currently conduct our business. In addition, the growth and development of the market for online commerce may lead to more stringent consumer protection laws, which may impose additional burdens on us. If we are required to comply with new regulations or legislation or new interpretations of existing regulations or legislation, this compliance could cause us to incur additional expenses or alter our business model.

The manner in which Internet and other legislation may be interpreted and enforced cannot be precisely determined and may subject either us or our customers to potential liability, which in turn could have an adverse effect on our business, results of operations and financial condition. The adoption of any laws or regulations that adversely affect the popularity or growth in use of the Internet, including laws limiting Internet neutrality, could decrease the demand for our subscription service and increase our cost of doing business.

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We are engaged in legal proceedings that could cause us to incur unforeseen expenses and could occupy a significant amount of our management's time and attention.

From time to time, we are subject to litigation or claims that could negatively affect our business operations and financial position. As we have grown, we have seen a rise in the number of litigation matters against us. Most of these matters relate to patent infringement lawsuits, which are typically expensive to defend. Litigation disputes could cause us to incur unforeseen expenses, could occupy a significant amount of our management's time and attention and could negatively affect our business operations and financial position.

Changes in securities laws and regulations have increased and may continue to increase our costs.

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and recently enacted rules promulgated by the Securities and Exchange Commission, have increased and may continue to increase our expenses as we devote resources to their requirements.

We may seek additional capital that may result in stockholder dilution or that may have rights senior to those of our common stockholders.

From time to time, we may seek to obtain additional capital, either through equity, equity-linked or debt securities. The decision to obtain additional capital will depend, among other things, on our development efforts, business plans, operating performance and condition of the capital markets. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

We issued \$200 million in a debt offering and may incur additional debt in the future, which may adversely affect our financial condition and future financial results.

As of December 31, 2009, we have \$200 million in 8.50% senior notes outstanding. Risks relating to our long-term indebtedness include:

- Requiring us to dedicate a portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of cash flow to fund working capital, capital expenditures, acquisitions and investments and other general corporate purposes;
- Limiting our flexibility in planning for, or reacting to, changes in our business and the markets in which we operate; and
- Limiting our ability to borrow additional funds or to borrow funds at rates or on other terms we find acceptable.

In addition, it is possible that we may need to incur additional indebtedness in the future in the ordinary course of business. The terms of indentures governing our outstanding senior notes allow us to incur additional debt subject to certain limitations. If new debt is added to current debt levels, the risks described above could intensify.

The agreements governing our indebtedness contain various covenants that limit our discretion in the operation of our business and also require us to meet certain covenants. The failure to comply with such covenants could have a material adverse effect on us.

The agreements governing our indebtedness contain various covenants, including those that restrict our ability to, among other things:

- Borrow money, and guarantee or provide other support for indebtedness of third parties including guarantees;
- Pay dividends on, redeem or repurchase our capital stock;
- Make investments in entities that we do not control, including joint ventures;

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- Enter into certain asset sale transactions;
- Enter into secured financing arrangements;
- Enter into sale and leaseback transactions; and
- Enter into unrelated businesses.

These covenants may limit our ability to effectively operate our businesses. Any failure to comply with the restrictions of any agreement governing our other indebtedness may result in an event of default under those agreements.

Risks Related to Our Stock Ownership

Our officers and directors and their affiliates will exercise significant control over Netflix.

As of December 31, 2009, our executive officers and directors, their immediate family members and affiliated venture capital funds beneficially owned, in the aggregate, approximately 23% of our outstanding common stock and stock options that are exercisable within 60 days. In particular, Jay Hoag, one of our directors, beneficially owned approximately 14% and Reed Hastings, our Chief Executive Officer, President and Chairman of the Board, beneficially owned approximately 6%. These stockholders may have individual interests that are different from other stockholders and will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us.

Provisions in our charter documents and under Delaware law could discourage a takeover that stockholders may consider favorable.

Our charter documents may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable because they:

- authorize our board of directors, without stockholder approval, to issue up to 10,000,000 shares of undesignated preferred stock;
- provide for a classified board of directors;
- prohibit our stockholders from acting by written consent;
- establish advance notice requirements for proposing matters to be approved by stockholders at stockholder meetings; and
- prohibit stockholders from calling a special meeting of stockholders.

In addition, a merger or acquisition may trigger retention payments to certain executive employees under the terms of our Executive Severance and Retention Incentive Plan, thereby increasing the cost of such a transaction. As a Delaware corporation, we are also subject to certain Delaware anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on Delaware law to prevent or delay an acquisition of us.

Our stock price is volatile.

The price at which our common stock has traded since our May 2002 initial public offering has fluctuated significantly. The price may continue to be volatile due to a number of factors including the following, some of which are beyond our control:

- variations in our operating results;
- variations between our actual operating results and the expectations of securities analysts, investors and the financial community;

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- announcements of developments affecting our business, systems or expansion plans by us or others;
- competition, including the introduction of new competitors, their pricing strategies and services;
- market volatility in general;
- the level of demand for our stock, including the amount of short interest in our stock; and
- the operating results of our competitors.

As a result of these and other factors, investors in our common stock may not be able to resell their shares at or above their original purchase price.

Following certain periods of volatility in the market price of our securities, we became the subject of securities litigation. We may experience more such litigation following future periods of volatility. This type of litigation may result in substantial costs and a diversion of management's attention and resources.

We record substantial stock compensation expenses related to our issuance of stock options and shares under our employee share purchase program that may have a material negative impact on our operating results for the foreseeable future.

Our stock-based compensation expenses totaled \$12.6 million, \$12.3 million and \$12.0 million during 2009, 2008 and 2007, respectively. We expect our stock-based compensation expenses will continue to be significant in future periods, which will have an adverse impact on our operating results. The lattice-binomial model used to value our stock option grants and the black-scholes models used to value shares granted under our employee share purchase program both require the input of highly subjective assumptions, including the price volatility of the underlying stock. If facts and circumstances change and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different valuation model, the future period expenses may differ significantly from what we have recorded in the current period and could materially affect the fair value estimate of stock-based payments, our operating income, net income and net income per share.

Financial forecasting by us and financial analysts who may publish estimates of our performance may differ materially from actual results.

Given the dynamic nature of our business, the current uncertain economic climate and the inherent limitations in predicting the future, forecasts of our revenues, gross margin, operating expenses, number of paying subscribers, number of DVDs shipped per day and other financial and operating data may differ materially from actual results. Such discrepancies could cause a decline in the trading price of our common stock.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

We do not own any real estate. The following table sets forth the location, approximate square footage, lease expiration and the primary use of each of our principal properties:

<u>Location</u>	<u>Estimated Square Footage</u>	<u>Lease Expiration Date</u>	<u>Primary Use</u>
Los Gatos, California	165,000	March 2013	Corporate office, general and administrative, marketing and technology and development
Columbus, Ohio	90,000	August 2016	Receiving for the Company and storage center, processing and shipping center for the Columbus Area
Hillsboro, Oregon	49,000	April 2011	Customer service center
Beverly Hills, California	20,000	August 2015	Content acquisition, general and administrative

We operate a nationwide network of distribution centers that serve major metropolitan areas throughout the United States. These fulfillment centers are under lease agreements that expire at various dates through August 2016. We also operate data centers in a leased third-party facility in Santa Clara, California. We believe that our current space will be adequate or that additional space will be available on commercially reasonable terms for the foreseeable future.

Item 3. Legal Proceedings

Information with respect to this item may be found in Note 5 of the Notes to the Consolidated Financial Statements in Item 8, which information is incorporated herein by reference.

Item 4. Submission of Matters to a Vote of Securities Holders

None.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock has traded on the NASDAQ Global Select Market and its predecessor, the NASDAQ National Market, under the symbol “NFLX” since our initial public offering on May 23, 2002. The following table sets forth the intraday high and low sales prices per share of our common stock for the periods indicated, as reported by the NASDAQ Global Select Market.

	2009		2008	
	High	Low	High	Low
First quarter	\$44.42	\$28.78	\$39.65	\$20.35
Second quarter	50.24	36.25	40.90	26.04
Third quarter	48.20	37.93	33.97	26.39
Fourth quarter	61.65	44.30	31.00	17.90

As of January 31, 2010, there were approximately 203 stockholders of record of our common stock, although there is a significantly larger number of beneficial owners of our common stock.

We have not declared or paid any cash dividends, and we have no present intention of paying any cash dividends in the foreseeable future.

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Stock Performance Graph

Notwithstanding any statement to the contrary in any of our previous or future filings with the Securities and Exchange Commission, the following information relating to the price performance of our common stock shall not be deemed "filed" with the Commission or "soliciting material" under the Securities Exchange Act of 1934 and shall not be incorporated by reference into any such filings.

The following graph compares, for the five year period ended December 31, 2009, the total cumulative stockholder return on the Company's common stock with the total cumulative return of the NASDAQ Composite Index and the S&P North American Technology Internet Index. Measurement points are the last trading day of each of the Company's fiscal years ended December 31, 2004, December 31, 2005, December 31, 2006, December 31, 2007, December 31, 2008 and December 31, 2009. Total cumulative stockholder return assumes \$100 invested at the beginning of the period in the Company's common stock, the stocks represented in the NASDAQ Composite Index and the stocks represented in the S&P North American Technology Internet Index, respectively, and reinvestment of any dividends. The S&P North American Technology Internet Index is a modified-capitalization weighted index of 23 stocks representing the Internet industry, including Internet content and access providers, Internet software and services companies and e-commerce companies. Historical stock price performance should not be relied upon as an indication of future stock price performance:

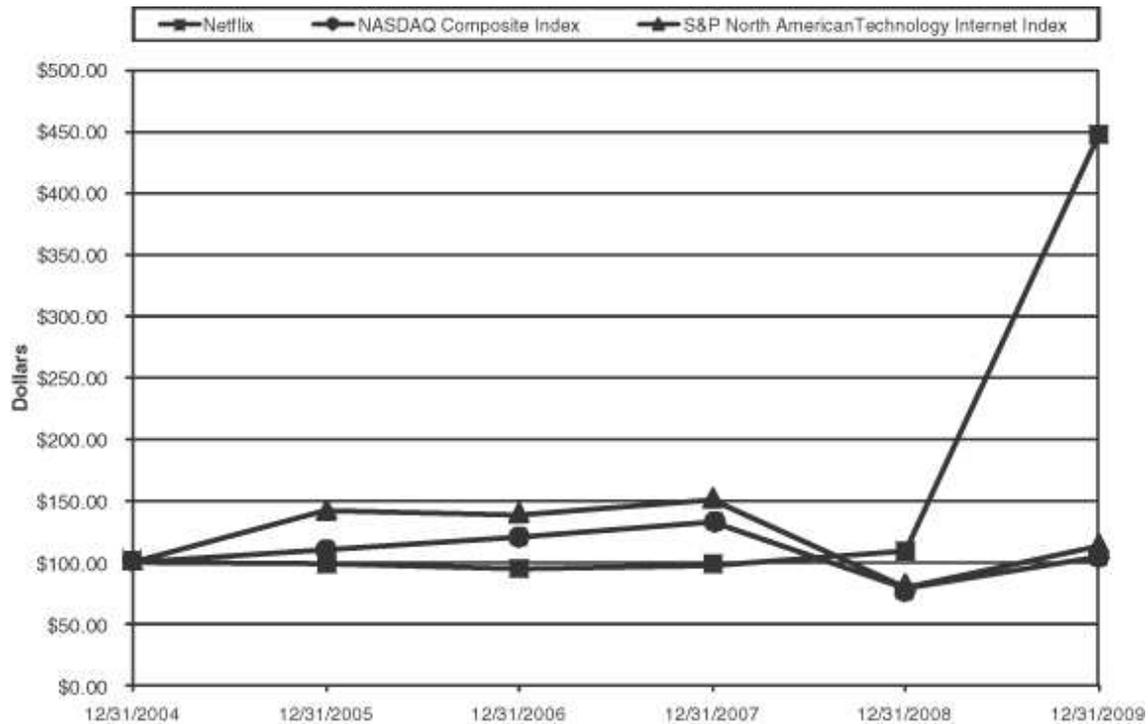


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Issuer Purchases of Equity Securities

Stock repurchases during the three months ended December 31, 2009 were as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as	Maximum Dollar Value That May Yet Be Purchased
			Part of Publicly Announced Programs	Under the Program
October 1, 2009—October 31, 2009	1,147,383	\$ 45.57	1,147,383	\$ 178,030,792
November 1, 2009—November 30, 2009	470,376	57.69	470,376	150,894,286
December 1, 2009—December 31, 2009	—	—	—	150,894,286
Total	<u>1,617,759</u>	<u>\$ 49.09</u>	<u>1,617,759</u>	<u>\$ 150,894,286</u>

On August 6, 2009, the Company announced that its Board of Directors authorized a stock repurchase plan that enables the Company to repurchase up to \$300 million of its common stock through the end of 2010. 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. Under this program, the Company repurchased 3,197,459 shares of common stock at an average price of approximately \$47 per share for an aggregate amount of \$149 million.

On January 26, 2009, the Company announced that its Board of Directors authorized a stock repurchase program for 2009. Under this program, the Company repurchased 4,173,855 shares of common stock at an average price of approximately \$42 per share for an aggregate amount of approximately \$175 million. This program terminated on August 6, 2009.

On March 5, 2008, the Company's Board of Directors authorized a stock repurchase program allowing the Company to repurchase up to \$150 million of its common stock through the end of 2008. Under this program, the Company repurchased 3,491,084 shares of common stock at an average price of approximately \$29 per share for an aggregate amount of \$100 million.

On January 31, 2008, the Company's Board of Directors authorized a stock repurchase program allowing the Company to repurchase up to \$100 million of its common stock through the end of 2008. Under this program, the Company repurchased 3,847,062 shares of common stock at an average price of approximately \$26 per share for an aggregate amount of \$100 million.

On April 17, 2007, the Company's Board of Directors authorized a stock repurchase program allowing the Company to repurchase up to \$100 million of its common stock through the end of 2007. During the year ended December 31, 2007, the Company repurchased 4,733,788 shares of common stock at an average price of approximately \$21 per share for an aggregate amount of \$100 million.

For further information regarding stock repurchase activity, see Note 7 of Notes to consolidated financial statements.

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Item 6. Selected Financial Data

The following selected financial data is not necessarily indicative of results of future operations and should be read in conjunction with “Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Item 8, Financial Statements and Supplementary Data .”

	Year ended December 31,				
	2009	2008	2007 (1)	2006	2005 (2)
	(in thousands, except per share data)				
Revenues	\$ 1,670,269	\$ 1,364,661	\$ 1,205,340	\$ 996,660	\$ 682,213
Total cost of revenues	1,079,271	910,234	786,168	626,985	465,775
Operating income	191,939	121,506	91,773	65,218	2,622
Net income	115,860	83,026	66,608	48,839	41,889
Net income per share:					
Basic	\$ 2.05	\$ 1.36	\$ 0.99	\$ 0.78	\$ 0.78
Diluted	\$ 1.98	\$ 1.32	\$ 0.97	\$ 0.71	\$ 0.64
Weighted-average shares outstanding:					
Basic	56,560	60,961	67,076	62,577	53,528
Diluted	58,416	62,836	68,902	69,075	65,518

Notes:

- Operating expenses for the year includes a one-time payment received in the amount of \$7.0 million as a result of resolving a patent litigation with Blockbuster, Inc.
- Net income for the year includes a benefit of realized deferred tax assets of \$34.9 million or approximately \$0.53 per diluted share, related to the recognition of the Company’s deferred tax assets. In addition, general and administrative expenses includes an accrual of \$8.1 million (net of expected insurance proceeds for reimbursement of legal defense costs of \$0.9 million) related to the settlement costs of a class action lawsuit.

	As of December 31,				
	2009	2008 (5)	2007 (in thousands)	2006	2005
Balance Sheet Data:					
Cash and cash equivalents	\$134,224	\$139,881	\$177,439	\$400,430	\$212,256
Short-term investments (3)	186,018	157,390	207,703	—	—
Working capital	184,644	142,908	223,518	234,582	105,776
Total assets	679,734	615,424	678,998	633,013	385,114
Long-term debt	200,000	—	—	—	—
Lease financing obligations, excluding current portion	36,572	37,988	35,652	23,798	19,876
Other non-current liabilities	17,650	14,264	4,629	1,761	1,421
Stockholders’ equity	199,143	347,155	429,812	413,618	225,902

	As of / Year Ended December 31,				
	2009	2008	2007	2006	2005
	(in thousands, except subscriber acquisition cost)				
Other Data:					
Total subscribers at end of period	12,268	9,390	7,479	6,316	4,179
Gross subscriber additions during period	9,332	6,859	5,340	5,250	3,729
Subscriber acquisition cost (4)	\$ 25.48	\$29.12	\$40.86	\$42.94	\$38.78

- Short-term investments are comprised of corporate debt securities, government and agency securities and asset and mortgage-backed securities.

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- (4) Subscriber acquisition cost is defined as total marketing expenses divided by total gross subscriber additions during the period.
- (5) Certain amounts as of December 31, 2008 have been reclassified to conform to the current period presentation.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Our Business

With more than 12 million subscribers, we are the world's largest subscription service streaming movies and TV episodes over the Internet and sending DVDs by mail. Our subscribers can instantly watch unlimited movies and TV episodes streamed to their TVs and computers and can receive DVDs delivered quickly to their homes. We offer a variety of subscription plans, with no due dates, no late fees, no shipping fees and no pay-per-view fees. Aided by our proprietary recommendation and merchandising technology, subscribers can select from a growing library of titles that can be watched instantly and a vast array of titles on DVD. On average, approximately 2 million discs are shipped daily from our distribution centers across the United States. Additionally, more than 48% of our subscribers instantly watched more than 15 minutes of streaming content in the fourth quarter of 2009.

Subscribers can:

- Watch streaming content without commercial interruption on their computers and TVs. The viewing experience is enabled by Netflix controlled software that can run on a variety of consumer electronics devices ("Netflix Ready Devices"). These Netflix Ready Devices currently include Blu-ray disc players, Internet-connected TVs, digital video players and game consoles.
- Receive DVDs 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.

Our core strategy is to grow a large subscription business consisting of streaming and DVD-by-mail content. By combining streaming and DVD as part of the Netflix subscription, we are able to offer subscribers a uniquely compelling selection of movies for one low monthly price. We believe this creates a competitive 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 the standard definition DVD, along with its high definition successor, Blu-ray (collectively referred to as "DVD"), will continue to be the primary means by which a majority of Netflix subscribers view content for the foreseeable future. However, at some point in the future, we expect that Internet delivery of content to the home will surpass DVD as the primary means by which most Netflix subscribers view content.

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Performance Highlights

The following represents our performance highlights for 2009, 2008 and 2007 (in thousands, except for per share amounts, percentages and subscriber acquisition costs):

	2009	2008	2007
Revenues	\$1,670,269	\$1,364,661	\$1,205,340
Net income	115,860	83,026	66,608
Net income per share—diluted	\$ 1.98	\$ 1.32	\$ 0.97
Total subscribers at end of period	12,268	9,390	7,479
Churn (annualized) (1)	4.2%	4.2%	4.3%
Subscriber acquisition cost	\$ 25.48	\$ 29.12	\$ 40.86
Gross margin	35.4%	33.3%	34.8%

- (1) Churn is a monthly measure defined as customer cancellations in the quarter divided by the sum of beginning subscribers and gross subscriber addition, then divided by three months. Churn (annualized) is the average of Churn for the four quarters of each respective year.

Critical Accounting Policies and Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported periods. The Securities and Exchange Commission (“SEC”) has defined a company’s critical accounting policies as the ones that are most important to the portrayal of a company’s financial condition and results of operations, and which require a company to make its most difficult and subjective judgments. Based on this definition, we have identified the critical accounting policies and judgments addressed below. We base our estimates on historical experience and on various other assumptions that the Company believes to be reasonable under the circumstances. Actual results may differ from these estimates.

Content Accounting

We obtain content through direct purchases, revenue sharing agreements and license agreements with studios, distributors, and other suppliers. DVD content is obtained through direct purchases or revenue sharing agreements. Streaming content is generally licensed for a fixed fee for the term of the license agreement but may also be obtained through a revenue sharing agreement.

We acquire DVD content for the purpose of rental to our subscribers and earning subscription rental revenues, and, as such, we consider our direct purchase DVD library to be a productive asset. Accordingly, we classify our DVD library as a non-current asset on our consolidated balance sheets. Additionally, cash outflows for the acquisition of the DVD library, net of changes in related accounts payable, are classified as cash flows from investing activities on our consolidated statements of cash flows. This is inclusive of any upfront non-refundable payments required under revenue sharing agreements.

We amortize our direct purchase DVDs, less estimated salvage value, on a “sum-of-the-months” accelerated basis over their estimated useful lives. The useful life of the new-release DVDs and back-catalog DVDs is estimated to be one year and three years, respectively. In estimating the useful life of our DVDs, we take into account library utilization as well as an estimate for lost or damaged DVDs. For those direct purchase DVDs that we estimate we will sell at the end of their useful lives, a salvage value is provided. For those DVDs that we do not expect to sell, no salvage value is provided. We periodically evaluate the useful lives and salvage values of our DVDs.

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Additionally, the terms of certain DVD direct purchase agreements with studios and distributors provide for volume purchase discounts or rebates based on achieving specified performance levels. Volume purchase discounts are recorded as a reduction of DVD library when earned. We accrue for rebates as earned based on historical title performance and estimates of demand for the titles over the remainder of the title term.

We obtain content distribution rights in order to stream movies and TV episodes without commercial interruption to subscribers' computers and TVs via Netflix Ready Devices. We account for streaming content in accordance with the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") topic 920 *Entertainment—Broadcasters*. Cash outflows associated with the streaming content are classified as cash flows from operating activities on our consolidated statements of cash flows.

We classify our streaming content obtained through a license agreement 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. We amortize licensed streaming content on a straight-line basis generally over the term of the related license agreements or the title's window of availability.

We also obtain DVD and streaming content through revenue sharing agreements with studios and distributors. We generally obtain titles for low initial cost in exchange for a commitment to share a percentage of our subscription revenues or to pay a fee, based on utilization, for a defined period of time, or the Title Term, which typically ranges from six to twelve months for each title. The initial cost may be in the form of an upfront non-refundable payment. This payment is capitalized in the content library in accordance with our DVD and streaming content policies as applicable. The initial cost may also be in the form of a prepayment of future revenue sharing obligations which is classified as prepaid revenue sharing expense. The terms of some revenue sharing agreements with studios obligate us to make minimum revenue sharing payments for certain titles. We amortize minimum revenue sharing prepayments (or accrete an amount payable to studios if the payment is due in arrears) as revenue sharing obligations are incurred. A provision for estimated shortfall, if any, on minimum revenue sharing payments is made in the period in which the shortfall becomes probable and can be reasonably estimated. Under the revenue sharing agreements for our DVD library, at the end of the Title Term, we generally have the option of returning the DVD to the studio, destroying the DVD or purchasing the DVD.

Stock-Based Compensation

Stock-based compensation expense is estimated at the grant date based on the fair value of the awards expected to vest and is recognized as expense ratably over the requisite service period, which is the vesting period.

We calculate the fair value of new stock-based compensation awards under our stock option plans using a lattice-binomial model. We use a Black-Scholes model to determine the fair value of employee stock purchase plan shares. These models require the input of highly subjective assumptions, including price volatility of the underlying stock. Changes in the subjective input assumptions can materially affect the estimate of fair value of options granted and our results of operations could be materially impacted.

- *Expected Volatility:* Our computation of expected volatility is based on a blend of historical volatility of our common stock and implied volatility of tradable forward call options to purchase shares of our common stock. Our decision to incorporate implied volatility was based on our assessment that implied volatility of publicly traded options in our common stock is more reflective of market conditions and, therefore, can reasonably be expected to be a better indicator of expected volatility than historical volatility of our common stock.
- *Suboptimal Exercise Factor:* Our computation of the suboptimal exercise factor is based on historical option exercise behavior and the terms and vesting periods of the options granted and is determined for both executives and non-executives.

We grant stock options to our employees on a monthly basis. We have elected to grant all options as non-qualified stock options which vest immediately. As a result of immediate vesting, stock-based compensation

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expense is fully recognized on the grant date and no estimate is required for post-vesting option forfeitures. We also issue shares through our employee stock purchase program ("ESPP") which has been determined to be compensatory in nature. Stock-based compensation expense for shares issued under this program is expensed over the offering period of six months.

Our stock-based compensation expenses totaled \$12.6 million, \$12.3 million and \$12.0 million during 2009, 2008 and 2007, respectively. As a result of changes in our compensation structure and related employee elections for 2010 resulting in an increase in the number of options granted to employees, we expect our stock-based compensation expense for 2010 and future periods will increase significantly. See Note 7 to the consolidated financial statements for further information about stock based compensation.

Income Taxes

We record a tax provision for the anticipated tax consequences of our reported results of operations using the asset and liability method. Deferred income taxes are recognized by applying the enacted tax rates applicable to future years to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance for any tax benefits for which future realization is uncertain.

We may recognize the tax benefit from an uncertain tax position only if it is more likely than not the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such positions are then measured based on the largest benefit that has a greater than 50% likelihood of being realized upon settlement. We recognize interest and penalties related to uncertain tax positions in income tax expense. See Note 8 to the consolidated financial statements for further information regarding income taxes.

In evaluating our ability to recover our deferred tax assets, in full or in part, we consider all available positive and negative evidence, including our past operating results, and our forecast of future market growth, forecasted earnings, future taxable income and prudent and feasible tax planning strategies. The assumptions utilized in determining future taxable income require significant judgment and are consistent with the plans and estimates we are using to manage the underlying businesses. We believe that the deferred tax assets recorded on our balance sheet will ultimately be realized. In the event we were to determine that we would not be able to realize all or part of our net deferred tax assets in the future, an adjustment to the deferred tax assets would be charged to earnings in the period in which we make such determination.

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Results of Operations

The following table sets forth, for the periods presented, the line items in our consolidated statements of operations as a percentage of total revenues. The information contained in the table below should be read in conjunction with the financial statements and notes thereto included in Item 8, *Financial Statements and Supplementary Data* of this Annual Report on Form 10-K.

	Year Ended December 31,		
	2009	2008	2007
Revenues	100.0%	100.0%	100.0%
Costs of revenues:			
Subscription	54.4	55.8	55.1
Fulfillment expenses	10.2	10.9	10.1
Total cost of revenues	64.6	66.7	65.2
Gross profit	35.4	33.3	34.8
Operating expenses:			
Technology and development	6.9	6.6	5.9
Marketing	14.2	14.6	18.1
General and administrative	3.1	3.6	4.3
Gain on disposal of DVDs	(0.3)	(0.4)	(0.5)
Gain on legal settlement	—	—	(0.6)
Total operating expenses	23.9	24.4	27.2
Operating income	11.5	8.9	7.6
Other income (expense):			
Interest expense	(0.4)	(0.2)	(0.1)
Interest and other income (expense)	0.4	0.9	1.7
Income before income taxes	11.5	9.6	9.2
Provision for income taxes	4.6	3.5	3.7
Net income	6.9%	6.1%	5.5%

Revenues

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 currently generate all our revenues in the United States, although we plan to launch a limited international expansion with a streaming subscription service in 2010.

We offer a variety of subscription plans combining streaming movies and TV episodes over the Internet and sending DVDs by mail. The price per plan varies based on the number of DVDs 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 DVDs pay a surcharge ranging from \$1 to \$4 for our most popular plans. Pricing of our plans is as follows:

	Price per 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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	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2009</u>	<u>2008</u>	<u>2009 vs 2008</u>
	(in thousands, except percentages and average monthly revenue per paying subscriber)		
Revenues	\$1,670,269	\$1,364,661	22.4%
Other data:			
Average number of paying subscribers	10,464	8,268	26.6%
Average monthly revenue per paying subscriber	\$ 13.30	\$ 13.75	(3.3)%

The \$305.6 million increase in our revenues was primarily a result of the 26.6% growth in the average number of paying subscribers arising from increased consumer awareness of the compelling value proposition of streaming and DVDs by mail for one low price and other benefits of our service. This increase was offset in part by a 3.3% decline in average monthly revenue per paying subscriber, resulting from the continued growth in our lower priced subscription plans. The total number of average paying subscribers in our 1 and 2-out plans grew by 48.1% as compared to a 1.1% decline in all other plans during the year ended December 31, 2009.

	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2008</u>	<u>2007</u>	<u>2008 vs. 2007</u>
	(in thousands, except percentages and average monthly revenue per paying subscriber)		
Revenues	\$1,364,661	\$1,205,340	13.2%
Other data:			
Average number of paying subscribers	8,268	6,718	23.1%
Average monthly revenue per paying subscriber	\$ 13.75	\$ 14.95	(8.0)%

The \$159.3 million increase in our revenues was primarily a result of the 23.1% growth in the average number of paying subscribers arising from increased consumer awareness of the compelling value proposition of streaming and DVDs by mail for one low price and other benefits of our service. This increase was offset in part by an 8.0% decline in average monthly revenue per paying subscriber, resulting from the continued growth in our lower priced subscription plans, as well as a price reduction for our most popular subscription plans during the third quarter of 2007. The total number of average paying subscribers in our 1 and 2-out plans grew by 39.8% as compared to 6.1% in all other plans during the year ended December 31, 2008.

Until the average price paid by our new subscriber additions is equal to the average price paid by 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. This decline could be partially offset by the growth in the number of subscribers electing to receive Blu-ray discs for a surcharge as described above. 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.

The following table presents our year-end subscriber information:

	<u>As of December 31,</u>		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
	(in thousands, except percentages)		
Free subscribers	376	226	153
As a percentage of total subscribers	3.1%	2.4%	2.0%
Paid subscribers	11,892	9,164	7,326
As a percentage of total subscribers	96.9%	97.6%	98.0%
Total subscribers	12,268	9,390	7,479
Percentage change over prior period	30.6%	25.6%	

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Cost of Revenues

Cost of Subscription

Cost of subscription revenues consists of content delivery costs related to shipping DVDs and providing streaming content to subscribers as well as expenses related to the acquisition of content. Costs related to free-trial periods are allocated to marketing expenses.

Content delivery expenses consist of the postage costs to mail DVDs to and from our paying subscribers, the packaging and label costs for the mailers and all costs associated with streaming content over the Internet. We utilize third party content delivery networks to help us efficiently stream content in high volume to our subscribers over the Internet.

Content acquisition expenses consist of costs incurred in obtaining content such as amortization of content and revenue sharing expense. We obtain content from studios, distributors and other suppliers through direct purchases, revenue sharing agreements and license agreements.

	Year ended December 31,		Change
	2009	2008	2009 vs. 2008
Cost of subscription	\$909,461	\$761,133	19.5%
As a percentage of revenues	54.4%	55.8%	

The \$148.3 million increase in cost of subscription revenues was due to the following factors:

- Content delivery expenses increased \$101.7 million primarily due to an 18.6% increase in the number of DVDs mailed to paying subscribers. The increase in the number of DVDs mailed was driven by a 26.6% increase in the average number of paying subscribers, partially offset by a 6.3% decline in monthly DVD rentals per average paying subscriber primarily attributed to the growing popularity of our lower priced plans.
- Content acquisition expenses increased by \$46.6 million. This increase was primarily attributable to investments in streaming content.

	Year ended December 31,		Change
	2008	2007	2008 vs. 2007
Cost of subscription	\$761,133	\$664,407	14.6%
As a percentage of revenues	55.8%	55.1%	

The \$96.7 million increase in cost of subscription revenues was due to the following factors:

- Content delivery expenses increased \$72.7 million primarily due to a 19.0% increase in the number of DVDs mailed to paying subscribers. The increase in the number of DVDs mailed was driven by a 23.1% increase in the average number of paying subscribers, partially offset by a 3.2% decline in monthly DVD rentals per average paying subscriber primarily attributed to the growing popularity of our lower priced plans. The increase is also due to an increase in the rates of first class postage in May 2008.
- Content acquisition expenses increased by \$24.0 million. This increase was primarily attributable to the increased investments in streaming content, as well as an increase in DVD revenue sharing costs.

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Fulfillment Expenses

Fulfillment expenses represent those expenses incurred in operating and staffing our shipping and customer service centers, including costs attributable to receiving, inspecting and warehousing our content library. Fulfillment expenses also include credit card fees.

	Year ended December 31,		Change
	2009	2008	2009 vs. 2008
	(in thousands, except percentages)		
Fulfillment expenses	\$169,810	\$149,101	13.9%
As a percentage of revenues	10.2%	10.9%	

The \$20.7 million increase in fulfillment expenses was due to the following:

- Shipping and customer service centers expenses increased \$10.5 million primarily due to a 14.0% increase in headcount to support the higher volume of content delivery and growth in subscribers.
- Credit card fees increased \$10.2 million as a result of the 22.4% growth in revenues.

	Year ended December 31,		Change
	2008	2007	2008 vs. 2007
	(in thousands, except percentages)		
Fulfillment expenses	\$149,101	\$121,761	22.5%
As a percentage of revenues	10.9%	10.1%	

The \$27.3 million increase in fulfillment expenses was due to the following:

- Shipping and customer service centers expenses increased \$22.0 million primarily due to a 29.8% increase in headcount to support the higher volume of content delivery and the addition of new shipping centers.
- Credit card fees increased \$5.3 million as a result of the 13.2% growth in revenues.

Gross Margin

	Year ended December 31,		Change
	2009	2008	2009 vs. 2008
	(in thousands, except percentages)		
Gross profit	\$590,998	\$454,427	30.1%
Gross margin	35.4%	33.3%	
Average monthly gross profit per paying subscriber	\$ 4.71	\$ 4.58	2.8%

The 2.1% increase in gross margin was primarily due to lower DVD content acquisition expenses per DVD mailed and a 6.3% decline in monthly DVD rentals per average paying subscriber driven by the growing popularity of our lower priced plans. This decline was higher than the decline in average revenue per paying subscriber of 3.3%. This was offset partially by increased investments in our streaming content.

	Year ended December 31,		Change
	2008	2007	2008 vs. 2007
	(in thousands, except percentages)		
Gross profit	\$454,427	\$419,172	8.4%
Gross margin	33.3%	34.8%	
Average monthly gross profit per paying subscriber	\$ 4.58	\$ 5.20	(11.9)%

The 1.5% decrease in gross margin was primarily due to an increase in postage rates effective May 2008 and a reduction in the prices of our most popular subscription plans during the second half of 2007.

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We expect to continue to make substantial investments in our content library and in particular may increase spending associated with streaming content. These investments would reduce our gross margin to the extent that increases outpace growth in our revenues.

Operating Expenses

Technology and Development

Technology and development expenses consist of payroll and related costs incurred in testing, maintaining and modifying our Web site, our recommendation and merchandising technology, developing solutions for streaming content to subscribers, telecommunications systems and infrastructure and other internal-use software systems. Technology and development expenses also include depreciation of the computer hardware and capitalized software we use to run our Web site and store our data.

	Year ended December 31,		Change
	2009	2008	2009 vs. 2008
	(in thousands, except percentages)		
Technology and development	\$114,542	\$ 89,873	27.4%
As a percentage of revenues	6.9%	6.6%	

The \$24.7 million increase in technology and development expenses was primarily the result of a \$17.4 million increase in personnel-related costs due to 26.6% growth in headcount to develop solutions for streaming content and continued improvements to our service. The increase is also partly due to a \$6.7 million increase in facilities and equipment expenses to support the increased headcount and overall growth of operations.

	Year ended December 31,		Change
	2008	2007	2008 vs. 2007
	(in thousands, except percentages)		
Technology and development	\$ 89,873	\$ 70,979	26.6%
As a percentage of revenues	6.6%	5.9%	

The \$18.9 million increase in technology and development expenses was primarily the result of a \$10.4 million increase in personnel-related costs due to 28.0% growth in headcount and an \$8.5 million increase in other expenses to develop solutions for streaming content and continued improvements to our service.

Marketing

Marketing expenses consist primarily of advertising expenses and payments made to our affiliates including consumer electronics partners. Advertising expenses include marketing program expenditures and other promotional activities, including allocated costs of revenues relating to free trial periods. Also included in marketing expense are payroll related expenses.

	Year ended December 31,		Change
	2009	2008	2009 vs. 2008
	(in thousands, except percentages)		
Marketing	\$237,744	\$199,713	19.0%
As a percentage of revenues	14.2%	14.6%	
Other Data:			
Gross subscriber additions	9,332	6,859	36.1%
Subscriber acquisition cost	\$ 25.48	\$ 29.12	(12.5)%

The \$38.0 million increase in marketing expenses was primarily attributable to an increase of \$21.4 million in spending related to affiliates including our consumer electronics partners. The increase is also due to an

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\$11.5 million increase in marketing program spending, principally in TV and radio advertising and direct mail to promote our hybrid service of streaming content and DVDs by mail. Subscriber acquisition cost decreased primarily due to momentum associated with the launch of new consumer electronics partner devices and the broad appeal of streaming content.

	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2008</u>	<u>2007</u>	<u>2008 vs. 2007</u>
Marketing	\$199,713	\$218,212	(8.5)%
As a percentage of revenues	14.6%	18.1%	
Other Data:			
Gross subscriber additions	6,859	5,340	28.4%
Subscriber acquisition cost	\$ 29.12	\$ 40.86	(28.7)%

The \$18.5 million decrease in marketing expenses was primarily attributable to a \$34.2 million decrease in marketing program spending, principally in direct mail and inserts, offset partially by an increase of \$11.5 million in spending related to affiliates including our consumer electronics partners. In the second half of 2007, we lowered prices on our most popular subscription plans and decided to partially offset the cost of our investment in lower prices by reducing our spending on marketing programs. The decrease was partially offset by higher personnel-related costs due to higher headcount and an increase in the costs of free trial periods due to the 28.4% increase in gross subscriber additions. Subscriber acquisition cost decreased in 2008 as compared to 2007 primarily due to more efficient marketing spending.

General and Administrative

General and administrative expenses consist of payroll and related expenses for executive, finance, content acquisition and administrative personnel, as well as recruiting, professional fees and other general corporate expenses.

	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2009</u>	<u>2008</u>	<u>2009 vs. 2008</u>
	(in thousands, except percentages)		
General and administrative	\$ 51,333	\$ 49,662	3.4%
As a percentage of revenues	3.1%	3.6%	

The \$1.7 million increase in general and administrative expenses was primarily attributable to a \$7.4 million increase in legal costs offset partially by a \$2.7 million decrease in costs related to our subsidiary, Red Envelope Entertainment, a \$2.1 million release of accruals in 2009 associated with a former class action suit that was settled in 2008, and decreases in personnel-related costs.

	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2008</u>	<u>2007</u>	<u>2008 vs. 2007</u>
	(in thousands, except percentages)		
General and administrative	\$ 49,662	\$ 52,404	(5.2)%
As a percentage of revenues	3.6%	4.3%	

The \$2.7 million decrease in general and administrative expenses was primarily attributable to a \$2.6 million decrease in costs related to our subsidiary, Red Envelope Entertainment, as well as a \$3.2 million decrease in legal costs. These decreases were partially offset by an increase in personnel-related costs due to a 9.6% increase in headcount.

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Gain on Disposal of DVDs

Gain on disposal of DVDs represents the difference between proceeds from sales of DVDs and associated cost of DVD sales. Cost of DVD sales includes the net book value of the DVDs sold, shipping charges and, where applicable, a contractually specified fee for the DVDs that are subject to revenue sharing agreements.

	Year ended December 31,		Change
	2009	2008	2009 vs. 2008
	(in thousands, except percentages)		
Gain on disposal of DVDs	\$ (4,560)	\$ (6,327)	(27.9)%
As a percentage of revenues	(0.3)%	(0.4)%	

The \$1.8 million decrease in gain on disposal of DVDs was primarily attributable to the discontinuation of retail sales of previously viewed DVDs to subscribers in the first quarter of 2009. We continue to sell previously viewed DVDs through wholesale channels and expect our future gains to continue to be insignificant in relation to our overall operations.

	Year ended December 31,		Change
	2008	2007	2008 vs. 2007
	(in thousands, except percentages)		
Gain on disposal of DVDs	\$ (6,327)	\$ (7,196)	(12.1)%
As a percentage of revenues	(0.4)%	(0.5)%	

The \$0.9 million decrease in gain on disposal of DVDs in absolute dollars was primarily attributable to a decrease in the sales price of DVDs.

Gain on Legal Settlement

On June 25, 2007, we resolved a pending patent litigation with Blockbuster, Inc. As part of the settlement, we received a one-time payment of \$7.0 million during the second quarter of 2007.

Interest Expense

Interest expense consists of the interest on our lease financing obligations and the interest on our 8.50% senior notes including the amortization of debt issuance costs. Also, in the fourth quarter of 2009, we expensed the debt issuance costs related to our line of credit.

In June 2004 and June 2006, we entered into two separate lease arrangements whereby we leased a building that was constructed by a third party. As discussed in Note 5 of the consolidated financial statements, we have accounted for these leases in accordance with ASC topic 840.40 *Leases—Sale-Leaseback Transactions* as it applies to situations in which an entity is involved with the construction funding of an asset that will be leased when the construction project is completed. This guidance requires Netflix to be considered the owner (for accounting purposes) of the two buildings.

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Accordingly, we have recorded assets on our balance sheet for the costs paid by our lessor to construct our headquarters facilities, along with corresponding financing liabilities for amounts equal to these lessor-paid construction costs. The monthly rent payments we make to our lessor under our lease agreements are recorded in our financial statements as land lease expense and principal and interest on the financing liabilities. Interest expense on lease financing obligations reflects the portion of our monthly lease payments that is allocated to interest expense.

	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2009</u>	<u>2008</u>	<u>2009 vs. 2008</u>
	(in thousands, except percentages)		
Interest Expense	\$ 6,475	\$ 2,458	163.4%
As a percentage of revenues	0.4%	0.2%	

The \$4.0 million increase in interest expense is entirely attributable to the interest expense associated with our 8.50% senior notes and line of credit. Interest expense in 2009 includes \$2.8 million for our lease financing obligations, \$2.6 million of interest payments due on our notes and \$1.1 million of amortization of debt issuance costs.

	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2008</u>	<u>2007</u>	<u>2008 vs. 2007</u>
	(in thousands, except percentages)		
Interest Expense	\$ 2,458	\$ 1,188	106.9%
As a percentage of revenues	0.2%	0.1%	

The \$1.3 million increase in interest expense is due to an increase in the interest on our lease financing obligations arising when the lease term for the second of our headquarter buildings commenced.

Interest and Other Income (Expense)

Interest and other income (expense) consist primarily of interest and dividend income generated from invested cash and short-term investments.

	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2009</u>	<u>2008</u>	<u>2009 vs. 2008</u>
	(in thousands, except percentages)		
Interest and other income (expense)	\$ 6,728	\$ 12,452	(46.0)%
As a percentage of revenues	0.4%	0.9%	

The \$5.7 million decrease in interest and other income was primarily attributable to lower cash and investment balances resulting from the repurchase of our common stock, and a \$1.6 million decrease in realized gains recognized as compared to the prior year. The decrease was offset by a \$1.8 million dollar gain realized in 2009 on the sale of our investment in a private company which we accounted for under the cost method.

	<u>Year ended December 31,</u>		<u>Change</u>
	<u>2008</u>	<u>2007</u>	<u>2008 vs. 2007</u>
	(in thousands, except percentages)		
Interest and other income (expense)	\$ 12,452	\$ 20,340	(38.8)%
As a percentage of revenues	0.9%	1.7%	

The \$7.9 million decrease in interest and other income was primarily a result of the lower cash and investment balances resulting from the repurchase of our common stock. The decrease was offset by a \$2.4 million increase in realized gains.

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Interest and dividend income was approximately \$3.7 million, \$9.2 million and \$19.7 million in 2009, 2008 and 2007, respectively. Interest and other income included gains of approximately \$1.5 million, \$3.1 million and \$0.7 million on the sale of short-term investments in 2009, 2008 and 2007, respectively.

Provision for Income Taxes

	Year ended December 31,		Change
	2009	2008	2009 vs. 2008
	(in thousands, except percentages)		
Provision for income taxes	\$ 76,332	\$ 48,474	57.5%
Effective tax rate	39.7%	36.9%	

In 2009, our effective tax rate differed from the federal statutory rate of 35% principally due to state income taxes of \$10 million or 5% of income before income tax. This was partially offset by Federal and California research and development (“R&D”) tax credits of \$2 million. The increase in our effective tax rate was primarily attributable to a cumulative benefit recorded as a discrete item in the second quarter of 2008 for prior period R&D tax credits.

	Year ended December 31,		Change
	2008	2007	2008 vs. 2007
	(in thousands, except percentages)		
Provision for income taxes	\$ 48,474	\$ 44,317	9.4%
Effective tax rate	36.9%	40.0%	

In 2008, our effective tax rate differed from the federal statutory rate of 35% principally due to state income taxes of \$5 million or 4% of income before income tax. This was partially offset by R&D tax credits of \$3 million. The decrease in our effective tax rate was primarily attributable to a cumulative benefit recorded as a discrete item in the second quarter of 2008 for prior period R&D 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 price of our service, the number of subscribers who sign up for our service and the growth or reduction in our subscriber base.

In September 2009, we entered into a credit agreement which provided for a \$100 million three-year revolving credit facility. In October 2009, the Company borrowed \$20 million under the credit agreement. In November 2009, we issued \$200 million of our 8.50% senior notes due in 2017. In connection with the notes offering, we repaid all outstanding amounts under our credit agreement and terminated it. 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 additional 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. Additionally, debt financing has also been a source of liquidity in fiscal 2009. Our primary uses of cash include our stock repurchase programs, shipping 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 August 6, 2009, we announced that our Board of Directors authorized a stock repurchase program through the end of 2010 allowing us to repurchase \$300 million of our common stock of which we have purchased \$149.1 million as of December 31, 2009. Subsequent to December 31, 2009, we purchased an

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additional \$62.4 million of our common stock under the program. 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 as of December 31, 2009, 2008 and 2007:

	Year Ended December 31,		
	2009	2008 (in thousands)	2007
Cash and cash equivalents	\$ 134,224	\$ 139,881	\$ 177,439
Short-term investments	186,018	157,390	207,703
	<u>\$ 320,242</u>	<u>\$ 297,271</u>	<u>\$ 385,142</u>
Net cash provided by operating activities	\$ 325,063	\$ 284,037	\$ 277,424
Net cash used in investing activities	\$(246,079)	\$(144,960)	\$(436,024)
Net cash used in financing activities	\$ (84,641)	\$(176,635)	\$ (64,391)

Operating Activities

During 2009, our operating activities consisted primarily of net income of \$115.9 million, increased by non-cash adjustments of \$254.9 million and offset by a decrease in net changes in operating assets and liabilities of \$45.7 million. The majority of the non-cash adjustments came from the amortization of the content library of \$219.5 million which increased by \$9.7 million over the prior period as we continue to purchase additional titles in order to support our larger subscriber base. The decrease in cash flow attributable to the net changes in operating assets and liabilities was mainly driven by acquisitions of content library related to our streaming content, as we continued to increase our investments in streaming content in 2009. Cash provided by operating activities increased \$41.0 million in 2009 as compared to 2008. This was primarily due to an increase in net income of \$32.8 million, increased non-cash adjustments of \$27.3 million and a decrease in net changes in operating assets and liabilities of \$19.1 million.

During 2008, our operating activities consisted primarily of net income of \$83.0 million, increased by non-cash adjustments of \$227.6 million offset by a decrease in net changes in operating assets and liabilities of \$26.6 million. The majority of the non-cash adjustments came from the amortization of the content library of \$209.8 million which increased by \$6.3 million over the prior period as we continue to purchase additional titles in order to support our larger subscriber base. The decrease in net changes in operating assets and liabilities was mainly driven by acquisitions of content library related to our streaming content, as we continued to increase our investments in streaming content in 2008. Cash provided by operating activities increased \$6.6 million in 2008 as compared to 2007. This was primarily due to an increase in net income of \$16.4 million, increased non-cash adjustments of \$32.3 million and a decrease in net changes in operating assets and liabilities of \$42.1 million.

Investing Activities

Our investing activities consisted primarily of purchases, sales and maturities of available-for-sale securities, acquisitions of DVD content library and purchases of property and equipment. Cash used in investing activities increased \$101.1 million in 2009 as compared to 2008. This increase was primarily driven by a decrease in the proceeds from the sales and maturities of short-term investments of \$105.0 million offset partially by a decrease in the purchases of short term investments of \$29.0 million. In addition, acquisitions of DVDs increased by \$30.2 million.

Cash used in investing activities decreased \$291.1 million in 2008 as compared to 2007. This decrease was primarily driven by a decrease in the purchases of short-term investments of \$148.4 million coupled with an increase in the proceeds from the sales and maturities of short-term investments of \$106.5 million. In addition, acquisitions of DVDs decreased by \$45.8 million as more DVDs were obtained through revenue sharing agreements in 2008.

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Financing Activities

Our financing activities consist primarily of issuance of debt, repurchases of our common stock, issuance of common stock, and the excess tax benefit from stock-based compensation. Cash used by financing activities decreased by \$92.0 million in 2009 as compared to 2008 primarily due to the \$193.9 million net proceeds received from the issuance of our 8.50% senior notes and a \$16.4 million increase in proceeds received from the issuance of common stock through option exercises and through our employee stock purchase plan. In addition, the excess tax benefits from stock-based compensation increased by \$7.5 million in 2009. These cash inflows were offset by an increase in repurchases of our common stock of \$124.4 million.

Cash used by financing activities increased by \$112.2 million in 2008 as compared to 2007 primarily due to an increase in stock repurchases of \$100.0 million. In addition, the excess tax benefits from stock-based compensation decreased by \$21.0 million in 2008, as remaining benefits from net operating losses were utilized. This use of cash was offset by an increase in proceeds from the issuance of our common stock of \$9.3 million.

Contractual Obligations

For the purposes of this table, contractual obligations for purchases of goods or services are defined as agreements that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. The expected timing of payment of the obligations discussed above is estimated based on information available to us as of December 31, 2009. Timing of payments and actual amounts paid may be different depending on the time of receipt of goods or services or changes to agreed-upon amounts for some obligations. The following table summarizes our contractual obligations at December 31, 2009 (in thousands):

<u>Contractual obligations (in thousands):</u>	<u>Payments due by Period</u>				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>More than 5 years</u>
8.50% senior notes	\$ 336,472	\$ 17,472	\$ 34,000	\$ 34,000	\$ 251,000
Operating lease obligations	40,347	13,313	17,354	7,812	1,868
Lease financing obligations	12,399	3,901	8,102	396	—
Other purchase obligations (1)	388,056	235,435	145,252	7,369	—
Total	<u>\$ 777,274</u>	<u>\$ 270,121</u>	<u>\$ 204,708</u>	<u>\$ 49,577</u>	<u>\$ 252,868</u>

(1) Other purchase obligations relate primarily to acquisitions for our content library and to marketing activities.

As of December 31, 2009, the Company had gross unrecognized tax benefits of \$13.2 million and an additional \$0.9 million for gross interest and penalties classified as non-current liabilities in the Consolidated Balance Sheet. At this time, the Company is unable to make a reasonably reliable estimate of the timing of payments in individual years due to uncertainties in the timing of tax audit outcomes; therefore, such amounts are not included in the above contractual obligation table.

License Agreements

In addition to the above contractual obligations, we have certain license agreements with studios that include a maximum number of titles that we may or may not receive in the future. Access to these titles is based on the discretion of the studios and, as such, we may not receive these titles. If we did receive access to the maximum number of titles, we would incur up to an additional \$6 million in commitments during 2010.

Off-Balance Sheet Arrangements

We have not engaged 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 presently subject to off-balance sheet risks.

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Indemnifications

In the ordinary course of business, we enter into contractual arrangements under which we agree 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 our 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, our obligations under these agreements may be limited in terms of time and/or amount, and in some instances, we may have recourse against third parties for certain payments. In addition, we have entered into indemnification agreements with our directors and certain of our officers that will require us, 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.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The primary objective of our investment activities is to preserve principal, while at the same time maximizing income we receive from investments without significantly increased risk. To achieve this objective, we follow an established investment policy and set of guidelines to monitor and help mitigate our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes. We maintain a portfolio of cash equivalents and short-term investments in a variety of securities. These securities are classified as available-for-sale and are recorded at fair value with unrealized gains and losses, net of tax, included in accumulated other comprehensive income within stockholders equity in the consolidated balance sheet.

As of December 31, 2009, we had no material impairment charges associated with our short-term investment portfolio. Although we believe our current investment portfolio has very little risk of material impairment, we cannot predict future market conditions or market liquidity and can provide no assurance that our investment portfolio will remain materially unimpaired. Some of the securities we invest in may be subject to market risk due to changes in prevailing interest rates which may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing interest rate later rises, the value of our investment will decline. At December 31, 2009, our cash equivalents were generally invested in money market funds, which are not subject to market risk because the interest paid on such funds fluctuates with the prevailing interest rate. Our short-term investments were comprised of corporate debt securities, government and agency securities and asset and mortgage-backed securities. Approximately 52% of the portfolio is invested in government and agency issued securities.

At December 31, 2009, we had securities classified as short-term investments of \$186.0 million. Changes in interest rates could adversely affect the market value of these investments. The table below separates these investments, based on stated maturities, to show the approximate exposure to interest rates.

	(in thousands)
Due within one year	\$ 44,455
Due within five years	137,763
Due within ten years	—
Due after ten years	3,800
Total	<u>\$ 186,018</u>

A sensitivity analysis was performed on our investment portfolio as of December 31, 2009. The analysis is based on an estimate of the hypothetical changes in market value of the portfolio that would result from an immediate parallel shift in the yield curve of various magnitudes. This methodology assumes a more immediate change in interest rates to reflect the current economic environment.

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The following tables present the hypothetical fair values (in \$ thousands) of our debt securities classified as short-term investments assuming immediate parallel shifts in the yield curve of 50 basis points (“BPS”), 100 BPS and 150 BPS. The analysis is shown as of December 31, 2009:

Fair Value December 31, 2009					
-150 BPS	-100 BPS	-50 BPS	+50 BPS	+100 BPS	+150 BPS
\$ 190,243	\$ 188,835	\$ 187,426	\$ 184,610	\$ 183,201	\$ 181,793

Item 8. Financial Statements and Supplementary Data

See “Financial Statements” beginning on page F-1 which are incorporated herein by reference.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

(a) 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 Annual Report on Form 10-K. 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 Annual Report on Form 10-K 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 recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

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.

(b) Management’s Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 as amended (the Exchange Act)). Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2009. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) in *Internal Control—Integrated Framework*. Based on our assessment under the framework in *Internal Control—Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2009. The effectiveness of our internal control over financial reporting as of December 31, 2009 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report that is included herein.

Table of Contents**(c) Changes in Internal Control Over Financial Reporting**

There was no change in our internal control over financial reporting that occurred during the quarter ended December 31, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Information regarding our directors and executive officers is incorporated by reference from the information contained under the sections “Proposal One: Election of Directors,” “Section 16(a) Beneficial Ownership Compliance” and “Code of Ethics” in our Proxy Statement for the Annual Meeting of Stockholders.

Item 11. Executive Compensation

Information required by this item is incorporated by reference from information contained under the section “Compensation of Executive Officers and Other Matters” in our Proxy Statement for the Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by this item is incorporated by reference from information contained under the sections “Security Ownership of Certain Beneficial Owners and Management” and “Equity Compensation Plan Information” in our Proxy Statement for the Annual Meeting of Stockholders.

Item 13. Certain Relationships and Related Transactions and Director Independence

Information required by this item is incorporated by reference from information contained under the section “Certain Relationships and Related Transactions” and “Director Independence” in our Proxy Statement for the Annual Meeting of Stockholders.

Item 14. Principal Accounting Fees and Services

Information with respect to principal independent registered public accounting firm fees and services is incorporated by reference from the information under the caption “Proposal Two: Ratification of Appointment of Independent Registered Public Accounting Firm” in our Proxy Statement for the Annual Meeting of Stockholders.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this Annual Report on Form 10-K:

(1) Financial Statements:

The financial statements are filed as part of this Annual Report on Form 10-K under “Item 8. Financial Statements and Supplementary Data.”

(2) Financial Statement Schedules:

The financial statement schedules are omitted as they are either not applicable or the information required is presented in the financial statements and notes thereto under “Item 8. Financial Statements and Supplementary Data.”

(3) Exhibits:

<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Incorporated by Reference</u>				<u>Filed Herewith</u>
		<u>Form</u>	<u>File No.</u>	<u>Exhibit</u>	<u>Filing Date</u>	
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	
4.2	Indenture, dated November 6, 2009, among Netflix, Inc., the guarantors from time to time party thereto and Wells Fargo Bank, National Association, relating to the 8.50% Senior Notes due 2017.	8-K	000-49802	4.1	November 9, 2009	
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	

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<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Incorporated by Reference</u>				<u>Filed Herewith</u>
		<u>Form</u>	<u>File No.</u>	<u>Exhibit</u>	<u>Filing Date</u>	
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	
23.1	Consent of Independent Registered Public Accounting Firm					X
24	Power of Attorney (see signature page)					
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 Annual Report on Form 10-K for the year ended December 31, 2009 filed with the SEC on February 19, 2010, formatted in XBRL includes: (i) Consolidated Balance Sheets as of December 31, 2009 and 2008, (ii) Consolidated Statements of Operations for the Years Ended December 31, 2009, 2008 and 2007, (iii) Consolidated Statements of Stockholders' Equity and Comprehensive Income for the Years Ended December 31, 2009, 2008 and 2007, (iv) Consolidated Statements of Cash Flows for the Years Ended December 31, 2009, 2008 and 2007 and (v) the Notes to 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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NETFLIX, INC.
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

**The Board of Directors and Stockholders
Netflix, Inc.:**

We have audited the accompanying consolidated balance sheets of Netflix, Inc. and subsidiary (the Company) as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2009. We also have audited Netflix, Inc.'s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Netflix, Inc.'s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting appearing under item 9A (b). Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Netflix, Inc. and subsidiary as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles. Also in our opinion, Netflix, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ KPMG LLP
Mountain View, California
February 19, 2010

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NETFLIX, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)

	<u>As of December 31,</u>	
	<u>2009</u>	<u>2008</u>
Assets		
Current assets:		
Cash and cash equivalents	\$134,224	\$ 139,881
Short-term investments	186,018	157,390
Prepaid expenses	12,491	8,122
Prepaid revenue sharing expenses	17,133	18,417
Current content library, net	37,329	18,691
Other current assets	23,818	16,424
Total current assets	<u>411,013</u>	<u>358,925</u>
Content library, net	108,810	98,547
Property and equipment, net	131,653	124,948
Deferred tax assets	15,958	22,409
Other non-current assets	12,300	10,595
Total assets	<u>\$679,734</u>	<u>\$ 615,424</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 91,475	\$ 100,344
Accrued expenses	33,387	31,394
Current portion of lease financing obligations	1,410	1,152
Deferred revenue	100,097	83,127
Total current liabilities	<u>226,369</u>	<u>216,017</u>
Long-term debt	200,000	—
Lease financing obligations, excluding current portion	36,572	37,988
Other non-current liabilities	17,650	14,264
Total liabilities	<u>480,591</u>	<u>268,269</u>
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value; 10,000,000 shares authorized at December 31, 2009 and 2008; no shares issued and outstanding at December 31, 2009 and 2008	—	—
Common stock, \$0.001 par value; 160,000,000 shares authorized at December 31, 2009 and 2008; 53,440,073 and 58,862,478 issued and outstanding at December 31, 2009 and 2008, respectively	53	62
Additional paid-in capital	—	338,577
Treasury stock at cost (3,491,084 shares at December 31, 2008)	—	(100,020)
Accumulated other comprehensive income	273	84
Retained earnings	198,817	108,452
Total stockholders' equity	<u>199,143</u>	<u>347,155</u>
Total liabilities and stockholders' equity	<u>\$679,734</u>	<u>\$ 615,424</u>

See accompanying notes to consolidated financial statements.

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NETFLIX, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Year ended December 31,		
	2009	2008	2007
Revenues	\$1,670,269	\$1,364,661	\$1,205,340
Cost of revenues:			
Subscription	909,461	761,133	664,407
Fulfillment expenses*	169,810	149,101	121,761
Total cost of revenues	<u>1,079,271</u>	<u>910,234</u>	<u>786,168</u>
Gross Profit	590,998	454,427	419,172
Operating expenses:			
Technology and development*	114,542	89,873	70,979
Marketing*	237,744	199,713	218,212
General and administrative*	51,333	49,662	52,404
Gain on disposal of DVDs	(4,560)	(6,327)	(7,196)
Gain on legal settlement	—	—	(7,000)
Total operating expenses	<u>399,059</u>	<u>332,921</u>	<u>327,399</u>
Operating income	191,939	121,506	91,773
Other income (expense):			
Interest expense	(6,475)	(2,458)	(1,188)
Interest and other income (expense)	6,728	12,452	20,340
Income before income taxes	192,192	131,500	110,925
Provision for income taxes	76,332	48,474	44,317
Net income	<u>\$ 115,860</u>	<u>\$ 83,026</u>	<u>\$ 66,608</u>
Net income per share:			
Basic	<u>\$ 2.05</u>	<u>\$ 1.36</u>	<u>\$ 0.99</u>
Diluted	<u>\$ 1.98</u>	<u>\$ 1.32</u>	<u>\$ 0.97</u>
Weighted-average common shares outstanding:			
Basic	<u>56,560</u>	<u>60,961</u>	<u>67,076</u>
Diluted	<u>58,416</u>	<u>62,836</u>	<u>68,902</u>

* Stock-based compensation included in expense line items:

Fulfillment expenses	\$ 380	\$ 466	\$ 427
Technology and development	4,453	3,890	3,695
Marketing	1,786	1,886	2,160
General and administrative	5,999	6,022	5,694

See accompanying notes to consolidated financial statements.

NETFLIX, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
(in thousands, except share data)

	Common Stock		Additional Paid-in Capital	Treasury Stock	Accumulated Other Comprehensive Income	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
	Shares	Amount					
Balances as of December 31, 2006	68,612,463	\$ 69	\$ 454,731	\$ —	\$ —	\$ (41,182)	\$ 413,618
Net Income	—	—	—	—	—	66,608	66,608
Unrealized gains on available-for-sale securities, net of taxes	—	—	—	—	1,611	—	1,611
Comprehensive income, net of taxes	—	—	—	—	—	—	68,219
Issuance of common stock upon exercise of options	828,824	—	5,822	—	—	—	5,822
Issuance of common stock under employee stock purchase plan	205,416	—	3,787	—	—	—	3,787
Repurchases of common stock	(4,733,788)	(4)	(99,854)	—	—	—	(99,858)
Stock-based compensation expense	—	—	11,976	—	—	—	11,976
Excess stock option income tax benefits	—	—	26,248	—	—	—	26,248
Balances as of December 31, 2007	64,912,915	\$ 65	\$ 402,710	\$ —	\$ 1,611	\$ 25,426	\$ 429,812
Net Income	—	—	—	—	—	83,026	83,026
Unrealized gains on available-for-sale securities, net of taxes	—	—	—	—	(1,527)	—	(1,527)
Comprehensive income, net of taxes	—	—	—	—	—	—	81,499
Issuance of common stock upon exercise of options	1,056,641	—	14,019	—	—	—	14,019
Issuance of common stock under employee stock purchase plan	231,068	—	4,853	—	—	—	4,853
Repurchases of common stock	(3,847,062)	(3)	(99,881)	—	—	—	(99,884)
Repurchases of common stock to be held in treasury	(3,491,084)	—	—	(100,020)	—	—	(100,020)
Stock-based compensation expense	—	—	12,264	—	—	—	12,264
Excess stock option income tax benefits	—	—	4,612	—	—	—	4,612
Balances as of December 31, 2008	58,862,478	\$ 62	\$ 338,577	\$(100,020)	\$ 84	\$ 108,452	\$ 347,155
Net Income	—	—	—	—	—	115,860	115,860
Unrealized gains on available-for-sale securities, net of taxes	—	—	—	—	189	—	189
Comprehensive income, net of taxes	—	—	—	—	—	—	116,049
Issuance of common stock upon exercise of options	1,724,110	1	29,508	—	—	—	29,509
Issuance of common stock under employee stock purchase plan	224,799	—	5,765	—	—	—	5,765
Repurchases of common stock and retirement of outstanding treasury stock	(7,371,314)	(10)	(398,850)	100,020	—	(25,495)	(324,335)
Stock-based compensation expense	—	—	12,618	—	—	—	12,618
Excess stock option income tax benefits	—	—	12,382	—	—	—	12,382
Balances as of December 31, 2009	53,440,073	\$ 53	\$ —	\$ —	\$ 273	\$ 198,817	\$ 199,143

See accompanying notes to consolidated financial statements.

NETFLIX, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year Ended December 31,		
	2009	2008	2007
Cash flows from operating activities:			
Net income	\$ 115,860	\$ 83,026	\$ 66,608
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation of property, equipment and intangibles	38,044	32,454	22,219
Amortization of content library	219,490	209,757	203,415
Amortization of discounts and premiums on investments	607	625	24
Amortization of debt issuance costs	1,124	—	—
Stock-based compensation expense	12,618	12,264	11,976
Excess tax benefits from stock-based compensation	(12,683)	(5,220)	(26,248)
Loss (gain) on disposal of property and equipment	254	101	142
Gain on sale of short-term investments	(1,509)	(3,130)	(687)
Gain on disposal of DVDs	(7,637)	(13,350)	(14,637)
Gain on sale of investment in business	(1,783)	—	—
Deferred taxes	6,328	(5,905)	(893)
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(11,001)	(4,181)	(3,893)
Content library	(64,217)	(48,290)	(34,821)
Accounts payable	(2,256)	7,111	16,555
Accrued expenses	13,169	(1,824)	32,809
Deferred revenue	16,970	11,462	1,987
Other assets and liabilities	1,685	9,137	2,868
Net cash provided by operating activities	<u>325,063</u>	<u>284,037</u>	<u>277,424</u>
Cash flows from investing activities:			
Purchases of short-term investments	(228,000)	(256,959)	(405,340)
Proceeds from sale of short-term investments	166,706	304,163	200,832
Proceeds from maturities of short-term investments	35,673	3,170	—
Purchases of property and equipment	(45,932)	(43,790)	(44,256)
Acquisition of intangible asset	(200)	(1,062)	(550)
Acquisitions of content library	(193,044)	(162,849)	(208,647)
Proceeds from sale of DVDs	11,164	18,368	21,640
Investment in business	—	(6,000)	—
Proceeds from sale of investment in business	7,483	—	—
Other assets	71	(1)	297
Net cash used in investing activities	<u>(246,079)</u>	<u>(144,960)</u>	<u>(436,024)</u>
Cash flows from financing activities:			
Principal payments of lease financing obligations	(1,158)	(823)	(390)
Proceeds from issuance of common stock	35,274	18,872	9,609
Excess tax benefits from stock-based compensation	12,683	5,220	26,248
Borrowings on line of credit, net of issuance costs	18,978	—	—
Payments on line of credit	(20,000)	—	—
Proceeds from issuance of debt, net of issuance costs	193,917	—	—
Repurchases of common stock	(324,335)	(199,904)	(99,858)
Net cash used by financing activities	<u>(84,641)</u>	<u>(176,635)</u>	<u>(64,391)</u>
Net decrease in cash and cash equivalents	(5,657)	(37,558)	(222,991)
Cash and cash equivalents, beginning of year	139,881	177,439	400,430
Cash and cash equivalents, end of year	<u>\$ 134,224</u>	<u>\$ 139,881</u>	<u>\$ 177,439</u>
Supplemental disclosure:			
Income taxes paid	\$ 58,770	\$ 40,494	\$ 15,775
Interest paid	3,878	2,458	1,188

See accompanying notes to consolidated financial statements.

NETFLIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

Description of Business

Netflix, Inc. (the “Company”) was incorporated on August 29, 1997 and began operations on April 14, 1998. The Company is a subscription service streaming movies and TV episodes over the Internet and sending DVDs by mail to more than 12 million subscribers. The Company’s subscribers can instantly watch unlimited movies and TV episodes streamed to their TVs and computers and can receive DVDs delivered quickly to their homes. The Company offers a variety of subscription plans, with no due dates, no late fees, no shipping fees and no pay-per-view fees. Aided by proprietary recommendation and merchandising technology, subscribers can select from a growing library of titles that can be watched instantly and a vast array of titles on DVD.

Subscribers can:

- Watch streaming content without commercial interruption on their computers and TVs. The viewing experience is enabled by Netflix controlled software that can run on a variety of consumer electronics devices (“Netflix Ready Devices”). These Netflix Ready Devices currently include Blu-ray disc players, Internet-connected TVs, digital video players and game consoles.
- Receive DVDs by U.S. mail and return them to the Company at their convenience using the Company’s prepaid mailers. After a DVD has been returned, the Company mails the next available DVD in a subscriber’s queue.

The Company is organized in a single operating segment. All revenues are currently generated in the United States, and there are no long-lived assets outside the United States. Substantially all revenues are derived from monthly subscription fees.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. Intercompany balances and transactions have been eliminated.

Reclassification

Certain prior period amounts have been reclassified to conform to current presentation. These reclassifications did not significantly impact any prior amounts of reported total assets or total liabilities, and did not impact stockholders’ equity, results of operations or cash flows.

Subsequent Events

The Company has evaluated subsequent events through February 19, 2010, the date which these financial statements were available to be issued.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Significant items subject to such estimates and assumptions include the estimate of useful lives and residual value of its content library; the valuation of stock-based compensation; and the recognition and measurement of income tax assets and liabilities. The Company bases its estimates on historical experience and on various other assumptions that the Company believes to be reasonable under the circumstances. Actual results may differ from these estimates.

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Cash Equivalents and Short-term Investments

The Company considers investments in instruments purchased with an original maturity of 90 days or less to be cash equivalents. The Company classifies short-term investments, which consist of marketable securities with original maturities in excess of 90 days as available-for-sale. Short-term investments are reported at fair value with unrealized gains and losses included in accumulated other comprehensive income within stockholders' equity in the consolidated balance sheet. The amortization of premiums and discounts on the investments, realized gains and losses, and declines in value judged to be other-than-temporary on available-for-sale securities are included in interest and other income in the consolidated statements of operations. The Company uses the specific identification method to determine cost in calculating realized gains and losses upon the sale of short-term investments.

Short-term investments are reviewed periodically to identify possible other-than-temporary impairment. When evaluating the investments, the Company reviews factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer, the Company's intent to sell, or whether it would be more likely than not that the Company would be required to sell the investments before the recovery of their amortized cost basis.

Content Library

The Company obtains content through direct purchases, revenue sharing agreements and license agreements with studios, distributors and other suppliers. DVD content is obtained through direct purchases or revenue sharing agreements. Streaming content is generally licensed for a fixed fee for the term of the license agreement but may also be obtained through a revenue sharing agreement.

The Company acquires DVD content for the purpose of rental to its subscribers and earns subscription rental revenues, and, as such, the Company considers its DVD library to be a productive asset. Accordingly, the Company classifies its DVD library as a non-current asset on its consolidated balance sheets. Additionally, cash outflows for the acquisition of the DVD library, net of changes in related accounts payable, are classified as cash flows from investing activities in the Company's consolidated statements of cash flows. This is inclusive of any upfront non-refundable payments required under revenue sharing agreements.

The Company amortizes its direct purchase DVDs, less estimated salvage value, on a "sum-of-the-months" accelerated basis over their estimated useful lives. The useful life of the new release DVDs and back catalog DVDs is estimated to be one year and three years, respectively. In estimating the useful life of its DVDs, the Company takes into account library utilization as well as an estimate for lost or damaged DVDs. The Company provides a salvage value for those direct purchase DVDs that the Company estimates it will sell at the end of their useful lives. For those DVDs that the Company does not expect to sell, no salvage value is provided.

Additionally, the terms of certain DVD purchase agreements with studios and distributors provide for volume purchase discounts or rebates based on achieving specified performance levels. Volume purchase discounts are recorded as a reduction of DVD library when earned. The Company accrues for rebates as earned based on historical title performance and estimates of demand for the titles over the remainder of the title term. Actual rebates may vary which could result in an increase or reduction in the estimated amounts previously accrued.

The Company obtains content distribution rights in order to stream movies and TV episodes without commercial interruption to subscribers' computers and TVs via Netflix Ready Devices. The Company accounts for streaming content in accordance with the Financial Accounting Standards Board's ("FASB") Accounting

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Standards Codification (“ASC”) topic 920 *Entertainment—Broadcasters* . Cash outflows associated with streaming content are classified as cash flows from operating activities on the consolidated statements of cash flow.

The Company classifies streaming content obtained through a license agreement 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. Streaming content is amortized on a straight-line basis generally over the terms of the license agreements or the title’s window of availability.

The Company also obtains DVD and streaming content through revenue sharing agreements with studios and distributors. The Company generally obtains titles for low initial cost in exchange for a commitment to share a percentage of its subscription revenues or to pay a fee, based on utilization, for a defined period of time, or the Title Term, which typically ranges from six to twelve months for each title. The initial cost may be in the form of an upfront non-refundable payment. This payment is capitalized in the content library in accordance with the Company’s DVD and streaming content policies as applicable. The initial cost may also be in the form of a prepayment of future revenue sharing obligations which is classified as prepaid revenue sharing expense. The terms of some revenue sharing agreements with studios obligate the Company to make minimum revenue sharing payments for certain titles. The Company amortizes minimum revenue sharing prepayments (or accretes an amount payable to studios if the payment is due in arrears) as revenue sharing obligations are incurred. A provision for estimated shortfall, if any, on minimum revenue sharing payments is made in the period in which the shortfall becomes probable and can be reasonably estimated. Under the revenue sharing agreements for its DVD library, at the end of the Title Term, the Company generally has the option of returning the DVD title to the studio, destroying the title or purchasing the title.

Property and Equipment

Property and equipment are carried at cost less accumulated depreciation. Depreciation is calculated using the straight-line method over the shorter of the estimated useful lives of the respective assets, generally up to 30 years, or the lease term for leasehold improvements, if applicable. Leased buildings are capitalized and included in property and equipment when the Company was involved in the construction funding and did not meet the “sale-leaseback” criteria as required by ASC topic 840.40 *Leases—Sale-Leaseback Transactions* .

Impairment of Long-Lived Assets

Long-lived assets such as content library, property and equipment and intangible assets subject to depreciation and amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of asset groups to be held and used is measured by a comparison of the carrying amount of an asset group to estimated undiscounted future cash flows expected to be generated by the asset group. If the carrying amount of an asset group exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of an asset group exceeds fair value of the asset group. The Company evaluated its long-lived assets, and impairment charges were not material for any of the years presented.

Capitalized Software Costs

Costs incurred during the application development stage for software programs to be used solely to meet the Company’s internal needs are capitalized. Costs incurred in connection with the development of software used by the Company’s subscribers, such as that included in consumer electronics partner devices, are capitalized during

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

the period between technological feasibility and general availability of the software. Capitalized software costs are included in property and equipment, net and are amortized over the estimated useful life of the software, generally up to three years. The net book value of capitalized software costs is not significant as of December 31, 2009 and 2008.

Revenue Recognition

Subscription revenues are recognized ratably over each subscriber's monthly subscription period. Refunds to subscribers are recorded as a reduction of revenues. Revenues are presented net of the taxes that are collected from customers and remitted to governmental authorities. Deferred revenue consists of subscriptions revenues billed to subscribers that have not been recognized and gift subscriptions that have not been redeemed.

Marketing

Marketing expenses consist primarily of advertising expenses and payments made to affiliates including the Company's consumer electronics partners. Advertising expenses include marketing program expenditures and other promotional activities, including allocated costs of revenues relating to free trial periods. Also included in marketing expenses are payroll related expenses. Advertising costs are expensed as incurred except for advertising production costs, which are expensed the first time the advertising is run. Advertising expense totaled approximately \$205.9 million, \$181.4 million and \$207.9 million in 2009, 2008, and 2007, respectively.

The Company and its vendors participate in a variety of cooperative advertising programs and other promotional programs in which the vendors provide the Company with cash consideration in exchange for marketing and advertising of the vendor's products. If the consideration received represents reimbursement of specific incremental and identifiable costs incurred to promote the vendor's product, it is recorded as an offset to the associated marketing expense incurred. Any reimbursement greater than the specific incremental and identifiable costs incurred is recognized as a reduction of cost of revenues when recognized in the Company's consolidated statements of operations.

Income Taxes

The Company accounts for income taxes using the asset and liability method. Deferred income taxes are recognized by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance for any tax benefits for which future realization is uncertain. There was no valuation allowance as of December 31, 2009 or 2008.

The Company recognizes the tax benefit from an uncertain tax position only if it is more likely than not the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such positions are then measured based on the largest benefit that has a greater than 50% likelihood of being realized upon settlement. The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. See Note 8 to the consolidated financial statements for further information regarding income taxes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock Repurchases

To facilitate a stock repurchase program, shares are repurchased by the Company in the open market and are accounted for when the transaction is settled. Shares held for future issuance are classified as treasury stock. Shares formally or constructively retired are deducted from common stock for par value and from additional paid in capital for the excess over par value. If additional paid in capital has been exhausted, the excess over par value is deducted from retained earnings. Direct costs incurred to acquire the shares are included in the total cost of the shares.

Comprehensive Income

Other comprehensive income consists of unrealized gains and losses on available-for-sale securities, net of tax. Total comprehensive income and the components of accumulated other comprehensive income are presented in the accompanying consolidated statements of stockholders' equity.

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, warrants to purchase common stock 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:

	Year ended December 31,		
	2009	2008	2007
	(in thousands, except per share data)		
Basic earnings per share:			
Net income	\$ 115,860	\$ 83,026	\$ 66,608
Shares used in computation:			
Weighted-average common shares outstanding	56,560	60,961	67,076
Basic earnings per share	<u>\$ 2.05</u>	<u>\$ 1.36</u>	<u>\$ 0.99</u>
Diluted earnings per share:			
Net income	\$ 115,860	\$ 83,026	\$ 66,608
Shares used in computation:			
Weighted-average common shares outstanding	56,560	60,961	67,076
Employee stock options and employee stock purchase plan shares	1,856	1,875	1,826
Weighted-average number of shares	<u>58,416</u>	<u>62,836</u>	<u>68,902</u>
Diluted earnings per share	<u>\$ 1.98</u>	<u>\$ 1.32</u>	<u>\$ 0.97</u>

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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:

	Year ended December 31		
	2009	2008	2007
Employee stock options	64	726	1,973

The weighted average exercise price of excluded outstanding stock options was \$45.78, \$32.42 and \$27.83 for the years ended December 31, 2009, 2008 and 2007, respectively.

Stock-Based Compensation

The Company grants stock options to its employees on a monthly basis. The Company has elected to grant all options as fully vested non-qualified stock options. As a result of immediate vesting, stock-based compensation expense is fully recognized on the grant date, and no estimate is required for post-vesting option forfeitures.

2. Short-term Investments

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:

	December 31, 2009			
	Amortized Cost	Gross Unrealized	Gross Unrealized	Estimated Fair Value
		Gains	Losses	
		(in thousands)		
Corporate debt securities	\$ 82,362	\$ 915	\$ (106)	\$ 83,171
Government and agency securities	96,998	72	(416)	96,654
Asset and mortgage backed securities	6,262	143	(212)	6,193
	<u>\$185,622</u>	<u>\$ 1,130</u>	<u>\$ (734)</u>	<u>\$186,018</u>
	December 31, 2008			
	Amortized Cost	Gross Unrealized	Gross Unrealized	Estimated Fair Value
		Gains	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
	<u>\$157,306</u>	<u>\$ 2,267</u>	<u>\$ (2,183)</u>	<u>\$157,390</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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 December 31, 2009					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Corporate debt securities	\$ 25,982	\$ (106)	\$ —	\$ —	\$ 25,982	\$ (106)
Government and agency securities	85,391	(414)	3,279	(2)	88,670	(416)
Asset and mortgage backed securities	280	(1)	768	(211)	1,048	(212)
	<u>\$111,653</u>	<u>\$ (521)</u>	<u>\$4,047</u>	<u>\$ (213)</u>	<u>\$115,700</u>	<u>\$ (734)</u>
	As of December 31, 2008					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
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)
	<u>\$ 50,445</u>	<u>\$ (2,148)</u>	<u>\$1,316</u>	<u>\$ (35)</u>	<u>\$ 51,761</u>	<u>\$ (2,183)</u>

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 December 31, 2009. There were no material other-than-temporary impairments or credit losses related to available-for-sale securities in 2009, 2008 or 2007.

The gross realized gains on the sales of available-for-sale securities for the three years ended December 31, 2009, 2008 and 2007 were \$1.9 million, \$4.9 million and \$0.8 million, respectively. The gross realized losses on the sales of available-for-sale securities for the three years ended December 31, 2009, 2008 and 2007 were \$0.4 million, \$1.8 million and \$0.1 million, respectively. 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 December 31, 2009 is as follows:

	(in thousands)
Due within one year	\$ 44,455
Due after one year and through 5 years	137,763
Due after 5 years and through 10 years	—
Due after 10 years	3,800
Total short-term investments	<u>\$ 186,018</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company measures certain financial assets at fair value on a recurring basis, including cash equivalents and available-for-sale securities. 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.

	Fair Value Measurements at December 31, 2009			
	Total	Quoted Prices in	Significant	Significant
		Active Markets	Other	Unobservable
		for Identical	Observable	
	Assets	Inputs	Inputs	
	(Level 1)	(Level 2)	(Level 3)	
(in thousands)				
Current Assets:				
Money market funds (1)	\$ 690	\$ 690	\$ —	\$ —
Fixed income available-for-sale securities (2)	186,018	—	186,018	—
Total current assets	186,708	690	186,018	—
Non-current Assets:				
Money market funds (3)	2,829	2,829	—	—
Total non-current assets	2,829	2,829	—	—
Total assets	\$189,537	\$ 3,519	\$186,018	\$ —

	Fair Value Measurements at December 31, 2008			
	Total	Quoted Prices in	Significant	Significant
		Active Markets	Other	Unobservable
		for Identical	Observable	
	Assets	Inputs	Inputs	
	(Level 1)	(Level 2)	(Level 3)	
(in thousands)				
Current Assets:				
Money market funds (1)	\$ 60,930	\$ 60,930	\$ —	\$ —
Cash equivalents (1)	16,600	—	16,600	—
Fixed income available-for-sale securities (2)	157,390	—	157,390	—
Total current assets	234,920	60,930	173,990	—
Non-current Assets:				
Money market funds (3)	1,929	1,929	—	—
Total non-current assets	1,929	1,929	—	—
Total assets	\$236,849	\$ 62,859	\$173,990	\$ —

- (1) Included in cash and cash equivalents in the Company's consolidated balance sheets.
- (2) Included in short-term investments in the Company's consolidated balance sheets.
- (3) Included in other non-current assets in the Company's consolidated balance sheets.

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 measured at fair value on a recurring basis as of December 31, 2009. See Note 4 for further information regarding the fair value of the 8.50% senior notes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

3. Balance Sheet Components

Content Library, Net

Content library and accumulated amortization consisted of the following:

	As of December 31,	
	2009	2008
	(in thousands)	
Content library, gross	\$ 742,802	\$ 637,336
Less: accumulated amortization	(596,663)	(520,098)
	146,139	117,238
Less: Current content library, net	37,329	18,691
Content library, net	<u>\$ 108,810</u>	<u>\$ 98,547</u>

Property and Equipment, Net

Property and equipment and accumulated depreciation consisted of the following:

		As of December 31,	
		2009	2008
		(in thousands)	
Computer equipment	3 years	\$ 62,132	\$ 44,598
Operations and other equipment	5 years	65,059	59,061
Software, including internal-use software	1-3 years	35,401	30,060
Furniture and fixtures	3 years	12,421	12,304
Building	30 years	40,681	40,681
Leasehold improvements	Over life of lease	35,156	33,124
Capital work-in-progress		15,097	3,958
Property and equipment, gross		265,947	223,786
Less: Accumulated depreciation		(134,294)	(98,838)
Property and equipment, net		<u>\$ 131,653</u>	<u>\$ 124,948</u>

Capital work-in-progress as of December 31, 2009 consists primarily of approximately \$13.1 million of operations equipment and \$1.9 million of software not yet in service, and approximately \$0.1 million of leasehold improvements.

Other Assets

Other assets consisted of the following:

	As of December 31,	
	2009	2008
	(in thousands)	
Patents, net	\$ 1,639	\$ 1,844
Investment in business	—	5,700
Restricted cash	2,829	1,929
Debt issuance costs, net	5,966	—
Other	1,866	1,122
Other assets	<u>\$12,300</u>	<u>\$10,595</u>

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Restricted cash of \$2.8 million and \$1.9 million, as of December 31, 2009 and 2008, respectively, related to workers' compensation insurance deposits.

Accrued Expenses

Accrued expenses consisted of the following:

	As of December 31,	
	2009	2008
	(in thousands)	
Accrued state sales and use tax	\$11,625	\$ 9,127
Accrued payroll and employee benefits	6,427	5,956
Accrued settlement costs	—	2,409
Accrued interest on debt	2,597	—
Accrued content acquisition costs	5,810	6,237
Other	6,928	7,665
Total accrued expenses	<u>\$33,387</u>	<u>\$31,394</u>

4. Long-term Debt

Senior Notes

In November 2009, the Company issued \$200.0 million aggregate principal amount of 8.50% senior notes due November 15, 2017 (the "8.50% Notes"). The net proceeds to the Company from the 8.50% Notes were approximately \$193.9 million. Debt issuance costs of \$6.1 million are recorded in other assets on the consolidated balance sheet and are amortized over the term of the notes as interest expense. The notes were issued at par and are senior unsecured obligations of the Company. Interest is payable semi-annually at a rate of 8.50% per annum on May 15 and November 15 of each year, commencing on May 15, 2010. The 8.50% Notes are repayable in whole or in part upon the occurrence of a change of control, at the option of the holders, at a purchase price in cash equal to 101% of the principal plus accrued interest. Prior to November 15, 2012, in the event of a qualified equity offering, the Company may redeem up to 35% of the 8.50% Notes at a redemption price of 108.50% of the principal plus accrued interest. Additionally, the Company may redeem the 8.50% Notes prior to November 15, 2013 in whole or in part at a redemption price of 100% of the principal plus accrued interest, plus a "make-whole" premium. On or after November 15, 2013, the Company may redeem the 8.50% Notes in whole or in part at specified prices ranging from 104.25% to 100% of the principal plus accrued interest.

The 8.50% Notes include, among other terms and conditions, limitations on the Company's ability to create, incur, assume or be liable for indebtedness (other than specified types of permitted indebtedness); dispose of assets outside the ordinary course (subject to specified exceptions); acquire, merge or consolidate with or into another person or entity (other than specified types of permitted acquisitions); create, incur or allow any lien on any of its property or assign any right to receive income (except for specified permitted liens); make investments (other than specified types of investments); or pay dividends or make distributions (each subject to specified exceptions). At December 31, 2009, the Company was in compliance with these covenants.

Based on quoted market prices, the fair value of the 8.50% Notes was approximately \$207.5 million as of December 31, 2009.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Credit Agreement

In September 2009, the Company entered into a credit agreement which provided for a \$100 million three-year revolving line of credit. Loans under the credit agreement bore interest, at the Company’s option, at either a base rate determined in accordance with the credit Agreement, plus a spread of 1.75% to 2.25%, or an adjusted LIBOR rate plus a spread of 2.75% to 3.25%. In October 2009, the Company borrowed \$20 million under the credit agreement. The proceeds, net of issuance costs, to the Company were approximately \$19.0 million. In connection with the issuance of the 8.50% Notes, the Company repaid all outstanding amounts under and terminated the credit agreement. Issuance costs related to the line of credit are included in interest expense.

5. Commitments and Contingencies

The Company leases facilities under non-cancelable operating leases with various expiration dates through 2016. The facilities generally require the Company to pay property taxes, insurance and maintenance costs. Further, several lease agreements contain rent escalation clauses or rent holidays. For purposes of recognizing minimum rental expenses on a straight-line basis over the terms of the leases, the Company uses the date of initial possession to begin amortization, which is generally when the Company enters the space and begins to make improvements in preparation of intended use. For scheduled rent escalation clauses during the lease terms or for rental payments commencing at a date other than the date of initial occupancy, the Company records minimum rental expenses on a straight-line basis over the terms of the leases in the consolidated statements of operations. The Company has the option to extend or renew most of its leases which may increase the future minimum lease commitments.

Because the terms of the Company’s original facilities lease agreements required the Company’s involvement in the construction funding of the buildings at its Los Gatos, California headquarters site, the Company is the “deemed owner” (for accounting purposes only) of these buildings. Accordingly, the Company recorded an asset of \$40.7 million, representing the total costs of the buildings and improvements, including the costs paid by the lessor (the legal owner of the buildings), with corresponding liabilities. Upon completion of construction of each building, the Company did not meet the sale-leaseback criteria for de-recognition of the building assets and liabilities. Therefore the leases are accounted for as financing obligations.

Future minimum payments under lease financing obligations and non-cancelable operating leases as of December 31, 2009 are as follows:

<u>Year Ending December 31,</u>	<u>Future Minimum Payments</u> (in thousands)
2010	\$ 17,214
2011	13,950
2012	11,506
2013	5,064
2014	3,144
Thereafter	1,868
Total minimum payments	\$ 52,746

Future minimum payments under lease financing obligations as of December 31, 2009 total \$12.4 million. The lease financing obligation balance at the end of the lease term will be approximately \$32.6 million which reflects the net book value of the buildings to be relinquished to the lessor.

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Rent expense associated with the operating leases was \$14.5 million, \$13.7 million and \$10.6 million for the years ended December 31, 2009, 2008 and 2007, respectively.

The Company also has \$114.8 million of commitments at December 31, 2009 related to streaming content license agreements that have been executed but for which the streaming content does not meet asset recognition criteria.

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 the Company 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 December 17, 2009, plaintiffs Jane Doe, Nelly Valdez-Marquez, Anthony Sinopoli, and Paul Navarro filed a purported class action lawsuit against the Company in the United District Court, District of Northern California, Case No. C09-05903 on behalf of (1) a nationwide class consisting of "all Netflix subscribers that rented a Netflix movie and also rated a movie on the Netflix website during the period of October 1998 through December 2005, residing in the United States," (2) a subclass of California residents and (3) an injunctive class consisting of "all Netflix subscribers since 2006, residing in the United States." Plaintiffs allege that Netflix breached the privacy rights of its subscribers by, among other things, releasing certain data in connection with the "Netflix Prize" contest. Plaintiffs have brought this action pursuant to the Video Privacy Protection Act, 18 U.S.C. § 2710; California Consumers Legal Remedies Act, Civil Code § 1750 ("CLRA"); California Customer Records Act, Civil Code § 1798.80; California's Unfair Competition Law, Bus. & Prof'l Code §§ 17200, 17500 ("UCL"); and common law actions for Unjust Enrichment and Public Disclosure of Private Facts. Plaintiffs are seeking declaratory relief; statutory, actual and punitive damages; disgorgement of profits; and injunctive relief.

On September 25, 2009, Alcatel-Lucent USA Inc. filed a complaint for patent infringement against the Company in the United States District Court for the Eastern District of Texas, captioned *Alcatel-Lucent USA Inc. v. Amazon.com Inc., et. al*, Civil Action No. 6:09-cv-422. The complaint alleges that the Company infringed U.S. Patents Nos. 5,649,131 entitled "Communications Protocol" issued on July 15, 1997, 5,623,656 entitled "Script Based Data Communication System and Method Utilizing State Memory" issued on April 22, 1997 and 5,404,507 entitled "Apparatus and Method for Finding Records in a Database by Formulating a Query Using Equivalent Terms Which Correspond to Terms in the Input Query" issued April 4, 1995. The complaint seeks unspecified compensatory and enhanced damages, interest, costs and fees, and seeks to permanently enjoin the Company from infringing the patents in the future.

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. On July 14, 2009, the Company filed a demurrer to the first amended complaint. On August 21, 2009, the Court granted the Company's demurrer and granted leave to amend. Plaintiff filed a second amended complaint on September 11, 2009. On November 30, 2009, plaintiff filed a voluntary request for dismissal. As set forth in the declaration of plaintiff's counsel in support of dismissal, neither plaintiff nor his counsel has received or will receive any compensation or other consideration from Netflix or any other entity as a result of the voluntary dismissal of this action. On December 18, 2009, the Court dismissed the action.

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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 DVDs 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 1, 2009, the federal Court entered an order granting defendants' motion to dismiss the two federal cases filed on behalf of Blockbuster subscribers. Plaintiffs have until March 1, 2010 to file an amended complaint. The lawsuit filed in Superior Court of the State of California, San Mateo County has been coordinated with the cases pending in Santa Clara County.

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 September 30, 2009, the Company filed a motion for summary judgment of invalidity. The Court has not set a hearing date for the motion.

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 August 14, 2009, the Company filed a motion for summary judgment of non-infringement. A hearing on the motion was held on November 17, 2009. On December 1, 2009, the Court granted the Company's motion for summary judgment of non-infringement. On February 10, 2009, plaintiff appealed the summary judgement ruling.

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.

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

6. Guarantees—Intellectual Property Indemnification Obligations

In the ordinary course of business, the Company has entered 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.

The Company's obligations under these agreements may be limited in terms of time 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 financial statements with respect to these indemnification guarantees.

7. Stockholders' Equity

On August 6, 2009, the Company announced that its Board of Directors authorized a stock repurchase plan that enables the Company to repurchase up to \$300 million of its common stock through the end of 2010. 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. Under this program, the Company repurchased 3,197,459 shares of common stock at an average price of approximately \$47 per share for an aggregate amount of \$149 million. Of this amount, 1,480,000 shares repurchased were initially held as treasury stock and accordingly repurchases were accounted for at cost under the treasury method. These shares were subsequently retired. The remaining 1,717,459 shares repurchased have also been retired. Subsequent to December 31, 2009, the Company repurchased 1,010,000 shares of common stock at an average price of approximately \$62 for an aggregate amount of \$62.4 million. 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.

On January 26, 2009, the Company announced that its Board of Directors authorized a stock repurchase program for 2009. Under this program, the Company repurchased 4,173,855 shares of common stock at an average price of approximately \$42 per share for an aggregate amount of approximately \$175 million. Shares repurchased under this program were initially held as treasury stock and accordingly repurchases were accounted for at cost under the treasury method. These shares were subsequently retired. This program terminated on August 6, 2009.

On March 5, 2008, the Company's Board of Directors authorized a stock repurchase program allowing the Company to repurchase up to \$150 million of its common stock through the end of 2008. Under this program, the Company repurchased 3,491,084 shares of common stock at an average price of approximately \$29 per share for an aggregate amount of \$100 million. Shares repurchased under this program were initially held as treasury stock and accordingly repurchases were accounted for under the treasury method. These shares have been subsequently retired.

On January 31, 2008, the Company's Board of Directors authorized a stock repurchase program allowing the Company to repurchase up to \$100 million of its common stock through the end of 2008. Under this program, the Company repurchased 3,847,062 shares of common stock at an average price of approximately \$26 per share for an aggregate amount of \$100 million. Shares repurchased under this program have been retired.

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

On April 17, 2007, the Company's Board of Directors authorized a stock repurchase program allowing the Company to repurchase up to \$100.0 million of its common stock through the end of 2007. During the year ended December 31, 2007, the Company repurchased 4,733,788 shares of common stock at an average price of approximately \$21 per share for an aggregate amount of \$100 million. Shares repurchased under this program have been retired.

In the fourth quarter of 2009, the Company determined that all shares held in treasury stock would be retired. Accordingly, these constructively retired shares were deducted from common stock for par value and from additional paid in capital for the excess over par value, until additional paid in capital was exhausted and then from retained earnings.

There were no unsettled share repurchases as of December 31, 2009.

Preferred Stock

The Company has authorized 10,000,000 shares of undesignated preferred stock with par value of \$0.001 per share. None of the preferred shares were issued and outstanding at December 31, 2009 and 2008.

Voting Rights

The holders of each share of common stock shall be entitled to one vote per share on all matters to be voted upon by the Company's stockholders.

Employee Stock Purchase Plan

In February 2002, the Company adopted the 2002 Employee Stock Purchase Plan ("ESPP"), which reserved a total of 1,166,666 shares of common stock for issuance. The 2002 Employee Stock Purchase Plan also provides for annual increases in the number of shares available for issuance on the first day of each year, beginning with 2003, equal to the lesser of:

- 2% of the outstanding shares of the common stock on the first day of the applicable year;
- 666,666 shares; and
- such other amount as the Company's Board of Directors may determine.

Under the Company's ESPP, employees may purchase common stock of the Company through accumulated payroll deductions. The purchase price of the common stock acquired by the employees participating in the ESPP is 85% of the closing price on either the first day of the offering period or the last day of the purchase period, whichever is lower. Through May 1, 2006, offering periods were twenty-four months, and the purchase periods were six months. Therefore, each offering period included four six-month purchase periods, and the purchase price for each six-month period was determined by comparing the closing prices on the first day of the offering period and the last day of the applicable purchase period. In this manner, the look-back for determining the purchase price was up to twenty-four months. However, effective May 1, 2006, the ESPP was amended so that offering and purchase periods take place concurrently in consecutive six month increments. Under the amended ESPP, therefore, the look-back for determining the purchase price is six months. Employees may invest up to 15% of their gross compensation through payroll deductions. In no event shall an employee be permitted to purchase more than 8,334 shares of common stock during any six-month purchase period. During the years ended December 31, 2009, 2008 and 2007, employees purchased approximately 224,799, 231,068 and 205,416 shares at average prices of \$25.65, \$21.00 and \$18.43 per share, respectively. Cash received from purchases

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

under the ESPP for the years ended December 31, 2009, 2008 and 2007 was \$5.8 million, \$4.9 million and \$3.8 million, respectively. As of December 31, 2009, 2,841,730 shares were available for future issuance under the 2002 Employee Stock Purchase Plan.

Stock Option Plans

In December 1997, the Company adopted the 1997 Stock Plan, which was amended and restated in October 2001. The 1997 Stock Plan provides for the issuance of stock purchase rights, incentive stock options or non-statutory stock options. In November 2007, the 1997 Stock Plan expired and, as a result, there were no shares reserved for future issuance upon the exercise of outstanding options under the 1997 Stock Plan as of December 31, 2009.

In February 2002, the Company adopted the 2002 Stock Plan, which was amended and restated in May 2006. The 2002 Stock Plan provides for the grant of incentive stock options to employees and for the grant of non-statutory stock options and stock purchase rights to employees, directors and consultants. As of December 31, 2009, 2,591,267 shares were reserved for future grant under the 2002 Stock Plan.

A summary of the activities related to the Company's options is as follows:

	Shares Available for Grant	Options Outstanding		Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value (in Thousands)
		Number of Shares	Weighted-Average Exercise Price		
Balances as of December 31, 2006	5,605,184	5,453,453	14.23		
Granted	(1,103,522)	1,103,522	21.72		
Exercised	—	(828,824)	7.03		
Canceled	108,513	(108,513)	29.46		
Expired	(615,309)	—	—		
Balances as of December 31, 2007	3,994,866	5,619,638	16.47		
Granted	(856,733)	856,733	27.98		
Exercised	—	(1,056,641)	13.27		
Canceled	54,714	(54,714)	28.88		
Expired	(332)	—	—		
Balances as of December 31, 2008	3,192,515	5,365,016	18.81		
Granted	(601,665)	601,665	41.65		
Exercised	—	(1,724,110)	17.11		
Canceled	1,133	(1,133)	12.69		
Expired	(716)	—	—		
Balances as of December 31, 2009	<u>2,591,267</u>	<u>4,241,438</u>	22.74	6.16	137,308
Vested and exercisable at December 31, 2009		4,241,438	22.74	6.16	137,308

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 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

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

exercised their options on December 31, 2009. This amount changes based on the fair market value of the Company's common stock. Total intrinsic value of options exercised for the years ended December 31, 2009, 2008 and 2007 was \$44.7 million, \$18.9 million and \$13.7 million, respectively.

Cash received from option exercises for the years ended December 31, 2009, 2008 and 2007 was \$29.5 million, \$14.0 million and \$5.8 million, respectively.

The following table summarizes information on outstanding and exercisable options as of December 31, 2009:

Options Outstanding and Exercisable			
Exercise Price	Number of Options	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price
\$1.50	581,057	1.86	\$ 1.50
\$ 3.00 – \$11.92	427,176	4.90	10.79
\$12.38 – \$19.48	463,604	5.69	16.61
\$20.02 – \$22.81	461,016	6.97	21.56
\$22.83 – \$26.29	462,788	7.19	24.67
\$26.35 – \$27.24	423,664	6.62	26.85
\$27.25 – \$30.84	505,602	7.07	29.19
\$30.89 – \$36.51	457,751	6.59	33.65
\$36.95 – \$53.80	421,536	9.49	43.23
\$58.23	37,244	9.92	58.23
	<u>4,241,438</u>		

Stock-Based Compensation

Vested stock options granted before June 30, 2004 can be exercised up to three months following termination of employment. Vested stock options granted after June 30, 2004 and before January 1, 2007 can be exercised up to one year following termination of employment. For newly granted options, beginning in January 2007, employee stock options will remain exercisable for the full ten year contractual term regardless of employment status. In conjunction with this change, the Company changed its method of calculating the fair value of new stock-based compensation awards granted under its stock option plans from a Black-Scholes model to a lattice-binomial model. The Company believes that the lattice-binomial model is more capable of incorporating the features of the Company's employee stock options than closed-form models such as the Black-Scholes model. The lattice-binomial model has been applied prospectively to options granted in 2007. The following table summarizes the assumptions used to value option grants using a lattice-binomial model:

	Year Ended December 31,		
	2009	2008	2007
Dividend yield	0%	0%	0%
Expected volatility	46% – 56%	50% – 60%	43% – 52%
Risk-free interest rate	2.60% – 3.62%	3.68% – 4.00%	4.40% – 4.92%
Suboptimal exercise factor	1.73 – 2.01	1.76 – 2.04	1.77 – 2.09

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The fair value of shares issued under the ESPP is estimated using the Black-Scholes option pricing model. The following table summarizes the assumptions used to value shares issued under the ESPP:

	Year Ended December 31,		
	2009	2008	2007
Dividend yield	0%	0%	0%
Expected volatility	42% – 55%	55% – 60%	38% – 47%
Risk-free interest rate	0.16% – 0.35%	1.23% – 1.58%	4.16% – 5.07%
Expected life (in years)	0.5	0.5	0.5

The Company estimates expected volatility based on a blend of historical volatility of the Company's common stock and implied volatility of tradable forward call options to purchase shares of its common stock. The Company believes that implied volatility of publicly traded options in its common stock is expected to be more reflective of market conditions and, therefore, can reasonably be expected to be a better indicator of expected volatility than historical volatility of its common stock.

The Company bifurcates its option grants into two employee groupings (executive and non-executive) based on exercise behavior and considers several factors in determining the estimate of expected term for each group, including the historical option exercise behavior, the terms and vesting periods of the options granted. In the year ended December 31, 2009, the Company used a suboptimal exercise factor ranging from 1.87 to 2.01 for executives and 1.73 to 1.76 for non-executives, which resulted in a calculated expected term of the option grants of 4 years for executives and 3 years for non-executives. In the year ended December 31, 2008, the Company used a suboptimal exercise factor ranging from 1.90 to 2.04 for executives and 1.76 to 1.77 for non-executives, which resulted in a calculated expected term of the option grants of 4 years for executives and 3 years for non-executives. In the year ended December 31, 2007, the Company used a suboptimal exercise factor ranging from 2.06 to 2.09 for executives and 1.77 to 1.78 for non-executives, which resulted in a calculated expected term of the option grants of 5 years for executives and 4 years for non-executives.

In valuing shares issued under the Company's employee stock options, the Company bases the risk-free interest rate on U.S. Treasury zero-coupon issues with terms similar to the contractual term of the options. In valuing shares issued under the Company's ESPP, the Company bases the risk-free interest rate on U.S. Treasury zero-coupon issues with terms similar to the expected term of the shares. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company does not use a post-vesting termination rate as options are fully vested upon grant date. The weighted-average fair value of employee stock options granted during 2009, 2008 and 2007 was \$17.79, \$12.25 and \$9.68 per share, respectively. The weighted-average fair value of shares granted under the employee stock purchase plan during 2009, 2008 and 2007 was \$14.44, \$8.28 and \$6.70 per share, respectively.

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes stock-based compensation expense, net of tax, related to stock option plans and employee stock purchases which was allocated as follows:

	Year Ended December 31,		
	2009	2008	2007
	(in thousands)		
Fulfillment expenses	\$ 380	\$ 466	\$ 427
Technology and development	4,453	3,890	3,695
Marketing	1,786	1,886	2,160
General and administrative	5,999	6,022	5,694
Stock-based compensation expense before income taxes	12,618	12,264	11,976
Income tax benefit	(5,017)	(4,585)	(4,760)
Total stock-based compensation after income taxes	<u>\$ 7,601</u>	<u>\$ 7,679</u>	<u>\$ 7,216</u>

8. Income Taxes

The components of provision for income taxes for all periods presented were as follows:

	Year Ended December 31,		
	2009	2008	2007
	(in thousands)		
Current tax provision:			
Federal	\$55,104	\$41,883	\$38,002
State	14,900	12,063	7,208
Total current	70,004	53,946	45,210
Deferred tax provision:			
Federal	6,568	(3,680)	(645)
State	(240)	(1,792)	(248)
Total deferred	6,328	(5,472)	(893)
Provision for income taxes	<u>\$76,332</u>	<u>\$48,474</u>	<u>\$44,317</u>

A reconciliation of the provision for income taxes, with the amount computed by applying the statutory federal income tax rate to income before provision for income taxes for the three years ended December 31, 2009 is as follows:

	Year Ended December 31,		
	2009	2008	2007
	(in thousands)		
Expected tax expense at U.S. federal statutory rate of 35%	\$67,267	\$46,060	\$39,025
State income taxes, net of Federal income tax effect	10,350	5,155	5,818
Valuation allowance	—	—	(80)
R&D tax credit	(1,600)	(3,321)	—
Stock-based compensation	(89)	108	(248)
Other	404	472	(198)
Provision for income taxes	<u>\$76,332</u>	<u>\$48,474</u>	<u>\$44,317</u>

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The tax effects of temporary differences and tax carryforwards that give rise to significant portions of the deferred tax assets are presented below (in thousands):

	Year Ended December 31,	
	2009	2008
Deferred tax assets:		
Accruals and reserves	\$ 1,144	\$ 1,378
Depreciation	(3,259)	2,947
Stock-based compensation	16,824	17,440
R&D credits	3,178	2,636
Other	1,166	1,103
Deferred tax assets	<u>\$ 19,053</u>	<u>\$ 25,504</u>

In evaluating its ability to realize the deferred tax assets, the Company considered all available positive and negative evidence, including its past operating results and the forecast of future market growth, forecasted earnings, future taxable income, and prudent and feasible tax planning strategies. As of December 31, 2009 and 2008, it was considered more likely than not that substantially all deferred tax assets would be realized, and no valuation allowance was recorded.

The Company classifies gross interest and penalties and unrecognized tax benefits that are not expected to result in payment or receipt of cash within one year as non-current liabilities in the consolidated balance sheet. As of December 31, 2009, the total amount of gross unrecognized tax benefits was \$13.2 million, of which \$10.7 million, if recognized, would favorably impact the Company's effective tax rate. As of December 31, 2008, the Company had \$10.9 million gross unrecognized benefits, of which \$8.7 million, if recognized, would favorably impact the Company's effective tax rate. The Company's unrecognized tax benefits are classified as other non-current liabilities in the Consolidated Balance Sheet. The aggregate changes in the Company's total gross amount of unrecognized tax benefits are summarized as follows (in thousands):

Balance as of December 31, 2007	\$ —
Increases related to tax positions taken during the current period	10,859
Balance as of December 31, 2008	\$10,859
Increases related to tax positions taken during the current period	2,385
Balance as of December 31, 2009	<u>\$13,244</u>

The Company includes interest and penalties related to unrecognized tax benefits within the provision for income taxes. As of the date of adoption, the Company had no accrued gross interest and penalties relating to unrecognized tax benefits. As of December 31, 2009, the total amount of gross interest and penalties accrued was \$0.9 million, which is classified as other non-current liabilities in the consolidated balance sheet.

The Company files income tax returns in the U.S. federal jurisdiction and all of the states where income tax is imposed. The Company is subject to US federal income tax examinations by the IRS for years after 2000 and state income tax examination by state taxing authorities for years after 1999. The Company does not believe it is reasonably possible that its unrecognized tax benefits would significantly change over the next twelve months.

NETFLIX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

9. Employee Benefit Plan

The Company maintains a 401(k) savings plan covering substantially all of its employees. Eligible employees may contribute up to 60% of their annual salary through payroll deductions, but not more than the statutory limits set by the Internal Revenue Service. The Company matches employee contributions at the discretion of the Board of Directors. During 2009, 2008 and 2007, the Company's matching contributions totaled \$2.3 million, \$2.0 million and \$1.5 million, respectively.

10. Related Party Transaction

In April 2007, Netflix entered into a license agreement with a company in which an employee had a significant ownership interest at that time. Pursuant to this agreement, Netflix recorded a charge of \$2.5 million in technology and development expense. In January 2008, in conjunction with various arrangements Netflix paid a total of \$6.0 million to this same company, of which \$5.7 million was accounted for as an investment under the cost method. In conjunction with these arrangements, the employee with the significant ownership interest in the same company terminated his employment with Netflix. In the fourth quarter of 2009, Netflix sold its investment in this company to an unrelated party and realized a pre-tax gain of \$1.8 million.

11. Selected Quarterly Financial Data (Unaudited)

	<u>December 31</u>	<u>September 30</u>	<u>June 30</u>	<u>March 31</u>
2009				
Total revenues	\$ 444,542	423,120	408,509	394,098
Gross profit	169,056	147,846	139,266	134,830
Net income	30,913	30,141	32,443	22,363
Net income per share:				
Basic	0.58	0.54	0.56	0.38
Diluted	0.56	0.52	0.54	0.37
2008				
Total revenues	\$ 359,595	\$ 341,269	\$337,614	\$326,183
Gross profit	126,749	116,773	107,527	103,378
Net income	22,732	20,371	26,579	13,344
Net income per share:				
Basic	0.39	0.34	0.43	0.21
Diluted	0.38	0.33	0.42	0.21

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Netflix, Inc.

Dated: February 19, 2010

By: /s/ R EED H ASTINGS
Reed Hastings
Chief Executive Officer
(principal executive officer)

Dated: February 19, 2010

By: /s/ B ARRY M C C ARTHY
Barry McCarthy
Chief Financial Officer
(principal financial and accounting officer)

POWER OF ATTORNEY

KNOWN ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Reed Hastings and Barry McCarthy, and each of them, as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place, and stead, in any and all capacities, to sign any and all amendments to this Report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming that all said attorneys-in-fact and agents, or any of them or their or his substitute or substituted, may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities and Exchange Act of 1934, this Annual Report on Form 10-K has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ R EED H ASTINGS</u> Reed Hastings	President, Chief Executive Officer and Director (principal executive officer)	February 19, 2010
<u>/s/ B ARRY M C C ARTHY</u> Barry McCarthy	Chief Financial Officer (principal financial and accounting officer)	February 19, 2010
<u>/s/ R ICHARD B ARTON</u> Richard Barton	Director	February 19, 2010
<u>/s/ T IMOTHY M. H ALEY</u> Timothy M. Haley	Director	February 19, 2010
<u>/s/ J AY C. H OAG</u> Jay C. Hoag	Director	February 19, 2010
<u>/s/ G REG S TANGER</u> Greg Stanger	Director	February 19, 2010
<u>/s/ M ICHAEL N. S CHUH</u> Michael N. Schuh	Director	February 19, 2010
<u>/s/ C HARLES H. G IANCARLO</u> Charles H. Giancarlo	Director	February 19, 2010
<u>/s/ A. G EORGE B ATTLE</u> A. George Battle	Director	February 19, 2010

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<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Incorporated by Reference</u>				<u>Filed Herewith</u>
		<u>Form</u>	<u>File No.</u>	<u>Exhibit</u>	<u>Filing Date</u>	
3.1	Amended and Restated Certificate of Incorporation	10-Q	000-49802	3.1	August 2, 2004	
3.2	Amended and Restated Bylaws	S-1/A	333-83878	3.4	April 16, 2002	
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	
4.2	Indenture, dated November 6, 2009, among Netflix, Inc., the guarantors from time to time party thereto and Wells Fargo Bank, National Association, relating to the 8.50% Senior Notes due 2017.	8-K	000-49802	4.1	November 9, 2009	
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	
23.1	Consent of Independent Registered Public Accounting Firm					X
24	Power of Attorney (see signature page)					
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

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<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Incorporated by Reference</u>			<u>Filed Herewith</u>
		<u>Form</u>	<u>File No.</u>	<u>Exhibit</u>	
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 Annual Report on Form 10-K for the year ended December 31, 2009 filed with the SEC on February 19, 2010, formatted in XBRL includes: (i) Consolidated Balance Sheets as of December 31, 2009 and 2008, (ii) Consolidated Statements of Operations for the Years Ended December 31, 2009, 2008 and 2007, (iii) Consolidated Statements of Stockholders' Equity and Comprehensive Income for the Years Ended December 31, 2009, 2008 and 2007, (iv) Consolidated Statements of Cash Flows for the Years Ended December 31, 2009, 2008 and 2007 and (v) the Notes to 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

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Netflix, Inc.:

We consent to the incorporation by reference in the registration statements (Nos. 333-89024, 333-104250, 333-113198, 333-123501, 333-136403, 333-145147, and 333-160946) on Form S-8 of Netflix, Inc. of our report dated February 19, 2010, with respect to the consolidated balance sheets of Netflix, Inc. and subsidiary as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2009, and the effectiveness of internal control over financial reporting as of December 31, 2009, which report appears in the December 31, 2009 annual report on Form 10-K of Netflix, Inc.

/s/ KPMG LLP
Mountain View, California
February 19, 2010

