

NETFLIX INC  
Form 10-Q  
July 25, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013  
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) 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)	77-0467272 (I.R.S. Employer Identification Number)
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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐  
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐  
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	(Do not check if a smaller reporting company) Smaller reporting company	<input type="checkbox"/>

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

As of June 30, 2013, there were 58,922,493 shares of the registrant's common stock, par value \$0.001, outstanding.



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## NETFLIX, INC.

## Consolidated Statements of Operations

(unaudited)

(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Revenues	\$1,069,372	\$889,163	\$2,093,333	\$1,758,954
Cost of revenues	753,525	643,428	1,480,388	1,267,361
Marketing	121,760	113,964	250,935	243,892
Technology and development	93,126	81,547	185,101	164,348
General and administrative	43,844	34,070	87,970	69,134
Operating income	57,117	16,154	88,939	14,219
Other income (expense):				
Interest expense	(7,528)	(5,006)	(14,268)	(9,980)
Interest and other income (expense)	(2,940)	(493)	(1,963)	(609)
Loss on extinguishment of debt	—	—	(25,129)	—
Income before income taxes	46,649	10,655	47,579	3,630
Provision for income taxes	17,178	4,491	15,419	2,050
Net income	\$29,471	\$6,164	\$32,160	\$1,580
Earnings per share:				
Basic	\$0.51	\$0.11	\$0.56	\$0.03
Diluted	\$0.49	\$0.11	\$0.53	\$0.03
Weighted average common shares outstanding:				
Basic	58,192	55,526	57,089	55,491
Diluted	60,590	58,809	60,369	58,878

See accompanying notes to the consolidated financial statements.

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## NETFLIX, INC.

## Consolidated Statements of Comprehensive Income

(unaudited)

(in thousands)

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Net income	\$29,471	\$6,164	\$32,160	\$1,580
Other comprehensive income (loss):				
Foreign currency translation adjustments	30	(767	) (2,259	) 44
Change in unrealized gains (losses) on available-for-sale securities, net of tax of \$(1,239), \$95, \$(1,451), and \$133, respectively	(1,985	) 151	(2,324	) 211
Total other comprehensive income (loss)	(1,955	) (616	) (4,583	) 255
Comprehensive income	\$27,516	\$5,548	\$27,577	\$1,835

See accompanying notes to the consolidated financial statements.

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## NETFLIX, INC.

## Consolidated Statements of Cash Flows

(unaudited)

(in thousands)

	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2013	2012	2013	2012
Cash flows from operating activities:				
Net income	\$29,471	\$6,164	\$32,160	\$1,580
Adjustments to reconcile net income to net cash provided by operating activities:				
Additions to streaming content library	(593,454 )	(374,252 )	(1,185,395 )	(1,139,145 )
Change in streaming content liabilities	7,284	(39,947 )	16,984	357,606
Amortization of streaming content library	510,250	375,997	995,990	715,733
Amortization of DVD content library	17,709	16,304	35,946	36,350
Depreciation and amortization of property, equipment and intangibles	12,026	11,047	24,077	22,378
Stock-based compensation expense	17,955	18,450	35,701	37,782
Excess tax benefits from stock-based compensation	(20,368 )	(307 )	(31,983 )	(4,062 )
Other non-cash items	1,188	(1,579 )	2,938	(3,098 )
Loss on extinguishment of debt	—	—	25,129	—
Deferred taxes	(2,040 )	—	(8,788 )	(10,843 )
Changes in operating assets and liabilities:				
Prepaid content	25,190	4,503	27,865	7,497
Other current assets	8,572	(8,077 )	170	3,664
Accounts payable	(5,138 )	316	11,881	(1,440 )
Accrued expenses	10,494	6,854	6,362	8,637
Deferred revenue	7,693	2,188	17,099	3,994
Other non-current assets and liabilities	7,111	1,746	15,557	1,883
Net cash provided by operating activities	33,943	19,407	21,693	38,516
Cash flows from investing activities:				
Acquisitions of DVD content library	(14,023 )	(8,012 )	(35,216 )	(21,540 )
Purchases of property and equipment	(8,088 )	(3,359 )	(20,206 )	(8,125 )
Other assets	1,087	3,132	5,137	4,466
Purchases of short-term investments	(146,050 )	(63,303 )	(381,673 )	(362,770 )
Proceeds from sale of short-term investments	33,979	48,173	115,207	220,508
Proceeds from maturities of short-term investments	5,410	12,715	9,830	20,990
Net cash used in investing activities	(127,685 )	(10,654 )	(306,921 )	(146,471 )
Cash flows from financing activities:				
Proceeds from issuance of common stock	28,846	524	67,992	1,748
Proceeds from issuance of debt	—	—	500,000	—
Issuance costs	—	(371 )	(9,414 )	(759 )
Redemption of debt	—	—	(219,362 )	—
Excess tax benefits from stock-based compensation	20,368	307	31,983	4,062
Principal payments of lease financing obligations	(255 )	(577 )	(658 )	(1,136 )
Net cash provided by (used in) financing activities	48,959	(117 )	370,541	3,915
Effect of exchange rate changes on cash and cash equivalents	(2,590 )	(2,377 )	(4,926 )	(1,762 )
Net (decrease) increase in cash and cash equivalents	(47,373 )	6,259	80,387	(105,802 )
Cash and cash equivalents, beginning of period	418,051	395,992	290,291	508,053

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Cash and cash equivalents, end of period	\$370,678	\$402,251	\$370,678	\$402,251
See accompanying notes to the consolidated financial statements.				

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## NETFLIX, INC.

## Consolidated Balance Sheets

(in thousands, except share and par value data)

	As of June 30, 2013 (unaudited)	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	\$370,678	\$290,291
Short-term investments	709,432	457,787
Current content library, net	1,363,609	1,368,162
Prepaid content	32,064	59,929
Other current assets	94,539	64,622
Total current assets	2,570,322	2,240,791
Non-current content library, net	1,682,202	1,506,008
Property and equipment, net	127,931	131,681
Other non-current assets	100,296	89,410
Total assets	\$4,480,751	\$3,967,890
Liabilities and Stockholders' Equity		
Current liabilities:		
Current content liabilities	\$1,321,217	\$1,366,847
Accounts payable	103,441	86,468
Accrued expenses	59,035	53,139
Deferred revenue	186,571	169,472
Total current liabilities	1,670,264	1,675,926
Non-current content liabilities	1,124,249	1,076,622
Long-term debt	500,000	200,000
Long-term debt due to related party	—	200,000
Other non-current liabilities	80,616	70,669
Total liabilities	3,375,129	3,223,217
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Common stock, \$0.001 par value; 160,000,000 shares authorized at June 30, 2013 and December 31, 2012; 58,922,493 and 55,587,167 issued and outstanding at June 30, 2013 and December 31, 2012, respectively	59	56
Additional paid-in capital	634,985	301,616
Accumulated other comprehensive (loss) income	(1,664	) 2,919
Retained earnings	472,242	440,082
Total stockholders' equity	1,105,622	744,673
Total liabilities and stockholders' equity	\$4,480,751	\$3,967,890
See accompanying notes to the consolidated financial statements.		



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NETFLIX, INC.

Notes to Consolidated Financial Statements  
(unaudited)

1. Basis of Presentation and Summary of Significant Accounting Policies

The accompanying consolidated interim financial statements of Netflix, Inc. and its wholly owned subsidiaries (the "Company") have been prepared in conformity with accounting principles generally accepted in the United States ("U.S.") and are consistent in all material respects with those applied in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 filed with the Securities and Exchange Commission (the "SEC") on February 1, 2013. The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires management to make estimates and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant items subject to such estimates and assumptions include the amortization policy for the streaming content library; the recognition and measurement of income tax assets and liabilities; and the valuation of stock-based compensation. 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.

The interim financial information is unaudited, but reflects all normal recurring adjustments that are, in the opinion of management, necessary to fairly present the information set forth herein. The interim financial statements should be read in conjunction with the audited financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. Interim results are not necessarily indicative of the results for a full year.

The Company is organized into three operating segments: Domestic streaming, International streaming and Domestic DVD. The Company's revenues are derived from monthly membership fees.

There have been no material changes in the Company's significant accounting policies as compared to the significant accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

2. Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation in the Consolidated Statements of Operations. Payroll and related expenses of \$4.3 million and \$10.2 million for the three and six months ended June 30, 2012, respectively, associated with corporate marketing personnel, previously classified in "Marketing" on the Consolidated Statements of Operations, have been reclassified as "General and administrative".

Historically these costs were substantially recorded in the Domestic streaming segment and impacted segment contribution profit. Management and the Company's chief operating decision maker consider such employee costs to be global corporate costs rather than direct marketing costs and as such are not indicative of any given segment's performance. Accordingly, such costs have been reclassified as "General and administrative" expenses which are not a component of contribution profit. There was no impact to operating income in any period.

In addition, certain prior period amounts in the Consolidated Statements of Cash Flows have been revised to correctly present changes in accounts payable related to purchases of fixed assets. For the three and six months ended June 30, 2012, a \$0.3 million increase in accounts payable has been reclassified from purchases of fixed assets in "Net cash used in investing activities" to changes in accounts payable in "Net cash provided by operating activities". There was no impact to the Consolidated Statements of Operations or Consolidated Balance Sheets.

3. Earnings Per Share

Basic earnings per share is computed using the weighted-average number of outstanding shares of common stock during the period. Diluted earnings 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 of shares issuable upon the assumed conversion of the Company's Senior Convertible Notes (prior to the conversion of such notes) and incremental shares issuable upon the assumed exercise of stock options. The computation of earnings per share is as follows:



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	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
	(in thousands, except per share data)			
Basic earnings per share:				
Net income	\$29,471	\$6,164	\$32,160	\$1,580
Shares used in computation:				
Weighted-average common shares outstanding	58,192	55,526	57,089	55,491
Basic earnings per share	\$0.51	\$0.11	\$0.56	\$0.03
Diluted earnings per share:				
Net income	\$29,471	\$6,164	\$32,160	\$1,580
Senior Convertible Notes interest expense, net of tax	—	48	49	98
Numerator for diluted earnings per share	\$29,471	\$6,212	\$32,209	\$1,678
Shares used in computation:				
Weighted-average common shares outstanding	58,192	55,526	57,089	55,491
Senior Convertible Notes shares	564	2,331	1,442	2,331
Employee stock options	1,834	952	1,838	1,056
Weighted-average number of shares	60,590	58,809	60,369	58,878
Diluted earnings per share	\$0.49	\$0.11	\$0.53	\$0.03

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

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
	(in thousands)			
Employee stock options	318	1,184	384	908

#### 4. 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. The following table summarizes, by major security type, the Company's assets that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy:

	As of June 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Cash	\$368,527	\$—	\$—	\$368,527
Level 1 securities:				
Money market funds	7,354	—	—	7,354
Level 2 securities:				
Corporate debt securities	332,174	918	(1,714)	331,378
Government and agency securities	181,638	180	(156)	181,662

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Asset and mortgage-backed securities	196,913	276	(797	)	196,392
Total (1)	\$1,086,606	\$1,374	\$(2,667	)	\$1,085,313

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	As of December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Cash	\$284,661	\$—	\$—	\$284,661
Level 1 securities:				
Money market funds	10,500	—	—	10,500
Level 2 securities:				
Corporate debt securities	150,322	1,605	(32 )	151,895
Government and agency securities	166,643	285	—	166,928
Asset and mortgage-backed securities	138,340	750	(125 )	138,965
Total (2)	\$750,466	\$2,640	\$(157 )	\$752,949

Includes \$370.7 million that is included in cash and cash equivalents, \$709.4 million included in short-term (1) investments and \$5.2 million of restricted cash that is included in other non-current assets related to workers compensation deposits.

Includes \$290.3 million that is included in cash and cash equivalents, \$457.8 million included in short-term (2) investments and \$4.8 million of restricted cash that is included in other non-current assets related to workers compensation deposits.

Fair value is a market-based measurement that is determined based on the assumptions that market participants would use in pricing an asset or liability. 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 fair value of available-for-sale securities and cash equivalents included in the Level 1 category is based on quoted prices that are readily and regularly available in an active market. The fair value of available-for-sale securities included in the Level 2 category is based on observable inputs, such as quoted prices for similar assets at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, either directly or indirectly. These values were obtained from an independent pricing service and were evaluated using pricing models that vary by asset class and may incorporate available trade, bid and other market information and price quotes from well-established independent pricing vendors and broker-dealers. The Company's procedures include controls to ensure that appropriate fair values are recorded, such as comparing prices obtained from multiple independent sources. See Note 6 to the consolidated financial statements for further information regarding the fair value of the Company's debt instruments.

Because the Company does not intend to sell the investments that are in an unrealized loss position and it is not likely that the Company will be required to sell any investments before recovery of their amortized cost basis, the Company does not consider those investments with an unrealized loss to be other-than-temporarily impaired at June 30, 2013.

There were no investments in an unrealized loss position for longer than 12 months as of June 30, 2013 or December 31, 2012, respectively. There were no material other-than-temporary impairments or credit losses related to available-for-sale securities in the three and six months ended June 30, 2013 and 2012. In addition, there were no material gross realized gains or losses in the three and six months ended June 30, 2013 and 2012.

The estimated fair value of short-term investments by contractual maturity as of June 30, 2013 is as follows:

	(in thousands)
Due within one year	\$138,342
Due after one year and through 5 years	524,210
Due after 5 years and through 10 years	1,755
Due after 10 years	45,125
Total short-term investments	\$709,432

5. Balance Sheet Components

Content Library

Content library consisted of the following:

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	As of June 30, 2013 (in thousands)	December 31, 2012
Total content library, gross	\$5,519,593	\$5,001,524
Accumulated amortization	(2,473,782)	(2,127,354)
Total content library, net	3,045,811	2,874,170
Current content library, net	1,363,609	1,368,162
Non-current content library, net	\$1,682,202	\$1,506,008

## Property and Equipment, Net

Property and equipment and accumulated depreciation consisted of the following:

		As of June 30, 2013 (in thousands)	December 31, 2012
Computer equipment	3 years	\$92,922	\$84,193
Operations and other equipment	5 years	99,153	100,207
Software	3 years	39,089	39,073
Furniture and fixtures	3 years	19,073	18,208
Building	30 years	40,681	40,681
Leasehold improvements	Over life of lease	46,839	45,393
Capital work-in-progress		9,947	8,282
Property and equipment, gross		347,704	336,037
Less: Accumulated depreciation		(219,773)	(204,356)
Property and equipment, net		\$127,931	\$131,681

## 6. Long-term Debt

## Senior Convertible Notes

In November 2011, the Company issued \$200.0 million aggregate principal amount of zero coupon Senior Convertible Notes due on December 1, 2018 (the "Convertible Notes") in a private placement offering to TCV VII, L.P., TCV VII(A), L.P. and TCV Member Fund, L.P. A general partner of these funds also serves on the Company's Board of Directors, and as such, the issuance of the notes was considered a related party transaction. At any time following May 28, 2012, the Company may have elected to cause the conversion of the Convertible Notes into shares of the Company's common stock when specified conditions are satisfied, including that the daily volume weighted average price of the Company's common stock was equal to or greater than \$111.54 for at least 50 trading days during a 65 trading day period prior to the conversion date.

In April 2013, after all specified conditions were satisfied, the Company elected to cause the conversion of all outstanding Convertible Notes with an aggregate principal amount of \$200.0 million in accordance with the terms of the Indenture governing such notes. Pursuant to this conversion, the Company issued 2.3 million shares of common stock to the holders of the Convertible Notes at a conversion ratio of 11.6553. The fair market value of one share of common stock on the date of conversion was \$216.99 per share.

## Senior Notes

In February 2013, the Company issued \$500.0 million aggregate principal amount of 5.375% Senior Notes due 2021 (the "5.375% Notes"). The 5.375% Notes were issued at par and are senior unsecured obligations of the Company. Interest is payable semi-annually at a rate of 5.375% per annum on February 1 and August 1 of each year, commencing on August 1, 2013. The 5.375% 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.

The Company may redeem the 5.375% Notes prior to maturity in whole or in part at an amount equal to the principal amount thereof plus accrued and unpaid interest plus a make-whole payment equivalent to the present value of the remaining interest payments through maturity.



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The 5.375% Notes include, among other terms and conditions, limitations on the Company's ability to create, incur or allow certain liens; enter into sale and lease-back transactions; create, assume, incur or guarantee additional indebtedness of the Company's subsidiaries; and consolidate or merge with, or convey, transfer or lease all or substantially all of the Company's and its subsidiaries assets, to another person.

In the first quarter of 2013, the Company used \$224.5 million of the net proceeds of the 5.375% Notes to redeem the outstanding \$200.0 million aggregate principal amount of 8.50% Senior Notes due 2017 (the "8.50% Notes") and pursuant to the make-whole provision in the Indenture governing the 8.50% Notes, paid a \$19.4 million premium and \$5.1 million of accrued and unpaid interest. The Company recognized a loss on extinguishment of debt of \$25.1 million related to redemption of the 8.50% Notes which included the write off of unamortized debt issuance costs of \$4.2 million.

Based on quoted market prices in less active markets (a Level 2 input for this financial instrument), the fair value of the 5.375% Notes as of June 30, 2013 was approximately \$497.5 million.

## 7. Stockholders' Equity

In April 2013, the Company issued 2.3 million shares of common stock in connection with the conversion of the Convertible Notes. See Note 6 to the consolidated financial statements for further details.

### Preferred Stock

In 2012, the Company designated 1,000,000 shares of its preferred stock with par value of \$0.001 per share as Series A Participating Preferred Stock. The remaining 9,000,000 shares of preferred stock with par value of \$0.001 remain undesignated. None of the preferred shares were issued and outstanding at June 30, 2013 or December 31, 2012.

### Stock Option Plan

In June 2011, the Company adopted the 2011 Stock Plan. The 2011 Stock Plan provides for the grant of incentive stock options to employees and for the grant of non-statutory stock options, stock appreciation rights, restricted stock and restricted stock units to employees, directors and consultants. As of June 30, 2013, 3.6 million shares were reserved for future grants under the 2011 Stock Plan.

A summary of the activities related to the Company's stock option plans 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, 2012	4,049,037	4,572,952	\$ 71.33		
Granted	(406,292)	406,292	162.52		
Exercised		(1,004,266)	67.70		
Balances as of June 30, 2013	3,642,745	3,974,978	81.57	6.49	\$ 524,708
Vested and exercisable at June 30, 2013		3,974,978	81.57	6.49	\$ 524,708

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the second quarter of 2013 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2013. This amount changes based on the fair market value of the Company's common stock. The total intrinsic value of options exercised for the three months ended June 30, 2013 and 2012 was \$68.3 million and \$1.0 million, respectively. The total intrinsic value of options exercised for the six months ended June 30, 2013 and 2012 was \$118.3 million and \$12.8 million, respectively.

Cash received from option exercises for the three months ended June 30, 2013 and 2012 was \$28.8 million and \$0.5 million, respectively. Cash received from option exercises for the six months ended June 30, 2013 and 2012 was \$68.0 million and \$1.7 million, respectively.

### 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. Vested stock options granted on or after January 1, 2007 will remain exercisable for the full ten year contractual term regardless of employment status.

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

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	Three Months Ended		Six Months Ended		
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012	
Dividend yield	—	% —	% —	% —	%
Expected volatility	53	% 61	% 53% - 54%	61% - 65%	
Risk-free interest rate	1.88	% 2.01	% 1.87% - 1.88%	1.97% - 2.01%	
Suboptimal exercise factor	2.39 - 3.61	2.26 - 3.65	2.33 - 3.61	2.26 - 3.65	

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.

The weighted-average fair value of employee stock options granted during the three months ended June 30, 2013 and 2012 was \$110.67 and \$45.38 per share, respectively. The weighted-average fair value of employee stock options granted during the six months ended June 30, 2013 and 2012 was \$87.87 and \$50.11 per share, respectively.

Stock-based compensation expense related to stock option plans was \$18.0 million and \$18.5 million for the three months ended June 30, 2013 and 2012, respectively. Stock-based compensation expense related to stock option plans was \$35.7 million and \$37.8 million for the six months ended June 30, 2013 and 2012, respectively. The total income tax benefit recognized in the income statement related to stock option plans was \$6.9 million and \$7.1 million for the three months ended June 30, 2013 and 2012, respectively. The total income tax benefit recognized in the income statement related to stock option plans was \$13.7 million and \$14.6 million for the six months ended June 30, 2013 and 2012, respectively.

## 8. Accumulated Other Comprehensive Income

The following tables summarize the changes in accumulated balances of other comprehensive income (loss), net of tax for the three and six months ended June 30, 2013:

	Foreign currency items	Change in unrealized gains on available for sale securities	Total
	(in thousands)		
Balance as of March 31, 2013	\$(908)	) \$1,199	\$291
Other comprehensive income before reclassifications	30	(2,068)	) (2,038)
Amounts reclassified from accumulated other comprehensive income	—	83	83
Net increase (decrease) in other comprehensive income	30	(1,985)	) (1,955)
Balance as of June 30, 2013	\$(878)	) \$(786)	) \$(1,664)

	Foreign currency items	Change in unrealized gains on available for sale securities	Total
	(in thousands)		
Balance as of December 31, 2012	\$1,381	\$1,538	\$2,919
Other comprehensive income before reclassifications	(2,259)	) (2,363)	) (4,622)

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Amounts reclassified from accumulated other comprehensive income	—	39	39
Net decrease in other comprehensive income	(2,259	) (2,324	) (4,583 )
Balance as of June 30, 2013	\$(878	) \$(786	) \$(1,664 )

All amounts reclassified from accumulated other comprehensive income were related to gains (losses) on available-for-sale securities. These reclassifications impacted "Interest and other income (expense)" on the Consolidated Statements of Operations.

9. Income Taxes

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The effective tax rates for the three months ended June 30, 2013 and 2012 were 37% and 42%, respectively. The effective tax rates for the six months ended June 30, 2013 and 2012 were 32% and 56%, respectively. These rates differed from the federal statutory rate primarily due to the Federal and California R&D tax credits partially offset by state taxes and nondeductible expenses. The decrease in the Company's effective tax rate for the three and six months ended June 30, 2013 as compared to the three and six months ended June 30, 2012 was primarily due to the retroactive reinstatement of the 2012 Federal R&D credit in January 2013.

On January 2, 2013, the American Taxpayer Relief Act of 2012 (H.R. 8) was signed into law which retroactively extended the Federal R&D credit from January 1, 2012 through December 31, 2013. As a result, the Company recognized the retroactive benefit of the 2012 Federal R&D credit of approximately \$3.1 million as a discrete item in the first quarter of 2013, the period in which the legislation was enacted.

As of December 31, 2012, the Company had \$43.3 million of gross unrecognized tax benefits. During the six months ended June 30, 2013, the Company had an increase in gross unrecognized tax benefits of approximately \$11.6 million. The gross unrecognized tax benefits, if recognized by the Company, will result in a reduction of approximately \$46.1 million to the provision for income taxes thereby favorably impacting the Company's effective tax rate. The Company's unrecognized tax benefits are classified as "Other non-current liabilities" on the Consolidated Balance Sheets. The Company includes interest and penalties related to unrecognized tax benefits within the "Provision for income taxes" on the Consolidated Statements of Operations. As of June 30, 2013, the total amount of gross interest and penalties accrued was \$3.5 million, and is classified as "Other non-current liabilities" on the Consolidated Balance Sheets. Deferred tax assets include \$11.6 million and \$11.0 million classified as "Other current assets" and \$66.5 million and \$56.9 million classified as "Other non-current assets" on the Consolidated Balance Sheets as of June 30, 2013 and December 31, 2012, respectively. In evaluating its ability to realize the net 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 June 30, 2013 and December 31, 2012, it was considered more likely than not that substantially all deferred tax assets would be realized, and no significant valuation allowance was recorded.

Income tax benefits attributable to the exercise of employee stock options of \$20.2 million and \$0.3 million, during the three months ended June 30, 2013 and 2012, respectively, were recorded directly to "Additional paid-in capital" on the Consolidated Balance Sheets. Income tax benefits attributable to the exercise of employee stock options of \$31.5 million and \$4.1 million, during the six months ended June 30, 2013 and 2012, respectively, were recorded directly to "Additional paid-in capital" on the Consolidated Balance Sheets.

The Company files U.S. federal, state and foreign tax returns. The Company is currently under examination by the IRS for the years 2008 through 2011. The Company is also currently under examination by the state of California for the years 2006 and 2007. The years 1997 through 2005, as well as 2008 through 2011, remain subject to examination by the state of California.

Given the potential outcome of the current examinations, as well as the impact of the current examination on the potential expiration of the statute of limitations, it is reasonably possible that the balance of unrecognized tax benefits could significantly change within the next twelve months. However, at this time, an estimate of the range of reasonably possible adjustments to the balance of unrecognized tax benefits cannot be made.

## 10. Commitments and Contingencies

### Streaming Content

The Company had \$6.4 billion and \$5.6 billion of obligations at June 30, 2013 and December 31, 2012, respectively, including agreements to license streaming content that represent current or long-term liabilities or that are not reflected on the Consolidated Balance Sheets because they do not meet the content library asset recognition criteria. The license agreements that are not reflected on the Consolidated Balance Sheets do not meet the content library asset recognition criteria because either the fee is not known or reasonably determinable for a specific title or it is known

but the title is not yet available for streaming to members.

For those agreements with variable terms, the Company does not estimate the total obligation beyond any minimum quantities and/or pricing as of the reporting date. For those agreements that include renewal provisions that are solely at the option of the content provider, the Company includes the commitments associated with the renewal period to the extent such commitments are fixed or a minimum amount is specified.

The Company has entered into certain license agreements that include an unspecified or a maximum number of titles that the Company may or may not receive in the future and/or that include pricing contingent upon certain variables, such as theatrical exhibition receipts for the title. As of the reporting date, it is unknown whether the Company will receive access to these titles or what the ultimate price per title will be. Accordingly, such amounts are not reflected in the commitments described below. However such amounts are expected to be significant and the expected timing of payments could range from less than one year to more than five years.

The expected timing of payments for these agreements to acquire and license streaming content that represent current or long-term liabilities as well as obligations not reflected on the Consolidated Balance Sheets is as follows:

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	As of June 30, 2013 (in thousands)	December 31, 2012
Less than one year	\$2,533,061	\$2,299,562
Due after one year and through 3 years	2,864,331	2,715,294
Due after 3 years and through 5 years	830,536	540,346
Due after 5 years	140,177	78,483
Total streaming content obligations	\$6,368,105	\$5,633,685

The Company has licenses with certain performing rights organizations (“PROs”), and is currently involved in negotiations with other PROs, that hold certain rights to music “publicly performed” in connection with streaming content into various territories. The Company accrues for estimated royalties that are expected to be due to PROs and adjusts these accruals based on any changes in estimates. These amounts are included in Current content liabilities on the Company's Consolidated Balance Sheets. If the Company is unable to reach mutually acceptable terms with the PROs, it could become involved in litigation and /or could be enjoined from delivering certain musical compositions, which could adversely impact the Company. Additionally, pending and ongoing litigation between certain PROs and other third parties in various territories could impact the Company's negotiations with PROs. The results of these negotiations are uncertain and may be materially different from management’s estimates.

#### Legal Proceedings

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, business practices and patent infringement. Litigation can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict and the Company's view of these matters may change in the future as the litigation and events related thereto unfold. The Company expenses legal fees as incurred. The Company records a provision for contingent losses when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. An unfavorable outcome to any legal matter, if material, could have an adverse effect on the Company's operations or its financial position, liquidity or results of operations.

On January 13, 2012, the first of three purported shareholder class action lawsuits was filed in the United States District Court for the Northern District of California against the Company and certain of its officers and directors. Two additional purported shareholder class action lawsuits were filed in the same court on January 27, 2012 and February 29, 2012 alleging substantially similar claims. These lawsuits were consolidated into *In re Netflix, Inc., Securities Litigation*, Case No. 3:12-cv-00225-SC, and the Court selected lead plaintiffs. Lead plaintiffs filed a consolidated complaint which alleged violations of the federal securities laws on June 26, 2012. The Court dismissed the consolidated complaint with leave to amend on February 13, 2013. Lead plaintiffs filed a first amended consolidated complaint on March 22, 2013. The first amended consolidated complaint alleges violations of the federal securities laws and seeks unspecified compensatory damages and other relief on behalf of a class of purchasers of the Company's common stock between October 20, 2010 and October 24, 2011. The first amended consolidated complaint alleges, among other things, that the Company issued materially false and misleading statements primarily regarding the Company's streaming business which led to artificially inflated stock prices. The Company filed a motion to dismiss the first amended consolidated complaint on April 24, 2013; that motion is fully briefed and pending. Management has determined a potential loss is reasonably possible however, based on its current knowledge, management does not believe that the amount of such possible loss or a range of potential loss is reasonably estimable.

On November 23, 2011, the first of six purported shareholder derivative suits was filed in the Superior Court of California, Santa Clara County, against the Company and certain of its officers and directors. Five additional purported shareholder derivative suits were subsequently filed: two in the Superior Court of California, Santa Clara County on February 9, 2012 and May 2, 2012; and three in the United States District Court for the Northern District of

California on February 13, 2012, February 24, 2012 and April 2, 2012. The purported shareholder derivative suits filed in the Northern District of California have been voluntarily dismissed. On July 5, 2012, the purported shareholder derivative suits filed in Santa Clara County were consolidated into In re Netflix, Inc. Shareholder Derivative Litigation, Case No. 1-12-cv-218399, and lead counsel was appointed. A consolidated complaint was filed December 4, 2012, with plaintiffs seeking compensatory damages and other relief. The consolidated complaint alleges, among other things, that certain of the Company's current and former officers and directors breached their fiduciary duties, issued false and misleading statements primarily regarding the Company's streaming business, violated accounting rules concerning segment reporting, violated provisions of the California Corporations Code, and wasted corporate assets. The consolidated complaint further alleges that the defendants caused the Company to buy back stock at artificially inflated prices to the detriment of the Company and its shareholders while contemporaneously selling personally held Company stock. The Company filed a demurrer to the consolidated complaint and a motion to stay the litigation on February 4, 2013 and on June 21, 2013, the Court granted the motion to stay the litigation. Management has determined a potential loss is reasonably possible however, based on its current knowledge, management does not believe that the amount of such possible loss or a range of potential loss is reasonably estimable.



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The Company is involved in other litigation matters not listed above but does not consider the matters to be material either individually or in the aggregate at this time. The Company's view of the matters not listed may change in the future as the litigation and events related thereto unfold.

**Indemnification**

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. In these circumstances, payment may be conditional on the other party making a claim pursuant to the procedures specified in the particular contract.

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 consolidated financial statements with respect to these indemnification obligations.

**11. Segment Information**

The Company has three operating segments: Domestic streaming, International streaming and Domestic DVD. Segment information is presented along the same lines that the Company's chief operating decision maker reviews the operating results in assessing performance and allocating resources. The Company's chief operating decision maker reviews revenues and contribution profit (loss) for each of the reportable segments. Contribution profit (loss) is defined as revenues less cost of revenues and direct marketing expenses.

The Domestic and International streaming segments derive revenues from monthly membership services consisting solely of streaming content. The Domestic DVD segment derives revenues from monthly membership services consisting solely of DVD-by-mail. Revenues and the related credit card fees are attributed to the operating segment based on the nature of the underlying membership (DVD or streaming) and the geographic region from which the membership originates. There are no internal revenue transactions between the Company's reporting segments. Cost of revenues are primarily attributed to the operating segment based on the amounts directly incurred by the segment to obtain content and deliver it to the specific region. Marketing expenses are primarily comprised of advertising expenses which are generally included in the segment in which the expenditures are directly incurred. As of June 30, 2013, the Company had \$3.9 million in long-lived tangible assets located internationally and \$124.0 million in long-lived tangible assets located in the United States. As of December 31, 2012, the Company had \$4.0 million in long-lived tangible assets located internationally and \$127.7 million in long-lived tangible assets located in the United States.

The following tables represent segment information for the quarter ended June 30, 2013:

	As of/ Three months ended June 30, 2013			
	Domestic Streaming	International Streaming	Domestic DVD	Consolidated
	(in thousands)			
Total members at end of period (1)	29,807	7,747	7,508	—
Revenues	\$671,089	\$ 165,902	\$232,381	\$ 1,069,372
Cost of revenues	449,473	182,885	121,167	753,525
Marketing	70,302	48,850	2,608	121,760
Contribution profit (loss)	\$151,314	\$(65,833)	\$108,606	\$ 194,087
Other operating expenses				136,970

Operating income	57,117
Other income (expense)	(10,468 )
Provision for income taxes	17,178
Net income	\$ 29,471

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	Three months ended June 30, 2013			
	Domestic Streaming	International Streaming	Domestic DVD	Consolidated
	(in thousands)			
Amortization of content library	\$344,441	\$165,809	\$17,709	\$527,959
	As of/ Six months ended June 30, 2013			
	Domestic Streaming	International Streaming	Domestic DVD	Consolidated
	(in thousands)			
Total members at end of period (1)	29,807	7,747	7,508	—
Revenues	\$1,309,738	\$307,921	\$475,674	\$2,093,333
Cost of revenues	885,979	347,909	246,500	1,480,388
Marketing	141,095	102,765	7,075	250,935
Contribution profit (loss)	\$282,664	\$ (142,753 )	\$222,099	\$362,010
Other operating expenses				273,071
Operating income				88,939
Other income (expense)				(41,360 )
Provision for income taxes				15,419
Net income				\$32,160

	Six months ended June 30, 2013			
	Domestic Streaming	International Streaming	Domestic DVD	Consolidated
	(in thousands)			
Amortization of content library	\$680,189	\$315,801	\$35,946	\$1,031,936
	As of June 30, 2013			
	Domestic Streaming	International Streaming	Domestic DVD	Consolidated
	(in thousands)			
Total content library, net	\$2,413,819	\$606,841	\$25,151	\$3,045,811

The following tables represent the Company's segment information for the quarter ended June 30, 2012:

	As of/ Three months ended June 30, 2012			
	Domestic Streaming	International Streaming	Domestic DVD	Consolidated
	(in thousands)			
Total members at end of period (1)	23,938	3,624	9,240	—
Revenues	\$532,705	\$64,973	\$291,485	\$889,163
Cost of revenues	378,574	108,542	156,312	643,428
Marketing	66,732	45,858	1,374	113,964
Contribution profit (loss)	\$87,399	\$ (89,427 )	\$133,799	\$131,771
Other operating expenses				115,617
Operating income				16,154
Other income (expense)				(5,499 )
Provision for income taxes				4,491
Net income				\$6,164

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	Three months ended June 30, 2012			Consolidated
	Domestic Streaming (in thousands)	International Streaming	Domestic DVD	
Amortization of content library	\$275,495	\$100,502	\$16,304	\$392,301
	As of/ Six months ended June 30, 2012			Consolidated
	Domestic Streaming (in thousands)	International Streaming	Domestic DVD	
Total members at end of period (1)	23,938	3,624	9,240	—
Revenues	\$1,039,370	\$108,398	\$611,186	\$1,758,954
Cost of revenues	739,350	199,953	328,058	1,267,361
Marketing	140,137	100,555	3,200	243,892
Contribution profit (loss)	\$159,883	\$ (192,110 )	\$279,928	\$247,701
Other operating expenses				233,482
Operating income				14,219
Other income (expense)				(10,589 )
Provision for income taxes				2,050
Net income				\$1,580
	Six months ended June 30, 2012			Consolidated
	Domestic Streaming (in thousands)	International Streaming	Domestic DVD	
Amortization of content library	\$530,020	\$185,713	\$36,350	\$752,083
The following table represents the Company's segment information as of December 31, 2012:				
	As of December 31, 2012			Consolidated
	Domestic Streaming (in thousands)	International Streaming	Domestic DVD	
Total content library, net	\$2,317,070	\$527,235	\$29,865	\$2,874,170

A membership (also referred to as a subscription) is defined as the right to receive either the Netflix streaming service or Netflix DVD service. In connection with these services, the Company offers free-trial memberships to new and certain rejoining members. For inclusion in the definition of a member in the above metrics, a method of payment is required to be provided even during the free-trial period. Total members therefore include those who are on a free-trial and have provided a method of payment. A membership would be canceled and cease to be reflected in the above metrics as of the effective cancellation date. Voluntary cancellations become effective at the end of the monthly membership period, while involuntary cancellation of the service, as a result of a failed method of payment, becomes effective immediately.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains 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, contribution profit (losses) and margins both domestically and internationally, DVD and streaming member trends, launch of our streaming service in the Netherlands, cash use in connection with content acquisitions and international expansion, investments in content, including expanding investments in Original content, content payments and expense, free and operating cash flow and available funds, deferred tax assets, accessing and obtaining additional capital and future contractual obligations. These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ materially from those included in forward-looking statements. These forward-looking statements can be identified by our use of words such as "anticipate", "expect", "will", "may" and derivations thereof. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in our Annual Report on Form 10-K for the year ended December 31, 2012 filed with the Securities and Exchange Commission ("SEC") on February 1, 2013, in particular the risk factors discussed under the heading "Risk Factors" in Part I, Item 1A.

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

We will disclose material non-public information through one or more of the following channels: Netflix's investor relations website (<http://ir.netflix.com>), the social media channels identified on Netflix's investor relations website, press releases, SEC filings, public conference calls and webcasts.

Overview

We are the world's leading Internet television network with nearly 38 million streaming members in over 40 countries enjoying more than one billion hours of TV shows and movies per month, including Netflix Original content. Our members can watch as much as they want, anytime, anywhere, on nearly any Internet-connected screen. Additionally, in the United States ("U.S."), our members can receive standard definition DVDs, and their high definition successor, Blu-ray discs (collectively referred to as "DVD"), delivered quickly to their homes.

We are a pioneer in the Internet delivery of TV shows and movies, launching our streaming service in 2007. Since this launch, we have developed an ecosystem for Internet-connected devices and have licensed increasing amounts of content that enable consumers to enjoy TV shows and movies directly on their TVs, computers and mobile devices. As a result of these efforts, we have experienced growing consumer acceptance of and interest in the delivery of TV shows and movies directly over the Internet. Historically, our acquisition of new members has been seasonal with the first and fourth quarters representing our strongest net member additions and our second quarter representing the lowest net member additions in a calendar year.

Our core strategy is to grow a streaming membership business domestically and internationally. We are continuously improving the member experience, with a focus on the quality of our streaming content mix, enhancing our user interface and improving the user experience on Internet-connected devices, while staying within the parameters of our consolidated net income and operating segment contribution profit targets. As we grow our streaming segments, we have shifted spending away from the Domestic DVD segment to invest more in streaming content and marketing for our streaming services.

We define contribution profit as revenues less cost of revenues and marketing expenses. We believe this is an important measure of our operating segment performance as it represents each segment's performance before discrete global corporate costs.

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For the Domestic and International streaming segments, content licensing expenses, which includes the amortization of the streaming content library and other expenses associated with the licensing of streaming content, represent the vast majority of cost of revenues. Streaming content rights are generally specific to a geographic region and accordingly our international expansion will require us to obtain additional streaming content licenses to support new international markets. Other cost of revenues such as content delivery expenses, customer service and payment processing fees tend to be lower as a percentage of total cost of revenues as compared to content licensing expenses. We utilize both our own and third-party content delivery networks to help us efficiently stream a high volume of content to our members over the Internet. Content delivery expenses therefore also include equipment costs related to our streaming content delivery network ("Open Connect") and all third-party costs associated with delivering streaming content over the Internet. Cost of revenues in the Domestic DVD segment consists primarily of content delivery, expenses related to the acquisition of content, including amortization of DVD content library and revenue sharing expenses, and other expenses associated with our DVD processing and customer service centers. Content delivery expenses for the Domestic DVD segment consist of the postage costs to mail DVDs to and from our paying members and the packaging and label costs for the mailers.

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For the Domestic and International streaming segments, marketing expenses consist primarily of advertising expenses and payments made to our affiliates and consumer electronics partners. Advertising expenses include promotional activities such as television and online advertising as well as allocated costs of revenues relating to free trial periods. Payments to our affiliates and consumer electronics partners may be in the form of a fixed fee or may be a revenue sharing payment. Marketing costs as a percentage of revenues are higher for the Domestic and International streaming segments given our focus on building consumer awareness of the streaming offerings. Marketing costs are immaterial for the Domestic DVD segment.

As a result of our focus on growing the streaming segments, contribution margins for the Domestic and International streaming segments are lower than for our Domestic DVD segment. We expect that the investments in content and marketing associated with the Domestic streaming segment will slow relative to revenues to allow for contribution margin expansion over time, and we have grown contribution margin sequentially over the past six quarters. Investments in content and marketing associated with the International streaming segment will continue to fluctuate dependent upon the number of International territories in which our streaming service is offered and the timing of the launch of new territories.

## Results of Operations

The following represents our consolidated performance highlights:

	Three Months Ended			Change	
	June 30, 2013	March 31, 2013	June 30, 2012	Q2'13 vs. Q1'13	Q2'13 vs. Q2'12
	(in thousands, except per share data)				
Revenues	\$1,069,372	\$1,023,961	\$889,163	4	% 20
Operating income	57,117	31,822			%