

BLOCKBUSTER INC  
Form 10-Q  
August 14, 2009  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended July 5, 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 001-15153**

**BLOCKBUSTER INC.**

(Exact name of registrant as specified in its charter)

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

**52-1655102**  
(I.R.S. Employer  
Identification No.)

**1201 Elm Street**  
**Dallas, Texas 75270**  
**Telephone 214-854-3000**

(Address, including zip code, and telephone number,  
including area code, of registrant's principal executive offices)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

Yes  No

**Number of shares of common stock outstanding at August 7, 2009:**

**Class A common stock, par value \$.01 per share: 122,099,933**

**Class B common stock, par value \$.01 per share: 72,000,000**



**Table of Contents**

**BLOCKBUSTER INC.**

**INDEX TO FORM 10-Q**

	<b>Page</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u>	3
<u>Consolidated Statements of Operations (Unaudited) Thirteen and Twenty-Six Weeks Ended July 5, 2009 and July 6, 2008</u>	3
<u>Consolidated Balance Sheets (Unaudited) July 5, 2009 and January 4, 2009</u>	4
<u>Consolidated Statements of Cash Flows (Unaudited) Twenty-Six Weeks Ended July 5, 2009 and July 6, 2008</u>	5
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	55
Item 4. <u>Controls and Procedures</u>	56
<b><u>PART II OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	57
Item 1A. <u>Risk Factors</u>	57
Item 3. <u>Defaults upon Senior Securities</u>	59
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	59
Item 6. <u>Exhibits</u>	60

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****BLOCKBUSTER INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)****(In millions, except per share amounts)**

	<b>Thirteen Weeks Ended</b>		<b>Twenty-Six Weeks Ended</b>	
	<b>July 5, 2009</b>	<b>July 6, 2008</b>	<b>July 5, 2009</b>	<b>July 6, 2008</b>
<b>Revenues:</b>				
Base rental revenues	\$ 654.2	\$ 812.0	\$ 1,374.7	\$ 1,713.7
Previously rented product ( PRP ) revenues	135.0	160.3	275.2	334.9
Total rental revenues	789.2	972.3	1,649.9	2,048.6
Merchandise sales	224.9	323.8	480.4	633.6
Other revenues	5.3	8.4	11.3	16.4
	1,019.4	1,304.5	2,141.6	2,698.6
<b>Cost of sales:</b>				
Cost of rental revenues	285.7	397.5	599.9	808.0
Cost of merchandise sold	172.7	251.8	390.0	493.7
Total cost of sales	458.4	649.3	989.9	1,301.7
Gross profit	561.0	655.2	1,151.7	1,396.9
<b>Operating expenses:</b>				
General and administrative	503.1	605.2	996.5	1,206.3
Advertising	25.6	31.9	38.0	62.4
Depreciation and intangible amortization	33.8	37.9	68.6	77.8
	562.5	675.0	1,103.1	1,346.5
<b>Operating income (loss)</b>	(1.5)	(19.8)	48.6	50.4
Interest expense	(28.8)	(18.4)	(46.2)	(37.6)
Interest income	0.8	0.6	1.0	1.7
Other items, net	(6.0)	(0.1)	(5.6)	0.3
<b>Income (loss) from continuing operations before income taxes</b>	(35.5)	(37.7)	(2.2)	14.8
Provision for income taxes	(1.4)	(4.2)	(7.0)	(11.0)
<b>Income (loss) from continuing operations</b>	(36.9)	(41.9)	(9.2)	3.8
Income (loss) from discontinued operations, net of tax				(0.3)

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<b>Net income (loss)</b>	(36.9)	(41.9)	(9.2)	3.5
Preferred stock dividends	(2.8)	(2.8)	(5.6)	(5.6)
<b>Net income (loss) applicable to common stockholders</b>	\$ (39.7)	\$ (44.7)	\$ (14.8)	\$ (2.1)
<b>Net income (loss) per common share:</b>				
Basic and diluted				
Continuing operations	\$ (0.21)	\$ (0.23)	\$ (0.08)	\$ (0.01)
Discontinued operations				
<b>Net income (loss)</b>	\$ (0.21)	\$ (0.23)	\$ (0.08)	\$ (0.01)
<b>Weighted-average common shares outstanding:</b>				
Basic and diluted	193.6	191.7	193.2	191.5

The accompanying notes are an integral part  
of these unaudited consolidated financial statements.

**Table of Contents****BLOCKBUSTER INC.****CONSOLIDATED BALANCE SHEETS****(Unaudited)****(In millions, except per share amounts)**

	<b>July 5, 2009</b>	<b>January 4, 2009</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 99.0	\$ 154.9
Restricted cash	123.9	
Receivables, less allowances of \$6.6 and \$7.4 for 2009 and 2008, respectively	63.3	117.1
Merchandise inventories	299.1	432.8
Rental library, net	336.5	355.8
Deferred income taxes	11.7	13.4
Prepaid and other current assets	136.2	184.6
Total current assets	1,069.7	1,258.6
Property and equipment, net	355.2	406.0
Deferred income taxes	102.8	124.3
Intangibles, net	10.7	11.5
Goodwill	338.1	338.1
Other assets	58.9	16.0
	\$ 1,935.4	\$ 2,154.5
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 243.8	\$ 427.3
Accrued expenses	390.8	493.8
Current portion of long-term debt	203.3	198.0
Current portion of capital lease obligations	7.0	8.5
Deferred income taxes	101.6	125.8
Total current liabilities	946.5	1,253.4
Long-term debt, less current portion	678.1	583.0
Capital lease obligations, less current portion	23.4	28.3
Other liabilities	63.3	75.5
	1,711.3	1,940.2
<b>Commitments and contingencies (Note 5)</b>		
<b>Stockholders' equity:</b>		
Preferred stock, par value \$0.01 per share with a liquidation preference of \$1,000 per share; 100 shares authorized; 0.146 and 0.150 shares issued and outstanding for 2009 and 2008	145.9	150.0
Class A common stock, par value \$0.01 per share; 400 shares authorized; 122.1 and 120.7 shares issued and outstanding for 2009 and 2008	1.2	1.2
Class B common stock, par value \$0.01 per share; 500 shares authorized; 72.0 shares issued and outstanding for 2009 and 2008	0.7	0.7
Additional paid-in capital	5,381.7	5,378.4
Accumulated deficit	(5,237.9)	(5,228.7)

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Accumulated other comprehensive loss	(67.5)	(87.3)
Total stockholders' equity	224.1	214.3
	\$ 1,935.4	\$ 2,154.5

The accompanying notes are an integral part  
of these unaudited consolidated financial statements.



**Table of Contents****BLOCKBUSTER INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)****(In millions)**

	<b>Twenty-Six Weeks Ended</b>	
	<b>July 5, 2009</b>	<b>July 6, 2008</b>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (9.2)	\$ 3.5
Adjustments to reconcile net income (loss) to net cash used for operating activities:		
Depreciation and intangible amortization	68.6	77.8
Rental library purchases	(226.4)	(340.5)
Rental library amortization	253.2	379.8
Non-cash share-based compensation	4.4	9.8
Deferred taxes and other	(2.0)	(0.8)
Changes in operating assets and liabilities:		
Change in receivables	52.8	27.8
Change in merchandise inventories	140.0	(98.8)
Change in prepaid and other assets	48.6	(19.2)
Change in accounts payable	(179.7)	(44.2)
Change in accrued expenses and other liabilities	(123.3)	(78.1)
<b>Net cash provided by (used in) operating activities</b>	<b>27.0</b>	<b>(82.9)</b>
<b>Cash flows from investing activities:</b>		
Capital expenditures	(14.0)	(40.6)
Change in restricted cash	(123.9)	
Other investing activities	0.7	(0.1)
<b>Net cash provided by (used in) investing activities</b>	<b>(137.2)</b>	<b>(40.7)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from credit agreements	381.4	115.0
Repayments on credit agreement	(281.1)	(27.3)
Cash dividends on preferred stock	(2.8)	(5.6)
Debt financing costs	(40.3)	
Capital lease payments	(4.2)	(5.1)
<b>Net cash provided by (used in) financing activities</b>	<b>53.0</b>	<b>77.0</b>
Effect of exchange rate changes on cash	1.3	2.1
<b>Net decrease in cash and cash equivalents</b>	<b>(55.9)</b>	<b>(44.5)</b>
Cash and cash equivalents at beginning of period	154.9	184.6
<b>Cash and cash equivalents at end of period</b>	<b>\$ 99.0</b>	<b>\$ 140.1</b>
Supplemental cash flow information:		
Cash payments for interest	\$ 38.1	\$ 35.4

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Cash payments for income taxes

\$ 14.2

\$ 14.7

The accompanying notes are an integral part  
of these unaudited consolidated financial statements.

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****(Tabular dollars in millions, except per share amounts)****Note 1 Basis of Presentation**

Blockbuster Inc. and its subsidiaries ( Blockbuster, we, us or our ) primarily operate and franchise entertainment-related stores in the United States and a number of other countries. We offer movies and video games for in-store rental, sale and trade and sell other entertainment-related merchandise. We also operate an online service offering rental and sale of movies delivered by mail and digital delivery through blockbuster.com.

We operate our business in two segments. The Domestic segment consists primarily of all U.S. store operations and by-mail subscription service operations, as well as the digital delivery of movies through blockbuster.com. The International segment is comprised of all non-U.S. store operations, including operations in Europe, Latin America, Australia, Canada, Mexico and Asia.

In the opinion of management, the accompanying unaudited consolidated financial statements include all recurring adjustments and normal accruals necessary for a fair statement of our financial position and our results of operations and cash flows for the dates and periods presented. Results for interim periods are not necessarily indicative of the results to be expected during the remainder of the current year or for any future period. All significant intercompany accounts and transactions have been eliminated in consolidation. We have performed an evaluation of subsequent events through August 13, 2009, which is the date the financial statements were available to be issued.

These unaudited consolidated financial statements should be read in conjunction with the more detailed audited consolidated financial statements for the fiscal year ended January 4, 2009, included in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission ( SEC ). Accounting policies used in the preparation of these unaudited consolidated financial statements are consistent in all material respects with the accounting policies described in the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K, except where discussed below.

***Restricted Cash***

Restricted cash, which is separately stated from our cash and cash equivalents, primarily represents the cash collateral for our letters of credit. On April 2, 2009, we amended our revolving credit facility. Under the terms of the amendment, we have cash-collateralized our letters of credit. See Note 2 below for further discussion.

Restricted cash consists of the following as of July 5, 2009:

	<b>Domestic</b>	<b>International</b>	<b>Total</b>
Letters of credit cash collateral	\$ 118.3	\$ 0.5	\$ 118.8
Credit facility		4.8	4.8
Other	0.3		0.3
	\$ 118.6	\$ 5.3	\$ 123.9

***Goodwill and Intangible Assets***

We assess goodwill and intangible assets with indefinite lives for impairment at the reporting unit level annually as of October 31 and between annual tests if events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. An impairment may be



**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

triggered by, among other factors, declines in the media entertainment industry, a reduction in our profitability, or a sustained decline in our stock price. The market price of our class A common stock has been subject to substantial volatility and we recently lowered our forecasted expectations for 2009 financial results. These circumstances are factors that may indicate the need to complete an interim impairment test and potentially recognize a non-cash impairment charge during the third quarter of 2009. Our goodwill balance totaled \$338.1 million as of July 5, 2009. Any required non-cash impairment charge could significantly reduce this balance and have a material impact on our reported financial position and results of operations.

***Fair Value of Financial Instruments***

At July 5, 2009, our carrying value of financial instruments approximated fair value except for \$559.9 million aggregate principal amount outstanding under our senior secured credit facilities ( Credit Facilities ) and our \$300.0 million aggregate principal amount of 9% senior subordinated notes due 2012 (the Senior Subordinated Notes ). The estimated fair values of our Credit Facilities and Senior Subordinated Notes at July 5, 2009, based on recent trading activity and quoted market prices, were approximately \$477.6 million and \$147.0 million, respectively. During fiscal 2008 and 2007, no financial instruments were held or issued for trading purposes.

***Store Closures***

As of July 5, 2009 and January 4, 2009, the remaining liability to be paid in the future related to store closure reserves was \$8.0 million and \$7.4 million, respectively. We made payments of \$3.7 million in rent and lease termination costs during the twenty-six weeks ended July 5, 2009. There have been no significant adjustments to previously accrued store closure costs during 2009.

The following table presents operating expenses related to store closures during the thirteen and twenty-six weeks ended July 5, 2009 and July 6, 2008:

	<b>Thirteen Weeks Ended</b>		<b>Twenty-Six Weeks Ended</b>	
	<b>July 5, 2009</b>	<b>July 6, 2008</b>	<b>July 5, 2009</b>	<b>July 6, 2008</b>
Closed store accruals and lease termination costs	\$ 2.5	\$ 1.3	\$ 3.6	\$ 1.5
Accelerated depreciation	0.8	1.3	3.1	3.9
<b>Total store closure expense</b>	<b>\$ 3.3</b>	<b>\$ 2.6</b>	<b>\$ 6.7</b>	<b>\$ 5.4</b>

***Severance Charges***

The following table presents the activity in severance liability for the twenty-six weeks ended July 5, 2009 and July 6, 2008:

	<b>Twenty-Six Weeks Ended</b>	
	<b>July 5, 2009</b>	<b>July 6, 2008</b>
Beginning balance	\$ 4.7	\$ 15.5
Expense incurred and accrued	3.7	3.1

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Adjustments to accruals	(0.4)	(2.2)
Reclassification		(0.7)
Amount paid	(5.6)	(9.5)
Ending balance	\$ 2.4	\$ 6.2

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)****Comprehensive Income (Loss)**

Comprehensive income (loss) is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It consists of net loss and other gains and losses affecting stockholders' equity that when prepared in accordance with US GAAP, are excluded from net income (loss), such as foreign currency translation gains and losses. Currency translation is the only item of comprehensive income (loss) impacting our accumulated other comprehensive loss of \$67.5 million and \$87.3 million as of July 5, 2009 and January 4, 2009, respectively.

Comprehensive income (loss) for the thirteen and twenty-six weeks ended July 5, 2009 and July 6, 2008 was as follows:

	<b>Thirteen Weeks Ended</b>		<b>Twenty-Six Weeks Ended</b>	
	<b>July 5, 2009</b>	<b>July 6, 2008</b>	<b>July 5, 2009</b>	<b>July 6, 2008</b>
Net income (loss)	\$ (36.9)	\$ (41.9)	\$ (9.2)	\$ 3.5
Foreign currency translation adjustment, net of tax	21.9	2.7	19.8	6.5
<b>Total comprehensive income (loss)</b>	<b>\$ (15.0)</b>	<b>\$ (39.2)</b>	<b>\$ 10.6</b>	<b>\$ 10.0</b>

**Income Taxes**

As of July 5, 2009, our liability for uncertain tax positions was approximately \$2.3 million and is reflected in "Other liabilities" on our Consolidated Balance Sheets. If recognized, this amount would result in a positive impact on our effective tax rate.

The following is a summary of our domestic tax returns and whether or not they remain subject to the amended and restated tax matters agreement (the "Tax Matters Agreement") with Viacom/CBS and examination by the Internal Revenue Service ("IRS"):

<b>Jurisdiction</b>	<b>Tax Year(s) Ending</b>	<b>Open</b>	<b>IRS Audit Complete</b>	<b>Currently Being Audited</b>	<b>Subject to Tax Matters Agreement with Viacom/CBS</b>
Domestic	12/31/03 and prior	No	Yes	N/A	Yes
Domestic	9/30/2004	Yes	Yes	N/A	Yes
Domestic	12/31/2004	No	Yes	N/A	No
Domestic	12/31/2005	Yes	N/A	No	No
Domestic	12/31/2006	Yes	N/A	No	No
Domestic	12/31/2007	Yes	N/A	No	No
Domestic	12/31/2008	Yes	N/A	No	No

<b>Jurisdictions</b>	<b>Closed Tax Years</b>	<b>Open Tax Years</b>	<b>Years Under Examination</b>
Canada	2000 and prior	Post 2000	2001-2002
Ireland	2003 and prior	Post 2003	N/A

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Italy	2004 and prior	Post 2004	N/A
Mexico	2000 and prior	Post 2000	N/A
United Kingdom	2004 and prior	Post 2004	N/A



**Table of Contents**

**BLOCKBUSTER INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**(Tabular dollars in millions, except per share amounts)**

Interest expense and penalties related to our uncertain tax positions have been reflected as a component of income tax expense in our Consolidated Statements of Operations. As of July 5, 2009, we had recorded liabilities of approximately \$0.3 million associated with accrued interest and penalties related to uncertain tax positions.

***Net Income (Loss) Per Share***

Basic net income (loss) per share ( EPS ) is computed by dividing the net income (loss) applicable to common shares by the weighted average number of common shares outstanding during the period. Diluted EPS adjusts the basic weighted average number of common shares outstanding by the assumed exercise of stock options, vesting of restricted shares and restricted share units, and shares issuable under the conversion feature of our Series A convertible preferred stock, as defined below, using the if-converted method only in periods in which such effect would have been dilutive on income before cumulative effect of change in accounting principle. Options to purchase 17.5 million and 18.5 million shares of Class A common stock were outstanding as of July 5, 2009 and July 6, 2008, respectively. Additionally, 6.3 million and 1.7 million restricted shares and restricted share units that can be settled in shares of Class A common stock were outstanding as of July 5, 2009 and July 6, 2008, respectively. For the thirteen and twenty-six weeks ended July 5, 2009 and July 6, 2008, the inclusion of all stock options, all restricted shares and restricted share units and all shares of Series A convertible preferred stock would be anti-dilutive and were therefore excluded from the computation of the weighted-average shares for dilutive EPS.

Our Board of Directors has determined not to declare or pay a dividend on our shares of Series A convertible preferred stock with respect to the two consecutive quarterly periods beginning on February 15, 2009 and ending on August 14, 2009. Dividends on the Series A convertible preferred stock are cumulative and began to accumulate on May 15, 2009, of which \$2.8 million has been accumulated as of July 5, 2009.

If we fail to pay dividends on the Series A convertible preferred stock for six quarterly dividend periods (whether or not consecutive), the dividend rate payable on the Series A convertible preferred stock will increase by 1.0% until all accumulated and unpaid dividends on the Series A convertible preferred stock have been paid in full. In addition, if we fail to pay dividends on the Series A convertible preferred stock for six quarterly dividend periods (whether or not consecutive), the size of our Board of Directors will be increased by two and the holders of the Series A convertible preferred stock will have the right to vote to fill the two vacancies created thereby until all accumulated and unpaid dividends on the Series A convertible preferred stock have been paid in full.

***Recently Adopted Accounting Pronouncements***

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements* ( SFAS 157 ). This statement defines fair value as used in various accounting pronouncements, establishes a framework for measuring fair value under US GAAP and expands disclosure related to the use of fair value measures in financial statements. SFAS 157 does not expand the use of fair value measures in financial statements, but standardizes its definition and guidance in US GAAP. SFAS 157 establishes a fair value hierarchy with observable market data as the highest level and fair value based on an entity's own fair value assumptions as the lowest level. The provisions of SFAS 157 are required to be applied to financial assets and liabilities for fiscal years beginning after November 15, 2007 and for nonfinancial assets and liabilities for fiscal years beginning after January 1, 2009. The adoption of SFAS 157 did not have a material impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*, which requires, among other things, the acquiring entity in a business combination to recognize the full fair value of the assets acquired,

**Table of Contents**

**BLOCKBUSTER INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**(Tabular dollars in millions, except per share amounts)**

liabilities assumed and any noncontrolling interest as of the acquisition date; the immediate expense recognition of transaction costs; and accounting for restructuring plans separately from the business combination. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. This standard has not had a material impact as of July 5, 2009, but will impact our accounting treatment for future business combinations.

In June 2008, the FASB issued FASB Staff Position ( FSP ) Emerging Issues Task Force ( EITF ) 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities* ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 clarifies that vested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of earnings per share under the two-class method described in SFAS No. 128, *Earnings per Share*. FSP EITF 03-6-1 is effective for fiscal years beginning after December 15, 2008. The adoption of FSP EITF 03-6-1 did not have a material impact on our consolidated financial statements.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* ( FSP FAS 107-1 ). FSP FAS 107-1 amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* to require disclosures about fair value of financial instruments in interim reporting periods. Such disclosures were previously required only in annual financial statements. FSP FAS 107-1 is effective for our quarter ending July 5, 2009. Because FSP FAS 107-1 applies only to financial statement disclosures, the adoption did not have a material effect on our consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* ( SFAS 165 ). This statement provides general standards for the accounting and reporting of subsequent events that occur between the balance sheet date and issuance of financial statements. The statement requires the issuer to recognize the effects, if material, of subsequent events in the financial statements if the subsequent event provides additional evidence about conditions that existed as of the balance sheet date. The issuer must also disclose the date through which subsequent events have been evaluated and the nature of any nonrecognized subsequent events. Nonrecognized subsequent events include events that provide evidence about conditions that did not exist as of the balance sheet date, but which are of such a nature that they must be disclosed to keep the financial statements from being misleading. The statement is effective for our quarter ending July 5, 2009. Because SFAS 165 applies only to financial statement disclosures, the adoption did not have a material effect on our consolidated financial statements.

***Recent Accounting Pronouncements***

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* ( the Codification ), effective for financial statements issued for interim and annual periods ending after September 15, 2009. Other than resolving certain minor inconsistencies, the Codification is not supposed to change US GAAP, but is intended to make it easier to find and research guidance applicable to particular transactions or specific accounting issues. The Codification is a new structure which takes accounting pronouncements and organizes them by approximately ninety accounting topics. The Codification will be the single source of authoritative US GAAP. All guidance included in the Codification will be considered authoritative at that time, even guidance that comes from what is currently deemed to be a non-authoritative section of a standard. Once the Codification becomes effective, all non-grandfathered, non-SEC accounting literature not included in the Codification will become non-authoritative.

**Table of Contents**

**BLOCKBUSTER INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**(Tabular dollars in millions, except per share amounts)**

**Note 2 Liquidity, Credit Agreement and Other Debt**

***Liquidity***

We generate cash from operations predominantly from the rental and retail sale of movies and games, and most of our revenue is received in cash and cash equivalents. Working capital requirements, including rental library purchases and normal capital expenditures, are generally funded with cash from operations.

On April 2, 2009, we amended our revolving credit facility, Term A loan facility and Term B loan facility to include commitments from certain of our lenders and certain new lenders to (a) replace the prior revolving credit facility with a \$250 million revolving credit facility with a maturity date of September 30, 2010, and (b) amend certain financial covenants, other covenants and other terms in our prior revolving credit facility, Term A loan facility and Term B loan facility. On May 11, 2009, we closed and funded our amended revolving credit facility, Term A loan facility and Term B loan facility. This amended facility and our other indebtedness may impact our business by, among other things:

limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate, including limiting our ability to invest in certain strategic initiatives, consequently placing us at a competitive disadvantage to our competitors;

requiring that a substantial portion of our cash flows from operations be used for debt service payments on our amended revolving credit facility beginning December 2009 through September 2010, thereby reducing the availability of cash flows to fund working capital requirements including inventory purchases, capital expenditures, acquisitions and other general corporate purposes; and

making us vulnerable to deterioration in our results of operations and to general adverse economic, market or industry conditions which could impact our ability to make our debt payments.

We are actively pursuing refinancing our debt to extend the availability of capital beyond our current debt maturity dates. If our efforts are successful, we will be able to prepay the amended credit facility and replace it without penalties.

See Amended Credit Facility below for additional information regarding our amended credit facility.

In recent months, our operating results and overall liquidity position have been negatively impacted due to competitive industry conditions and the current state of the global economy. However, we expect cash on hand, cash from operations and anticipated external liquidity generating events, such as divestitures of certain non-core international assets and the reduction of amounts committed under one or more outstanding letters of credit, will be sufficient to fund our anticipated cash requirements for working capital purposes including rental library purchases as well as commitments and payments of principal and interest on borrowings for at least the next twelve months. This expectation is subject to a number of assumptions, many of which are outside of our control. Such assumptions include, among others, that we achieve our projected financial results for the remainder of 2009 and 2010, we complete the divestiture of certain of our international assets, we reduce our obligations under letters of credit or other external liquidity generating events and that there is no significant contraction in our trade terms. In recent months, our ability to accurately forecast our results of operations and cash position has been negatively impacted due to the contingent nature of certain of the anticipated external liquidity generating events, as well as competitive pressures, rapidly changing consumer preferences for acquisition of video and game entertainment, and the current state of the global economy. Our current 2009 plan contemplates that worldwide same-store revenues will be lower than what we experienced in 2008. Further deterioration would negatively impact our anticipated revenues and cash from operations.



**Table of Contents**

**BLOCKBUSTER INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**(Tabular dollars in millions, except per share amounts)**

In order to reduce our exposure to liquidity risk, we have implemented a cash management strategy to enhance and preserve as much of our liquidity as possible. This plan contemplates, among other things:

reducing our capital expenditures by eliminating, delaying or curtailing discretionary and non-essential spending;

aggressively pursuing options for the divestiture of certain non-core assets, including selling and/or licensing some of our international operations;

managing our working capital through the optimization of inventory levels;

continuing to renegotiate leases to generate significant reductions in future store occupancy costs;

reducing expenditures on consultants and professional service providers;

restructuring and reengineering our organization and processes to reduce our operating costs and increase efficiency;

working to further reduce our obligations in connection with the provision of letters of credit;

exploring our options with respect to borrowing against unpledged assets in certain international markets;

exploring the availability of issuing additional equity or debt securities; and

allowing preferred stock dividends to accumulate or paying preferred stock dividends in-kind as opposed to in cash.

We cannot make assurances as to whether any of these actions can be effected on a timely basis, on satisfactory terms or maintained once initiated. Our cash management strategy has limited certain of our operational and strategic initiatives designed to grow our business over the long term and will continue to do so for as long as the strategy remains in place. For us to proceed with certain anticipated external liquidity generating events such as the divestiture of non-core international assets, we will be required to obtain an amendment to our credit facility. We cannot be assured of obtaining such an amendment.

We rely upon vendor financing in managing our liquidity. As a result, if our trade creditors were to impose unfavorable terms on us, it would negatively impact our ability to obtain products and services on acceptable terms and operate our business. Given our liquidity limitations and uncertainty surrounding our ability to finance our obligations as they become due, we are currently in discussions with some of the large studios

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regarding the credit terms for our inventory purchases. If the studios further tighten their credit terms or if studios eliminate their provision of credit to us altogether, this could result in up-front cash commitments that we may be unable to sustain on a long-term basis given our debt service and other business obligations. In such event, our ability to maintain optimal product in-stock and availability levels would be adversely affected and our results of operations and financial performance would suffer.

As part of our ongoing efforts to better manage working capital and work within our liquidity constraints, we have and may continue to lengthen the cycle of payables to certain vendors. As of July 5, 2009, our accounts payable balance was \$243.8 million, compared our accounts payable balance of \$427.3 million at January 4, 2009, and \$433.2 million at July 6, 2008. The year over year decline in accounts payable was primarily a result of reduced general and administrative spending and lower inventory purchases. We may attempt to manage working capital on a go-forward basis in a manner that will result in increased accounts payable balances over time.

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

Our amended credit facility requires significant amortization payments beginning in December 2009. If we are unable to generate sufficient cash flow from operations or if we cannot generate sufficient additional liquidity through the anticipated divestiture of certain non-core assets to service our indebtedness and remain in compliance with our financial covenants, we would be in default under one or more of our debt agreements, which if not cured or waived, could result in the acceleration of all of our debt due to cross-default provisions contained in such agreements and in certain of our leases. In such event, we would be required to search for alternative sources of liquidity to refinance our debt, which may not be available to us on acceptable terms, if at all. Our ability to obtain alternative financing would likely be adversely affected by unfavorable conditions in the worldwide credit markets, because substantially all of our domestic and Canadian assets have been secured as collateral for our existing debt and because our financial results, substantial indebtedness and credit ratings could each adversely affect the availability and terms of any such financing. If we were unable to make scheduled amortization payments, or if we are unable to repay our debt upon acceleration, we could be forced to file for protection under the U.S. Bankruptcy Code.

Adverse future developments regarding our pending and any future legal proceedings and other contingencies may also have a material adverse impact on our liquidity and results of operations. See Note 5 for further discussion of these items.

**Credit Agreement**

The following table sets forth our current portion of long-term debt and capital lease obligations:

	July 5, 2009	January 4, 2009
<b>Credit Facilities:</b>		
Revolving credit facility, interest rate of 13.5% at July 5, 2009	\$ 160.0	\$ 120.0
Term A loan facility, interest rate of 4.2% at July 5, 2009	8.7	18.6
Term B loan facility, interest rate ranging from 4.9% to 5.5% at July 5, 2009	34.6	59.4
<b>Total current portion of long-term debt</b>	<b>203.3</b>	<b>198.0</b>
Current portion of capital lease obligations	7.0	8.5
	<b>\$ 210.3</b>	<b>\$ 206.5</b>

The following table sets forth our long-term debt and capital lease obligations, less current portion:

	July 5, 2009	January 4, 2009
<b>Credit Facilities:</b>		
Revolving credit facility, interest rate of 13.5% at July 5, 2009	\$ 90.0	\$
Term B loan facility, interest rate ranging from 4.9% to 5.5% at July 5, 2009	266.6	283.0
Canadian Credit Facility, interest rate of 18.0% at July 5, 2009	21.5	
Senior Subordinated Notes, interest rate of 9.0% at July 5, 2009	300.0	300.0
<b>Total long-term debt, less current portion</b>	<b>678.1</b>	<b>583.0</b>

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Capital lease obligations, less current portion	23.4	28.3
	\$ 701.5	\$ 611.3



**Table of Contents**

**BLOCKBUSTER INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**(Tabular dollars in millions, except per share amounts)**

As of July 5, 2009, \$250.0 million was outstanding under our amended revolving credit facility ( revolver ) and \$309.9 million was outstanding under the term loan portions of our amended credit facilities. Borrowings under the credit facilities accrue interest at a rate equal to the London Inter Bank Offering Rate ( LIBOR ) plus an applicable margin or the prime rate or the federal funds rate plus applicable margins. The applicable margins vary based on the borrowing and specified leverage ratios. The weighted-average interest rate at July 5, 2009 for borrowings under the credit facilities was 9.2%.

As of July 5, 2009, \$300.0 million of principal was outstanding under our Senior Subordinated Notes. Interest accrues on the Senior Subordinated Notes from August 20, 2004, and is payable on March 1 and September 1 of each year.

The Term A Loan Facility is payable in quarterly installments of 3.75% of the original principal balance from October 2005 through July 2008, and 13.75% of the original principal balance beginning October 2008 through August 2009. The Term B Loan Facility is payable in quarterly installments of 0.25% of the original principal balance from October 2005 through July 2008, 2.5% of the original principal balance beginning October 2008 through July 2010 and 19.25% of the original principal balance beginning October 2010 through August 2011. The term loans are subject to mandatory prepayments from a portion of proceeds from asset sales and excess cash flow. The scheduled principal payments for the Term A and B loan facilities have and will continue to be adjusted to reflect any prepayments resulting from excess cash flow we generated as discussed below.

Through May 11, 2009, we were required to make prepayments on the credit facilities in an aggregate amount equal to 50% of annual excess cash flow, as defined by our credit agreement. Such payments were due at the end of the first quarter of the following year. In fiscal 2008, we generated excess cash flow, as defined by our credit agreement, and made a prepayment of \$25.1 million on April 6, 2009.

Additionally, we were required to make prepayments on the credit facilities related to sales of store operations and property and equipment, as defined by our credit agreement. There were no required prepayments related to sales of assets during the first and second quarters of 2009. We made a prepayment of \$0.3 million during the first quarter of 2008. We did not have any required prepayments during the second quarter of 2008.

As a result of a significant reduction in our gross leverage ratio determined by our results of operations for the period ended April 6, 2008, our borrowing rate decreased 50 basis points during the second quarter of 2008.

On August 14, 2008, Moody's Investors Service downgraded our probability of default rating to Caa1 from B3 based on perceived refinancing challenges given current and anticipated market conditions and the general unavailability of capital on favorable terms. However, Moody's Investors Service upgraded the rating on our credit facility to B1 from B3 on the same date as a result of our operating improvements. As a result of the upgrade on our credit facility, our borrowing rate decreased 25 basis points during the third quarter of 2008. On April 13, 2009, Standard & Poor's Ratings Service downgraded our credit ratings to CCC from B- in light of the pending maturities of our revolving credit facility and Term A loan facility in August 2009. As a result of the downgrade, our borrowing rate increased 25 basis points effective April 13, 2009. On April 17, 2009, Moody's Investors Service downgraded our probability of default rating to Caa3 from Caa1, reflecting our continued exposure to refinancing risk, short payment schedule of the revolving credit and Term B loan facilities as well as the restrictive terms of the amended revolving credit facility that limits our ability to invest in our business. Any further downgrade in our credit ratings could adversely affect our ability to access capital in the future upon acceptable terms and conditions.

**Table of Contents**

**BLOCKBUSTER INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**(Tabular dollars in millions, except per share amounts)**

***Canadian Credit Facility***

On May 8, 2009, Blockbuster Canada Co. ( BB Canada ) signed a credit facility with Callidus Capital Corporation (the Lender ), a privately-held Canadian lender (the Canadian Credit Facility ), subject to the terms and conditions set forth below. BB Canada is a wholly-owned subsidiary of Blockbuster Canada Inc., which in turn is a wholly-owned subsidiary of Blockbuster Inc.

The Canadian Credit Facility provides for a single advance non-revolving loan in the amount of CAN \$25 million (the Facility A Loan ) and, at the Lender 's discretion, a single advance non-revolving loan in the amount of CAN \$10 million (the Facility B Loan, and together with the Facility A Loan, the Loans ) and is secured by substantially all of the assets of BB Canada. Proceeds of the Loans are to be used for general corporate purposes. The Canadian Credit Facility matures on the earlier of September 30, 2010 or the date the Amended Revolver (as defined under Amended Credit Facility below) terminates.

The Canadian Credit Facility closed on May 8, 2009, and the full amount of the Facility A Loan was advanced on May 11, 2009 into a controlled disbursement account out of which disbursements are made by the Lender from time to time to BB Canada in amounts calculated in accordance with a formula set forth in the Canadian Credit Facility. BB Canada may request the Facility B Loan advance at any time after the 60<sup>th</sup> day following the Facility A Loan advance, and funding of the Facility B Loan is subject to the Lender 's discretion. If funded, proceeds of the Facility B Loan are to be advanced into a controlled disbursement account to be disbursed in the manner provided for the Facility A Loan proceeds. The formula for disbursement is based upon a borrowing base of Eligible Inventory as defined in the Canadian Credit Facility. Outstanding Loan amounts bear interest at 18% per annum.

We have paid or will pay the following fees in connection with the Canadian Credit Facility:

a non-refundable facility fee of CAN \$250,000 paid upon execution of the Canadian Credit Facility;

a non-refundable facility fee equal to 1% of the amount of the Facility B Loan advance, paid upon funding of the Facility B Loan;

a monthly maintenance and monitoring fee of CAN \$1,750 for each month or partial month until the Loans are repaid in full; and

a fee of CAN \$200,000 if the Loans are prepaid on or before November 8, 2009 or CAN \$100,000 if the Loans are prepaid after November 8, 2009 but before September 20, 2010.

In connection with the Canadian Credit Facility, BB Canada has agreed, among other things, to:

maintain specified minimum quarterly levels of EBITDA and equity, as defined in the Canadian Credit Facility;

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deposit all funds received from all sources, with certain limited exceptions, into designated cash management accounts to be held by the Lender as cash collateral for the Loan and from which disbursements will be made by the Lender on a daily basis into BB Canada's disbursement account for use as operating capital;

limit capital expenditures in any fiscal year in the aggregate to CAN \$6 million; and

assign to the Lender for the term of the Loan as security under the Canadian Credit Facility rights to certain trademarks and other intellectual property, and information technology systems and services that BB Canada licenses from Blockbuster Inc.

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

We were in compliance with the minimum EBITDA covenant, required minimum equity covenant, the maximum capital expenditure covenant and all other applicable covenants, as of July 5, 2009.

***Amended Credit Facility***

As discussed above, on April 2, 2009, we amended our revolving credit facility, Term A loan facility and Term B loan facility to include commitments from certain of our lenders and certain new lenders to (a) replace the existing revolving credit facility with a \$250 million revolving credit facility with a maturity date of September 30, 2010 and (b) amend certain financial covenants, other covenants and other terms in our prior revolving credit facility, Term A loan facility and Term B loan facility. On May 11, 2009, we closed and funded the amended revolving credit facility, Term A loan facility and Term B loan facility. The \$250 million amended revolving credit facility (the Amended Revolver ) will mature on September 30, 2010, and requires that we make the following amortization payments prior to and on such date:

<b>Date</b>	<b>Amount of Payment</b>
December 15, 2009	\$25.0
January 31, 2010	\$20.0
February 28, 2010	\$20.0
March 31, 2010	\$20.0
April 30, 2010	\$10.0
May 31, 2010	\$15.0
June 30, 2010	\$50.0
July 31, 2010	\$10.0
August 31, 2010	\$10.0
September 30, 2010	any remaining

outstanding amounts

Up to \$12.5 million in voluntary prepayments made prior to December 15, 2009 may be applied to the foregoing scheduled amortization payments in their direct order of maturity, and any remainder would be applied to the amounts due in the reverse order of maturity. These payments will require a substantial portion of our cash flows from operations, thereby reducing the availability of cash flows to fund working capital requirements, including inventory purchases, capital expenditures, acquisitions and other general corporate purposes.

We will borrow the full availability under the Amended Revolver through the term thereof. Borrowings under the Amended Revolver bear interest at an alternate base rate (with a floor of 4.5%) plus 9% or at LIBOR (with a floor of 3.5%) plus 10%, at our discretion, which interest payments are due and payable monthly. Should we be in default of the credit agreement, a default rate of interest of an additional 300 basis points on amounts outstanding under the Amended Revolver, Term A and Term B loan facilities would also be payable.

In connection with the Amended Revolver, certain other provisions of our credit agreement have been amended as follows:

we are no longer required to make prepayments on our term loan facilities upon sales, transfers or other dispositions of assets;

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we are no longer subject to a mandatory available cash sweep;

we are required to make certain prepayments on our revolving loans based on excess cash flow;

**Table of Contents**

**BLOCKBUSTER INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**(Tabular dollars in millions, except per share amounts)**

the letters of credit issued under our prior revolving credit facility have been continued and cash-collateralized and will be renewed when applicable, and we are restricted with respect to the issuance of any new letters of credit;

to the extent cash collateral is released with respect to the letters of credit in an amount in excess of \$52.5 million, we are required to repay the revolving loans with such amounts, allocated to the amortization schedule in reverse order of maturity;

80% of the net proceeds of any foreign indebtedness incurred is required to be used to repay the revolving loans, allocated to the amortization schedule in reverse order of maturity;

with respect to certain extraordinary receipts received (which do not include disposition proceeds or insurance or condemnation proceeds), we are required to apply the net proceeds to repay the revolving loans, allocated to the amortization schedule in reverse order of maturity;

with respect to certain other indebtedness and equity offerings, we are required to repay the revolving loans (x) with 75% of any net proceeds greater than \$25 million and less than \$50 million and (y) with 50% of any net proceeds greater than \$50 million;

to the extent that the outstanding principal balance of the revolving loans on April 30, 2010 is in excess of \$75 million, we will be required to pay a fee to the revolving lenders equal to the lesser of \$5 million and 10% of such excess;

we are permitted to enter into the sale and leaseback of our domestic store locations, provided that the fair market value of all property sold does not exceed \$28 million, and after giving effect to such sale the Leverage Ratio does not exceed 2.50 to 1.00;

we are restricted against paying dividends on our common stock until the revolving loans are paid in full;

we are restricted from making additional investments in Foreign Subsidiaries in excess of \$20 million;

we are permitted to enter into certain intercompany affiliate transactions with non-loan parties on an arms length basis;

our Fixed Charge Coverage Ratio was amended such that we are required to maintain a Fixed Charge Coverage Ratio of not less than 1.25 to 1.00 for periods ending March 31, 2009 through January 3, 2010, and of not less than 1.30 to 1.00 for periods ending March 31, 2010 and thereafter;

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our Leverage Ratio was amended such that we are required to maintain a maximum Leverage Ratio of 2.75 to 1.00, tested on a quarterly basis; and

we are restricted from making capital expenditures (a) in excess of \$30 million in the 2009 fiscal year, (b) in excess of \$40 million in the 2010 fiscal year, plus up to \$10 million of amounts unused in the 2009 fiscal year, and (c) in excess of \$80 million in the 2011 fiscal year.

We will pay or have paid the following fees in connection with the amendment to our credit agreement and Amended Revolver:

an amendment fee of 25 basis points to all consenting term lenders;

a commitment fee of up to 2% to certain of the lenders who provided early commitments to fund the Amended Revolver (the specified lenders );

a funding fee of 8.0% to the specified lenders funding the Amended Revolver, and a funding fee of 11.25% to the other lenders funding the Amended Revolver;

letter of credit fees computed at a rate 2% per annum on the aggregate face amount of outstanding letters of credit;

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

an exit fee of 3% on all repayments of the Amended Revolver; and

a work fee of \$250,000, which was credited toward deposit and other expenses.

The following table reflects the net proceeds from the funding of the Canadian Credit Facility and the Amended Revolver:

Proceeds from Canadian Credit Facility (1)	\$ 21.4
Payment of fees on Canadian Credit Facility (1)	(0.2)
Proceeds from Amended Revolver	250.0
Payment of pre-amendment revolver balance	(205.0)
Payment of fees on amended credit facility (2)	(24.3)
Net proceeds from funding	\$ 41.9

(1) Converted to US Dollars based on the May 11, 2009 exchange rate.

(2) Includes only those fees paid directly to lenders as part of the funding transaction. Other fees have been incurred for financing costs. In addition, we used \$118.3 million of our previous cash balances, cash from operations and net proceeds from the fundings to cash-collateralize our letter of credit requirements on May 11, 2009.

The following table sets forth our principal borrowings (payments) on long-term debt by quarter:

	Prior Revolving Credit Facility	Amended Revolver	Term A Loan Facility	Term B Loan Facility	Canadian Credit Facility *	Senior Subordinated Notes	Total Payments Due
<b>Fiscal 2009:</b>							
Second quarter (pre-funding)	\$	\$	\$ (1.3)	\$ (23.8)	\$	\$	\$ (25.1)
Second quarter (post-funding)	(205.0)	250.0		(8.7)	21.4		57.7
Third quarter			(8.7)	(8.6)			(17.3)
Fourth quarter		(25.0)		(8.7)			(33.7)
	\$ (205.0)	\$ 225.0	\$ (10.0)	\$ (49.8)	\$ 21.4	\$	\$ (18.4)
<b>Fiscal 2010:</b>							
First quarter	\$	\$ (60.0)	\$	\$ (8.6)	\$	\$	\$ (68.6)
Second quarter		(75.0)		(8.7)			(83.7)



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Third quarter		(90.0)		(66.6)	(21.4)		(178.0)
Fourth quarter				(66.7)			(66.7)
	\$	\$ (225.0)	\$	\$ (150.6)	\$ (21.4)	\$	\$ (397.0)
<b>Fiscal 2011:</b>							
First quarter	\$	\$	\$	\$ (66.6)	\$	\$	\$ (66.6)
Second quarter							
Third quarter				(66.7)			(66.7)
Fourth quarter							
	\$	\$	\$	\$ (133.3)	\$	\$	\$ (133.3)
<b>Fiscal 2012:</b>							
First quarter	\$	\$	\$	\$	\$	\$	\$
Second quarter							
Third quarter						(300.0)	(300.0)
Fourth quarter							
	\$	\$	\$	\$	\$	\$ (300.0)	\$ (300.0)

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

\* Converted to US Dollars based on the May 11, 2009 exchange rate

We were in compliance with the maximum leverage ratio covenant, required minimum fixed charge coverage ratio covenant, the maximum capital expenditure covenant and all other applicable covenants, as of July 5, 2009, and we expect to remain in compliance under the amended credit facility for the foreseeable future.

**Note 3 Stock and Share-Based Payments**

For the thirteen weeks ended July 5, 2009 and July 6, 2008, we recognized \$2.4 million and \$5.6 million, respectively, of share-based compensation expense related to stock options, restricted shares and restricted share units. For the twenty-six weeks ended July 5, 2009 and July 6, 2008, we recognized approximately \$4.4 million and \$9.8 million, respectively, of share-based compensation expense related to stock options, restricted shares and restricted share units.

During the twenty-six weeks ended July 5, 2009, no stock options were granted or exercised and 0.6 million stock options were cancelled. In addition, 5.6 million restricted shares or restricted share units were granted to employees, 1.0 million restricted shares and restricted share units vested, and 0.1 million restricted shares and restricted share units were cancelled. As of July 5, 2009, 17.5 million stock options and 6.3 million restricted shares and restricted share units remained outstanding.

The unamortized compensation expense, net of estimated forfeitures, related to restricted shares, restricted share units and stock options issued and outstanding as of July 5, 2009 will be recognized in future periods as follows:

	<b>Restricted Shares and Restricted Share Units</b>	<b>Stock Options</b>	<b>Total</b>
Twenty-six week period ending January 3, 2010	\$ 1.4	\$ 1.4	\$ 2.8
Year ending January 2, 2011	1.2	1.3	2.5
Year ending January 1, 2012 and thereafter	0.5		0.5
Total	\$ 3.1	\$ 2.7	\$ 5.8

**Note 4 Related Party Transactions**

On March 29, 2007, Strauss Zelnick, a member of our Board of Directors, was appointed chairman of the board of directors of Take-Two Interactive Software, Inc. ( Take-Two ), a global publisher, developer and distributor of interactive games software, hardware and accessories and a party to considerable commercial transactions with us. On February 15, 2008, Take-Two announced the appointment of Mr. Zelnick as executive chairman. In addition, ZelnickMedia Corporation ( ZelnickMedia ), of which Mr. Zelnick is a founder and principal owner, entered into a management agreement with Take-Two on March 30, 2007, as amended on July 26, 2007 and February 14, 2008, pursuant to which ZelnickMedia provides financial and management consulting services to Take-Two. Mr. Zelnick is entitled during the term of the management agreement to serve as chairman of Take-Two's board of directors and will also have the authority during such term to hire and/or terminate the chief executive officer and chief financial officer of Take-Two, subject to the approval of Take-Two's compensation committee. We paid Take-Two \$0.8 million and \$3.3 million, respectively, for the thirteen and twenty-six weeks ended July 5, 2009, and \$32.2 million and \$36.6 million, respectively, for the thirteen and twenty-six weeks ended July 6, 2008, respectively, pursuant to our commercial arrangements with Take-Two. At



**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

July 5, 2009, our Consolidated Balance Sheets included \$0.1 million of accrued revenue-share expenses for Take-Two recorded in Accrued expenses and a net \$0.5 million reduction for product returns and other vendor credits from Take-Two in Accounts payable. At January 4, 2009, our Consolidated Balance Sheets included \$1.1 million of accrued revenue-share expenses for Take-Two recorded in Accrued expenses and a net \$2.6 million reduction for product returns and other vendor credits from Take-Two in Accounts payable.

**Note 5 Commitments and Contingencies**

On June 8, 2001, *C-Span Entertainment, et al v. Blockbuster Inc., et al*, was filed in the 192<sup>nd</sup> Judicial District Court of Dallas County, Texas. Plaintiffs purchased eleven Blockbuster corporate stores in East Texas in 1999 and turned them into franchise stores. Plaintiffs claimed that before consummation of the sales, they received inaccurate financial information and that Blockbuster made false verbal representations concerning inventory of the stores. On September 21, 2001, plaintiffs amended their lawsuit to include as a defendant the law firm that represented them in the store purchase. On February 2, 2004, the court granted Blockbuster's motion for partial summary judgment and dismissed all of plaintiffs' fraud claims. On September 28, 2004, the court granted Blockbuster's motion to enforce plaintiffs' waiver of a jury trial and to try the case as a non-jury case. Plaintiffs' claims against the law firm will be adjudicated in a separate trial. On the eve of trial, the court allowed the plaintiffs to amend their pleadings and assert fraud in the inducement, along with plaintiffs' pending claims for breach of warranties, breach of contract and conversion. Plaintiffs' amended petition sought \$6 million to \$20 million in actual damages, \$20 million in punitive damages, pre-judgment and post-judgment interest and attorneys' fees. On April 5, 2006, the trial court rendered a judgment in the case awarding plaintiffs damages of \$5.9 million, pre-judgment interest of approximately \$2.1 million and attorneys' fees through the date of the judgment of approximately \$0.5 million, for a total of approximately \$8.6 million. On June 15, 2006, Blockbuster appealed the judgment to the Fifth Court of Appeals, Dallas County, Texas. On August 12, 2008, the Fifth Court of Appeals, Dallas County, Texas reversed the before-referenced judgment of the trial court and rendered judgment for Blockbuster and awarded Blockbuster damages of \$2.5 million in costs and attorney's fees. Plaintiffs asked the Fifth Court of Appeals, Dallas County, Texas to reconsider their granting of this judgment. On November 6, 2008, the Fifth Court of Appeals, Dallas County, Texas overruled Plaintiffs' request for reconsideration. On January 21, 2009, Plaintiffs filed a petition for review with the Texas Supreme Court of the before-referenced judgment for Blockbuster by the Fifth Court of Appeals, Dallas County, Texas. On May 7, 2009, plaintiffs and Blockbuster filed a joint motion to dismiss with prejudice and the trial court set aside its April 5, 2006 judgment for plaintiffs and dismissed the case with prejudice.

Blockbuster was a defendant in 12 lawsuits filed by customers in nine states and the District of Columbia between November 1999 and April 2001. These putative class action lawsuits alleged common law and statutory claims for fraud and deceptive practices and/or unlawful business practices regarding our extended viewing fee policies for customers who chose to keep rental product beyond the initial rental term. Some of the cases also alleged that these policies imposed unlawful penalties and resulted in unjust enrichment. In January 2002, the 136<sup>th</sup> Judicial District Court of Jefferson County, Texas entered a final judgment approving a national class settlement (the Scott settlement). Under the approved settlement, we paid \$9.25 million in plaintiffs' attorneys' fees during the first quarter of 2005 and made certificates available to class members for rentals and discounts through November 2005. One additional extended viewing fee case in the United States is inactive and subject to dismissal pursuant to the Scott settlement. In addition, there is one case, filed on February 18, 1999 in the Circuit Court of Cook County, Illinois, Chancery Division, *Cohen v. Blockbuster*, not completely resolved by the Scott settlement. Marc Cohen, Uwe Stueckrad, Marc Perper and Denita Sanders assert common law and statutory claims for fraud and deceptive practices, unjust enrichment and unlawful penalties regarding Blockbuster's extended viewing fee policies. Such claims were brought against Blockbuster, individually and on behalf of all

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

entities doing business as Blockbuster or Blockbuster Video. Plaintiffs seek relief on behalf of themselves and other plaintiff class members including actual damages, attorneys' fees and injunctive relief. By order dated April 27, 2004, the *Cohen* trial court certified plaintiff classes for U.S. residents who incurred extended viewing fees and/or purchased unreturned videos between February 18, 1994 and December 31, 2004, and who were not part of the Scott settlement or who do not have a Blockbuster membership with an arbitration clause. In the same order, the trial court certified a defendant class comprised of all entities that have done business in the United States as Blockbuster or Blockbuster Video since February 18, 1994. On August 15, 2005, the trial court denied Blockbuster's motion to reconsider the trial court's certification of plaintiff classes. On September 26, 2007, the Illinois Appellate Court remanded the trial court's decision to certify plaintiff classes back to the trial court for reconsideration of our motion to decertify plaintiff classes. Plaintiffs did not petition the Illinois Supreme Court for leave to appeal. On March 14, 2008, upon reconsideration the trial court granted Blockbuster's motion to decertify plaintiff classes and decertified both plaintiff and defendant classes. We believe the plaintiffs' position in *Cohen* is without merit and we intend to vigorously defend ourselves in the lawsuit. In addition, two putative class action lawsuits are pending against Blockbuster in Canada. William Robert Hazell filed an action in the Supreme Court of British Columbia on August 24, 2001 against Viacom Entertainment Canada Inc., Viacom, Blockbuster Canada Inc. and Blockbuster. The case asserts claims for unconscionability, violations of the trade practices act, breach of contract and high handed conduct. The relief sought includes actual damages, disgorgement, and exemplary and punitive damages. Douglas R. Hedley filed an action in the Court of Queen's Bench, Judicial Centre of Regina, in Saskatchewan on July 19, 2002. The case asserts claims of unconscionability, unjust enrichment, misrepresentation and deception, and seeks recovery of actual damages of \$3 million, disgorgement, declaratory relief, punitive and exemplary damages of \$1 million and attorneys' fees. We believe the plaintiffs' positions in all of these cases are without merit and, if necessary, intend to vigorously defend ourselves.

Blockbuster is a defendant in two putative class action lawsuits arising out of our no late fees program. On March 4, 2005, Beth Creighton filed a putative class action in the Circuit Court of Multnomah County, Oregon alleging that Blockbuster's no late fees program violates Oregon's consumer protection statutes prohibiting deceptive and misleading business practices. The suit alleges fraud and unjust enrichment and seeks equitable and injunctive relief. Blockbuster removed the case to the United States District Court of Oregon. We believe that this claim is without merit and we intend to vigorously defend ourselves. On May 20, 2009, Nicholas Lampone filed a putative class action in the Superior Court of Los Angeles County, California alleging Blockbuster's no late fees program is a breach of contract and violates California's consumer protection and unfair competition statutes prohibiting unfair, unlawful and deceptive business practices. Plaintiff seeks class certification, restitution, injunctive relief, general damages, special damages, compensatory damages, punitive damages, equitable relief, attorneys' fees, interest, and costs. Blockbuster removed the case to the United States District Court for the Central District of California. We believe that this claim is without merit and we intend to vigorously defend ourselves.

Blockbuster is a defendant in two lawsuits arising out of the Blockbuster and Facebook websites. On April 9, 2008, Cathryn Elaine Harris filed a putative class action complaint under the Video Privacy Protection Act ( VPPA ) in the United States District Court for the Eastern District of Texas. On June 3, 2008, plaintiff Harris filed her first amended class action complaint adding Mario Herrera and Maryam Hosseiny as additional named plaintiffs. Plaintiffs are purporting to act on behalf of every individual who has ever been a member of Facebook and Blockbuster online during the same time period since November 6, 2007, whose name, and/or address, or a title, description, or subject matter of any video tapes or other audio visual materials that were rented, sold or delivered to each individual were distributed to third parties by Blockbuster without the informed written consent of such individuals obtained at the time the disclosure was made. Plaintiffs claim Blockbuster

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

violated the VPPA when we knowingly distributed plaintiffs video tape rental and sales records to Facebook, a third party, without plaintiffs consent at the time of the disclosure. Plaintiffs seek class certification, statutory damages, punitive damages, attorneys' fees, costs, and injunctive relief. On December 30, 2008, the trial court granted Blockbuster's amended motion to transfer venue and transferred the lawsuit to the United States District Court for the Northern District of Texas, Dallas Division. We believe that the claims are without merit and intend to vigorously defend ourselves in the lawsuit. On August 12, 2008, Sean Lane, Mohannaed Sheikha, Sean Martin, Ali Sammour, Mohammed Zidan, Sara Karrow, Colby Henson, Denton Hunker, Firas Sheikha, Hassen Sheikha, Linda Stewart, Tina Tran, Matthew Smith, Erica Parnell, John Conway, Austin Muhs, Phillip Huerta, Alicia Hunker, and Megan Lynn Hancock (a minor, through her parent Rebecca Holey) filed a putative class action complaint under the VPPA, the Electronic Communications Privacy Act ( ECPA ), the Computer Fraud and Abuse Act ( CFAA ), California's Consumer Legal Remedies Act, and California's Computer Crime Law in the United States District Court for the Northern District of California. Plaintiffs assert claims against Facebook, Inc., Blockbuster Inc., Fandango, Inc., Hotwire, Inc., STA Travel, Inc., Overstock.com, Inc., Zappos.com, Inc., Gamefly, Inc., and John Does 1-40, corporations. Plaintiffs are purporting to act on behalf of every Facebook member who visited one or more of Facebook's affiliates' websites and engaged in activities that triggered the Facebook affiliates' websites to communicate with Facebook regarding the activity from November 6, 2007 to December 5, 2007. Plaintiffs claim Blockbuster violated the VPPA, ECPA, and CFAA by allegedly violating the plaintiffs' privacy through their activities on the Blockbuster and Facebook websites. Plaintiffs seek class certification, injunctive and equitable relief, statutory damages, attorneys' fees, and costs. Plaintiffs have stipulated that Blockbuster is not required to respond to the pending complaint at this time. We believe that the claims are without merit and should it become necessary, we intend to vigorously defend ourselves.

Blockbuster is subject to various other legal proceedings in the course of conducting our business, including our business as a franchisor. Although we believe that these proceedings are not likely to result in judgments that will have a material adverse effect on our business, we cannot predict the impact of future developments affecting our outstanding claims and litigation.

**Note 6 Segment Information**

We operate our business in two reportable business segments: Domestic and International. Segments have been identified based on how management makes operating decisions, assesses performance and allocates resources. Management reviews asset information on a global basis, not by segment.

The Domestic segment is comprised of all U.S. store operations and by-mail subscription service operations in addition to the digital delivery of movies through blockbuster.com. The International segment is comprised of all non-U.S. store operations, including operations in Europe, Latin America, Australia, Canada, Mexico and Asia.

	<b>Domestic Segment</b>	<b>International Segment</b>	<b>Unallocated Corporate</b>	<b>Total</b>
<b>Thirteen weeks ended July 5, 2009</b>				
Revenues	\$ 712.0	\$ 307.4	\$	\$ 1,019.4
Operating income (loss)	28.6	2.6	(32.7)	(1.5)
Depreciation and intangible amortization	24.5	7.9	1.4	33.8
Net capital expenditures	3.3	0.9	1.3	5.5
<b>Thirteen weeks ended July 6, 2008</b>				
Revenues	\$ 896.5	\$ 408.0	\$	\$ 1,304.5
Operating income (loss)	21.1	2.1	(43.0)	(19.8)
Depreciation and intangible amortization	24.8	11.7	1.4	37.9

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Net capital expenditures	12.0	6.1	2.6	20.7
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**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

	<b>Domestic Segment</b>	<b>International Segment</b>	<b>Unallocated Corporate</b>	<b>Total</b>
<b>Twenty-six weeks ended July 5, 2009</b>				
Revenues	\$ 1,518.2	\$ 623.4	\$	\$ 2,141.6
Operating income (loss)	89.4	13.3	(54.1)	48.6
Depreciation and intangible amortization	50.1	15.7	2.8	68.6
Net capital expenditures	9.3	2.2	2.5	14.0
<b>Twenty-six weeks ended July 6, 2008</b>				
Revenues	\$ 1,853.3	\$ 845.3	\$	\$ 2,698.6
Operating income (loss)	105.3	24.0	(78.9)	50.4
Depreciation and intangible amortization	50.7	23.0	4.1	77.8
Net capital expenditures	27.7	8.5	4.4	40.6

**Note 7 Condensed Consolidating Financial Statements**

Our Senior Subordinated Notes were issued by Blockbuster Inc., which conducts the majority of our domestic operations. All domestic subsidiaries have provided, on a senior subordinated basis, a joint and several guarantee of the Senior Subordinated Notes. Our domestic subsidiaries consist primarily of our distribution center. There are no significant restrictions on the parent company's ability to obtain funds from any of the guarantor subsidiaries in the form of a dividend or loan. The notes are not guaranteed by our foreign subsidiaries. Additional information regarding our Senior Subordinated Notes is included in Note 2 above.

Blockbuster Inc. and its non-guarantor subsidiaries are parties to various intercompany agreements, which affect the amount of operating expenses reported in the following condensed consolidating statements of operations and corresponding amounts in the condensed consolidating balance sheets and condensed consolidating statements of cash flows. Among other things, management fees are charged to the non-guarantor subsidiaries relating to the use of tradenames, information systems and other corporate overhead. An allocation of corporate overhead expenses has also been made to our guarantor subsidiaries. These intercompany amounts are eliminated in consolidation.

We file a consolidated U.S. federal income tax return. All income taxes are allocated in accordance with our tax matters agreement with Viacom.



Table of Contents**BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

The following financial information presents condensed consolidating statements of operations, balance sheets and statements of cash flows for Blockbuster Inc., all guarantor subsidiaries, all non-guarantor subsidiaries and the eliminations necessary to arrive at the information for Blockbuster on a consolidated basis. The information has been presented as if Blockbuster Inc. accounted for its ownership of the guarantor and non-guarantor subsidiaries using the equity method of accounting.

	<b>Statement of Operations for the Thirteen Weeks Ended July 5, 2009</b>				
	<b>Blockbuster Inc.</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Blockbuster Inc.</b>
<b>Revenues:</b>					
Rental revenues	\$ 609.8	\$	\$ 179.4	\$	\$ 789.2
Merchandise sales	97.8		127.1		224.9
Other revenues	11.8	17.1	0.5	(24.1)	5.3
	719.4	17.1	307.0	(24.1)	1,019.4
<b>Cost of sales:</b>					
Cost of rental revenues	227.2		58.5		285.7
Cost of merchandise sold	78.8		93.9		172.7
	306.0		152.4		458.4
Gross profit	413.4	17.1	154.6	(24.1)	561.0
<b>Operating expenses:</b>					
General and administrative	366.1	17.1	144.0	(24.1)	503.1
Advertising	19.2		6.4		25.6
Depreciation and intangible amortization	26.0		7.8		33.8
	411.3	17.1	158.2	(24.1)	562.5
<b>Operating income (loss)</b>	2.1		(3.6)		(1.5)
Interest (expense) income, net	(28.6)		0.6		(28.0)
Other items, net	(5.9)		(0.1)		(6.0)
<b>Income (loss) before income taxes</b>	(32.4)		(3.1)		(35.5)
Provision for income taxes	(0.2)		(1.2)		(1.4)
Equity in income (loss) of affiliated companies, net of tax	(4.3)			4.3	
<b>Net income (loss)</b>	\$ (36.9)	\$	\$ (4.3)	\$ 4.3	\$ (36.9)



**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

	<b>Statement of Operations for the Thirteen Weeks Ended July 6, 2008</b>				
	<b>Blockbuster Inc.</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Blockbuster Inc.</b>
<b>Revenues:</b>					
Rental revenues	\$ 749.4	\$	\$ 222.9	\$	\$ 972.3
Merchandise sales	140.9		182.9		323.8
Other revenues	16.9	23.3	1.6	(33.4)	8.4
	907.2	23.3	407.4	(33.4)	1,304.5
<b>Cost of sales:</b>					
Cost of rental revenues	323.7		73.8		397.5
Cost of merchandise sold	111.8		140.0		251.8
	435.5		213.8		649.3
Gross profit	471.7	23.3	193.6	(33.4)	655.2
<b>Operating expenses:</b>					
General and administrative	434.0	23.3	181.3	(33.4)	605.2
Advertising	24.9		7.0		31.9
Depreciation and intangible amortization	26.2		11.7		37.9
	485.1	23.3	200.0	(33.4)	675.0
<b>Operating income (loss)</b>	(13.4)		(6.4)		(19.8)
Interest (expense) income, net	(19.1)		1.3		(17.8)
Other items, net	(0.2)		0.1		(0.1)
<b>Income (loss) from continuing operations before income taxes</b>	(32.7)		(5.0)		(37.7)
Provision for income taxes	(1.4)		(2.8)		(4.2)
Equity in income (loss) of affiliated companies, net of tax	(7.8)			7.8	
<b>Net income (loss)</b>	\$ (41.9)	\$	\$ (7.8)	\$ 7.8	\$ (41.9)

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

	<b>Statement of Operations for the Twenty-Six Weeks Ended July 5, 2009</b>				
	<b>Blockbuster Inc.</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Blockbuster Inc.</b>
<b>Revenues:</b>					
Rental revenues	\$ 1,292.6	\$	\$ 357.3	\$	\$ 1,649.9
Merchandise sales	216.0		264.4		480.4
Other revenues	24.6	34.6	1.0	(48.9)	11.3
	1,533.2	34.6	622.7	(48.9)	2,141.6
<b>Cost of sales:</b>					
Cost of rental revenues	484.8		115.1		599.9
Cost of merchandise sold	193.4		196.6		390.0
	678.2		311.7		989.9
Gross profit	855.0	34.6	311.0	(48.9)	1,151.7
<b>Operating expenses:</b>					
General and administrative	728.3	34.7	282.4	(48.9)	996.5
Advertising	25.9		12.1		38.0
Depreciation and intangible amortization	53.0		15.6		68.6
	807.2	34.7	310.1	(48.9)	1,103.1
<b>Operating income (loss)</b>	47.8	(0.1)	0.9		48.6
Interest (expense) income, net	(46.6)		1.4		(45.2)
Other items, net	(7.3)		1.7		(5.6)
<b>Income (loss) before income taxes</b>	(6.1)	(0.1)	4.0		(2.2)
Provision for income taxes	(2.3)		(4.7)		(7.0)
Equity in income (loss) of affiliated companies, net of tax	(0.8)			0.8	
<b>Net income (loss)</b>	\$ (9.2)	\$ (0.1)	\$ (0.7)	\$ 0.8	\$ (9.2)

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

	<b>Statement of Operations for the Twenty-Six Weeks Ended July 6, 2008</b>				
	<b>Blockbuster Inc.</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Blockbuster Inc.</b>
<b>Revenues:</b>					
Rental revenues	\$ 1,574.8	\$	\$ 473.8	\$	\$ 2,048.6
Merchandise sales	266.0		367.6		633.6
Other revenues	35.3	44.4	2.5	(65.8)	16.4
	1,876.1	44.4	843.9	(65.8)	2,698.6
<b>Cost of sales:</b>					
Cost of rental revenues	660.3		147.7		808.0
Cost of merchandise sold	212.5		281.2		493.7
	872.8		428.9		1,301.7
Gross profit	1,003.3	44.4	415.0	(65.8)	1,396.9
<b>Operating expenses:</b>					
General and administrative	859.7	44.5	367.9	(65.8)	1,206.3
Advertising	43.9		18.5		62.4
Depreciation and intangible amortization	54.8		23.0		77.8
	958.4	44.5	409.4	(65.8)	1,346.5
<b>Operating income (loss)</b>	44.9	(0.1)	5.6		50.4
Interest (expense) income, net	(38.5)		2.6		(35.9)
Other items, net	0.3				0.3
<b>Income (loss) from continuing operations before income taxes</b>	6.7	(0.1)	8.2		14.8
Provision for income taxes	(2.3)		(8.7)		(11.0)
Equity in income (loss) of affiliated companies, net of tax	(0.9)			0.9	
<b>Income (loss) from continuing operations</b>	3.5	(0.1)	(0.5)	0.9	3.8
Income (loss) from discontinued operations, net of tax		(0.2)	(0.1)		(0.3)
<b>Net income (loss)</b>	\$ 3.5	\$ (0.3)	\$ (0.6)	\$ 0.9	\$ 3.5

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

	<b>Balance Sheet as of July 5, 2009</b>				
	<b>Blockbuster Inc.</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Blockbuster Inc.</b>
<b>Assets</b>					
Current assets:					
Cash and cash equivalents	\$ 62.2	\$ 0.6	\$ 36.2	\$	\$ 99.0
Restricted cash	118.6		5.3		123.9
Receivables, net	40.6		22.7		63.3
Intercompany receivables		0.8	88.7	(89.5)	
Merchandise inventories	147.5		151.6		299.1
Rental library, net	245.0		91.5		336.5
Deferred income taxes			11.7		11.7
Prepaid and other current assets	98.4		37.8		136.2
<b>Total current assets</b>	<b>712.3</b>	<b>1.4</b>	<b>445.5</b>	<b>(89.5)</b>	<b>1,069.7</b>
Property and equipment, net	270.7		84.5		355.2
Deferred income taxes	88.0		14.8		102.8
Investment in subsidiaries	443.3			(443.3)	
Intangibles, net	10.0		0.7		10.7
Goodwill	231.9		106.2		338.1
Other assets	56.6		2.3		58.9
	\$ 1,812.8	\$ 1.4	\$ 654.0	\$ (532.8)	\$ 1,935.4
<b>Liabilities and Stockholders Equity</b>					
Current liabilities:					
Accounts payable	\$ 158.4	\$ 1.9	\$ 83.5	\$	\$ 243.8
Intercompany payables	89.5			(89.5)	
Accrued expenses	311.5	0.3	79.0		390.8
Current portion of long-term debt	203.3				203.3
Current portion of capital lease obligations	6.7		0.3		7.0
Deferred income taxes	88.0		13.6		101.6
<b>Total current liabilities</b>	<b>857.4</b>	<b>2.2</b>	<b>176.4</b>	<b>(89.5)</b>	<b>946.5</b>
Long-term debt, less current portion	656.6		21.5		678.1
Capital lease obligations, less current portion	23.4				23.4
Other liabilities	51.3		12.0		63.3
	1,588.7	2.2	209.9	(89.5)	1,711.3
Total stockholders equity	224.1	(0.8)	444.1	(443.3)	224.1
	\$ 1,812.8	\$ 1.4	\$ 654.0	\$ (532.8)	\$ 1,935.4

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

	<b>Balance Sheet as of January 4, 2009</b>				
	<b>Blockbuster Inc.</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Blockbuster Inc.</b>
<b>Assets</b>					
Current assets:					
Cash and cash equivalents	\$ 92.5	\$ 0.1	\$ 62.3	\$	\$ 154.9
Receivables, net	84.6		32.5		117.1
Intercompany receivables		4.9	66.8	(71.7)	
Merchandise inventories	257.6		175.2		432.8
Rental library, net	272.7		83.1		355.8
Deferred income taxes			13.4		13.4
Prepaid and other current assets	145.7		38.9		184.6
<b>Total current assets</b>	<b>853.1</b>	<b>5.0</b>	<b>472.2</b>	<b>(71.7)</b>	<b>1,258.6</b>
Property and equipment, net	312.4		93.6		406.0
Deferred income taxes	111.2		13.1		124.3
Investment in subsidiaries	425.4			(425.4)	
Intangibles, net	10.7		0.8		11.5
Goodwill	231.9		106.2		338.1
Other assets	14.2		1.8		16.0
	<b>\$ 1,958.9</b>	<b>\$ 5.0</b>	<b>\$ 687.7</b>	<b>\$ (497.1)</b>	<b>\$ 2,154.5</b>
<b>Liabilities and Stockholders Equity</b>					
Current liabilities:					
Accounts payable	\$ 283.6	\$ 5.5	\$ 138.2	\$	\$ 427.3
Intercompany payables	71.7			(71.7)	
Accrued expenses	397.4	0.2	96.2		493.8
Current portion of long-term debt	198.0				198.0
Current portion of capital lease obligations	8.4		0.1		8.5
Deferred income taxes	111.2		14.6		125.8
<b>Total current liabilities</b>	<b>1,070.3</b>	<b>5.7</b>	<b>249.1</b>	<b>(71.7)</b>	<b>1,253.4</b>
Long-term debt, less current portion	583.0				583.0
Capital lease obligations, less current portion	28.3				28.3
Other liabilities	63.0		12.5		75.5
	<b>1,744.6</b>	<b>5.7</b>	<b>261.6</b>	<b>(71.7)</b>	<b>1,940.2</b>
<b>Total stockholders equity</b>	<b>214.3</b>	<b>(0.7)</b>	<b>426.1</b>	<b>(425.4)</b>	<b>214.3</b>
	<b>\$ 1,958.9</b>	<b>\$ 5.0</b>	<b>\$ 687.7</b>	<b>\$ (497.1)</b>	<b>\$ 2,154.5</b>

**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

	<b>Statement of Cash Flows for Twenty-Six Weeks Ended July 5, 2009</b>				
	<b>Blockbuster Inc.</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Blockbuster Inc.</b>
<b>Net cash provided by (used in) operating activities</b>	\$ 56.1	\$ 0.5	\$ (29.6)	\$	\$ 27.0
<b>Investing activities:</b>					
Capital expenditures	(11.8)		(2.2)		(14.0)
Change in restricted cash	(118.6)		(5.3)		(123.9)
Other investing activities	0.5		0.2		0.7
Net cash provided by (used in) investing activities	(129.9)		(7.3)		(137.2)
<b>Financing activities:</b>					
Proceeds from credit agreement	360.0		21.4		381.4
Repayments on credit agreement	(281.1)				(281.1)
Cash dividends	(2.8)				(2.8)
Debt financing costs	(39.8)		(0.5)		(40.3)
Capital lease payments	(4.1)		(0.1)		(4.2)
Intercompany loans	11.3		(11.3)		
Net cash provided by (used in) financing activities	43.5		9.5		53.0
Effect of exchange rate changes on cash			1.3		1.3
Net decrease in cash and cash equivalents	(30.3)	0.5	(26.1)		(55.9)
Cash and cash equivalents at beginning of period	92.5	0.1	62.3		154.9
Cash and cash equivalents at end of period	\$ 62.2	\$ 0.6	\$ 36.2	\$	\$ 99.0



**Table of Contents****BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)**

	<b>Statement of Cash Flows for Twenty-Six Weeks Ended July 6, 2008</b>				
	<b>Blockbuster Inc.</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated Blockbuster Inc.</b>
<b>Net cash provided by (used in) operating activities</b>	\$ (50.6)	\$	\$ (32.3)	\$	\$ (82.9)
<b>Investing activities:</b>					
Capital expenditures	(32.1)		(8.5)		(40.6)
Other investing activities			(0.1)		(0.1)
<b>Net cash provided by (used in) investing activities</b>	(32.1)		(8.6)		(40.7)
<b>Financing activities:</b>					
Proceeds from credit agreement	115.0				115.0
Repayments on credit agreement	(27.3)				(27.3)
Cash dividends	(5.6)				(5.6)
Capital lease payments	(5.1)				(5.1)
Intercompany loans	2.7		(2.7)		
<b>Net cash provided by (used in) financing activities</b>	79.7		(2.7)		77.0
<b>Effect of exchange rate changes on cash</b>			2.1		2.1
<b>Net decrease in cash and cash equivalents</b>	(3.0)		(41.5)		(44.5)
<b>Cash and cash equivalents at beginning of period</b>	65.7	0.2	118.7		184.6
<b>Cash and cash equivalents at end of period</b>	\$ 62.7	\$ 0.2	\$ 77.2	\$	\$ 140.1

**Table of Contents**

**Item 2. *Managements Discussion and Analysis of Financial Condition and Results of Operations***  
**(Tabular Dollars in Millions)**

**Overview**

Blockbuster Inc. is a leading global provider of in-home rental and retail movie and game entertainment, with over 7,100 stores in the United States, its territories and 20 other countries as of July 5, 2009. We also offer rental and retail movie entertainment through the Internet and by mail in the United States.

While the overall media entertainment industry has remained stable over the past few years, it has experienced a channel shift primarily driven by the emergence of new methods of distribution. Recognizing that shift, we have broadened our focus beyond DVD rental to providing convenient access to media entertainment across five channels of distribution:

in-store,

by mail,

vending and kiosks,

online, and

at home (direct to the TV).

***2009 Strategic Objectives***

*Stores* We will focus on improving the customer shopping experience by:

working to restructure studio contracts to improve unit availability in the remainder of 2009; and

continuing to benefit from the proliferation of Blu-ray.

*By-Mail* We will optimize our by-mail distribution channel by:

enhancing our product offering with by-mail game rentals; and

benefitting from new multi-channel marketing efforts.

*Vending* We will pursue this distribution channel through:

an alliance with NCR, who plans to deploy over 2,500 kiosks by the end of 2009 and a total of 10,000 kiosks by the middle of 2010; and

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adding retail DVD product and games to our vending offering.

*Digital* We have and will continue to expand our digital presence using methods such as:

strategic alliances with consumer electronics device manufacturers and infrastructure providers, including:

joining forces with Samsung to provide premium digital entertainment via select new Samsung HDTVs, home theater systems and Blu-ray players; and

partnering with TiVo® to provide premium digital movie titles directly to the television set via TiVo DVRs;

adding retail Blu-ray, DVD and games to our digital library; and

improvements to our blockbuster.com website.

## **Table of Contents**

*Continued cost reductions and other financial initiatives* We intend to further reduce annualized worldwide general and administrative costs by more than \$200 million through the elimination of staffing and operational redundancies in our in-store, online and corporate support structure as well as through operational improvements. Our primary focus has been on cost reductions through:

outsourcing and reductions in compensation expense;

lease renegotiations to generate significant reductions in future store occupancy costs;

the closure of less profitable stores; and

the ongoing pursuit of the sale and licensing of our international assets.

### ***Key Financial Points for the Thirteen Weeks Ended July 5, 2009***

Same-store revenues decreased 14.7%.

General and administrative expenses decreased by \$102 million, or 17%, compared to prior year mainly due to continued cost reduction initiatives, a favorable foreign currency impact and the closure of approximately 5% of company-operated stores.

Rapidly changing consumer preferences for accessing film and game entertainment, and the worldwide economic downturn continued to negatively impact our results of operations.

Our amended credit facility was funded on May 11, 2009.

## **Outlook**

During the first half of 2009, we temporarily changed our strategy to manage the business for cash conservation, not for growth. This temporary business strategy was necessary due to the upcoming debt maturities and challenging market conditions. We completed the funding of our \$250 million amended and extended credit facility in May 2009. We believe that our new financing, combined with our cost saving initiatives and anticipated external liquidity enhancements, will improve our overall operational health and financial performance.

In the remainder of 2009, we plan to return to our strategic objectives above by increasing our unit availability, securing additional strategic alliances that leverage our strong brand and expand upon our digital presence, and to continue our cost reduction initiatives. We believe these actions will allow us to deliver solid operating results and improve our financial position through the substantial reduction of debt.

We also expect to continue facing the challenges of a depressed economy and the fragmentation of the media entertainment industry. Our current fiscal 2009 plan contemplates that worldwide same-store revenues will be lower than what we experienced in 2008. We believe that the actions we have taken to reduce costs and diversify our product offerings will help mitigate these challenges. However, there can be no assurances that conditions currently affecting the worldwide economic environment and other macroeconomic factors that could influence consumer confidence and spending behavior will not further alter our strategic objectives.

**Table of Contents****Results of Operations****Consolidated Results**

The following table sets forth a summary of consolidated results of certain operating and other financial data.

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	July 5, 2009	July 6, 2008	July 5, 2009	July 6, 2008
<b>Statements of Operations Data:</b>				
Revenues	\$ 1,019.4	\$ 1,304.5	\$ 2,141.6	\$ 2,698.6
Cost of sales	458.4	649.3	989.9	1,301.7
Gross profit	561.0	655.2	1,151.7	1,396.9
Operating expenses	562.5	675.0	1,103.1	1,346.5
Operating income (loss)	(1.5)	(19.8)	48.6	50.4
Interest expense	(28.8)	(18.4)	(46.2)	(37.6)
Interest income	0.8	0.6	1.0	1.7
Other items, net	(6.0)	(0.1)	(5.6)	0.3
Income (loss) before income taxes	(35.5)	(37.7)	(2.2)	14.8
Provision for income taxes	(1.4)	(4.2)	(7.0)	(11.0)
Income (loss) from continuing operations	(36.9)	(41.9)	(9.2)	3.8
Income (loss) from discontinued operations, net of tax				(0.3)
Net Income (loss)	\$ (36.9)	\$ (41.9)	\$ (9.2)	\$ 3.5
<b>Cash Flow Data:</b>				
Cash provided by (used in) operating activities	\$ 114.2	\$ (63.4)	\$ 27.0	\$ (82.9)
Cash provided by (used in) investing activities	\$ (129.1)	\$ (20.8)	\$ (137.2)	\$ (40.7)
Cash provided by (used in) financing activities	\$ 4.3	\$ 86.1	\$ 53.0	\$ 77.0
<b>Other Data:</b>				
Depreciation and intangible amortization	\$ 33.8	\$ 37.9	\$ 68.6	\$ 77.8
<b>Margins:</b>				
Rental margin (1)	63.8%	59.1%	63.6%	60.6%
Merchandise margin (2)	23.2%	22.2%	18.8%	22.1%
Gross margin (3)	55.0%	50.2%	53.8%	51.8%
<b>Worldwide Data:</b>				
Same-store revenues increase (decrease) (4)				
Rental revenues	(10.7)%	3.5%	(11.1)%	1.9%
Merchandise sales	(26.1)%	28.0%	(15.1)%	15.1%
Total revenues	(14.7)%	9.0%	(12.1)%	4.9%
Total stores at end of period	7,129	7,619	7,129	7,619

	Total Number	Avg Sq. Footage (in thousands)	Total Sq. Footage (in thousands)
<b>Real Estate Data at July 5, 2009:</b>			
Domestic			
Company-operated stores	3,750	5.5	20,754

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Distribution centers	39	N/A	1,121
Corporate / regional offices	12	N/A	410
International			
Company-operated stores	1,906	3.1	5,897
Distribution centers	7	N/A	180
Corporate / regional offices	7	N/A	101

**Table of Contents**

- (1) Rental gross profit (rental revenues less cost of rental revenues) as a percentage of rental revenues.
- (2) Merchandise gross profit (merchandise sales less cost of merchandise sold) as a percentage of merchandise sales.
- (3) Gross profit as a percentage of total revenues.
- (4) A store is included in the same-store revenues calculation after it has been opened and operated by us for more than 52 weeks. An acquired store becomes part of the same-store base in the 53rd week after its acquisition and conversion. The percentage change is computed by comparing total net revenues for same-stores at the end of the applicable reporting period with total net revenues from these same-stores for the comparable period in the prior year. The same-store revenues calculation does not include the impact of foreign exchange or by-mail subscription revenue. The method of calculating same-store revenues varies across the retail industry; therefore, our method of calculating same-store revenues may not be the same as other retailers' methods.

**Segments**

We operate our business in two reportable segments: Domestic and International. We identify segments based on how management makes operating decisions, assesses performance and allocates resources.

The Domestic segment is comprised of all U.S. store operations and by-mail subscription service operations in addition to the digital delivery of movies through blockbuster.com. As of July 5, 2009, we had 4,356 stores operating under the BLOCKBUSTER® brand in the United States and its territories. Of these stores, 606 stores were operated through our franchisees.

The International segment is comprised of all non-U.S. store operations including operations in Europe, Latin America, Australia, Canada, Mexico and Asia. As of July 5, 2009, we had 2,773 stores operating under the BLOCKBUSTER brand and other brand names owned by us located in 20 markets outside of the United States. Of these stores, 867 stores were operated through our franchisees. In the Republic of Ireland and Northern Ireland, we operate under the XTRA-VISION® brand name due to its strong local brand awareness. In Canada, Italy, Mexico and Denmark, we also operate freestanding and store-in-store game locations under the GAME RUSH® brand. During 2008, we sold our Chilean subsidiary coupled with a license agreement. The results for Chile have been included in continuing operations through the period in which it was sold.

The following table is a summary of operating income (loss) by business segment.

	Domestic Segment	International Segment	Unallocated/ Corporate	Total
<b>Statement of Operations Data:</b>				
<b>Thirteen Weeks Ended July 5, 2009</b>				
Revenues	\$ 712.0	\$ 307.4	\$	\$ 1,019.4
Cost of sales	306.0	152.4		458.4
Gross profit	406.0	155.0		561.0
Operating expenses	377.4	152.4	32.7	562.5
Operating income (loss)	\$ 28.6	\$ 2.6	\$ (32.7)	\$ (1.5)
<b>Thirteen Weeks Ended July 6, 2008</b>				
Revenues	\$ 896.5	\$ 408.0	\$	\$ 1,304.5

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Cost of sales	435.6	213.7		649.3
Gross profit	460.9	194.3		655.2
Operating expenses	439.8	192.2	43.0	675.0
Operating income (loss)	\$ 21.1	\$ 2.1	\$ (43.0)	\$ (19.8)



**Table of Contents**

	Domestic Segment	International Segment	Unallocated/ Corporate	Total
<b>Statement of Operations Data:</b>				
<b>Twenty-six Weeks Ended July 5, 2009</b>				
Revenues	\$ 1,518.2	\$ 623.4	\$	\$ 2,141.6
Cost of sales	678.1	311.8		989.9
Gross profit	840.1	311.6		1,151.7
Operating expenses	750.7	298.3	54.1	1,103.1
Operating income (loss)	\$ 89.4	\$ 13.3	\$ (54.1)	\$ 48.6
<b>Twenty-six Weeks Ended July 6, 2008</b>				
Revenues	\$ 1,853.3	\$ 845.3	\$	\$ 2,698.6
Cost of sales	872.8	428.9		1,301.7
Gross profit	980.5	416.4		1,396.9
Operating expenses	875.2	392.4	78.9	1,346.5
Operating income (loss)	\$ 105.3	\$ 24.0	\$ (78.9)	\$ 50.4

**Table of Contents**

**Thirteen Weeks Ended July 5, 2009 Compared with Thirteen Weeks Ended July 6, 2008**

*Domestic Segment.* The following table is a summary of domestic results of operations.

	Thirteen Weeks Ended July 5, 2009		Thirteen Weeks Ended July 6, 2008		Increase/(Decrease)	
	Amount	Percent of Revenue	Amount	Percent of Revenue	Dollar	Percent
<b>Revenues:</b>						
Rental revenues:						