NETFLIX INC
Form 10-Q/A
October 31, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q/A
Amendment No. 1

(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2012
OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number: 000-49802

Netflix, Inc.
(Exact name of Registrant as specified in its charter)

Delaware	77-0467272
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

100 Winchester Circle, Los Gatos, California 95032
(Address and zip code of principal executive offices)
(408) 540-3700
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o
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 ý No o
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 ý		Accelerated filer	o
Non-accelerated filer o	(Do not check if a smaller reporting company)	Smaller reporting company	o

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). Yes o No ý
As of September 30, 2012, there were 55,545,531 shares of the registrant's common stock, par value $0.001, outstanding.

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EXPLANATORY NOTE

Netflix, Inc. is filing this Amendment No. 1 to its Quarterly Report on Form 10-Q for the three months ended September 30, 2012, as filed with the Securities and Exchange Commission on October 29, 2012, to correct a typographical error in “Management's Discussion and Analysis of Financial Condition and Results of Operations.” The Company disclosed the sequential change of 14% in International content expense and incorrectly repeated this 14% as the change in International content expense year over year. Specifically, page 24 of the initial filing included the following sentence: “Additionally, the launches in Latin America and the U.K. and Ireland have contributed to a 14% increase in our content expenses in the International segment.” The sentence has been amended to state the following: “Additionally, the launches in Latin America and the U.K. and Ireland have contributed to a 348% increase in our content expenses in the International segment.” Other than the change to the percentage increase in content expenses in the International segment set forth above, all information included in the initial filing is unchanged.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. These forward-looking statements include, but are not limited to statements regarding: our core strategy, contribution profit (losses) and margins both domestically and internationally, consolidated revenues, DVD and streaming subscription trends, investments in our international segment, cash use in connection with content acquisitions and international expansion, investments in content and marketing, consolidated revenue, content payments and expense, free cash flow and available funds, deferred tax assets, stock repurchases and future contractual obligations. These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ materially from those included in forward-looking statements. These forward-looking statements can be identified by our use of words such as "anticipate", "expect", "will", "may" and derivations thereof. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission ("SEC") on February 10, 2012, in particular the risk factors discussed under the heading "Risk Factors" in Part I, Item IA.

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

Overview

We are the world's leading Internet subscription service for enjoying TV shows and movies. Our subscribers can instantly watch as many TV shows and movies as they want, streamed over the Internet to their TVs, computers and mobile devices. Additionally, in the U.S., our subscribers can receive standard definition DVDs, and their high definition successor, Blu-ray discs (collectively referred to as "DVD"), delivered quickly to their homes.

Our core strategy is to grow our streaming subscription business domestically and globally. We are continuously improving the customer experience, with a focus on expanding our streaming content, enhancing our user interface and extending our streaming service to even more Internet-connected devices, while staying within the parameters of our consolidated net income (loss) and operating segment contribution profit (loss) targets. Contribution profit (loss) is defined as revenue less cost of revenues and marketing expenses.

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

Prior to July 2011, in the U.S., our streaming and DVDs-by-mail operations were combined and subscribers could receive both streaming content and DVDs under a single "hybrid" plan. In July 2011, we introduced DVD only plans and separated the combined plans, making it necessary for subscribers who wish to receive both streaming services and DVDs-by-mail to have two separate subscription plans. This resulted in a price increase for our members who were taking a hybrid plan. We made a subsequent announcement during the third quarter of 2011 concerning the rebranding of our DVDs-by-mail service and the separation of the DVDs-by-mail and streaming websites. The consumer reaction to the price change, and to a lesser degree, the branding announcement, was very negative leading to significant customer cancellations. We subsequently retracted our plans to rebrand our DVDs-by-mail service and separate the DVDs-by-mail and streaming websites.

In September 2010, we began international operations by offering our streaming service in Canada. In September 2011, we expanded our streaming service to Latin America. In January 2012, we launched our streaming service in the United Kingdom ("U.K.") and Ireland. In October 2012, we launched our streaming service in Norway, Denmark, Sweden and Finland. We anticipate significant contribution losses in the International streaming segment in 2012 and extending into 2013.

As a result of the changes to our pricing and plan structure, we no longer offer a single subscription plan including both DVDs-by-mail and streaming in the U.S. Domestic subscribers who wish to receive DVDs-by-mail and watch streaming content must elect both a DVDs-by-mail subscription plan and a streaming subscription plan. Accordingly, beginning with the third quarter of 2011, management views the number of paid subscriptions as the key driver of revenues. The following metrics reflect these changes.

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Subscription Metrics:	As of /Three Months Ended, September 30, 2012 (in thousands)	June 30, 2012	September 30, 2011
Domestic streaming (1):			
Net additions	1,163	528	
Paid subscriptions at end of period	23,801	22,686	
Total subscriptions at end of period	25,101	23,938	
International streaming (1):			
Net additions	687	559	513
Paid subscriptions at end of period	3,689	3,024	989
Total subscriptions at end of period	4,311	3,624	1,480
Domestic DVD (1):			
Net losses	(634)	(849)	
Paid subscriptions at end of period	8,465	9,145	
Total subscriptions at end of period	8,606	9,240	
Consolidated (2):			
Net unique subscriber additions during period	1,700	979	(292)
Paid unique subscribers at end of period	29,892	28,254	23,832
Total unique subscribers at end of period	31,818	30,118	25,269

(1) A subscription is defined as the right to receive either the Netflix streaming service or Netflix DVD service. In connection with our subscription services, we offer free-trial memberships to new and certain rejoining members. A method of payment is required to be provided even during the free-trial period for the membership to be defined as a subscription and included in the above metrics. Total unique subscribers and total subscriptions include those subscribers who are on a free-trial. Paid unique subscribers and paid subscriptions exclude free trial memberships. A subscription would cease to be reflected in the above metrics as of the effective cancellation date. Voluntary cancellations become effective at the end of the monthly subscription period, while involuntary cancellation of the service, as a result of a failed method of payment, becomes effective immediately.

(2) For purposes of determining the number of unique subscribers, domestic subscribers who have elected both a DVD and a streaming subscription plan are considered a single unique subscriber.

The following represents our consolidated performance highlights:

	Three Months Ended September 30, 2012	June 30, 2012	September 30, 2011	Change Q3'12 vs. Q2'12	Q3'12 vs. Q3'11
	(in thousands, except per share data)				
Revenues	$905,089	$889,163	$ 821,839	2 %	10 %
Operating income	16,135	16,154	96,842	— %	(83)%
Net income	7,675	6,164	62,460	25 %	(88)%
Diluted earnings per share	0.13	0.11	1.16	18 %	(89)%
Free cash flow (3)	(20,462)	11,168	13,781	NM	NM

(3) See “Liquidity and Capital Resources” for a definition of “free cash flow” and a reconciliation of “net cash provided by operating activities” to “free cash flow.”

Consolidated revenues, operating income and net income for the third quarter of 2012 were relatively flat as compared to the second quarter of 2012. We expect consolidated revenues to increase at a modest pace sequentially in future quarters driven by the growth in global streaming subscriptions and partially offset by a decline in domestic DVD subscriptions. Investments in streaming content and marketing to support new international markets may result in future consolidated net losses.

Free cash flow for the three months ended September 30, 2012 decreased $31.6 million as compared to the three months ended June 30, 2012 to negative $20.5 million. Significant uses of cash in the quarter were cash payments for content (in excess of the expense), cash payments for property and equipment (in excess of depreciation expense) primarily related to equipment for our Open Connect content delivery

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program and reductions in miscellaneous accounts payable and accrued expenses. These uses of cash were partially offset by net income excluding the impact of non-cash stock compensation. The excess content payments over expense will continue to fluctuate over time based on new content licenses domestically and internationally and in particular may increase as a result of the timing of payments for original programming. Our movement into original programming will require more up-front cash payments than our typical licensing agreements, beginning in the fourth quarter of 2012 and increasing in 2013. We expect that free cash flow in future periods will be negatively impacted by investments in new international markets and in original content.

Segment Overview

The following tables set forth, for the periods presented, financial information for each of our reportable segments including revenues from subscriptions and contribution profit (loss) which is the measure of profitability used by our chief operating decision maker.

	Three months ended September 30, 2012			
	Domestic Streaming	International Streaming	Domestic DVD	Consolidated
	(in thousands)			
Revenues	$556,027	$77,744	$271,318	$905,089
Cost of revenues and marketing expense	465,079	170,121	140,671	775,871
Contribution profit (loss)	$90,948	$(92,377)	$130,647	$129,218

	Three months ended June 30, 2012			
	Domestic Streaming	International Streaming	Domestic DVD	Consolidated
	(in thousands)			
Revenues	$532,705	$64,973	$291,485	$889,163
Cost of revenues and marketing expense	449,533	154,400	157,719	761,652
Contribution profit (loss)	$83,172	$(89,427)	$133,766	$127,511

	Three months ended September 30, 2011 (1)		
	Domestic	International	Consolidated
	(in thousands)		
Revenues	$799,152	$22,687	$821,839
Cost of revenues and marketing expense	579,720	46,005	625,725
Contribution profit (loss)	$219,432	$(23,318)	$196,114

(1) Presented using our segment reporting prior to the fourth quarter of 2011. Prior to the fourth quarter of 2011, our domestic streaming service and DVDs-by-mail operations were combined.

Our core strategy is to grow a streaming subscription business domestically and globally. As we grow our streaming subscription segments, we have shifted spending away from the Domestic DVD segment to invest more in streaming content and marketing our streaming services. Content acquisition and licensing expenses are higher as a percentage of revenues for the Domestic and International Streaming segments as compared to the Domestic DVD segment. Content delivery expenses and fulfillment expenses tend to be lower for the streaming business. Marketing costs for the streaming business are higher as a percentage of revenues given our focus on building consumer awareness of the streaming offerings. Marketing costs are immaterial for the Domestic DVD segment. As a result of our focus on growing the streaming segments, contribution margins for the Domestic and International Streaming segments are lower than for our Domestic DVD segment. Also impacting the Domestic streaming segment was the loss of subscribers resulting from the consumer reaction to the pricing and plan changes made in the third quarter of 2011. We expect that the investments in content and marketing associated with the streaming service segments will slow relative to revenue to allow for contribution margin expansion over time. Streaming content rights are generally specific to a geographic region and accordingly our international expansion will require us to obtain additional streaming content licenses to support new global markets.

Our Domestic Streaming segment had a contribution margin of 16% for the third quarter of 2012. We expect further contribution margin expansion as investments in domestic content and marketing grow slower than domestic streaming revenue. Average number of paying domestic streaming subscriptions for the three months ending September 30, 2012 increased 4% from the prior quarter, driving the increase in Domestic streaming revenues. Content acquisition and licensing expense for our Domestic streaming segment represent the vast majority of expenses for this segment and increased 5% quarter over quarter. Marketing decreased by 7% due to reduced spending in TV and Radio

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advertising partially offset by an increase in online and direct-mail advertising. Content delivery and fulfillment expenses were immaterial for this period for the Domestic streaming segment.

Our International Streaming segment does not benefit from the established subscriber base that exists for the Domestic Streaming segment. As a result of having to build a member base from zero, investments in streaming content and marketing for our International segment are larger initially relative to revenues, in particular as new territories are launched. Marketing expenses incurred by our International streaming segment have been significant and will fluctuate dependent upon the number of International territories in which our streaming service is offered and the timing of the launch of new territories. Typically for a specific territory, marketing expenses represent a larger percentage of total expenses at launch. The contribution losses for our International segment have been significant and we expect will continue to be significant as we expand globally. Our International streaming segment had a contribution loss of $92.4 million for the third quarter of 2012 compared to a contribution loss of $89.4 million for the second quarter of 2012 due to increased investments in our content library to drive more membership growth and viewing. International streaming subscriptions increased 19% from June 30, 2012 to September 30, 2012, and the number of average paid subscriptions increased even more at 24% from the second to third quarters of 2012 due to conversion of free trial members. The increase in average paid subscriptions was the driver of the increase in International streaming revenues in the third quarter of 2012 as compared to the second quarter of 2012. International streaming subscriptions account for 15% of total streaming subscriptions at the end of the third quarter. The increase in revenues was partially offset by increases in content acquisition and licensing expenses of 14%. Content acquisition and licensing expense for our International streaming segment represent the vast majority of costs of revenues. Content delivery and fulfillment expenses were immaterial for this period and are not a material contributor to the contribution loss in our International segment.

The Domestic DVD segment had a small increase in contribution margin to 48% compared to 46% in the second quarter of 2012 due to a lower revenue mix in content utilization subject to revenue sharing agreements. Given that our core strategy is to grow a streaming subscription business both domestically and internationally, we do not expect future investments in DVD content, technology or marketing to be material. Current and future expenses for the Domestic DVD segment are primarily variable in nature such as shipping and packaging associated with delivery of DVDs-by-mail. As a result, contribution margins for the Domestic DVD segment are expected to increase slightly for the remainder of the year, while DVD subscription declines continue to moderate. DVD subscriptions as of September 30, 2012 decreased 7% from June 30, 2012, due to cancellations during the quarter, resulting in a 7% decrease in Domestic DVD revenues.

Consolidated Results of Operations

The following table sets forth, for the periods presented, the line items on our Consolidated Statements of Operations as a percentage of total revenues.

	Three Months Ended						Nine Months Ended			
	September 30, 2012		June 30, 2012		September 30, 2011		September 30, 2012		September 30, 2011	
Revenues	100	%	100	%	100	%	100	%	100	%
Cost of revenues:										
Subscription	66	%	65	%	57	%	66	%	55	%
Fulfillment expenses	7	%	7	%	8	%	7	%	8	%
Total cost of revenues	73	%	72	%	65	%	73	%	63	%
Operating expenses:										
Marketing	13	%	13	%	11	%	14	%	12	%
Technology and development	9	%	9	%	8	%	9	%	8	%
General and administrative	3	%	4	%	4	%	3	%	4	%
Total operating expenses	25	%	26	%	23	%	26	%	24	%
Operating income	2	%	2	%	12	%	1	%	13	%

Other income (expense):					
Interest expense	(1)%	(1)%	— %	(1)%	— %
Interest and other income (expense)	— %	— %	— %	— %	— %
Income before income taxes	1 %	1 %	12 %	— %	13 %
Provision for income taxes	— %	— %	4 %	— %	5 %
Net income	1 %	1 %	8 %	— %	8 %

Revenues

We derive our revenues from monthly subscription fees and recognize subscription revenues ratably over each subscriber’s monthly subscription period. We currently generate substantially all of our revenues in the U.S.

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In the Domestic streaming segment, we derive revenues from services consisting solely of streaming content offered through a subscription plan priced at $7.99 per month. In the Domestic DVD segment, we derive revenues from our DVDs-by-mail subscription services. The price per plan for DVDs-by-mail varies from $4.99 to $43.99 per month based on the number of DVDs that a subscriber may have out at any given point. Customers electing access to high definition Blu-ray discs in addition to standard definition DVDs pay a surcharge ranging from $2 to $4 per month for our most popular plans.

In July 2011, in the U.S., we introduced DVD only plans and separated DVDs-by-mail and streaming making it necessary for subscribers who opt to receive both streaming and DVDs-by-mail to have two separate subscription plans. As subscribers were able to receive both streaming and DVDs-by-mail under a single hybrid plan prior to the fourth quarter of 2011, it is impracticable to allocate revenues to the Domestic streaming and Domestic DVD segments prior to the fourth quarter of 2011.

In the International streaming segment, we derive revenues from services consisting solely of streaming content offered through a subscription plan priced at approximately the equivalent of USD7.99 per month. In September 2010, we began international operations in Canada. We expanded to Latin America in September 2011 and the U.K. and Ireland in January 2012. In October 2012, we launched our streaming service in Norway, Denmark, Sweden and Finland.

Three months ended September 30, 2012 as compared to the three months ended September 30, 2011

	Three Months Ended		Change	
	September 30, 2012	September 30, 2011	Q3'12 vs. Q3'11	
	(in thousands, except percentages)			
Revenues (1)	$905,089	$821,839	10	%
Domestic	827,345	799,152	4	%
International	77,744	22,687	243	%

(1) Presented using our segment reporting prior to the fourth quarter of 2011. The Domestic segment consists of both our domestic streaming service and DVDs-by-mail as prior to the fourth quarter of 2011, our domestic streaming service and DVDs-by-mail operations were combined.

The $83.3 million increase in our consolidated revenues was due to the $28.2 million increase in domestic revenues and a $55.1 million increase in international revenues. Domestic revenues increased 4% as a result of the 12% growth in the domestic average number of unique paying subscribers driven by new streaming subscriptions. This increase was offset in part by a 7% decline in domestic average monthly revenue per unique paying subscriber, resulting from the popularity of the streaming subscription service and a decline in the percentage of unique paying subscribers electing both a streaming and a DVD subscription.

International revenues increased by $55.1 million primarily due to our launch in Latin America in September 2011 and our launch in the U.K. and Ireland in January 2012.

Nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011

	Nine Months Ended		Change	
	September 30, 2012	September 30, 2011	YTD'12 vs. YTD'11	
	(in thousands, except percentages)			
Revenues (2)	$2,664,043	$2,329,002	14	%
Domestic	2,477,901	2,275,140	9	%
International	186,142	53,862	246	%

(2) Presented using our segment reporting prior to the fourth quarter of 2011. Prior to the fourth quarter of 2011, our domestic streaming service and DVDs-by-mail operations were combined.

The $335.0 million increase in our consolidated revenues was due to the $202.8 million increase in domestic revenues and $132.3 million increase in international revenues. Domestic revenues increased 9% as a result of the 14% growth in the domestic average number of unique paying subscribers driven by new streaming subscriptions. This increase was offset in part by a 5% decline in domestic average monthly

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revenue per unique paying subscriber, resulting from the popularity of the streaming subscription service and a decline in the percentage of unique paying subscribers electing both a streaming and a DVD subscription.
International revenues increased by $132.3 million primarily due to our launch in Latin America in September 2011 and our launch in the U.K. and Ireland in January 2012.
Three months ended September 30, 2012 as compared to the three months ended June 30, 2012

	Three Months Ended		Change	
	September 30, 2012	June 30, 2012	Q3'12 vs. Q2'12	
	(in thousands, except percentages)			
Revenues	$905,089	$889,163	2	%
Domestic streaming	556,027	532,705	4	%
International streaming	77,744	64,973	20	%
Domestic DVD	271,318	291,485	(7	)%

The $15.9 million increase in our consolidated revenues was due to the $23.3 million increase in Domestic streaming revenues and the $12.8 million increase in International streaming revenues. Domestic streaming revenues increased 4% as a result of the growth in the average number of paying streaming subscriptions. International streaming revenues increased 20% as a result of the growth in the average number of paying international streaming subscriptions resulting from continued subscription growth across all international regions. These increases in streaming revenues were offset by a $20.2 million decrease in Domestic DVD revenue due to an 8% decrease in the average number of paying DVD subscriptions.
We expect streaming subscriptions both domestically and internationally to continue to grow and DVD subscription declines to continue to moderate. As a result, we expect consolidated revenues to increase at a modest pace sequentially in future quarters.

Cost of Revenues

Cost of revenues consists of expenses related to the acquisition and licensing of content, content delivery expenses and fulfillment expenses. Costs related to free-trial periods are allocated to marketing expenses.

Content acquisition and licensing expenses consist primarily of amortization of streaming content licenses, which may or may not be recognized in the streaming content library, amortization of DVD content library and revenue sharing expenses. We obtain content through streaming content license agreements, DVD direct purchases and DVD revenue sharing agreements with studios, distributors and other suppliers. Content agreements are made in the ordinary course of business and our business is not substantially dependent on any particular agreement.

Content delivery expenses consist primarily of the postage costs to mail DVDs to and from our paying subscribers and the packaging and label costs for the mailers. We utilize both our own and third-party content delivery networks to help us efficiently stream content in high volume to our subscribers over the Internet. Content delivery expenses therefore also include equipment costs related to our own streaming content delivery networks ("Open Connect") and all third party costs associated with delivering streaming content over the Internet.

Fulfillment expenses represent those expenses incurred in content processing including operating and staffing our DVD shipping centers, as well as receiving, encoding, inspecting and warehousing our content library. Fulfillment expenses also include operating and staffing our customer service centers and credit card fees.

Three months ended September 30, 2012 as compared to the three months ended September 30, 2011

	Three Months Ended	Change

	September 30, 2012	September 30, 2011	Q3'12 vs. Q3'11
	(in thousands, except percentages)		
Total cost of revenues	$662,638	$536,617	23 %
As a percentage of revenues	73 %	65 %	

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The $126.0 million increase in cost of revenues was primarily due to the following factors:

- Content acquisition and licensing expenses increased by $171.2 million. This increase was primarily due to a 26% increase in the Domestic segment. Additionally, the launches in Latin America and the U.K. and Ireland have contributed to a 348% increase in our content expenses in the International segment. The increases in both Domestic and International content acquisition expense are due to the continued investments in existing and new streaming content available for viewing to our subscribers.
- Content delivery expenses decreased $40.8 million primarily due to a 43% decrease in the number of DVDs mailed for paid subscriptions. The decrease in the number of DVDs mailed was driven by the decrease in the average number of paid DVD subscriptions. Costs associated with our use of our own and third-party streaming content delivery networks increased 37% but were not a significant contributor to the total variance in content delivery expense.

Nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011

	Nine Months Ended September 30, 2012	September 30, 2011	Change YTD'12 vs. YTD'11
	(in thousands, except percentages)		
Total cost of revenues	$1,929,999	$1,464,746	32 %
As a percentage of revenues	73 %	63 %	

The $465.3 million increase in cost of revenues was primarily due to the following factors:

- Content acquisition and licensing expenses increased by $608.9 million. This increase was primarily due to a 44% increase in the Domestic segment. Additionally, the launches in Latin America and the U.K. and Ireland have contributed to an increase in our content expenses in the International segment. The increases in both Domestic and International content acquisition expense were due to the continued investments in existing and new streaming content available for viewing to our subscribers.
- Content delivery expenses decreased $136.1 million primarily due to a 43% decrease in the number of DVDs mailed for paid subscriptions. The decrease in the number of DVDs mailed was driven by the decrease in the average paid DVD subscriptions. Costs associated with our use of our own and third-party streaming content delivery networks increased 41% but were not a significant contributor to the total variance in content delivery expense.

Three months ended September 30, 2012 as compared to the three months ended June 30, 2012

	Three Months Ended September 30, 2012	June 30, 2012	Change Q3'12 vs. Q2'12
	(in thousands, except percentages)		
Total cost of revenues	$662,638	$643,428	3 %
As a percentage of revenues	73 %	72 %	

The $19.2 million increase in cost of revenues was primarily due a $20.1 million increase in content acquisition and licensing expenses. This increase was attributable to a 14% increase in the International segment due to an increase in streaming content titles available in our International locations and to the 5% increase in the Domestic streaming segment due to the continued investments in existing and new streaming content available for viewing to our domestic subscribers. These increases were offset by a decrease in the Domestic DVD segment of 18%.

Marketing

Marketing expenses consist primarily of advertising expenses and also include payments made to our affiliates and consumer electronics partners and payroll related expenses. Advertising expenses include promotional activities such as television and online advertising as well as allocated costs of revenues relating to free trial periods. Payments to our affiliates and consumer electronics partners may be in the form of a fixed-fee or may be a revenue sharing payment.

Three months ended September 30, 2012 as compared to the three months ended September 30, 2011

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	Three Months Ended September 30, 2012	September 30, 2011	Change Q3'12 vs. Q3'11
	(in thousands, except percentages)		
Marketing	$113,233	$89,108	27 %
As a percentage of revenues	13 %	11 %	

The $24.1 million increase in marketing expenses was primarily due to a $25.0 million increase in marketing program spending primarily in online advertising. International marketing expenses increased by 166% as expenses were higher in the third quarter of 2012 to support the marketing of our service in Latin America and U.K. and Ireland. Domestic marketing expenses decreased by 6%.

Nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011

	Nine Months Ended September 30, 2012	September 30, 2011	Change YTD'12 vs. YTD'11
	(in thousands, except percentages)		
Marketing	$367,357	$288,350	27 %
As a percentage of revenues	14 %	12 %	

The $79.0 million increase in marketing expenses was primarily due to an $85.8 million increase in marketing program spending primarily in online and television advertising. International marketing expenses increased by 220% as expenses were higher in the nine months ended September 30, 2012 to support the launch of our service in the U.K. and Ireland and continued marketing in Latin America and Canada. Domestic marketing expenses decreased by 9%.

Three months ended September 30, 2012 as compared to the three months ended June 30, 2012

	Three Months Ended September 30, 2012	June 30, 2012	Change Q3'12 vs. Q2'12
	(in thousands, except percentages)		
Marketing	$113,233	$118,224	(4)%
As a percentage of revenues	13 %	13 %	

The $5.0 million decrease in marketing expenses was primarily due to a $5.5 million decrease in domestic marketing program spending primarily in television advertising partially offset by increases in online and direct-mail advertising. Marketing expenses in our International streaming segment were relatively flat.

Technology and Development

Technology and development expenses consist of payroll and related costs incurred in making improvements to our service offerings, including testing, maintaining and modifying our user interface, our recommendation, merchandising technology and content delivery technology, as well as, telecommunications systems and infrastructure. Technology and development expenses also include costs associated with computer hardware and software.

Three months ended September 30, 2012 as compared to the three months ended September 30, 2011

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	Three Months Ended		Change
	September 30, 2012	September 30, 2011	Q3'12 vs. Q3'11
	(in thousands, except percentages)		
Technology and development	$82,521	$69,480	19 %
As a percentage of revenues	9 %	8 %	

The $13.0 million increase in technology and development expenses was primarily the result of a $13.4 million increase in personnel-related costs, including a $3.0 million increase in stock-based compensation. This increase in personnel-related costs is due to a 30% growth in average headcount supporting continued improvements in our streaming service and our international expansion.

Nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011

	Nine Months Ended		Change
	September 30, 2012	September 30, 2011	YTD'12 vs. YTD'11
	(in thousands, except percentages)		
Technology and development	$246,869	$178,250	38 %
As a percentage of revenues	9 %	8 %	

The $68.6 million increase in technology and development expenses was primarily the result of a $60.1 million increase in personnel-related costs, including an $11.7 million increase in stock-based compensation. This increase in personnel-related costs is due to a 43% growth in average headcount supporting continued improvements in our streaming service and our international expansion.

Three months ended September 30, 2012 as compared to the three months ended June 30, 2012

	Three Months Ended		Change
	September 30, 2012	June 30, 2012	Q3'12 vs. Q2'12
	(in thousands, except percentages)		
Technology and development	$82,521	$81,547	1 %
As a percentage of revenues	9 %	9 %	

Technology and development expenses were relatively flat as compared to the prior period.

General and Administrative

General and administrative expenses consist of payroll and related expenses for executive and administrative personnel, as well as professional fees and other general corporate expenses. General and administrative expenses also include the gain on disposal of DVDs.

Three months ended September 30, 2012 as compared to the three months ended September 30, 2011

	Three Months Ended		Change
	September 30, 2012	September 30, 2011	Q3'12 vs. Q3'11
	(in thousands, except percentages)		
General and administrative	$30,562	$29,792	3 %
As a percentage of revenues	3 %	4 %	

General and administrative expenses were relatively flat, primarily due to a $2.8 million increase in personnel-related costs offset by a$1.9 million decrease in costs associated with miscellaneous expenses primarily related to the use of outside and professional services, taxes and insurance.
Nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011

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	Nine Months Ended September 30, 2012	September 30, 2011	Change YTD'12 vs. YTD'11
	(in thousands, except percentages)		
General and administrative	$89,464	$83,460	7 %
As a percentage of revenues	3 %	4 %	

The $6.0 million increase in general and administrative expenses was primarily attributable to an increase in personnel-related costs of $17.2 million, including a $3.6 million increase in stock-based compensation resulting from a 13% increase in average headcount. This increase was partially offset by a $7.8 million decrease in costs associated with various legal claims against us and other miscellaneous expenses primarily related to the use of outside and professional services, taxes and insurance.

Three months ended September 30, 2012 as compared to the three months ended June 30, 2012

	Three Months Ended September 30, 2012	June 30, 2012	Change Q3'12 vs. Q2'12
	(in thousands, except percentages)		
General and administrative	$30,562	$29,810	3 %
As a percentage of revenues	3 %	4 %	

General and administrative expenses were relatively flat as compared to the prior period.

Provision for Income Taxes

Our effective tax rates for the three months ended September 30, 2012, June 30, 2012 and September 30, 2011 were 35.8%, 42.1% and 33.3%, respectively. Our effective tax rates for the nine months ended September 30, 2012 and 2011 were 40.6% and 36.9%, respectively. These rates differed from the federal statutory rate due primarily to state taxes which were partially offset by the California R&D tax credit. The increase in our effective tax rates for the three and nine months ended September 30, 2012 as compared to the three and nine months ended September 30, 2011 was primarily attributable to the expiration of the Federal R&D tax credit on December 31, 2011 and the expiration of the statute of limitations for years 1997 through 2007, resulting in a discrete benefit of $3.5 million in the third quarter of 2011.

Liquidity and Capital Resources

Cash, cash equivalents and short-term investments were $798.4 million and $797.8 million at September 30, 2012 and December 31, 2011, respectively. Our primary uses of cash include the acquisition and licensing of content, content delivery expenses, marketing and payroll related expenses. We expect to continue to make significant investments to license streaming content both domestically and internationally and expect to obtain more original programs in the fourth quarter of 2012 and in 2013. These investments could impact our liquidity and we may have negative operating cash flows and/or use of cash in future periods. Although we currently anticipate that our available funds will be sufficient to meet our cash needs for the foreseeable future, we may be required or choose to obtain additional financing. Our ability to obtain additional financing will depend on, among other things, our development efforts, business plans, operating performance, current and projected compliance with our debt covenants, and the condition of the capital markets at the time we seek financing. We may not be able to obtain such financing on terms acceptable to us or at all. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

In November 2011, we issued $200.0 million of Senior Convertible Notes and raised an additional $200.0 million through a public offering of common stock. The Senior Convertible Notes consist of $200.0 million aggregate principal amount due on December 1, 2018 and do not bear interest. In November 2009, we issued $200.0 million of our 8.50% senior notes due November 15, 2017 (the “8.50% Notes”). Interest on the 8.50% Notes is payable semi-annually at a rate of 8.50% per annum on May 15 and November 15 of each year, commencing on May 15, 2010. (See Note 5 to the consolidated financial statements.)

On June 11, 2010, we announced that our Board of Directors authorized a stock repurchase program allowing us to repurchase $300.0 million of our common stock through the end of 2012. As of September 30, 2012, $41.0 million of this authorization remained. The timing and actual number of shares repurchased is in the discretion of management and will depend on various factors, including

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price, corporate and regulatory requirements, debt covenant requirements, alternative investment opportunities and other market conditions. We do not expect to make further stock repurchases for the foreseeable future.

Free Cash Flow

We define free cash flow as cash provided by operating and investing activities excluding the non-operational cash flows from purchases, maturities and sales of short-term investments. We believe free cash flow is an important liquidity metric because it measures, during a given period, the amount of cash generated that is available to repay debt obligations, make investments, repurchase our stock, and for certain other activities. Free cash flow is considered a non-GAAP financial measure and should not be considered in isolation of, or as a substitute for, net income, operating income, cash flow from operating activities, or any other measure of financial performance or liquidity presented in accordance with GAAP.

In comparing free cash flow to net income, the major recurring differences are excess content payments over expenses, stock-based compensation expense, deferred revenue, taxes and semi-annual interest payments on the 8.50% Notes. Our receivables from customers settle quickly and deferred revenue is a source of cash flow. For streaming content, we typically enter into multi-year licenses with studios and other distributors that may result in an increase in content library and a corresponding increase in liabilities on the Consolidated Balance Sheets. The payment terms for these license fees may extend over the term of the license agreements, which typically range from six months to five years.

Three months ended September 30, 2012 as compared to the three months ended September 30, 2011

	Three Months Ended	
	September 30, 2012	September 30, 2011
	(in thousands)	
Net cash provided by operating activities	$150	$49,531
Net cash used in investing activities	(33,524)	(41,581)
Net cash used in financing activities	(158)	(23,958)
Non-GAAP free cash flow reconciliation:		
Net cash provided by operating activities	150	49,531
Acquisitions of DVD content library	(8,586)	(20,826)
Purchases of property and equipment	(13,883)	(14,080)
Other assets	1,857	(844)
Non-GAAP free cash flow	$(20,462)	$13,781

Cash provided by operating activities decreased $49.4 million, primarily due to increased payments for content acquisition and licensing other than DVD library of $158.9 million or 42%, partially offset by an increase in subscription revenues of $83.3 million or 10%.

Cash used in investing activities decreased $8.1 million, primarily due to a $12.2 million decrease in the acquisitions of DVD content. These decreases were offset by an increase of $7.1 million in the purchases, net of proceeds from sales and maturities, of short-term investments.

Cash used in financing activities was immaterial for the third quarter of 2012. In the third quarter of 2011, cash used in financing activities was $24.0 million which consisted primarily of stock repurchases of $39.6 million offset partially by the excess tax benefit and proceeds from issuance of stock options.

Free cash flow for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 decreased $34.2 million primarily due to a decrease of $52.0 million in net income as adjusted for non-cash stock based compensation resulting from cost of revenues, marketing and technology and development expenses growing faster than revenue as well as to an $11.6 million decrease in the cash flow from deferred revenue. This was partially offset by a $24.5 million decrease in the excess content payments over content expenses and a $6.2 million decrease in excess tax payments over tax provision. Payments for content increased $146.7 million while content expenses increased $171.2 million.

Nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011

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	Nine Months Ended September 30, 2012	September 30, 2011
	(in thousands)	
Net cash provided by operating activities	$38,951	$252,246
Net cash used in investing activities	(180,280)	(150,205)
Net cash provided by (used in) financing activities	3,757	(137,341)
Non-GAAP free cash flow reconciliation:		
Net cash provided by operating activities	38,951	252,246
Acquisitions of DVD content library	(30,126)	(62,010)
Purchases of property and equipment	(22,293)	(39,026)
Other assets	6,323	1,419
Non-GAAP free cash flow	$(7,145)	$152,629

Cash provided by operating activities decreased $213.3 million, primarily due to increased payments for content acquisition and licensing other than DVD library of $599.6 million or 66%, partially offset by an increase in subscription revenues of $335.0 million or 14%.

Cash used in investing activities increased $30.1 million primarily due to an $83.6 million increase in the purchases, net of proceeds from sales and maturities, of short-term investments. These increases were partially offset by a $31.9 million decrease in the acquisitions of DVD content library and a $16.7 million decrease in the purchase of property and equipment due to a decrease in purchases of automation equipment for our various shipping centers.

Cash provided by financing activities for the nine months ended September 30, 2012 was $3.8 million which consisted primarily of the excess tax benefits from stock-based compensation coupled with the proceeds from issuance of common stock, partially offset by principal payments of lease financing obligations. Cash used in financing activities for the nine months ended September 30, 2011 was $137.3 million, which consisted primarily of $199.7 million of stock repurchases in the nine months ended September 30, 2011, partially offset by the excess tax benefit from stock-based compensation and proceeds from issuance of stock options.

Free cash flow for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 decreased $159.8 million primarily due to a decrease of $168.9 million in net income as adjusted for non-cash stock based compensation resulting from cost of revenues, marketing and technology and development expenses growing faster than revenue as well as to a decrease of $27.4 million in the cash flow from deferred revenue and a $16.1 million increase in excess tax payments over tax provision. This was partially offset by a $41.2 million decrease in excess content payments over content expenses and a $21.4 million decrease in excess property and equipment payments over depreciation expense. Content payments increased $567.7 million while content expenses increased $608.9 million.

Three months ended September 30, 2012 as compared to the three months ended June 30, 2012

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	Three Months Ended September 30, 2012	June 30, 2012
	(in thousands)	
Net cash provided by operating activities	$150	$19,692
Net cash used in investing activities	(33,524)	(10,939)
Net cash used in financing activities	(158)	(117)
Non-GAAP free cash flow reconciliation:		
Net cash provided by operating activities	150	19,692
Acquisitions of DVD content library	(8,586)	(8,012)
Purchases of property and equipment	(13,883)	(3,644)
Other assets	1,857	3,132
Non-GAAP free cash flow	$(20,462)	$11,168

Cash provided by operating activities decreased $19.5 million, primarily due to increased payments for content acquisition and licensing other than DVD library of $32.5 million or 6%, partially offset by an increase in subscription revenues of $15.9 million or 2%.

Cash used in investing activities increased $22.6 million primarily due to a $10.5 million increase in the purchases, net of proceeds from sales and maturities of short-term investments. Investing activities were further impacted by a $10.2 million increase in the purchase of property and equipment primarily due to equipment for our own streaming content delivery networks ("Open Connect").

Cash used in financing activities was relatively flat in the three months ended September 30, 2012 as compared to June 30, 2012.

Free cash flow for the three months ended September 30, 2012 as compared to the three months ended June 30, 2012 decreased $31.6 million primarily due to a $13.0 million increase in excess content payments over content expenses, a $10.4 million increase in excess property and equipment payments over depreciation expense and a decrease in miscellaneous accounts payable and accrued expenses. Content payments increased $33.1 million while content expenses increased $20.1 million.

Contractual Obligations

For the purposes of this table, contractual obligations for purchases of goods or services are defined as agreements that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. The expected timing of payment of the obligations discussed above is estimated based on information available to us as of September 30, 2012. Timing of payments and actual amounts paid may be different depending on the time of receipt of goods or services or changes to agreed-upon amounts for some obligations. The following table summarizes our contractual obligations at September 30, 2012:

	Payments due by Period				
Contractual obligations (in thousands):	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Streaming content obligations (1)	$4,973,027	$2,088,881	$2,391,629	$433,549	$58,968
8.50% Notes (2)	293,500	17,000	34,000	34,000	208,500
Senior Convertible Notes (2)	200,000	—	—	—	200,000
Operating lease obligations	59,647	19,360	23,968	13,555	2,764
Lease financing obligations (3)	16,187	3,435	5,886	5,886	980

Other purchase obligations (4)	179,838	113,972	65,241	625	—
Total	$5,722,199	$2,242,648	$2,520,724	$487,615	$471,212

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(1) Streaming content obligations include agreements to acquire and license streaming content. As of September 30, 2012 such obligations were comprised of $1.3 billion of current "Content liabilities", $1.0 billion of "Non-current content liabilities" on the Consolidated Balance Sheets and $2.7 billion of obligations that are not reflected on the Consolidated Balance Sheets as they do not yet meet the criteria for asset recognition.

For those agreements with variable terms, we do not estimate what the total obligation may be beyond any minimum quantities and/or pricing as of the reporting date. For those agreements that include renewal provisions that are solely at the option of the content provider, we include the commitments associated with the renewal period to the extent such commitments are fixed or a minimum amount is specified. For these reasons, the amounts presented in the table may not provide a reliable indicator of our expected future cash outflows.
We have entered into certain streaming content license agreements that include an unspecified or a maximum number of titles that we may or may not receive in the future and/or that include pricing contingent upon certain variables, such as theatrical exhibition receipts for the title. As of the reporting date, it is unknown whether we will receive access to these titles or what the ultimate price per title will be. Accordingly such amounts are not reflected in the above contractual obligations table. However, such amounts are expected to be significant and the expected timing of payments for these commitments could range from less than one year to more than five years.

(2) Long-term debt obligations include our 8.50% senior notes consisting of principal and interest payments and the Convertible Notes consisting solely of the principal amount. Please see Note 5 of the notes to consolidated financial statements for further details.

(3) Represents the lease financing obligations for our Los Gatos, California headquarters.

(4) Other purchase obligations include all other non-cancelable contractual obligations. These contracts are primarily related to streaming content delivery, DVD content acquisition, and miscellaneous open purchase orders for which we have not received the related services or goods.

As of September 30, 2012, we had gross unrecognized tax benefits of $29.2 million and an additional $2.8 million for gross interest and penalties classified as “Other non-current liabilities” on the Consolidated Balance Sheets. At this time, we are not able to make a reasonably reliable estimate of the timing of payments in individual years due to uncertainties in the timing of tax audit outcomes; therefore, such amounts are not included in the above contractual obligations table.

Off-Balance Sheet Arrangements

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

Indemnification

The information set forth under Note 8 in the notes to the consolidated financial statements under the caption “Indemnification” is incorporated herein by reference.

Critical Accounting Policies and Estimates
The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported periods. The SEC has defined a company’s critical accounting

policies as the ones that are most important to the portrayal of a company’s financial condition and results of operations, and which require a company to make its most difficult and subjective judgments. Based on this definition, we have identified the critical accounting policies and judgments addressed below. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates.

Content Accounting

We obtain content through streaming content license agreements, DVD direct purchases and DVD revenue sharing agreements with studios, distributors and other suppliers.

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We obtain content distribution rights in order to stream TV shows and movies to subscribers' TVs, computers and mobile devices. Streaming content is generally licensed for a fixed-fee for the term of the license agreement which may have multiple windows of availability. The license agreement may or may not be recognized in content library.

When the streaming license fee is known or reasonably determinable for a specific title and the specific title is first available for streaming to subscribers, the title is recognized on the Consolidated Balance Sheets as "Current content library" for the portion available for streaming within one year and as "Non-current content library" for the remaining portion. New titles recognized in the content library are classified in the line item "Additions to streaming content library" within net cash provided by operating activities on the Consolidated Statements of Cash Flows. The streaming content library is reported at the lower of unamortized cost or estimated net realizable value. We amortize the content library on a straight-line basis over each title's contractual window of availability, which typically ranges from six months to five years.

The amortization of the streaming content library is classified in "Cost of revenues—Subscription" on the Consolidated Statements of Operations and in the line item "Amortization of streaming content library" within net cash provided by operating activities on the Consolidated Statements of Cash Flows. Costs related to subtitles, dubbing, and closed captioning are capitalized in "Current content library" on the Consolidated Balance Sheets and amortized over the window of availability. Payment terms for these license fees may extend over the term of the license agreement, which typically ranges from six months to five years. For the titles recognized in content library, the license fees due but not paid are classified on the Consolidated Balance Sheets as current "Content liabilities" for the amounts due within one year and as "Non-current content liabilities" for the amounts due beyond one year. Changes in these liabilities are classified in the line item "Change in streaming content liabilities" within net cash provided by operating activities on the Consolidated Statement of Cash Flows. We record the streaming content library assets and their related liability on our Consolidated Balance Sheets at the gross amount of the liability. Payments for the titles not yet available for streaming are not yet recognized in the content library but in prepaid content. Minimum commitments for the titles not yet available for streaming are not yet recognized in the content library and are included in Note 8 to the consolidated financial statements.

When the streaming license fee is not known or reasonably determinable for a specific title, the title does not meet the criteria for asset recognition in the content library. Titles do not meet the criteria for asset recognition in the content library because the underlying license agreement does not specify the number of titles or the license fee per title or the windows of availability per title, so that the license fee is not known or reasonably determinable for a specific title. Typical payment terms for these agreements, which can range from three to five years, require us to make equal fixed payments at the beginning of each quarter of the license term. To the extent that cumulative payments exceed cumulative amortization, prepaid content is recorded on the Consolidated Balance Sheets. We amortize the license fees on a straight-line basis over the term of each license agreement. The amortization is classified in "Cost of revenues—Subscription" on the Consolidated Statements of Operations and in the line item "Net income" within net cash provided by operating activities on the Consolidated Statements of Cash Flows. Changes in prepaid content are classified within net cash provided by operating activities in the line item "Prepaid content" on the Consolidated Statements of Cash Flows. Commitments for licenses that do not meet the criteria for asset recognition in the content library are included in Note 8 to the consolidated financial statements.

Streaming content licenses (including both those that are recorded in the streaming content library and those that do not meet the criteria for asset recognition) are reviewed in aggregate at the geographic region level for impairment when an event or change in circumstances indicates a change in the expected usefulness of the content. The level of geographic aggregation is determined based on the streaming content rights which are generally specific to a geographic region inclusive of several countries (such as Latin America). An impairment would be recorded as necessary to adjust the streaming content library to the lower of unamortized cost or estimated net realizable value. No material write down from unamortized cost to a lower net realizable value was recorded in any of the periods presented.

We acquire DVD content for the purpose of renting such content to our subscribers and earning subscription rental revenues, and, as such, we consider our direct purchase DVD library to be a productive asset. Accordingly, we classify our DVD library in “Non-current content library” on the Consolidated Balance Sheets. The acquisition of DVD content library, net of changes in related liabilities, is classified in the line item “Acquisitions of DVD content library” within cash used in investing activities on the Consolidated Statements of Cash Flows because the DVD content library is considered a productive asset. Other companies in the in-home entertainment video industry classify these cash flows as operating activities. We amortize our direct purchase DVDs, less estimated salvage value, on a “sum-of-the-months” accelerated basis over their estimated useful lives. The useful life of the new release DVDs and back-catalog DVDs is estimated to be one year and three years, respectively. The amortization of the DVD content library is classified in “Cost of revenues—Subscription” on the Consolidated Statement of Operations and in the line item “Amortization of DVD content library” within net cash provided by operating activities on the Consolidated Statements of Cash Flows. We also obtain DVD content through revenue sharing agreements with studios and distributors. Revenue sharing obligations incurred based on utilization are classified in “Cost of revenues—Subscription” on the Consolidated Statements of Operations and in the line item “Net income” within net cash provided by operating activities on the Consolidated Statements of Cash Flows. The terms of some revenue sharing agreements obligate us to make a low initial payment for certain titles, representing a minimum contractual obligation under the agreement. The low initial payment is in exchange for a commitment to share a percentage of our subscription revenues or to pay a fee, based on utilization, for a defined period of time. The initial payment may be in the form of an upfront non-refundable payment which is classified in content library or in the form of a prepayment of future revenue sharing obligations which is classified as prepaid content.

Stock-Based Compensation

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

We calculate the fair value of new stock-based compensation awards under our stock option plans using a lattice-binomial model. This model requires the input of highly subjective assumptions, including price volatility of the underlying stock. Changes in the subjective input assumptions can materially affect the estimate of fair value of options granted and our results of operations could be impacted.

- Expected Volatility: Our computation of expected volatility is based on a blend of historical volatility of our common stock and implied volatility of tradable forward call options to purchase shares of our common stock. Our decision to incorporate implied volatility was based on our assessment that implied volatility of publicly traded options in our common stock is more reflective of market conditions and, therefore, can reasonably be expected to be a better indicator of expected volatility than historical volatility of our common stock. We include the historical volatility in our computation due to low trade volume of our tradable forward call options in certain periods thereby precluding sole reliance on implied volatility. An increase of 10% in our computation of expected volatility would increase the total stock-based compensation expense by approximately $0.8 million for the three months ended September 30, 2012.
- Suboptimal Exercise Factor: Our computation of the suboptimal exercise factor is based on historical option exercise behavior and the terms and vesting periods of the options granted and is determined for both executives and non-executives. An increase in the suboptimal exercise factor of 10% would increase the total stock-based compensation expense by approximately $0.7 million for the three months ended September 30, 2012.

Income Taxes

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

Although we believe our assumptions, judgments and estimates are reasonable, changes in tax laws or our interpretation of tax laws and the resolution of any tax audits could significantly impact the amounts provided for income taxes in our consolidated financial statements.

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

We did not recognize certain tax benefits from uncertain tax positions within the provision for income taxes. We may recognize a tax benefit only if it is more likely than not the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such positions are then measured based on the largest benefit that has a greater than 50% likelihood of being realized upon settlement. At September 30, 2012, our estimated gross unrecognized tax benefits were $29.2 million of which $23.0 million, if recognized, would favorably impact our future earnings. Due to uncertainties in any tax audit outcome, our estimates of the ultimate settlement of our unrecognized tax positions may change and the actual tax benefits may differ significantly from the estimates. See Note 7 to the consolidated financial statements for further information regarding income taxes.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	NETFLIX, INC.
Dated: October 30, 2012	By: /s/ REED HASTINGS
	Reed Hastings
	Chief Executive Officer
	(Principal executive officer)
Dated: October 30, 2012	By: /s/ DAVID WELLS
	David Wells
	Chief Financial Officer
	(Principal financial and accounting officer)

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EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Exhibit	Filing Date	
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
32.1*	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					X

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