

BLOCKBUSTER INC
Form 10-Q
August 15, 2008
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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 6, 2008

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 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 8, 2008:

Class A common stock, par value \$.01 per share: 125,337,246

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

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

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	July 6, 2008	July 1, 2007 (As restated)	July 6, 2008	July 1, 2007 (As restated)
Revenues:				
Base rental revenues	\$ 812.0	\$ 798.5	\$ 1,713.7	\$ 1,682.3
Previously rented product (PRP) revenues	160.3	166.0	334.9	334.3
Total rental revenues	972.3	964.5	2,048.6	2,016.6
Merchandise sales	323.8	285.2	633.6	677.4
Other revenues	8.4	13.5	16.4	43.1
	1,304.5	1,263.2	2,698.6	2,737.1
Cost of sales:				
Cost of rental revenues	397.5	414.1	808.0	828.6
Cost of merchandise sold	251.8	214.3	493.7	511.2
Total cost of sales	649.3	628.4	1,301.7	1,339.8
Gross profit	655.2	634.8	1,396.9	1,397.3
Operating expenses:				
General and administrative	605.2	622.5	1,206.3	1,278.0
Advertising	31.9	54.8	62.4	131.4
Depreciation and intangible amortization	37.9	48.7	77.8	98.5
Gain on sale of Gamestation		(81.3)		(81.3)
	675.0	644.7	1,346.5	1,426.6
Operating income (loss)	(19.8)	(9.9)	50.4	(29.3)
Interest expense	(18.4)	(21.1)	(37.6)	(44.7)
Interest income	0.6	1.9	1.7	3.8
Other items, net	(0.1)	1.8	0.3	(0.2)
Income (loss) before income taxes	(37.7)	(27.3)	14.8	(70.4)
Provision for income taxes	(4.2)	(3.0)	(11.0)	(11.5)
Income (loss) from continuing operations	(41.9)	(30.3)	3.8	(81.9)
Income (loss) from discontinued operations (Note 6)		(1.1)	(0.3)	1.5

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Net income (loss)	(41.9)	(31.4)	3.5	(80.4)
Preferred stock dividends	(2.8)	(2.8)	(5.6)	(5.6)
Net income (loss) applicable to common stockholders	\$ (44.7)	\$ (34.2)	\$ (2.1)	\$ (86.0)
Net income (loss) per common share:				
Basic and diluted				
Continuing operations	\$ (0.23)	\$ (0.17)	\$ (0.01)	\$ (0.46)
Discontinued operations		(0.01)		0.01
Net income (loss)	\$ (0.23)	\$ (0.18)	\$ (0.01)	\$ (0.45)
Weighted-average common shares outstanding:				
Basic and diluted				
	191.7	190.0	191.5	189.7

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)**

	July 6, 2008	January 6, 2008
Assets		
Current assets:		
Cash and cash equivalents	\$ 140.1	\$ 184.6
Receivables, less allowances of \$9.0 and \$8.7 for 2008 and 2007, respectively	86.2	113.1
Merchandise inventories	447.3	343.9
Rental library, net	405.0	441.1
Deferred income taxes	16.6	15.9
Prepaid and other current assets	241.5	220.6
Total current assets	1,336.7	1,319.2
Property and equipment, net	426.8	463.0
Deferred income taxes	140.4	144.8
Intangibles, net	12.7	13.7
Goodwill	772.6	772.6
Other assets	21.5	20.3
	\$ 2,710.7	\$ 2,733.6
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 433.2	\$ 472.8
Accrued expenses	547.4	618.4
Current portion of long-term debt	65.9	44.7
Current portion of capital lease obligations	9.6	10.1
Deferred income taxes	137.9	142.5
Total current liabilities	1,194.0	1,288.5
Long-term debt, less current portion	732.1	665.6
Capital lease obligations, less current portion	32.8	37.4
Other liabilities	81.6	86.4
	2,040.5	2,077.9
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Preferred stock, par value \$0.01 per share; 100 shares authorized; 0.15 shares issued and outstanding for 2008 and 2007 with a liquidation preference of \$1,000 per share	150.0	150.0
Class A common stock, par value \$0.01 per share; 400 shares authorized; 120.8 and 121.2 shares issued and outstanding for 2008 and 2007, respectively	1.2	1.2
Class B common stock, par value \$0.01 per share; 500 shares authorized; 72.0 shares issued and outstanding for 2008 and 2007	0.7	0.7
Additional paid-in capital	5,379.7	5,375.2
Accumulated deficit	(4,851.1)	(4,854.6)

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Accumulated other comprehensive loss	(10.3)	(16.8)
Total stockholders' equity	670.2	655.7
	\$ 2,710.7	\$ 2,733.6

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)**

	Twenty-Six Weeks Ended	
	July 6, 2008	July 1, 2007 (As restated)
Cash flows from operating activities:		
Net income (loss)	\$ 3.5	\$ (80.4)
Adjustments to reconcile net income (loss) to net cash used for operating activities:		
Depreciation and intangible amortization	77.8	98.5
Rental library purchases	(340.5)	(316.3)
Rental library amortization	379.8	366.1
Non-cash share-based compensation	9.8	8.7
Gain on sale of Gamestation		(81.3)
Deferred taxes and other	(0.8)	(1.3)
Change in operating assets and liabilities:		
Change in receivables	27.8	37.9
Change in merchandise inventories	(98.8)	(21.3)
Change in prepaid and other assets	(19.2)	26.2
Change in accounts payable	(44.2)	(114.1)
Change in accrued expenses and other liabilities	(78.1)	(107.0)
Net cash provided by (used for) operating activities	(82.9)	(184.3)
Cash flows from investing activities:		
Capital expenditures	(40.6)	(30.5)
Proceeds from sale of Gamestation		135.8
Proceeds from sale of real estate		8.5
Acquisition of intangible assets		(7.0)
Other investing activities	(0.1)	
Net cash provided by (used for) investing activities	(40.7)	106.8
Cash flows from financing activities:		
Proceeds from credit agreement	115.0	40.0
Repayments on credit agreement	(27.3)	(200.9)
Cash dividends on preferred stock	(5.6)	(5.6)
Capital lease payments	(5.1)	(6.0)
Net cash provided by (used for) financing activities	77.0	(172.5)
Effect of exchange rate changes on cash	2.1	3.0
Net decrease in cash and cash equivalents	(44.5)	(247.0)
Cash and cash equivalents at beginning of period	184.6	394.9
Cash and cash equivalents at end of period	\$ 140.1	\$ 147.9

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Supplemental cash flow information:

Cash payments for interest	\$ 35.4	\$ 44.3
Cash payments for income taxes	\$ 14.7	\$ 18.0

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

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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 pre-recorded videos, as well as video games, for in-store rental, sale and trade and also 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.

These unaudited consolidated financial statements should be read in conjunction with the more detailed audited consolidated financial statements for the fiscal year ended January 6, 2008, included in the 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.

Use of Estimates

The preparation of our consolidated financial statements, in conformity with accounting principles generally accepted in the United States (US GAAP), requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those related to the useful lives and residual values surrounding our rental library, estimated accruals related to revenue-sharing titles subject to performance guarantees, merchandise inventory reserves, revenues generated by customer programs and incentives, useful lives of property and equipment, income taxes, impairment of our long-lived assets, including goodwill, share-based compensation and contingencies. We base our estimates on historical experience and on other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may materially differ from these estimates under different assumptions or conditions.

Goodwill

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), we assess goodwill and intangible assets with indefinite lives for impairment at the reporting unit level on an annual basis 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 interim impairment test). Events may occur or circumstances may change that would require us to perform an interim impairment test prior to our annual

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

impairment test. Potential indicators that may trigger such an interim impairment test are declines in the media entertainment industry, a reduction in our planned improved profitability, or a sustained decline in our stock price. We will continue to evaluate the recoverability of our goodwill and intangible assets. This continued evaluation could result in additional non-cash impairments which could have a significant negative impact on our reported net income.

Net Income (Loss) Per Share

Basic net income (loss) per share (EPS) is computed by dividing the net income (loss) applicable to common stockholders 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 Blockbuster stock options and stock-settled stock appreciation rights (SSARs), vesting of restricted shares and restricted share units and shares issuable under the conversion feature of our 7.5% Series A cumulative convertible perpetual preferred stock (the Series A convertible preferred stock) using the if-converted method only in periods in which such effect would have been dilutive on income from continuing operations before cumulative effect of change in accounting principle. Options to purchase 18.5 million and 8.4 million shares of Class A common stock were outstanding as of July 6, 2008 and July 1, 2007, respectively. Additionally, 1.7 million and 4.1 million restricted shares and restricted share units that are settleable in shares of Class A common stock were outstanding as of July 6, 2008 and July 1, 2007, respectively, and 5.9 million SSARs were issued and outstanding as of July 6, 2008. For the thirteen and twenty-six weeks ended July 6, 2008 and July 1, 2007, respectively, the inclusion of all stock options, all restricted shares and restricted share units, all SSARs and all shares of Series A convertible preferred stock would be anti-dilutive and they were therefore excluded from the computation of the weighted-average shares for diluted EPS.

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 income (loss) and other gains and losses affecting stockholders' equity that, under 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 \$10.3 million and \$16.8 million as of July 6, 2008 and January 6, 2008, respectively.

Comprehensive loss for the thirteen and twenty-six weeks ended July 6, 2008 and July 1, 2007 was as follows:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	July 6, 2008	July 1, 2007 (As restated)	July 6, 2008	July 1, 2007 (As restated)
Net income (loss)	\$ (41.9)	\$ (31.4)	\$ 3.5	\$ (80.4)
Foreign currency translation adjustment, net of tax	2.7	(12.1)	6.5	(10.2)
Total comprehensive income (loss)	\$ (39.2)	\$ (43.5)	\$ 10.0	\$ (90.6)

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

Income taxes are provided based on the liability method of accounting. Deferred taxes are recorded to reflect the tax benefit and consequences of future years differences between the tax basis of assets and liabilities and their financial reporting basis. We record a valuation allowance to reduce deferred tax assets if it is more likely than not that some portion or all of the deferred tax assets will not be realized.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for and disclosure of uncertainty in tax positions. Upon adoption of FIN 48 on January 1, 2007, we reduced the total liability relating to our uncertain tax positions by approximately \$1.1 million, which is reflected as a decrease to accumulated deficit.

As of July 6, 2008, the liability for uncertain tax positions was approximately \$2.0 million and is reflected as Other liabilities on our Consolidated Balance Sheets. If recognized, this amount would result in a favorable effect on our effective tax rate.

While we expect the amount of unrecognized tax liabilities to change in the next twelve months, we do not expect the change to have a significant impact on our results from operations or financial position.

The following is a summary of our domestic tax years that 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):

Jurisdiction	Tax Year(s) Ending	Open	IRS Audit Complete	Currently Being Audited	Subject to Tax Matters Agreement with Viacom/CBS
Domestic	12/31/2002 and prior	No	Yes	N/A	Yes
Domestic	12/31/2003	No	Yes	N/A	Yes
Domestic	09/30/2004	Yes	No	Yes	Yes
Domestic	12/31/2004	Yes	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

The following is a summary of our other major tax jurisdictions:

Jurisdictions	Closed Tax Years	Open Tax Years	Years under Examination
Canada	1999 and prior	Post 1999	2000 & 2001
Ireland	1999 and prior	Post 1999	N/A
Italy	2001 and prior	Post 2001	N/A
Mexico	2002 and prior	Post 2002	N/A
United Kingdom	2003 and prior	Post 2003	N/A

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 6, 2008, we had recorded liabilities of approximately \$0.6 million associated with accrued interest and penalties related to uncertain tax positions.

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The following table presents the activity in the severance liability for the twenty-six weeks ended July 6, 2008 and July 1, 2007:

	Twenty-Six Weeks Ended	
	July 6, 2008	July 1, 2007
Beginning balance	\$ 15.5	\$ 6.2
Expense incurred and accrued	3.1	9.6
Adjustments to accruals	(2.2)	
Reclassification	(0.7)	
Amount paid	(9.5)	(6.3)
Ending balance	\$ 6.2	\$ 9.5

Store Closures

In accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, we establish reserves for store closures in the period that a store is closed. Reserves for store closures are established by calculating the present value of the remaining lease obligation, adjusted for estimated subtenant rental income and any contractual lease buyouts. Expenses associated with the establishment of these reserves are reflected in General and administrative on our Consolidated Statement of Operations. The future lease obligation is inclusive of the net future minimum lease payments plus estimated common area maintenance charges, less any remaining accrual for straight-line average rent. When a store is identified for closure, the depreciation of store assets is accelerated over the estimated remaining life of the store.

As of July 6, 2008 and January 6, 2008, the remaining liability to be paid in the future related to lease termination reserves was \$9.7 million and \$11.5 million, respectively. We made payments of \$3.0 million in rent and lease termination costs for the twenty-six weeks ended July 6, 2008. There have been no significant adjustments to previously accrued store closure costs during 2008.

The following table presents operating expenses related to store closures during the thirteen and twenty-six weeks ended July 6, 2008 and July 1, 2007:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	July 6, 2008	July 1, 2007 (As restated)	July 6, 2008	July 1, 2007 (As restated)
Closed store accruals and lease termination costs	\$ 1.3	\$ 4.1	\$ 1.5	\$ 7.1
Accelerated depreciation	1.3	3.2	3.9	5.0
Total store closure expense	\$ 2.6	\$ 7.3	\$ 5.4	\$ 12.1

Amended and Restated Employment Agreement with former CEO

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As previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006, filed with the SEC on March 1, 2007, we were in discussions with our former Chief Executive Officer, John F. Antioco, in an attempt to resolve a disagreement concerning the Board of Directors' 2006 bonus award to Mr. Antioco. On January 25, 2007, the Board of Directors exercised negative discretion and awarded a 2006

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BLOCKBUSTER INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(Tabular dollars in millions, except per share amounts)

bonus to Mr. Antioco of \$2.28 million, which would be in addition to his 2006 salary and deferred compensation of approximately \$2.5 million. This bonus award was subject to the condition that the Board of Directors would award him no 2006 bonus if Mr. Antioco contested the award.

Mr. Antioco maintained that he would be entitled to a 2006 bonus of \$7.65 million based on the application of the 2006 senior bonus plan performance goals. We had accrued \$4.5 million at December 31, 2006 for this contingency based on the guidance outlined in SFAS No. 5, *Accounting for Contingencies*. On March 20, 2007, we announced that we reached a settlement agreement with Mr. Antioco. The settlement agreement provided for an amended and restated employment agreement that collectively resolved the disagreement and set forth the terms of Mr. Antioco's continued employment with Blockbuster. Under the amended and restated employment agreement, Mr. Antioco received a 2006 bonus of approximately \$3.1 million. As a result, we reversed approximately \$1.4 million of bonus expense during the first quarter of 2007 which had been accrued at December 31, 2006.

On July 2, 2007, we announced the appointment of James W. Keyes as our new Chairman of the Board and Chief Executive Officer as discussed in Note 4 below. As a result of the appointment of Mr. Keyes, the amended and restated employment agreement with Mr. Antioco was terminated and we recorded approximately \$6.3 million in costs during the second quarter of 2007 in accordance with the provisions of the agreement. Additionally, we recorded \$1.4 million in share-based compensation expense relating to the immediate vesting of Mr. Antioco's previously unvested restricted share units and stock options as further discussed in Note 4 below.

Franchisee Termination Agreement

During the first quarter of 2007, our franchisee in Brazil sold its store base to Lojas Americanas. As part of this transaction, we entered into a termination agreement with the existing franchisee and subsequently entered into a license agreement with Lojas Americanas. As a result of the termination agreement, we received a termination fee of approximately \$20 million, which was included in *Other revenues* in our Consolidated Statements of Operations. Additionally, during the second quarter of 2007, we received \$5 million related to the license agreement with Lojas Americanas which is included in *Other revenues* in our Consolidated Statements of Operations.

Recent Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards 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. The adoption of SFAS 157 did not have a material impact on our consolidated financial statements. In February 2008, the FASB delayed the effective date of SFAS 157 for nonfinancial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. We are currently evaluating the potential impact of SFAS 157 as it relates to nonfinancial assets and liabilities.

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BLOCKBUSTER INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(Tabular dollars in millions, except per share amounts)

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159), which permits entities to choose to measure certain financial assets and liabilities at fair value. The provisions of SFAS 159 are effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 159 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, 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. Early adoption is not allowed. This standard will impact our accounting treatment for future business combinations.

In June 2008, the FASB issued FSP No. Emerging Issues Task Force (EITF) 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities* (FSP 03-6-1). FSP 03-6-1 clarifies that unvested 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 03-6-1 is effective for fiscal years beginning after December 15, 2008. We are still in the process of evaluating the impact, if any, this FSP 03-6-1 will have on our consolidated financial statements.

Note 2 Restatement

As previously disclosed in our Form 10-K for the fiscal year ended January 6, 2008, we have restated our unaudited consolidated financial statements for the thirteen and twenty-six weeks ended July 1, 2007 to correct errors in such consolidated financial statements. The restatement adjustments also include previously identified errors which were not initially corrected based on materiality as well as errors that were corrected through the adoption of SAB No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*, during the fourth quarter of fiscal 2006.

This note should be read in conjunction with Note 2 and Note 14 of our Annual Report on Form 10-K for the fiscal year ended January 6, 2008.

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

The following tables present the impact of the restatement adjustments, further described below, on the unaudited consolidated statements of operations for the thirteen and twenty-six weeks ended July 1, 2007, respectively:

	Thirteen Weeks Ended July 1, 2007			Twenty-Six Weeks Ended July 1, 2007		
	As reported	Adjustment	As restated	As reported	Adjustment	As restated
Revenues:						
Base rental revenues (1)	\$ 798.5	\$	\$ 798.5	\$ 1,681.4	\$ 0.9	\$ 1,682.3
Previously rented product (PRP) revenues	166.0		166.0	334.3		334.3
Total rental revenues	964.5		964.5	2,015.7	0.9	2,016.6
Merchandise sales	285.2		285.2	677.4		677.4
Other revenues	13.5		13.5	43.1		43.1
	1,263.2		1,263.2	2,736.2	0.9	2,737.1
Cost of sales:						
Cost of rental revenues (2)	414.5	(0.4)	414.1	828.6		828.6
Cost of merchandise sold (3)	213.2	1.1	214.3	510.1	1.1	511.2
	627.7	0.7	628.4	1,338.7	1.1	1,339.8
Gross profit	635.5	(0.7)	634.8	1,397.5	(0.2)	1,397.3
Operating expenses:						
General and administrative (4)	624.3	(1.8)	622.5	1,278.8	(0.8)	1,278.0
Advertising	54.8		54.8	131.4		131.4
Depreciation and intangible amortization (5)	47.8	0.9	48.7	97.1	1.4	98.5
Gain on sale of Gamestation (6)	(77.7)	(3.6)	(81.3)	(77.7)	(3.6)	(81.3)
	649.2	(4.5)	644.7	1,429.6	(3.0)	1,426.6
Operating income (loss)	(13.7)	3.8	(9.9)	(32.1)	2.8	(29.3)
Interest expense	(21.1)		(21.1)	(44.7)		(44.7)
Interest income	1.9		1.9	3.8		3.8
Other items, net (7)	1.7	0.1	1.8	1.3	(1.5)	(0.2)
Income (loss) from continuing operations before income taxes	(31.2)	3.9	(27.3)	(71.7)	1.3	(70.4)
Benefit (provision) for income taxes	(3.0)		(3.0)	(11.5)		(11.5)
Income (loss) from continuing operations	(34.2)	3.9	(30.3)	(83.2)	1.3	(81.9)
Income (loss) from discontinued operations	(1.1)		(1.1)	1.5		1.5

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Net income (loss)	(35.3)	3.9	(31.4)	(81.7)	1.3	(80.4)
Preferred stock dividends	(2.8)		(2.8)	(5.6)		(5.6)
Net income (loss) applicable to common stockholders	\$ (38.1)	\$ 3.9	\$ (34.2)	\$ (87.3)	\$ 1.3	\$ (86.0)
Net income (loss) per common share:						
Basic						
Continuing operations	\$ (0.19)	\$ 0.02	\$ (0.17)	\$ (0.47)	\$ 0.01	\$ (0.46)
Discontinued operations	(0.01)		(0.01)	0.01		0.01
Net income (loss)	\$ (0.20)	\$ 0.02	\$ (0.18)	\$ (0.46)	\$ 0.01	\$ (0.45)
Diluted						
Continuing operations	\$ (0.19)	\$ 0.02	\$ (0.17)	\$ (0.47)	\$ 0.01	\$ (0.46)
Discontinued operations	(0.01)		(0.01)	0.01		0.01
Net income (loss)	\$ (0.20)	\$ 0.02	\$ (0.18)	\$ (0.46)	\$ 0.01	\$ (0.45)
Weighted-average common shares outstanding:						
Basic and diluted	190.0		190.0	189.7		189.7

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- (1) Adjustments for gift card service fee errors.
- (2) Adjustments for excess cooperative advertising errors.
- (3) Adjustments for classification errors between cost of merchandise sold and gain on sale of Gamestation.
- (4) Adjustments for rent expense errors and general and administrative expense accruals errors.
- (5) Adjustments for depreciation expense errors on store fixtures and signage and classification errors between depreciation and intangible amortization and gain on sale of Gamestation.
- (6) Adjustments for errors in the computation of gain on sale of Gamestation.
- (7) Adjustments for foreign currency translation adjustment errors impacting recognized foreign currency transaction gains and losses.
- The following table presents the impact of the restatement adjustments on the consolidated statement of cash flows for the twenty-six weeks ended July 1, 2007:

	Twenty-Six Weeks Ended July 1, 2007		
	As reported	Adjustments	As restated
Cash flows from operating activities:			
Net income (loss)	\$ (81.7)	\$ 1.3	\$ (80.4)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:			
Depreciation and intangible amortization (1)	97.1	1.4	98.5
Rental library purchases	(316.3)		(316.3)
Rental library amortization	366.1		366.1
Non-cash share-based compensation	8.7		8.7
Gain on sale of real estate			
Gain on sale of Gamestation (2)	(77.7)	(3.6)	(81.3)
Deferred taxes and other (3)	(2.8)	1.5	(1.3)
Change in operating assets and liabilities:			
Change in receivables	37.9		37.9
Change in merchandise inventories (4)	(22.4)	1.1	(21.3)

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Change in prepaid and other assets	26.2		26.2
Change in accounts payable (5)	(111.3)	(2.8)	(114.1)
Change in accrued expenses and other liabilities (6)	(108.1)	1.1	(107.0)
Net cash flow provided by (used for) operating activities	(184.3)		(184.3)
Cash flows from investing activities:			
Capital expenditures	(30.5)		(30.5)
Proceeds from sale of Gamestation	135.8		135.8
Proceeds from sale of store operations			
Proceeds from sale of real estate	8.5		8.5
Other investing activities	(7.0)		(7.0)
Net cash flow provided by (used for) investing activities	106.8		106.8
Cash flows from financing activities:			
Proceeds from credit agreement	40.0		40.0
Repayments on credit agreement	(200.9)		(200.9)
Cash dividends on preferred stock	(5.6)		(5.6)
Capital lease payments	(6.0)		(6.0)
Net cash provided by (used for) financing activities	(172.5)		(172.5)
Effect of exchange rate changes on cash	3.0		3.0
Net increase (decrease) in cash and cash equivalents	(247.0)		(247.0)
Cash and cash equivalents at beginning of period	394.9		394.9
Cash and cash equivalents at end of period	\$ 147.9	\$	\$ 147.9

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- (1) Adjustments for depreciation expense errors on store fixtures and signage and classification errors between depreciation and intangible amortization and gain on sale of Gamestation.
- (2) Adjustments for errors in the computation of gain on sale of Gamestation.
- (3) Adjustments for foreign currency translation adjustment errors.
- (4) Adjustments for classification errors between cost of merchandise sold and gain on sale of Gamestation.
- (5) Adjustments for general and administrative expense accruals errors.
- (6) Adjustments for rent expense errors and gift card service fee errors.

Note 3 Credit Agreement and Other Debt

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

	July 6, 2008	January 6, 2008
Credit facilities:		
Term A loan, interest rate ranging from 6.3% to 6.5% at July 6, 2008	\$ 28.2	\$ 24.0
Term B loan, interest rate ranging from 6.5% to 7.0% at July 6, 2008	37.7	20.7
Total current portion of long-term debt	65.9	44.7
Current portion of capital lease obligations	9.6	10.1
	\$ 75.5	\$ 54.8

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

July 6, 2008	January 6, 2008
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Credit facilities:		
Revolving credit facility, interest rate ranging from 6.2% to 6.7% at July 6, 2008	\$ 95.0	\$
Term A loan, interest rate ranging from 6.3% to 6.5% at July 6, 2008	9.4	18.8
Term B loan, interest rate ranging from 6.5% to 7.0% at July 6, 2008	327.7	346.8
Senior subordinated notes, interest rate of 9.0% at July 6, 2008	300.0	300.0
Total long-term debt, less current portion	732.1	665.6
Capital lease obligations, less current portion	32.8	37.4
	\$ 764.9	\$ 703.0

As of July 6, 2008, \$95.0 million was outstanding under our revolving credit facility and \$403.0 million was outstanding under the term loan portions of our credit facilities. The available borrowing capacity under the revolving credit facility, excluding the \$150.0 million reserved for issuance of letters of credit provided for Viacom Inc. ("Viacom"), at Viacom's expense (the "Viacom Letters of Credit"), and \$48.7 million reserved to support other letters of credit, totaled \$106.3 million at July 6, 2008. Borrowings under the credit facilities accrue interest at a rate equal to either 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 6, 2008 for borrowings under the credit facilities was 6.7%. As of July 6, 2008, commitment fees are charged at an annual rate of 0.500% on the unused portion of the revolving credit facility, and participation and fronting fees are also incurred on letters of credit.

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As of July 6, 2008, \$300.0 million of principal was outstanding under our senior subordinated notes. The senior subordinated notes mature on September 1, 2012. Interest accrues on the senior subordinated notes and is payable on March 1 and September 1 of each year.

On April 18, 2007, we entered into an amendment to our amended and restated credit agreement which provided for additional sales, transfers or other dispositions of assets with a cumulative aggregate fair market value of up to \$150 million, and required that we make prepayments on the credit facilities in an amount equal to 100% of the net proceeds received from such additional sales, transfers or other dispositions of assets.

On July 2, 2007, we entered into an additional amendment (the Second Amendment) to our amended and restated credit agreement which became effective on July 13, 2007 and which:

accelerated reductions in the revolving commitments that were previously scheduled to occur on October 1, 2007 and January 1, 2008 which effectively reduces the total amount of the revolving commitments from \$500 million to \$450 million;

modified the applicable interest rate margins;

amended the definition of Consolidated EBITDA;

amended the asset sale baskets and the related mandatory prepayment requirements;

provided for a premium of 1.0% in the event of certain refinancings through April 6, 2008;

deferred the applicability of the Fixed Charge Coverage Ratio and Leverage Ratio requirements from fiscal 2008 to fiscal 2009;

provided for a one-time fee payable by us to the administrative agent, for the accounts of the lenders, in an amount equal to (a) 0.25% of the aggregate amount of revolving commitments and outstanding term loans on April 6, 2008, if the Leverage Ratio on such date exceeds 3.00 to 1.00 but does not exceed 3.50 to 1.00 or (b) 0.50% of the aggregate amount of revolving commitments and outstanding term loans on April 6, 2008, if the Leverage Ratio on such date exceeds 3.50 to 1.00;

amended the Consolidated EBITDA requirements such that we may not permit Consolidated EBITDA for any period of four consecutive fiscal quarters to be less than (a) \$140 million for the periods ending July 1, 2007 and September 30, 2007, (b) \$165 million for the period ending January 6, 2008, (c) \$180 million for the period ending April 6, 2008, (d) \$200 million for the period ending July 6, 2008, (e) \$225 million for the period ending October 5, 2008, and (f) \$250 million for the period ending January 4, 2009; and

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waived any default resulting from our failure to comply with the Consolidated EBITDA requirement with respect to the period of four consecutive fiscal quarters ending July 1, 2007.

Without the benefit of the lenders' waiver of the Consolidated EBITDA requirement with respect to the period of four consecutive fiscal quarters ending July 1, 2007 that is contained in the Second Amendment, we would have been in default of such covenant.

In connection with the Second Amendment, the applicable margin for our borrowings under the credit facilities increased 50 basis points. We were also required to pay a standard amendment fee to the administrative agent and the syndicate lenders.

We were in compliance with the required minimum EBITDA covenant, the maximum capital expenditure covenant and all other applicable covenants as of July 6, 2008. We also expect cash on hand, cash from

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operations and available borrowings under our revolving credit facility to be sufficient to fund the anticipated cash requirements for working capital purposes, including rental library purchases, and capital expenditures under our normal operations as well as commitments and payments of principal and interest on borrowings and dividends on our Series A convertible preferred stock for at least the next twelve months.

Beginning with fiscal 2005, we have been required to make prepayments on the credit facilities in an aggregate amount equal to 50% of annual excess cash flow, as defined by the amended and restated credit agreement. For the twenty-six weeks ended July 6, 2008, we generated excess cash flow, as defined by our credit agreement. However, we cannot estimate with certainty the excess cash flow, if any, for the fiscal year ended January 4, 2009. Such payments are due at the end of the first quarter of the following year. We did not generate excess cash flow in fiscal 2007. In fiscal 2006, we generated excess cash flow, as defined, and made a prepayment of \$46 million on the term portions of the credit facilities during the quarter ended April 1, 2007.

Additionally, we are required to make prepayments on the credit facilities related to sales of store operations and property and equipment, as defined by the amended and restated credit agreement. Therefore, we made prepayments of \$0.3 million and \$9 million during the first quarter of 2008 and 2007, respectively. During the second quarter of 2007, we made prepayments of \$136 million related to such transactions. 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 ending April 6, 2008, our borrowing rate decreased 50 basis points.

The revolving credit facility and Term A loan mature in August 2009, before which time we will pursue strategic alternatives for a new capital structure.

Note 4 Stock and Share-Based Payments

We recognize expense for our share-based payments in accordance with SFAS 123 (revised), *Share-Based Payment* (SFAS 123R). For the thirteen weeks ended July 6, 2008 and July 1, 2007, we recognized approximately \$5.6 million and \$0.6 million, respectively, of share-based compensation expense related to stock options, restricted shares, restricted share units and SSARs. For the twenty-six weeks ended July 6, 2008 and July 1, 2007, we recognized approximately \$9.8 million and \$8.7 million, respectively, of share-based compensation expense related to stock options, restricted shares, restricted share units and SSARs.

During the twenty-six weeks ended July 6, 2008, 0.6 million stock options were granted, no stock options were exercised, 0.3 million stock options were cancelled and 5.9 million SSARs were awarded. In addition, 0.2 million restricted shares or restricted share units were granted to employees, 0.6 million restricted shares and restricted share units were exercised, and 0.7 million restricted shares and restricted share units were cancelled during the twenty-six weeks ended July 6, 2008. As of July 6, 2008, 18.5 million stock options, 1.7 million restricted shares and restricted share units and 5.9 million SSARs remained outstanding.

During the first quarter of 2007, we entered into an amended and restated employment agreement with our former Chief Executive Officer, John F. Antioco, as discussed in Note 1. As a result of the amended and restated employment agreement, Mr. Antioco was entitled to the immediate vesting of his restricted share units that were settleable in cash upon the conclusion of his employment with Blockbuster. We paid approximately \$7.5 million to settle this award. As of January 6, 2008, no liability remained related to Mr. Antioco's restricted share units. Additionally, the exercisability of all of his previously granted stock options that had not become exercisable on or prior to the date of the conclusion of his employment was accelerated and such stock options, together with all

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of his previously granted stock options that were exercisable on or prior to the date of the conclusion of his employment, will be exercisable for 30 months following December 31, 2007. As a result, we recorded approximately \$1.4 million in stock compensation expense related to the acceleration of Mr. Antioco's unvested restricted share units and stock options during the second quarter of 2007. Under Mr. Antioco's previous employment agreement, he was allowed 24 months to exercise his stock options if his employment agreement was not renewed. The additional twelve months during which Mr. Antioco is allowed to exercise his stock options is considered a modification under SFAS 123R and resulted in additional compensation expense of approximately \$0.9 million, of which approximately \$0.8 million was recorded during the second quarter of 2007 related to options that had vested and the remainder was recognized during the second quarter of 2007 upon termination of his employment.

On July 2, 2007, Blockbuster announced the appointment of James W. Keyes as our new Chairman of the Board and Chief Executive Officer. The Company entered into a three-year employment agreement with Mr. Keyes commencing on July 2, 2007 (the Effective Date). On the Effective Date, Mr. Keyes was granted approximately 7.8 million stock options to purchase shares of Class A common stock, of which approximately 33.3% were granted at an exercise price of \$4.485, approximately 22.2% were granted at an exercise price of \$5.1578, approximately 22.2% were granted at an exercise price of \$5.9314 and approximately 22.2% were granted at an exercise price of \$6.8211. The options vest over a three-year period on each anniversary of the Effective Date and expire on the fifth anniversary of the Effective Date. Additionally, under Mr. Keyes' employment agreement, he was issued approximately 0.7 million restricted share units settleable in shares of Class A common stock, which will vest in full on the third anniversary of the Effective Date.

The unamortized compensation expense, net of estimated forfeitures, related to restricted shares, restricted share units, stock options issued and outstanding, and SSARs as of July 6, 2008 will be recognized in future periods as follows:

	Restricted Shares				
	and Restricted	Stock	SSARs	Total	
	Share Units	Options			
Twenty-Six week period ended January 4, 2009	\$ 1.2	\$ 3.7	\$ 1.6	\$ 6.5	
Year ended January 3, 2010	1.5	4.5	1.8	7.8	
Year ended January 2, 2011 and thereafter	0.5	1.3	0.6	2.4	
Total	\$ 3.2	\$ 9.5	\$ 4.0	\$ 16.7	

Note 5 Commitments and Contingencies

On June 8, 2001, *C-Span Entertainment, et al v. Blockbuster Inc., et al*, was filed in the 192nd 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 claim 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

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\$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 may choose to appeal this judgment. We continue to deny all material allegations of the complaint.

On January 31, 2001, an antitrust complaint alleging federal and California state law claims was filed in the Superior Court of California, Los Angeles County, by over 200 individual plaintiffs seeking class certification and monetary damages against Blockbuster, Viacom, and major motion picture studios and their home video subsidiaries. In January 2002, the California court denied the plaintiffs' request for class certification. By order dated February 20, 2003, the California state court judge dismissed with prejudice all claims against Blockbuster and the other defendants. On appeal, the California appellate court affirmed dismissal of the antitrust conspiracy claims but reversed and remanded to the trial court for further consideration the state law unfair practices and unfair competition claims. The appellate court did not consider the appeal of the decision denying class certification. On May 2, 2007, the trial court granted Blockbuster's motion for summary judgment dismissing the state law unfair practices and unfair competition claims. On August 17, 2007, plaintiffs filed their notice of intent to appeal the trial court's dismissal. On July 9, 2008, plaintiffs' appeal of the trial court's dismissal was dismissed 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 136th 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 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.

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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.

On February 10, 2004, Howard Vogel filed a lawsuit in the Newcastle County Chancery Court, Delaware naming John Muething, Linda Griego, John Antioco, Jackie Clegg, Blockbuster, Viacom and Blockbuster's directors who were also directors and/or officers of Viacom as defendants. The plaintiff alleges that a stock swap mechanism anticipated to be announced by Viacom would be a breach of fiduciary duty to minority stockholders and that the defendants engaged in unfair dealing and coercive conduct. The stockholder class action complaint asks the court to certify a class and to enjoin the then-anticipated transaction. We believe the plaintiff's position is without merit. Plaintiff has confirmed that Blockbuster and the other defendants are not required to respond to the pending complaint. Should it become necessary, we intend to vigorously defend ourselves in the litigation.

Blockbuster is a defendant in two lawsuits arising out of its no late fees program. On February 25, 2005, Michael L. Galeno filed a putative class action in the Supreme Court of New York County, New York, alleging breach of contract, unjust enrichment and that Blockbuster's no late fees program violates New York's consumer protection statutes prohibiting deceptive and misleading business practices. The suit seeks compensatory and punitive damages and injunctive relief. Blockbuster removed the case to the United States District Court, Southern District of New York. 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. Blockbuster believes each of the claims still pending is without merit and intends to vigorously defend itself.

On September 8, 2006, John Halaris filed a putative class action complaint under the Employee Retirement Income Security Act (ERISA) in the United States District Court for the Northern District of Texas purporting to act on behalf of all persons who were participants in or beneficiaries of the Blockbuster Investment Plan whose accounts included investments in Blockbuster stock, at any time, since November 15, 2003. Plaintiff asserts claims against Viacom, the Viacom Investment Committee, the Viacom Retirement Committee, William A. Roskin, John R. Jacobs, Mary Bell, Bruce Lewis, Robert G. Freedline, Larry J. Zine, Keith M. Holtz, Barbara Mickowski, Dan Satterthwaite, Phillippe P. Dauman, Sumner M. Redstone, Richard Bressler, Michael D. Fricklas, John L. Muething, Linda Griego, Jackie M. Clegg, John F. Antioco, Peter A. Bassi, Robert A. Bowman, Gary J. Fernandes, Mel Karmazin, Blockbuster, the Blockbuster Retirement Committee and the Blockbuster Investment Committee. Plaintiff claims that the above-named defendants breached their fiduciary duties in violation of ERISA. Plaintiff seeks declaratory relief, recovery of actual damages, court costs, attorneys' fees, a constructive trust, restoration of lost profits to the Blockbuster Investment Plan and an injunction. On

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September 21, 2007, the trial court partially granted the above-named defendants' motions to dismiss the complaint and dismissed plaintiff's claims for restitution damages and alleged omissions by the above-named defendants. The trial court denied other portions of defendants' motions to dismiss and reserved judgment on other portions of defendants' motions to dismiss. The trial court allowed plaintiff the opportunity to re-plead his claims in light of the trial court's partial dismissal. On November 5, 2007, plaintiff Halaris filed an amended class action complaint adding Dennis Conniff as an additional named plaintiff. We believe that the claims are without merit and intend to vigorously defend ourselves in the lawsuit.

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 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. We believe that the claims are without merit and intend to vigorously defend ourselves in the lawsuit.

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 Divestitures and Discontinued Operations

Divestitures

On May 2, 2007, we completed the divestiture of Games Station Ltd. (Gamestation) to the THE GAME GROUP PLC for \$151.2 million before selling expenses of \$6.8 million and cash held in Gamestation accounts of \$8.6 million. Additionally, we subsequently received \$11.9 million relating to a working capital adjustment. The working capital adjustment was recorded as Receivables on our Consolidated Balance Sheets at July 1, 2007 and the cash was received on July 25, 2007. We recorded a gain on sale of approximately \$81.3 million. Because we retained 34 Gamestation locations that operate as a store-in-store within BLOCKBUSTER stores, the operations of Gamestation remain in continuing operations in our fiscal 2007 consolidated financial statements. These retained stores continue to be operated as specialty game stores under the BLOCKBUSTER brand, as permitted by the sale agreement.

Discontinued Operations

During the first quarter of 2007, we completed the sale of RHINO VIDEO GAMES® (RHINO) to GameStop Corp. We recorded a gain on sale of approximately \$2.1 million in connection with the divestiture of RHINO.

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In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), the RHINO operations have been classified as discontinued operations. Additionally, discontinued operations also include MOVIE TRADING CO.[®] and Movie Brands Inc., which were divested during the third and fourth quarters of 2006, respectively. As a result, our consolidated financial statements and related notes have been adjusted to reflect these entities as discontinued operations for the periods presented.

The following table summarizes the results of discontinued operations:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	July 6, 2008	July 1, 2007	July 6, 2008	July 1, 2007
Revenues	\$	\$	\$	\$ 2.0
Income (loss) before income taxes	\$	\$ (1.1)	\$ (0.3)	\$ 1.5
Provision for income taxes				
Income (loss) from discontinued operations	\$	\$ (1.1)	\$ (0.3)	\$ 1.5

Note 7 Related Party Transactions

On March 29, 2007, Strauss Zelnick, a member Blockbuster's 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 executive 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 \$32.2 million and \$36.6 million, respectively, for the thirteen and twenty-six weeks ended July 6, 2008, and \$3.7 million and \$11.5 million, respectively for the thirteen and twenty-six weeks ended July 1, 2007, pursuant to our commercial arrangements with Take-Two. During the thirteen weeks ended July 6, 2008, payments to Take-Two substantially increased due to increased purchases of games software. At July 6, 2008, our payables to Take-Two included \$1.4 million of accrued revenue-share expenses recorded in *Accrued expenses* and \$2.1 million recorded in *Accounts payable* in the Consolidated Balance Sheets. At January 6, 2008, our payables to Take-Two included \$0.9 million of accrued revenue-sharing recorded in *Accrued expenses* and \$0.1 million payable recorded in *Accounts payable* in the Consolidated Balance Sheets.

Note 8 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. Beginning in the fourth quarter of fiscal 2007, we increased our reporting segments from one to two. Segment information from all prior periods presented reflects these two segments.

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

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.

	Domestic Segment	International Segment	Unallocated Corporate	Total
Thirteen weeks ended July 6, 2008				
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
Net capital expenditures	12.0	6.1	2.6	20.7
Thirteen weeks ended July 1, 2007 (as restated)				
Revenues	\$ 839.2	\$ 424.0	\$	\$ 1,263.2
Operating income (loss)	(44.8)	84.4	(49.5)	(9.9)
Depreciation and intangible amortization	32.8	11.4	4.5	48.7
Net capital expenditures	13.2	6.3		19.5
Twenty-Six weeks ended July 6, 2008				
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
Twenty-Six weeks ended July 1, 2007 (as restated)				
Revenues	\$ 1,776.5	\$ 960.6	\$	\$ 2,737.1
Operating income (loss)	(47.5)	112.1	(93.9)	(29.3)
Depreciation and intangible amortization	65.0	25.8	7.7	98.5
Net capital expenditures	21.1	9.4		30.5

Note 9 Acquisition of Movielink, LLC

On August 8, 2007, we completed the acquisition (the Acquisition) of all of the outstanding membership interests of Movielink, LLC (Movielink), an online movie downloading business. We purchased all of the outstanding membership interests of Movielink from MGM On Demand Inc., DIGICO Inc., SPDE MF Holdings, Inc., Universal VOD Venture Holdings LLC, and WB MF LLC for \$7.0 million in cash, as adjusted for Movielink's working capital at the closing and before considering cash held in Movielink accounts of \$1.0 million. Additionally, we paid approximately \$0.7 million of acquisition-related expenses. The purchase price for the acquisition and acquisition-related expenses were financed from our available cash, and the results of Movielink's operations have been included in our consolidated financial statements since the date of acquisition.

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

The acquisition was accounted for under the purchase method of accounting. The following table summarizes estimated fair values of the assets acquired and liabilities assumed:

Net assets of Movielink at August 8, 2007	\$ 2.0
Liabilities assumed for estimated Movielink severance costs recorded in accordance with Emerging Issues Task Force (EITF) No. 95-3, <i>Recognition of Liabilities in Connection with a Purchase Business Combination</i>	(0.8)
Adjustment to reflect Movielink's property and equipment at fair value	1.4
Estimated acquired library encoding costs	2.1
Allocation of excess purchase price to goodwill	3.0
	\$ 7.7

The following unaudited pro forma summary presents information as if Movielink had been acquired at the beginning of the period presented and assumes that there were no other changes in our operations. The pro forma information does not necessarily reflect the actual results that would have occurred had we been combined with Movielink during the period presented, nor is it necessarily indicative of the future results of operations of the combined companies.

	Thirteen Weeks Ended July 1, 2007 (As restated)	Twenty-Six Weeks Ended July 1, 2007 (As restated)
Pro forma net revenues	\$ 1,264.1	\$ 2,739.1
Pro forma net income (loss)	(36.1)	(91.4)
Pro forma basic earnings per share	(0.20)	(0.51)
Pro forma diluted earnings per share	(0.20)	(0.51)

Note 10 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 our Annual Report on Form 10-K for the fiscal year ended January 6, 2008.

Blockbuster Inc. and its non-guarantor subsidiaries are parties to various intercompany agreements that 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.

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.

	Statement of Operations for the Thirteen Weeks Ended July 6, 2008				
	Blockbuster Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Blockbuster Inc.
Revenues:					
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
Cost of sales:					
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
Operating expenses:					
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
Operating income (loss)	(13.4)		(6.4)		(19.8)
Interest expense	(19.3)		(0.1)	1.0	(18.4)
Interest income	0.2		1.4	(1.0)	0.6
Other items, net	(0.2)		0.1		(0.1)
Income (loss) before income taxes	(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	
Net income (loss)	\$ (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)****Statement of Operations for the Thirteen Weeks Ended July 1, 2007 (as restated)**

	Blockbuster Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Blockbuster Inc.
Revenues:					
Rental revenues	\$ 741.9	\$	\$ 222.6	\$	\$ 964.5
Merchandise sales	91.3		193.9		285.2
Other revenues	17.2	17.8	2.2	(23.7)	13.5
	850.4	17.8	418.7	(23.7)	1,263.2
Cost of sales:					
Cost of rental revenues	343.1		71.0		414.1
Cost of merchandise sold	61.9		152.4		214.3
	405.0		223.4		628.4
Gross profit	445.4	17.8	195.3	(23.7)	634.8
Operating expenses:					
General and administrative	447.3	17.9	181.0	(23.7)	622.5
Advertising	45.2		9.6		54.8
Depreciation and intangible amortization	37.1		11.6		48.7
Gain on sale of Gamestation			(81.3)		(81.3)
	529.6	17.9	120.9	(23.7)	644.7
Operating income (loss)	(84.2)	(0.1)	74.4		(9.9)
Interest expense	(21.1)		(2.5)	2.5	(21.1)
Interest income	3.9		0.5	(2.5)	1.9
Other items, net	2.0		(0.2)		1.8
Income (loss) before income taxes	(99.4)	(0.1)	72.2		(27.3)
Provision for income taxes	(1.5)		(1.5)		(3.0)
Equity in income (loss) of affiliated companies, net of tax	69.5			(69.5)	
Income (loss) from continuing operations	(31.4)	(0.1)	70.7	(69.5)	(30.3)
Income from discontinued operations, net of tax		(1.0)	(0.1)		(1.1)
Net income (loss)	\$ (31.4)	\$ (1.1)	\$ 70.6	\$ (69.5)	\$ (31.4)

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

Statement of Operations for the Twenty-Six Weeks Ended July 6, 2008					
	Blockbuster Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Blockbuster Inc.
Revenues:					
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
Cost of sales:					
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
Operating expenses:					
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
Operating income (loss)	44.9	(0.1)	5.6		50.4
Interest expense	(39.3)		(0.3)	2.0	(37.6)
Interest income	0.8		2.9	(2.0)	1.7
Other items, net	0.3				0.3
Income (loss) before income taxes	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	
Income (loss) from continuing operations	3.5	(0.1)	(0.5)	0.9	3.8
Income from discontinued operations, net of tax		(0.2)	(0.1)		(0.3)
Net income (loss)	\$ 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)**

	Statement of Operations for the Twenty-Six Weeks Ended July 1, 2007 (as restated)				
	Blockbuster Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Blockbuster Inc.
Revenues:					
Rental revenues	\$ 1,563.6	\$	\$ 453.0	\$	\$ 2,016.6
Merchandise sales	200.5		476.9		677.4
Other revenues	50.6	34.8	4.8	(47.1)	43.1
	1,814.7	34.8	934.7	(47.1)	2,737.1
Cost of sales:					
Cost of rental revenues	685.2		143.4		828.6
Cost of merchandise sold	139.0		372.2		511.2
	824.2		515.6		1,339.8
Gross profit	990.5	34.8	419.1	(47.1)	1,397.3
Operating expenses:					
General and administrative	916.1	35.1	373.9	(47.1)	1,278.0
Advertising	108.3		23.1		131.4
Depreciation and intangible amortization	72.5		26.0		98.5
Gain on sale of Gamestation			(81.3)		(81.3)
	1,096.9	35.1	341.7	(47.1)	1,426.6
Operating income (loss)	(106.4)	(0.3)	77.4		(29.3)
Interest expense	(44.7)		(5.9)	5.9	(44.7)
Interest income	8.1		1.6	(5.9)	3.8
Other items, net	0.3		(0.5)		(0.2)
Income (loss) before income taxes	(142.7)	(0.3)	72.6		(70.4)
Provision for income taxes	(5.0)		(6.5)		(11.5)
Equity in income (loss) of affiliated companies, net of tax	67.3			(67.3)	
Income (loss) from continuing operations	(80.4)	(0.3)	66.1	(67.3)	(81.9)
Income from discontinued operations, net of tax		1.6	(0.1)		1.5
Net income (loss)	\$ (80.4)	\$ 1.3	\$ 66.0	\$ (67.3)	\$ (80.4)

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

	Balance Sheet at July 6, 2008				
	Blockbuster Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Blockbuster Inc.
Assets					
Current assets:					
Cash and cash equivalents	\$ 62.7	\$ 0.2	\$ 77.2	\$	\$ 140.1
Receivables, net	55.1		31.1		86.2
Intercompany receivables	1.9	2.5	45.4	(49.8)	
Merchandise inventories	257.3		190.0		447.3
Rental library, net	302.8		102.2		405.0
Deferred income taxes			16.6		16.6
Prepaid and other current assets	182.0		59.5		241.5
Total current assets	861.8	2.7	522.0	(49.8)	1,336.7
Property and equipment, net	303.8		123.0		426.8
Deferred income taxes	124.7		15.7		140.4
Investment in subsidiaries	456.0			(456.0)	
Intangibles, net	12.7				12.7
Goodwill	664.6		108.0		772.6
Other assets	15.3		6.2		21.5
	\$ 2,438.9	\$ 2.7	\$ 774.9	\$ (505.8)	\$ 2,710.7
Liabilities and Stockholders Equity					
Current liabilities:					
Accounts payable	\$ 265.3	\$ 3.0	\$ 164.9	\$	\$ 433.2
Intercompany payables	49.8			(49.8)	
Accrued expenses	424.0	0.4	123.0		547.4
Current portion of long-term debt	65.9				65.9
Current portion of capital lease obligations	9.5		0.1		9.6
Deferred income taxes	124.7		13.2		137.9
Total current liabilities	939.2	3.4	301.2	(49.8)	1,194.0
Long-term debt, less current portion	732.1				732.1
Capital lease obligations, less current portion	32.8				32.8
Other liabilities	64.6		17.0		81.6
	1,768.7	3.4	318.2	(49.8)	2,040.5
Total stockholders equity	670.2	(0.7)	456.7	(456.0)	670.2
	\$ 2,438.9	\$ 2.7	\$ 774.9	\$ (505.8)	\$ 2,710.7

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

	Balance Sheet at January 6, 2008				
	Blockbuster Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Blockbuster Inc.
Assets					
Current assets:					
Cash and cash equivalents	\$ 65.7	\$ 0.2	\$ 118.7	\$	\$ 184.6
Receivables, net	75.0		38.1		113.1
Intercompany receivables	4.7	3.3		(8.0)	
Merchandise inventories	158.9		185.0		343.9
Rental library, net	337.8		103.3		441.1
Deferred income taxes			15.9		15.9
Prepaid and other current assets	173.3		47.3		220.6
Total current assets	815.4	3.5	508.3	(8.0)	1,319.2
Property and equipment, net	328.4		134.6		463.0
Deferred income taxes	128.4		16.4		144.8
Investment in subsidiaries	403.2			(403.2)	
Intangibles, net	13.7				13.7
Goodwill	664.6		108.0		772.6
Other assets	16.2		4.1		20.3
	\$ 2,369.9	\$ 3.5	\$ 771.4	\$ (411.2)	\$ 2,733.6
Liabilities and Stockholders Equity					
Current liabilities:					
Accounts payable	\$ 289.1	\$ 3.8	\$ 179.9	\$	\$ 472.8
Intercompany payables	5.1		2.9	(8.0)	
Accrued expenses	464.3	0.3	153.8		618.4
Current portion of long-term debt	44.7				44.7
Current portion of capital lease obligations	10.0		0.1		10.1
Deferred income taxes	128.4		14.1		142.5
Total current liabilities	941.6	4.1	350.8	(8.0)	1,288.5
Long-term debt, less current portion	665.6				665.6
Capital lease obligations, less current portion	37.4				37.4
Other liabilities	69.6		16.8		86.4
	1,714.2	4.1	367.6	(8.0)	2,077.9
Total stockholders equity	655.7	(0.6)	403.8	(403.2)	655.7
	\$ 2,369.9	\$ 3.5	\$ 771.4	\$ (411.2)	\$ 2,733.6

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

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

Table of Contents**BLOCKBUSTER INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****(Tabular dollars in millions, except per share amounts)****Statement of Cash Flows for Twenty-Six Weeks Ended July 1, 2007 (as restated)**

	Blockbuster Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Blockbuster Inc.
Net cash used for operating activities	\$ (90.7)	\$ (14.6)	\$ (79.0)	\$	\$ (184.3)
Investing activities:					
Capital expenditures	(21.1)		(9.4)		(30.5)
Proceeds from sale of store operations		8.5			8.5
Proceeds from sale of Gamestation			135.8		135.8
Other investing activities	(7.0)				(7.0)
Net cash provided by investing activities	(28.1)	8.5	126.4		106.8
Financing activities:					
Repayments on credit agreements	(200.9)				(200.9)
Cash dividends	(5.6)				(5.6)
Capital lease payments	(5.7)		(0.3)		(6.0)
Proceeds from credit agreement	40.0				40.0
Intercompany loans	139.9		(139.9)		
Net cash provided by financing activities	(32.3)		(140.2)		(172.5)
Effect of exchange rate changes on cash			3.0		3.0
Net decrease in cash and cash equivalents	(151.1)	(6.1)	(89.8)		(247.0)
Cash and cash equivalents at beginning of period	228.5	8.3	158.1		394.9
Cash and cash equivalents at end of period	\$ 77.4	\$ 2.2	\$ 68.3	\$	\$ 147.9

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (tabular dollar amounts in millions)

Management's discussion and analysis of financial condition and results of operations should be read in conjunction with the consolidated financial statements and the related notes included elsewhere in this Quarterly Report on Form 10-Q.

Restatement of Financial Statements

We have restated herein our consolidated financial statements for the thirteen and twenty-six weeks ended July 1, 2007 to correct errors in such consolidated financial statements. See Note 2 to the consolidated financial statements for more information regarding the impact of the restatement on our consolidated financial statements.

Overview

Blockbuster Inc. is a leading global provider of in-home rental and retail movie and game entertainment, with over 7,600 stores in the United States, its territories and 21 other countries as of July 6, 2008. 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 are broadening 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)

The three principal strategies behind our mission to provide convenient access to media entertainment across these five points of distribution are:

Profitable growth of our core rental business;

Transition our stores to include more retail offerings; and

Development of new channels for digital distribution.

In the second quarter of 2008, we have continued to build on the series of actions we took during the second half of 2007 and first quarter of 2008 that were designed to both improve short-term profitability and position us to achieve our strategic objectives.

Leveraging and growing our leadership position in the movie and game rental business These changes include greatly enhanced product availability of new releases (including our continued expansion of Blu-ray), simplifying pricing terms, improving customer

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service, obtaining exclusive content and innovatively merchandising our product offerings. Additionally, we are currently testing a number of new store prototypes ranging from a refreshed and modernized look and feel of a typical Blockbuster store to Rock-the-Block stores that emphasize gaming, beverages and snacks and video-enabled electronic devices.

Developing new retail opportunities We are leveraging our leadership position in the rental market to increase sales of movies, games and other complementary entertainment-related products by cross-merchandising retail and rental product in high-traffic areas throughout our store base. We also have

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broadened our product assortment to include Blu-ray, and have rolled out games software, hardware and accessories in all our U.S. corporate-owned stores.

Enhancing digital distribution We have launched digital downloading on blockbuster.com that enables our customers to download entertainment content for both rental and purchase. We are also in the process of testing digital delivery through kiosks in our stores to digitally deliver entertainment content to our customers' portable devices.

Implementing cost controls We have taken actions to reduce annualized overhead costs by approximately \$100 million through the elimination of staffing and operational redundancies in our in-store and online corporate support structure and through operational improvements. Further, we will continue to evaluate a number of other methods to reduce costs, including outsourcing various corporate functions.

Proposed Acquisition of Circuit City Stores, Inc.

On February 17, 2008, we made a proposal to the Circuit City Stores, Inc. (Circuit City) Chairman and Chief Executive Officer to acquire all of the outstanding shares of Circuit City for cash in the range of \$6.00 to \$8.00 per share, subject to due diligence, representing a total value in the range of approximately \$1.01 billion to \$1.35 billion based on the number of Circuit City shares outstanding as of December 31, 2007.

On July 1, 2008, we announced the decision not to pursue the acquisition after completing our due diligence process which had a total cost impact of \$1.9 million. Our decision was reached after a careful review of all of the available facts and circumstances. Based on market conditions and the completion of our initial due diligence process, we determined that it was not in the best interest of our shareholders to proceed with the acquisition. We continue to believe in the strategic merits of a consumer retail proposition that would bring media content and electronic devices together under one brand. We will pursue this strategy through our stores as a way to diversify the business and better serve the entertainment retail segment.

Key Financial Points for the Thirteen Weeks Ended July 6, 2008

Same-store revenues increased 9.0% and total revenue increased 3% year-over-year as a result of increases in both same-store rental revenues and same-store merchandise revenues.

Merchandise sales increased year-over-year despite the sale of 217 GAMESTATION® stores (Gamestation) in the second quarter of 2007.

General and administrative expenses decreased \$17 million over the second quarter of 2007 due to the continuation of cost savings measures begun in late 2007.

Outlook

For the remainder of 2008, we continue to be committed to executing our strategy and improving our financial results primarily through improving the profitability of our by-mail channel, ensuring the realization of our cost savings measures and developing new retail and rental opportunities including games initiatives. We will also continue to explore the divestiture of our non-core assets, including selling and/or licensing some of our international operations. Additionally, we believe that the continued consolidation in the home-video rental industry, expansion and growth of Blu-ray players and content, and a weakened economy in the U.S. could have a favorable impact on our 2008 results. We are considering strategic alliances where appropriate to further our mission to provide convenient access to media entertainment.

Goodwill

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), we assess goodwill and intangible assets with indefinite lives for impairment at the reporting unit level on an annual basis and

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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 interim impairment test). Events may occur or circumstances may change that would require us to perform an interim impairment test prior to our annual impairment test. Potential indicators that may trigger such an interim impairment test are declines in the media entertainment industry, a reduction in our planned improved profitability, or a sustained decline in our stock price. We will continue to evaluate the recoverability of our goodwill and intangible assets. This continued evaluation could result in additional non-cash impairments which could have a significant negative impact on our reported net income.

Results of Operations

The following table sets forth unaudited consolidated results of operations and other financial data:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	July 6, 2008	July 1, 2007 (As restated)	July 6, 2008	July 1, 2007 (As restated)
Statement of Operations Data:				
Revenues	\$ 1,304.5	\$ 1,263.2	\$ 2,698.6	\$ 2,737.1
Cost of sales	649.3	628.4	1,301.7	1,339.8
Gross profit	655.2	634.8	1,396.9	1,397.3
Operating expenses	675.0	644.7	1,346.5	1,426.6
Operating income (loss) (1)	(19.8)	(9.9)	50.4	(29.3)
Interest expense	(18.4)	(21.1)	(37.6)	(44.7)
Interest income	0.6	1.9	1.7	3.8
Other items, net	(0.1)	1.8	0.3	(0.2)
Income (loss) before income taxes	(37.7)	(27.3)	14.8	(70.4)
Provision for income taxes	(4.2)	(3.0)	(11.0)	(11.5)
Income (loss) before discontinued operations	(41.9)	(30.3)	3.8	(81.9)
Income (loss) from discontinued operations, net of tax (2)		(1.1)	(0.3)	1.5
Net Income (loss)	\$ (41.9)	\$ (31.4)	\$ 3.5	\$ (80.4)
Cash Flow Data:				
Cash from operating activities	N/A	N/A	\$ (82.9)	\$ (184.3)
Cash from investing activities	N/A	N/A	\$ (40.7)	\$ 106.8
Cash from financing activities	N/A	N/A	\$ 77.0	\$ (172.5)
Other Data:				
Depreciation and intangible amortization	\$ 37.9	\$ 48.7	\$ 77.8	\$ 98.5
Margins:				
Rental margin (3)	59.1%	57.1%	60.6%	58.9%
Merchandise margin (4)	22.2%	24.9%	22.1%	24.5%
Gross margin (5)	50.2%	50.3%	51.8%	51.1%
Worldwide Data:				
Same-store revenues (6)	9.0%	-5.9%	4.9%	-2.7%
Total stores at end of period	7,619	7,878	7,619	7,878

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	Total Number	Avg Sq. Footage (in thousands)	Total Sq. Footage (in thousands)
Real Estate Data at July 6, 2008:			
Domestic			
Stores	3,936	5.6	21,873
Distribution centers	40	N/A	1,133
Corporate/regional offices	14	N/A	423
International			
Stores	2,013	3.1	6,169
Distribution centers	8	N/A	192
Corporate/regional offices	8	N/A	108

- (1) During the second quarter of 2007, we recorded an \$81.3 million gain on the sale of Gamestation.
- (2) During January 2007, we completed the sale of RHINO VIDEO GAMES®. In accordance with SFAS No. 144, these operations have been classified as discontinued operations.
- (3) Rental gross profit (rental revenues less cost of rental revenues) as a percentage of rental revenues.
- (4) Merchandise gross profit (merchandise sales less cost of merchandise sold) as a percentage of merchandise sales.
- (5) Gross profit as a percentage of total revenues.
- (6) 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. 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 6, 2008, we had 4,737 stores operating under the BLOCKBUSTER® brand in the United States and its territories. Of these stores, 801 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 6, 2008, we had 2,882 stores operating under the BLOCKBUSTER brand and other brand names owned by us located in 21 markets outside of the United States. Of these stores, 869 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 2007, we sold our freestanding game locations which operated under the brand name GAMESTATION® and we retained 34 Gamestation locations that operate as a store-in-store within BLOCKBUSTER stores. Additionally, during 2007, we

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sold our Australian subsidiary coupled with a master franchise license and terminated a franchise agreement in Brazil. The results of Gamestation, Australia and franchise termination fees incurred in Brazil prior to disposal are included in continuing operations.

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The following tables summarize income from continuing operations by business segment.

	Domestic Segment	International Segment	Unallocated / Corporate	Total
Statement of Operations Data:				
Thirteen Weeks Ended July 6, 2008				
Revenues	\$ 896.5	\$ 408.0	\$	\$ 1,304.5
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)

Thirteen Weeks Ended July 1, 2007 (as restated)

Revenues	\$ 839.2	\$ 424.0	\$	\$ 1,263.2
Cost of sales	405.0	223.4		628.4
Gross profit	434.2	200.6		634.8
Operating expenses	479.0	116.2	49.5	644.7
Operating income (loss)	\$ (44.8)	\$ 84.4	\$ (49.5)	\$ (9.9)

	Domestic Segment	International Segment	Unallocated / Corporate	Total
Statement of Operations Data:				
Twenty-Six Weeks Ended July 6, 2008				
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

Twenty-Six Weeks Ended July 1, 2007 (as restated)

Revenues	\$ 1,776.5	\$ 960.6	\$	\$ 2,737.1
Cost of sales	824.2	515.6		1,339.8
Gross profit	952.3	445.0		1,397.3
Operating expenses	999.8	332.9	93.9	1,426.6
Operating income (loss)	\$ (47.5)	\$ 112.1	\$ (93.9)	\$ (29.3)

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

	Thirteen Weeks Ended July 6, 2008		Thirteen Weeks Ended July 1, 2007		Increase/(Decrease)	
	Amount	Percent of Revenue	Amount (As restated)	Percent of Revenue	Dollar	Percent
Revenues:						
Rental revenues:						
Base movie rental	\$ 573.3	63.9%	\$ 555.6	66.2%	\$ 17.7	3.2%
Base game rental	52.5	5.9%	52.0	6.2%	0.5	1.0%
Previously rented product (PRP)	123.6	13.8%	134.3	16.0%	(10.7)	-8.0%
Total rental revenues	749.4	83.6%	741.9	88.4%	7.5	1.0%
Merchandise sales:						
Movie sales	47.5	5.3%	42.4	5.1%	5.1	12.0%
Game sales	43.3	4.8%	6.7	0.8%	36.6	546.3%
General merchandise sales	50.0	5.6%	42.1	5.0%	7.9	18.8%
Total merchandise sales	140.8	15.7%	91.2	10.9%	49.6	54.4%
Royalties and other	6.3	0.7%	6.1	0.7%	0.2	3.3%
Total revenues	896.5	100.0%	839.2	100.0%	57.3	6.8%
Cost of sales:						
Cost of rental revenues	323.8	36.1%	343.1	40.9%	(19.3)	-5.6%
Cost of merchandise sold	111.8	12.5%	61.9	7.4%	49.9	80.6%
	435.6	48.6%	405.0	48.3%	30.6	7.6%
Gross profit	460.9	51.4%	434.2	51.7%	26.7	6.1%
Operating expenses:						
General and administrative:						
Stores	343.8	38.3%	345.2	41.2%	(1.4)	-0.4%
Corporate and field	46.3	5.2%	55.8	6.6%	(9.5)	-17.0%
Total general and administrative	390.1	43.5%	401.0	47.8%	(10.9)	-2.7%
Advertising	24.9	2.7%	45.2	5.3%	(20.3)	-44.9%
Depreciation and intangible amortization	24.8	2.8%	32.8	3.9%	(8.0)	-24.4%
	439.8	49.0%	479.0	57.0%	(39.2)	-8.2