

NETFLIX INC  
Form 10-Q  
October 16, 2015  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2015  
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: 001-35727

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

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

77-0467272  
(I.R.S. Employer  
Identification Number)

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

As of September 30, 2015, there were 427,388,288 shares of the registrant's common stock, par value \$0.001, outstanding.



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## NETFLIX, INC.

## Consolidated Statements of Operations

(unaudited)

(in thousands, except per share data)

|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September 30,<br>2015 | September 30,<br>2014 | September 30,<br>2015 | September 30,<br>2014 |
| Revenues                                    | \$1,738,355           | \$ 1,409,432          | \$4,956,178           | \$ 4,019,928          |
| Cost of revenues                            | 1,173,958             | 954,394               | 3,342,111             | 2,738,428             |
| Marketing                                   | 208,102               | 145,654               | 599,919               | 403,515               |
| Technology and development                  | 171,762               | 120,953               | 469,929               | 346,445               |
| General and administrative                  | 110,892               | 78,024                | 298,287               | 193,938               |
| Operating income                            | 73,641                | 110,407               | 245,932               | 337,602               |
| Other income (expense):                     |                       |                       |                       |                       |
| Interest expense                            | (35,333 )             | (13,486 )             | (97,287 )             | (36,866 )             |
| Interest and other income (expense)         | 3,930                 | 616                   | (27,491 )             | 3,117                 |
| Income before income taxes                  | 42,238                | 97,537                | 121,154               | 303,853               |
| Provision for income taxes                  | 12,806                | 38,242                | 41,691                | 120,425               |
| Net income                                  | \$29,432              | \$ 59,295             | \$79,463              | \$ 183,428            |
| Earnings per share:                         |                       |                       |                       |                       |
| Basic                                       | \$0.07                | \$ 0.14               | \$0.19                | \$ 0.44               |
| Diluted                                     | \$0.07                | \$ 0.14               | \$0.18                | \$ 0.42               |
| Weighted-average common shares outstanding: |                       |                       |                       |                       |
| Basic                                       | 426,869               | 421,194               | 425,289               | 419,972               |
| Diluted                                     | 437,606               | 432,742               | 435,849               | 431,683               |

See accompanying notes to the consolidated financial statements.

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NETFLIX, INC.

Consolidated Statements of Comprehensive Income

(unaudited)

(in thousands)

|   | Three Months Ended |               | Nine Months Ended |               |
|---|--------------------|---------------|-------------------|---------------|
|   | September 30,      | September 30, | September 30,     | September 30, |
|   | 2015               | 2014          | 2015              | 2014          |
| Net income  | \$29,432           | \$ 59,295     | \$79,463          | \$ 183,428    |
| Other comprehensive income (loss):  |                    |               |                   |               |
| Foreign currency translation adjustments  | 302                | (4,354 )      | (33,628 )         | (1,975 )      |
| Change in unrealized gains on available-for-sale securities, net<br>of tax of \$(45), \$(313), \$113 and \$28, respectively | (72 )              | (503 )        | 184               | 45            |
| Total other comprehensive income (loss)   | 230                | (4,857 )      | (33,444 )         | (1,930 )      |
| Comprehensive income  | \$29,662           | \$ 54,438     | \$46,019          | \$ 181,498    |

See accompanying notes to the consolidated financial statements.

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## NETFLIX, INC.

Consolidated Statements of Cash Flows  
(unaudited)  
(in thousands)

|   | Three Months Ended |               | Nine Months Ended |               |
|---|--------------------|---------------|-------------------|---------------|
|   | September 30,      | September 30, | September 30,     | September 30, |
|   | 2015               | 2014          | 2015              | 2014          |
| Cash flows from operating activities:   |                    |               |                   |               |
| Net income  | \$29,432           | \$ 59,295     | \$79,463          | \$ 183,428    |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: |                    |               |                   |               |
| Additions to streaming content library  | (1,308,943 )       | (1,202,484 )  | (4,194,545 )      | (2,765,197 )  |
| Change in streaming content liabilities   | 104,684            | 346,752       | 922,163           | 467,355       |
| Amortization of streaming content library   | 871,403            | 686,154       | 2,443,521         | 1,925,926     |
| Amortization of DVD content library   | 18,589             | 18,269        | 60,587            | 51,313        |
| Depreciation and amortization of property, equipment and intangibles                        | 16,047             | 14,357        | 46,795            | 39,716        |
| Stock-based compensation expense  | 32,834             | 29,878        | 88,865            | 84,988        |
| Excess tax benefits from stock-based compensation   | (37,726 )          | (21,060 )     | (106,154 )        | (68,420 )     |
| Other non-cash items  | 10,866             | 3,360         | 23,854            | 8,807         |
| Deferred taxes  | (29,417 )          | (7,892 )      | (70,691 )         | (37,564 )     |
| Changes in operating assets and liabilities:  |                    |               |                   |               |
| Other current assets  | 71,172             | 12,960        | 54,667            | 27,341        |
| Accounts payable  | 6,762              | 13,003        | 2,584             | 32,729        |
| Accrued expenses  | 10,883             | (6,980 )      | 88,429            | 51,586        |
| Deferred revenue  | 27,985             | 11,626        | 55,153            | 37,189        |
| Other non-current assets and liabilities  | (20,540 )          | 5,323         | 615               | 15,747        |
| Net cash (used in) provided by operating activities   | (195,969 )         | (37,439 )     | (504,694 )        | 54,944        |
| Cash flows from investing activities:   |                    |               |                   |               |
| Acquisition of DVD content library  | (14,467 )          | (15,530 )     | (57,159 )         | (51,425 )     |
| Purchases of property and equipment   | (37,820 )          | (21,032 )     | (78,394 )         | (54,235 )     |
| Other assets  | (3,760 )           | 341           | (4,174 )          | 1,765         |
| Purchases of short-term investments   | (66,444 )          | (123,883 )    | (225,333 )        | (355,337 )    |
| Proceeds from sale of short-term investments  | 43,887             | 107,568       | 144,247           | 340,278       |
| Proceeds from maturities of short-term investments  | 31,125             | 32,125        | 82,182            | 127,229       |
| Net cash (used in) provided by investing activities   | (47,479 )          | (20,411 )     | (138,631 )        | 8,275         |
| Cash flows from financing activities:   |                    |               |                   |               |
| Proceeds from issuance of common stock  | 35,089             | 9,877         | 69,809            | 56,794        |
| Proceeds from issuance of debt  | —                  | —             | 1,500,000         | 400,000       |
| Issuance costs  | —                  | —             | (17,629 )         | (7,080 )      |
| Excess tax benefits from stock-based compensation   | 37,726             | 21,060        | 106,154           | 68,420        |
| Principal payments of lease financing obligations   | (61 )              | (275 )        | (599 )            | (813 )        |
| Net cash provided by financing activities   | 72,754             | 30,662        | 1,657,735         | 517,321       |
| Effect of exchange rate changes on cash and cash equivalents                                | (7,741 )           | (3,839 )      | (12,581 )         | (2,288 )      |
| Net (decrease) increase in cash and cash equivalents  | (178,435 )         | (31,027 )     | 1,001,829         | 578,252       |
| Cash and cash equivalents, beginning of period  | 2,293,872          | 1,214,244     | 1,113,608         | 604,965       |
| Cash and cash equivalents, end of period  | \$2,115,437        | \$ 1,183,217  | \$2,115,437       | \$ 1,183,217  |

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Supplemental disclosure of non-cash investing activities:

|  |             |             |          |          |
|--|-------------|-------------|----------|----------|
| (Decrease) increase in accounts payable related to purchases of property and equipment | \$ (9,790 ) | \$ (1,362 ) | \$ 2,362 | \$ 4,431 |
|--|-------------|-------------|----------|----------|

See accompanying notes to the consolidated financial statements.

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## NETFLIX, INC.

## Consolidated Balance Sheets

(in thousands, except share and par value data)

|  | As of<br>September 30,<br>2015<br>(unaudited) | December 31,<br>2014 |
|--|---|----------------------|
| Assets   |   |                      |
| Current assets:  |   |                      |
| Cash and cash equivalents  | \$2,115,437                                   | \$1,113,608          |
| Short-term investments   | 494,205                                       | 494,888              |
| Current content library, net   | 2,695,184                                     | 2,125,702            |
| Other current assets   | 264,887                                       | 206,271              |
| Total current assets   | 5,569,713                                     | 3,940,469            |
| Non-current content library, net   | 3,891,790                                     | 2,773,326            |
| Property and equipment, net  | 181,268                                       | 149,875              |
| Other non-current assets   | 273,496                                       | 192,981              |
| Total assets   | \$9,916,267                                   | \$7,056,651          |
| Liabilities and Stockholders' Equity   |   |                      |
| Current liabilities:   |   |                      |
| Current content liabilities  | \$2,622,964                                   | \$2,117,241          |
| Accounts payable   | 209,365                                       | 201,581              |
| Accrued expenses   | 179,350                                       | 69,746               |
| Deferred revenue   | 329,739                                       | 274,586              |
| Total current liabilities  | 3,341,418                                     | 2,663,154            |
| Non-current content liabilities  | 1,966,854                                     | 1,575,832            |
| Long-term debt   | 2,400,000                                     | 900,000              |
| Other non-current liabilities  | 40,677  | 59,957               |
| Total liabilities  | 7,748,949                                     | 5,198,943            |
| Commitments and contingencies (Note 9)   |   |                      |
| Stockholders' equity:  |   |                      |
| Common stock, \$0.001 par value; 4,990,000,000 and 160,000,000 shares authorized at September 30, 2015 and December 31, 2014, respectively; 427,388,288 and 422,910,887 issued and outstanding at September 30, 2015 and December 31, 2014, respectively | 1,306,461                                     | 1,042,870            |
| Accumulated other comprehensive loss   | (37,890                                       | ) (4,446 )           |
| Retained earnings  | 898,747                                       | 819,284              |
| Total stockholders' equity   | 2,167,318                                     | 1,857,708            |
| Total liabilities and stockholders' equity   | \$9,916,267                                   | \$7,056,651          |

See accompanying notes to the consolidated financial statements.



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NETFLIX, INC.

Notes to Consolidated Financial Statements  
(unaudited)

## 1. Basis of Presentation and Summary of Significant Accounting Policies

The accompanying consolidated interim financial statements of Netflix, Inc. and its wholly owned subsidiaries (the "Company") have been prepared in conformity with accounting principles generally accepted in the United States ("U.S.") and are consistent in all material respects with those applied in the Company's Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Securities and Exchange Commission (the "SEC") on January 29, 2015. The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires management to make estimates and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant items subject to such estimates and assumptions include the streaming content library amortization policy; the recognition and measurement of income tax assets and liabilities; and the valuation of stock-based compensation. The Company bases its estimates on historical experience and on various other assumptions that the Company believes to be reasonable under the circumstances. On a regular basis, the Company evaluates the assumptions, judgments and estimates. Actual results may differ from these estimates. The interim financial information is unaudited, but reflects all normal recurring adjustments that are, in the opinion of management, necessary to fairly present the information set forth herein. The interim financial statements should be read in conjunction with the audited financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014. Interim results are not necessarily indicative of the results for a full year.

The Company has three reportable segments: Domestic streaming, International streaming and Domestic DVD. The majority of the Company's revenues are generated in the United States, and substantially all of the Company's long-lived tangible assets are held in the United States. The Company's revenues are derived from monthly membership fees.

There have been no material changes in the Company's significant accounting policies as compared to the significant accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2014. Prior to January 1, 2015, the functional currency of certain of the Company's European entities was the British pound. The Company changed the functional currency of these entities to the euro effective January 1, 2015 following the redomiciliation of the European headquarters and the launch of the Netflix service in several significant European countries. The change in functional currency was applied prospectively from January 1, 2015. Monetary assets and liabilities have been remeasured to the euro at current exchange rates. Non-monetary assets and liabilities have been remeasured to the euro using the exchange rate effective for the period in which the balance arose. As a result of this change of functional currency, the Company recorded a \$21.8 million cumulative translation adjustment included in other comprehensive loss for the nine months ended September 30, 2015.

On July 14, 2015, the Company completed a seven-for-one stock split in the form of a stock dividend. References made to outstanding shares or per share amounts in the accompanying consolidated financial statements and applicable disclosures have been retroactively adjusted to reflect this seven-for-one stock split. The number of authorized shares as reflected on the Consolidated Balance Sheets was not affected by the stock split and accordingly has not been adjusted. See Notes 2 and 6 for additional information.

In the third quarter of 2015, the Company changed the amortization method of certain content given changes in estimated viewing patterns of this content. The effect of this change in estimate was a \$12.8 million decrease in operating income and an \$8.0 million decrease in net income for the three and nine month periods ended September 30, 2015. The effect on both basic earnings per share and diluted earnings per share was a decrease of \$0.02, for the three and nine months ended September 30, 2015.

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers (Topic 606) which amended the existing accounting standards for revenue recognition. ASU 2014-09 establishes principles for recognizing revenue upon the transfer of promised goods or services to customers, in an amount that reflects the expected consideration received in exchange for those goods or

services. In July 2015, the FASB deferred the effective date for annual reporting periods beginning after December 15, 2017 (including interim reporting periods within those periods). Early adoption is permitted to the original effective date of December 15, 2016 (including interim reporting periods within those periods). The amendments may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. The Company is currently in the process of evaluating the impact of adoption of the ASU on its consolidated financial statements, but does not expect the impact to be material.

In April 2015, the FASB issued ASU 2015-03, Simplifying the Presentation of Debt Issuance Costs which changes the presentation of debt issuance costs in financial statements. ASU 2015-03 requires an entity to present such costs in the balance sheet as a direct deduction from the related debt liability rather than as an asset. Amortization of the costs will continue to be reported as interest expense. It is effective for annual reporting periods beginning after December 15, 2015. Early adoption is permitted. The Company will adopt ASU 2015-03 on January 1, 2016, at which time the Company will retrospectively reclassify approximately \$30 million of debt issuance costs associated with the Company's long-term debt from other non-current assets to long-term debt.

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In April 2015, the FASB issued ASU 2015-05, Customer's Accounting for Fees Paid in a Cloud Computing Arrangement, which provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If the arrangement does not include a software license, the customer should account for a cloud computing arrangement as a service contract. The Company has elected to early adopt the ASU in the third quarter of 2015 and will apply the guidance prospectively to all future arrangements. The impact of the adoption of the ASU was not material to the Company's consolidated financial statements.

## 2. Earnings Per Share

In June 2015, the Company's Board of Directors declared a seven-for-one stock split in the form of a stock dividend that was paid on July 14, 2015 to all shareholders of record as of July 2, 2015 ("Stock Split").

Outstanding share and per-share amounts disclosed as of September 30, 2015 and for all other comparative periods provided have been retroactively adjusted to reflect the effects of the Stock Split.

Basic earnings per share is computed using the weighted-average number of outstanding shares of common stock during the period. Diluted earnings per share is computed using the weighted-average number of outstanding shares of common stock and, when dilutive, potential common shares outstanding during the period. Potential common shares consist of incremental shares issuable upon the assumed exercise of stock options. The computation of earnings per share, as adjusted to reflect the effects of the Stock Split, are as follows:

|  | Three Months Ended<br>September 30,   |           | Nine Months Ended<br>September 30, |            |
|--|---------------------------------------|-----------|------------------------------------|------------|
|  | 2015                                  | 2014      | 2015                               | 2014       |
|  | (in thousands, except per share data) |           |                                    |            |
| Basic earnings per share:                  |                                       |           |                                    |            |
| Net income                                 | \$29,432                              | \$ 59,295 | \$79,463                           | \$ 183,428 |
| Shares used in computation:                |                                       |           |                                    |            |
| Weighted-average common shares outstanding | 426,869                               | 421,194   | 425,289                            | 419,972    |
| Basic earnings per share                   | \$0.07                                | \$ 0.14   | \$0.19                             | \$ 0.44    |
| Diluted earnings per share:                |                                       |           |                                    |            |
| Net income                                 | \$29,432                              | \$ 59,295 | \$79,463                           | \$ 183,428 |
| Shares used in computation:                |                                       |           |                                    |            |
| Weighted-average common shares outstanding | 426,869                               | 421,194   | 425,289                            | 419,972    |
| Employee stock options                     | 10,737                                | 11,548    | 10,560                             | 11,711     |
| Weighted-average number of shares          | 437,606                               | 432,742   | 435,849                            | 431,683    |
| Diluted earnings per share                 | \$0.07                                | \$ 0.14   | \$0.18                             | \$ 0.42    |

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

|                        | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|------------------------|-------------------------------------|------|------------------------------------|------|
|                        | 2015                                | 2014 | 2015                               | 2014 |
|                        | (in thousands)                      |      |                                    |      |
| Employee stock options | 130                                 | 371  | 668                                | 448  |



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## 3. Short-term Investments

The Company's investment policy is consistent with the definition of available-for-sale securities. The Company does not buy and hold securities principally for the purpose of selling them in the near future. The Company's policy is focused on preservation of capital, liquidity and return. From time to time, the Company may sell certain securities but the objectives are generally not to generate profits on short-term differences in price. The following tables summarize, by major security type, the Company's assets that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy and where they are classified on the Consolidated Balance Sheets:

|                           | As of September 30, 2015 |                              |                               |                         |
|---------------------------|--------------------------|------------------------------|-------------------------------|-------------------------|
|                           | Amortized<br>Cost        | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
|                           | (in thousands)           |                              |                               |                         |
| Cash                      | \$2,008,627              | \$—                          | \$—                           | \$2,008,627             |
| Level 1 securities:       |                          |                              |                               |                         |
| Money market funds        | 115,316                  | —                            | —                             | 115,316                 |
| Level 2 securities:       |                          |                              |                               |                         |
| Corporate debt securities | 251,192                  | 406                          | (467)                         | 251,131                 |
| Government securities     | 212,256                  | 599                          | (9)                           | 212,846                 |
| Certificate of deposits   | 3,600                    | —                            | —                             | 3,600                   |
| Agency securities         | 26,599                   | 29                           | —                             | 26,628                  |
| Total                     | \$2,617,590              | \$1,034                      | \$(476)                       | \$2,618,148             |

|                                      | As of December 31, 2014 |                              |                               |                         |
|--------------------------------------|-------------------------|------------------------------|-------------------------------|-------------------------|
|                                      | Amortized<br>Cost       | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
|                                      | (in thousands)          |                              |                               |                         |
| Cash                                 | \$1,007,543             | \$—                          | \$—                           | \$1,007,543             |
| Level 1 securities:                  |                         |                              |                               |                         |
| Money market funds                   | 111,759                 | —                            | —                             | 111,759                 |
| Level 2 securities:                  |                         |                              |                               |                         |
| Corporate debt securities            | 295,500                 | 432                          | (199)                         | 295,733                 |
| Government securities                | 168,749                 | 120                          | (95)                          | 168,774                 |
| Asset and mortgage-backed securities | 112                     | —                            | —                             | 112                     |
| Certificate of deposits              | 3,600                   | —                            | —                             | 3,600                   |
| Agency securities                    | 26,665                  | 5                            | (1)                           | 26,669                  |
| Total                                | \$1,613,928             | \$557                        | \$(295)                       | \$1,614,190             |

|                              | As of              |                   |
|------------------------------|--------------------|-------------------|
|                              | September 30, 2015 | December 31, 2014 |
|                              | (in thousands)     |                   |
| Cash and cash equivalents    | \$2,115,437        | \$1,113,608       |
| Short-term investments       | 494,205            | 494,888           |
| Other non-current assets (1) | 8,506              | 5,694             |
| Total                        | \$2,618,148        | \$1,614,190       |

(1) Primarily restricted cash that is related to workers compensation deposits and letter of credit agreements.

Fair value is a market-based measurement that is determined based on the assumptions that market participants would use in pricing an asset or liability. The hierarchy level assigned to each security in the Company's available-for-sale portfolio and cash equivalents is based on its assessment of the transparency and reliability of the inputs used in the valuation of such instrument at the measurement date. The fair value of available-for-sale securities and cash equivalents included in the Level 1 category is based on quoted prices that are readily and regularly available in an active market. The fair value of available-for-sale securities included in the Level 2 category is based on observable inputs, such as quoted prices for similar assets at the measurement date; quoted prices in markets that are not active; or other inputs that are

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observable, either directly or indirectly. These values were obtained from an independent pricing service and were evaluated using pricing models that vary by asset class and may incorporate available trade, bid and other market information and price quotes from well-established independent pricing vendors and broker-dealers. The Company's procedures include controls to ensure that appropriate fair values are recorded, such as comparing prices obtained from multiple independent sources. See Note 5 to the consolidated financial statements for further information regarding the fair value of the Company's debt instruments.

There were no investments in a material unrealized loss position as of September 30, 2015 or December 31, 2014.

There were no material other-than-temporary impairments or credit losses related to available-for-sale securities in the three or nine months ended September 30, 2015 and 2014. In addition, there were no material gross realized gains or losses in the three or nine months ended September 30, 2015 and 2014.

The estimated fair value of short-term investments by contractual maturity as of September 30, 2015 is as follows:

|   | (in thousands) |
|---|----------------|
| Due within one year                       | \$ 155,330     |
| Due after one year and through five years | 338,875        |
| Total short-term investments              | \$ 494,205     |

## 4. Balance Sheet Components

## Content Library

Content library consisted of the following:

|                                  | As of                 |                      |
|----------------------------------|-----------------------|----------------------|
|                                  | September 30,<br>2015 | December 31,<br>2014 |
|                                  | (in thousands)        |                      |
| Total content library, gross     | \$11,133,463          | \$ 8,497,403         |
| Accumulated amortization         | (4,546,489 )          | (3,598,375 )         |
| Total content library, net       | 6,586,974             | 4,899,028            |
| Current content library, net     | 2,695,184             | 2,125,702            |
| Non-current content library, net | \$3,891,790           | \$ 2,773,326         |

Content library includes costs capitalized for licensed streaming content, production of original content and DVD content.

## Property and Equipment, Net

Property and equipment and accumulated depreciation consisted of the following:

|                                | As of                 |                      | Estimated Useful<br>Lives |
|--------------------------------|-----------------------|----------------------|---------------------------|
|                                | September 30,<br>2015 | December 31,<br>2014 |                           |
|                                | (in thousands)        |                      |                           |
| Information technology assets  | \$190,929             | \$ 189,274           | 3 years                   |
| Furniture and fixtures         | 35,967                | 25,758               | 3 years                   |
| Building                       | 40,681                | 40,681               | 30 years                  |
| Leasehold improvements         | 103,113               | 57,339               | Over life of lease        |
| DVD operations equipment       | 89,132                | 89,144               | 5 years                   |
| Capital work-in-progress       | 12,483                | 12,495               |                           |
| Property and equipment, gross  | 472,305               | 414,691              |                           |
| Less: Accumulated depreciation | (291,037 )            | (264,816 )           |                           |
| Property and equipment, net    | \$181,268             | \$ 149,875           |                           |

Leasehold improvements as of September 30, 2015 includes \$44.3 million for the expansion of the Company's headquarters that were placed into service during the quarter ended September 30, 2015.



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## 5. Long-term Debt

As of September 30, 2015, the Company had aggregate outstanding principal of \$2.4 billion in long-term notes with varying maturities (the "Notes"). Each of the Notes were issued at par and are senior unsecured obligations of the Company. Interest is payable semi-annually at fixed rates.

The following table provides a summary of the Company's long-term debt as of September 30, 2015 and December 31, 2014:

|                         | Principal Amount at Par (in millions) | Issuance Date | Maturity | Interest Due Dates      | Level 2 Fair Value (1) as of |                   |
|-------------------------|---------------------------------------|---------------|----------|-------------------------|------------------------------|-------------------|
|                         |                                       |               |          |                         | September 30, 2015           | December 31, 2014 |
| 5.375% Senior Notes     | \$500.0                               | February 2013 | 2021     | February 1 and August 1 | \$518.8                      | \$ 520.0          |
| 5.750% Senior Notes     | 400.0                                 | February 2014 | 2024     | March 1 and September 1 | 408.0                        | 416.0             |
| 5.50% Senior Notes (2)  | 700.0                                 | February 2015 | 2022     | April 15 and October 15 | 707.0                        | —                 |
| 5.875% Senior Notes (2) | 800.0                                 | February 2015 | 2025     | April 15 and October 15 | 822.0                        | —                 |

(1) Based on quoted market prices in less active markets.

(2) The net proceeds to the Company for the 5.50% and 5.875% Senior Notes issued in the first quarter of 2015 were an aggregate \$1,482.4 million. Debt issuance costs of \$17.6 million were recorded in "Other non-current assets" on the Consolidated Balance Sheets and are amortized over the term of the notes as "Interest expense" on the Consolidated Statements of Operations.

Each of the Notes are repayable in whole or in part upon the occurrence of a change of control, at the option of the holders, at a purchase price in cash equal to 101% of the principal plus accrued interest. The Company may redeem the Notes prior to maturity in whole or in part at an amount equal to the principal amount thereof plus accrued and unpaid interest and an applicable premium. The Notes include, among other terms and conditions, limitations on the Company's ability to create, incur or allow certain liens; enter into sale and lease-back transactions; create, assume, incur or guarantee additional indebtedness of certain of the Company's subsidiaries; and consolidate or merge with, or convey, transfer or lease all or substantially all of the Company's and its subsidiaries assets, to another person. As of September 30, 2015 and December 31, 2014, the Company was in compliance with all related covenants.

## 6. Stockholders' Equity

## Stock Split

In March 2015, the Company's Board of Directors adopted an amendment to the Company's Certificate of Incorporation, to increase the number of shares of capital stock the Company is authorized to issue from 170,000,000 (160,000,000 shares of common stock and 10,000,000 shares of preferred stock), par value \$0.001 to 5,000,000,000 (4,990,000,000 shares of common stock and 10,000,000 shares of preferred stock), par value \$0.001. This amendment to the Company's certificate of incorporation was approved by the Company's stockholders at the 2015 Annual Meeting held on June 9, 2015.

On June 23, 2015, the Company's Board of Directors declared a seven-for-one stock split in the form of a stock dividend that was paid on July 14, 2015 to all shareholders of record as of July 2, 2015. Outstanding share and per-share amounts disclosed as of September 30, 2015 and for all other comparative periods presented have been retroactively adjusted to reflect the effects of the Stock Split.

#### Stock Option Plan

In June 2011, the Company adopted the 2011 Stock Plan. The 2011 Stock Plan provides for the grant of incentive stock options to employees and for the grant of non-statutory stock options, stock appreciation rights, restricted stock and restricted stock units to employees, directors and consultants. As of September 30, 2015, 17.5 million shares were reserved for future grants under the 2011 Stock Plan.

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A summary of the activities related to the Company's stock option plans, as adjusted for the Stock Split, is as follows:

|   | Shares Available for Grant | Options Outstanding |   | Weighted-Average Remaining Contractual Term (in Years) | Aggregate Intrinsic Value (in Thousands) |
|---|----------------------------|---------------------|---|--|--|
|   |                            | Number of Shares    | Weighted-Average Exercise Price (per share) |  |  |
| Balances as of December 31, 2014                | 20,025,208                 | 22,845,417          | \$ 21.65                                    |  |  |
| Granted   | (2,565,445 )               | 2,565,445           | 75.55                                       |  |  |
| Exercised                                       |                            | (4,477,401 )        | 15.45                                       |  |  |
| Balances as of September 30, 2015               | 17,459,763                 | 20,933,461          | \$ 29.58                                    | 6.32   | \$ 1,544,838                             |
| Vested and exercisable as of September 30, 2015 |                            | 20,933,461          | \$ 29.58                                    | 6.32   | \$ 1,544,838                             |

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the third quarter of 2015 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on the last trading day of the third quarter of 2015. This amount changes based on the fair market value of the Company's common stock.

A summary of the amounts related to option exercises, is as follows:

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2015 | September 30, 2014 | September 30, 2015 | September 30, 2014 |
| Total intrinsic value of options exercised | \$118,259          | \$60,337           | \$313,880          | \$208,057          |
| Cash received from options exercised       | \$35,089           | \$9,877            | \$69,809           | \$56,794           |
| Stock-based Compensation                   |                    |                    |                    |                    |

The following table summarizes the assumptions used to value stock option grants using the lattice-binomial model and the valuation data, as adjusted for the Stock Split:

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2015 | September 30, 2014 | September 30, 2015 | September 30, 2014 |
| Dividend yield   | —                  | % —                | % —                | % —                |
| Expected volatility  | 45                 | % 43               | % 36% - 45%        | % 43% - 48%        |
| Risk-free interest rate  | 2.29               | % 2.52             | % 2.03% - 2.29%    | % 2.52% - 2.83%    |
| Suboptimal exercise factor                                       | 2.48               | 2.68 - 4.57        | 2.47 - 2.48        | 2.66 - 4.57        |
| Valuation data:  |                    |                    |                    |                    |
| Weighted-average fair value (per share)                          | \$50.58            | \$33.85            | \$34.64            | \$31.03            |
| Total stock-based compensation expense (in thousands)            | \$32,834           | \$29,878           | \$88,865           | \$84,988           |
| Total income tax benefit related to stock options (in thousands) | \$12,365           | \$11,438           | \$33,553           | \$32,562           |

The Company considers several factors in determining the suboptimal exercise factor, including the historical and estimated option exercise behavior and the employee groupings. Prior to January 1, 2015, the Company bifurcated its option grants into two employee groupings (executive and non-executive) to determine the suboptimal exercise factor. Beginning on January 1, 2015, the Company began aggregating employee groupings for its determination of the suboptimal exercise factor as the previous bifurcation into two groupings did not have a material impact on the fair value of the options granted.

Prior to January 1, 2015, the Company's computation of expected volatility was based on a blend of historical volatility of its common stock and implied volatility of tradable forward call options to purchase shares of its common stock, as low trade volume of its tradable forward call options prior to 2011 precluded sole reliance on implied volatility. Beginning on January 1, 2015, expected volatility is based solely on implied volatility. The Company believes that implied volatility of publicly traded options in its common stock is more reflective of market conditions, and given consistently high trade volumes of the options, can reasonably be expected to be a better indicator of expected volatility than historical volatility of its common stock.

In valuing shares issued under the Company's employee stock option plans, the Company bases the risk-free interest rate on U.S. Treasury zero-coupon issues with terms similar to the contractual term of the options. The Company does not anticipate paying any cash

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dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company does not use a post-vesting termination rate as options are fully vested upon grant date.

## 7. Accumulated Other Comprehensive Loss

The following table summarizes the changes in the accumulated balance of other comprehensive loss, net of tax, for the three and nine months ended September 30, 2015:

|  | Foreign<br>currency | Change in<br>unrealized gains<br>on<br>available-for-sale<br>securities | Total       |
|--|---------------------|---|-------------|
|  | (in thousands)      |   |             |
| Balance as of June 30, 2015                                    | \$(38,545 )         | \$ 425  | \$(38,120 ) |
| Other comprehensive (loss) income before reclassifications     | 302                 | (59 )   | 243         |
| Amounts reclassified from accumulated other comprehensive loss | —                   | (13 )   | (13 )       |
| Net increase (decrease) in other comprehensive (loss) income   | 302                 | (72 )   | 230         |
| Balance as of September 30, 2015                               | \$(38,243 )         | \$ 353  | \$(37,890 ) |

|  | Foreign<br>currency | Change in<br>unrealized gains<br>on<br>available-for-sale<br>securities | Total       |
|--|---------------------|---|-------------|
|  | (in thousands)      |   |             |
| Balance as of December 31, 2014                                | \$(4,615 )          | \$ 169  | \$(4,446 )  |
| Other comprehensive (loss) income before reclassifications     | (33,628 )           | 374   | (33,254 )   |
| Amounts reclassified from accumulated other comprehensive loss | —                   | (190 )  | (190 )      |
| Net increase (decrease) in other comprehensive (loss) income   | (33,628 )           | 184   | (33,444 )   |
| Balance as of September 30, 2015                               | \$(38,243 )         | \$ 353  | \$(37,890 ) |

As discussed in Note 1, other comprehensive loss for the nine months ended September 30, 2015 includes the impact of the change in functional currency for certain of the Company's European entities.

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

## 8. Income Taxes

The effective tax rates for the three months ended September 30, 2015 and 2014 were 30% and 39%, respectively. The effective tax rates for the nine months ended September 30, 2015 and 2014 were 34% and 40%, respectively. The effective tax rates for the three and nine months ended September 30, 2015 and 2014 differed from the federal statutory rate primarily due to state taxes, foreign taxes and non-deductible expenses, partially offset by the California R&D credit.

The decrease in the Company's effective tax rates for the three and nine months ended September 30, 2015 as compared to the three and nine months ended September 30, 2014 was primarily attributable to lower tax reserves on uncertain tax positions following an IRS Appeals settlement in the fourth quarter of 2014.

Gross unrecognized tax benefits were \$41.1 million and \$34.8 million as of September 30, 2015 and December 31, 2014, respectively. The gross unrecognized tax benefits, if recognized by the Company, will result in a reduction of

approximately \$33.7 million to the provision for income taxes thereby favorably impacting the Company's effective tax rate. The Company's unrecognized tax benefits are primarily classified as "Accrued expenses" on the Consolidated Balance Sheets as of September 30, 2015. The Company includes interest and penalties related to unrecognized tax benefits within the "Provision for income taxes" on the Consolidated Statements of Operations. As of September 30, 2015, the total amount of gross interest and penalties accrued was \$0.5 million, and is primarily classified as "Accrued expenses" on the Consolidated Balance Sheets.

Deferred tax assets include \$20.2 million and \$13.4 million classified as "Other current assets" and \$170.7 million and \$106.9 million classified as "Other non-current assets" on the Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014, respectively. In evaluating its ability to realize the net deferred tax assets, the Company considered all available positive and negative evidence, including its past operating results and the forecast of future market growth, forecasted earnings, future taxable income, and prudent and feasible tax

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planning strategies. As of September 30, 2015 and December 31, 2014, it was considered more likely than not that all deferred tax assets would be realized.

Income tax benefits attributable to the exercise of employee stock options are recorded in additional paid-in-capital. These benefits amounted to \$37.7 million and \$21.0 million, during the three months ended September 30, 2015 and 2014, respectively and \$105.6 million and \$68.1 million, during the nine months ended September 30, 2015 and 2014, respectively.

The Company files U.S. federal, state and foreign tax returns. The Company is currently under examination by the IRS for the years 2010 through 2013. During the third quarter ending September 30, 2015, the Company reached a tentative settlement with the IRS and expects to reach a final settlement within the next twelve months, at which time the tax reserves on the related uncertain tax position will be adjusted. The Company has reclassified the tax reserves related to these years from "Other non-current liabilities" to "Accrued expenses" on the Consolidated Balance Sheets. The year 2014 remains subject to examination by the IRS.

The Company is also currently under examination by the state of California for the years 2006 and 2007. The state of California has completed its Field Exam and has issued a Notice of Proposed Assessment primarily related to the Company's R&D Credits claimed in those years. The Company has filed a protest against the proposed assessment. During the third quarter ending September 30, 2015, the Company has reached a tentative settlement with the Franchise Tax Board for tax years 1997 - 2007 and expects to reach a final settlement within the next twelve months, at which time the tax reserves on the related uncertain tax position will be adjusted. The Company has reclassified the tax reserves related to these years from "Other non-current liabilities" to "Accrued expenses" on the Consolidated Balance Sheets. The years 2008 through 2013 remain subject to examination by the state of California.

The Company has no significant foreign jurisdiction audits underway. The years 2011 through 2014 remain subject to examination by foreign jurisdictions. Given the potential outcome of the current examinations, as well as the impact of the current examination on the potential expiration of the statute of limitations, it is reasonably possible that the balance of unrecognized tax benefits could significantly change within the next twelve months. However, at this time, an estimate of the range of reasonably possible adjustments to the balance of unrecognized tax benefits cannot be made.

## 9. Commitments and Contingencies

### Streaming Content

As of September 30, 2015, the Company had \$10.4 billion of obligations comprised of \$2.6 billion included in "Current content liabilities" and \$2.0 billion of "Non-current content liabilities" on the Consolidated Balance Sheets and \$5.8 billion of obligations that are not reflected on the Consolidated Balance Sheets.

As of December 31, 2014, the Company had \$9.5 billion of obligations comprised of \$2.1 billion included in "Current content liabilities" and \$1.6 billion of "Non-current content liabilities" on the Consolidated Balance Sheets and \$5.8 billion of obligations that are not reflected on the Consolidated Balance Sheets.

The expected timing of payments for these streaming content obligations is as follows:

|  | As of              |                   |
|--|--------------------|-------------------|
|  | September 30, 2015 | December 31, 2014 |
|  | (in thousands)     |                   |
| Less than one year                           | \$4,535,209        | \$ 3,747,648      |
| Due after one year and through three years   | 4,888,130          | 4,495,103         |
| Due after three years and through five years | 908,111            | 1,164,308         |
| Due after five years                         | 46,768             | 44,053            |
| Total streaming content obligations          | \$10,378,218       | \$ 9,451,112      |

A streaming content obligation is incurred at the time the Company enters into an agreement to obtain future titles. Once a title becomes available, a content liability is generally recorded on the Consolidated Balance Sheets. Certain agreements include the obligation to license rights for unknown future titles, the ultimate quantity and/or fees for which are not yet determinable as of the reporting date. The Company does not include any estimated obligation for these future titles beyond the known minimum amount. However, the unknown obligations are expected to be significant and the expected timing of payments could range from less than one year to more than five years. The Company has entered into certain licenses with collective management organizations ("CMOs"), and is currently involved in negotiations with other CMOs, that hold certain rights to music and other entertainment works "publicly performed" in connection with streaming content into various territories. Accruals for estimated license fees are recorded and then adjusted based on any change in estimates. These amounts are included in the streaming content obligations. The results of these negotiations are uncertain and may be materially different from management's estimates.



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### Legal Proceedings

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

On January 13, 2012, the first of three purported shareholder class action lawsuits was filed in the United States District Court for the Northern District of California against the Company and certain of its officers and directors. Two additional purported shareholder class action lawsuits were filed in the same court on January 27, 2012 and February 29, 2012 alleging substantially similar claims. These lawsuits were consolidated into *In re Netflix, Inc., Securities Litigation*, Case No. 3:12-cv-00225-SC, and the Court selected lead plaintiffs. On June 26, 2012, lead plaintiffs filed a consolidated complaint which alleged violations of the federal securities laws. The Court dismissed the consolidated complaint with leave to amend on February 13, 2013. Lead plaintiffs filed a first amended consolidated complaint on March 22, 2013. The Court dismissed the first amended consolidated complaint with prejudice on August 20, 2013, and judgment was entered on September 27, 2013. Lead plaintiffs filed a motion to alter or amend the judgment and requested leave to file a second amended complaint on October 25, 2013. On January 17, 2014, the Court denied that motion. On February 18, 2014, lead plaintiffs appealed that decision to the United States Court of Appeals for the Ninth Circuit. Management has determined a potential loss is reasonably possible however, based on its current knowledge, management does not believe that the amount of such possible loss or a range of potential loss is reasonably estimable.

On November 23, 2011, the first of six purported shareholder derivative suits was filed in the Superior Court of California, Santa Clara County, against the Company and certain of its officers and directors. Five additional purported shareholder derivative suits were subsequently filed: two in the Superior Court of California, Santa Clara County on February 9, 2012 and May 2, 2012; and three in the United States District Court for the Northern District of California on February 13, 2012, February 24, 2012 and April 2, 2012. The purported shareholder derivative suits filed in the Northern District of California have been voluntarily dismissed. On July 5, 2012, the purported shareholder derivative suits filed in Santa Clara County were consolidated into *In re Netflix, Inc. Shareholder Derivative Litigation*, Case No. 1-12-cv-218399, and lead counsel was appointed. A consolidated complaint was filed on December 4, 2012, with plaintiffs seeking compensatory damages and other relief. The consolidated complaint alleges, among other things, that certain of the Company's current and former officers and directors breached their fiduciary duties, issued false and misleading statements primarily regarding the Company's streaming business, violated accounting rules concerning segment reporting, violated provisions of the California Corporations Code, and wasted corporate assets. The consolidated complaint further alleges that the defendants caused the Company to buy back stock at artificially inflated prices to the detriment of the Company and its shareholders while contemporaneously selling personally held Company stock. The Company filed a demurrer to the consolidated complaint and a motion to stay the derivative litigation in favor of the related federal securities class action on February 4, 2013. On June 21, 2013, the Court granted the motion to stay the derivative litigation pending resolution of the related federal securities class action. Management has determined a potential loss is reasonably possible however, based on its current knowledge, management does not believe that the amount of such possible loss or a range of potential loss is reasonably estimable.

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

### Indemnification

In the ordinary course of business, the Company has entered into contractual arrangements under which it has agreed to provide indemnification of varying scope and terms to business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of the Company's breach of such agreements and out of intellectual property infringement claims made by third parties. In these circumstances, payment may be conditional on the other party making a claim pursuant to the procedures specified in the particular contract.

The Company's obligations under these agreements may be limited in terms of time or amount, and in some instances, the Company may have recourse against third parties for certain payments. In addition, the Company has entered into indemnification agreements with its directors and certain of its officers that will require it, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. The terms of such obligations vary.

It is not possible to make a reasonable estimate of the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the unique facts and circumstances involved in each particular agreement. No amount has been accrued in the accompanying consolidated financial statements with respect to these indemnification obligations.

## 10. Segment Information

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The Company has three reportable segments: Domestic streaming, International streaming and Domestic DVD. Segment information is presented in the same manner that the Company's chief operating decision maker ("CODM") reviews the operating results in assessing performance and allocating resources. The Company's CODM reviews revenues and contribution profit (loss) for each of the reportable segments. Contribution profit (loss) is defined as revenues less cost of revenues and marketing expenses directly incurred by the segment. The Company has aggregated the results of the International operating segments into one reportable segment because these operating segments share similar long-term economic and other qualitative characteristics.

The Domestic and International streaming segments derive revenues from monthly membership fees for services consisting solely of streaming content. The Domestic DVD segment derives revenues from monthly membership fees for services consisting solely of DVD-by-mail. Revenues and the related payment card fees are attributed to the operating segment based on the nature of the underlying membership (streaming or DVD) and the geographic region from which the membership originates. There are no internal revenue transactions between the Company's segments. Cost of revenues are primarily attributed to the operating segment based on the amounts directly incurred by the segment to obtain content and deliver it to the specific region. Content rights increasingly include multiple geographies as the Company aspires to obtain global content rights to support global expansion. The Company allocates this content between the International and Domestic segments based on estimated fair market value. Marketing expenses are primarily comprised of advertising expenses which are generally included in the segment in which the expenditures are directly incurred.

The Company's long-lived tangible assets were located as follows:

|               | As of                 |                         |
|---------------|-----------------------|-------------------------|
|               | September 30,<br>2015 | December<br>31,<br>2014 |
|               | (in thousands)        |                         |
| United States | \$ 168,569            | \$ 138,704              |
| International | 12,699                | 11,171                  |

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The following tables represent segment information for the periods ended September 30, 2015:

|  | As of/ Three Months Ended September 30, 2015 |                         |              |              |
|--|--|-------------------------|--------------|--------------|
|  | Domestic Streaming                           | International Streaming | Domestic DVD | Consolidated |
|  | (in thousands)                               |                         |              |              |
| Total memberships at end of period (1) | 43,181                                       | 25,987                  | 5,060        | —            |
| Revenues                               | \$ 1,063,961                                 | \$ 516,870              | \$ 157,524   | \$ 1,738,355 |
| Cost of revenues                       | 644,914                                      | 451,251                 | 77,793       | 1,173,958    |
| Marketing                              | 74,835                                       | 133,267                 | —            | 208,102      |
| Contribution profit (loss)             | \$344,212                                    | \$ (67,648 )            | \$ 79,731    | \$ 356,295   |
| Other operating expenses               |  |                         |              | 282,654      |
| Operating income                       |  |                         |              | 73,641       |
| Other income (expense)                 |  |                         |              | (31,403 )    |
| Provision for income taxes             |  |                         |              | 12,806       |
| Net income                             |  |                         |              | \$ 29,432    |

|  | As of/ Nine Months Ended September 30, 2015 |                         |              |              |
|--|---|-------------------------|--------------|--------------|
|  | Domestic Streaming                          | International Streaming | Domestic DVD | Consolidated |
|  | (in thousands)                              |                         |              |              |
| Total memberships at end of period (1) | 43,181                                      | 25,987                  | 5,060        | —            |
| Revenues                               | \$3,074,406                                 | \$ 1,387,030            | \$ 494,742   | \$ 4,956,178 |
| Cost of revenues                       | 1,840,134                                   | 1,249,495               | 252,482      | 3,342,111    |
| Marketing                              | 237,813                                     | 362,106                 | —            | 599,919      |
| Contribution profit (loss)             | \$996,459                                   | \$ (224,571 )           | \$ 242,260   | \$ 1,014,148 |
| Other operating expenses               |   |                         |              | 768,216      |
| Operating income                       |   |                         |              | 245,932      |
| Other income (expense)                 |   |                         |              | (124,778 )   |
| Provision for income taxes             |   |                         |              | 41,691       |
| Net income                             |   |                         |              | \$ 79,463    |

The following tables represent segment information for the periods ended September 30, 2014:

|  | As of/ Three Months Ended September 30, 2014 |                         |              |              |
|--|--|-------------------------|--------------|--------------|
|  | Domestic Streaming                           | International Streaming | Domestic DVD | Consolidated |
|  | (in thousands)                               |                         |              |              |
| Total memberships at end of period (1) | 37,219                                       | 15,843                  | 5,986        | —            |
| Revenues                               | \$877,150                                    | \$ 345,685              | \$ 186,597   | \$ 1,409,432 |
| Cost of revenues                       | 565,251                                      | 291,942                 | 97,201       | 954,394      |
| Marketing                              | 61,045                                       | 84,609                  | —            | 145,654      |
| Contribution profit (loss)             | \$250,854                                    | \$ (30,866 )            | \$ 89,396    | \$ 309,384   |
| Other operating expenses               |  |                         |              | 198,977      |
| Operating income                       |  |                         |              | 110,407      |
| Other income (expense)                 |  |                         |              | (12,870 )    |
| Provision for income taxes             |  |                         |              | 38,242       |
| Net income                             |  |                         |              | \$ 59,295    |



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|  | As of/ Nine Months Ended September 30, 2014 |                         |              |              |
|--|---|-------------------------|--------------|--------------|
|  | Domestic Streaming<br>(in thousands)        | International Streaming | Domestic DVD | Consolidated |
| Total memberships at end of period (1) | 37,219                                      | 15,843                  | 5,986        | —            |
| Revenues                               | \$2,513,992                                 | \$ 920,264              | \$585,672    | \$ 4,019,928 |
| Cost of revenues                       | 1,628,568                                   | 803,906                 | 305,954      | 2,738,428    |
| Marketing                              | 206,030                                     | 197,485                 | —            | 403,515      |
| Contribution profit (loss)             | \$679,394                                   | \$ (81,127 )            | \$279,718    | \$ 877,985   |
| Other operating expenses               |   |                         |              | 540,383      |
| Operating income                       |   |                         |              | 337,602      |
| Other income (expense)                 |   |                         |              | (33,749 )    |
| Provision for income taxes             |   |                         |              | 120,425      |
| Net income                             |   |                         |              | \$ 183,428   |

The following table represents the amortization of the content library:

|                                       | Domestic Streaming | International Streaming | Domestic DVD | Consolidated |
|---------------------------------------|--------------------|-------------------------|--------------|--------------|
|                                       | (in thousands)     |                         |              |              |
| Three months ended September 30, 2015 | \$493,025          | \$ 378,378              | \$18,589     | \$ 889,992   |
| 2014                                  | 433,266            | 252,888                 | 18,269       | 704,423      |
| Nine months ended September 30, 2015  | 1,387,242          | 1,056,279               | 60,587       | 2,504,108    |
| 2014                                  | 1,229,477          | 696,449                 | 51,313       | 1,977,239    |

The following table represents total content library, net:

|                          | Domestic Streaming | International Streaming | Domestic DVD | Consolidated |
|--------------------------|--------------------|-------------------------|--------------|--------------|
|                          | (in thousands)     |                         |              |              |
| As of September 30, 2015 | \$4,367,750        | \$2,193,785             | \$25,439     | \$ 6,586,974 |
| As of December 31, 2014  | 3,476,226          | 1,392,701               | 30,101       | 4,899,028    |

(1) A membership (also referred to as a subscription or member) is defined as the right to receive either the Netflix streaming service or Netflix DVD service. Memberships are assigned to territories based on the geographic location used at time of sign-up as determined by the Company's internal systems, which utilize industry standard geo-location technology. The Company offers free-trial memberships to new and certain rejoining members. For inclusion in the definition of a membership in the above metrics, a method of payment is required to be provided even during the free-trial period. Total memberships therefore include those who are on a free-trial and have provided a method of payment. A membership is canceled and ceases to be reflected in the above metrics as of the effective cancellation date. Voluntary cancellations become effective at the end of the prepaid membership period, while involuntary cancellation of the service, as a result of a failed method of payment, becomes effective immediately.

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

## Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. These forward-looking statements include, but are not limited to statements regarding: our core strategy; the impact of, and the Company's response to, new accounting standards; pricing; dividends; impact of foreign currency and exchange rate fluctuations; investments in marketing and content, including original content; international expansion and investments related thereto; cash use in connection with content acquisitions and licensing and international expansion; contribution margin and free cash flow trends; unrecognized tax benefits; deferred tax assets; tax settlements with the IRS and the state of California; accessing and obtaining additional capital; and future contractual obligations, including unknown streaming content obligations. These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ materially from those included in forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Securities and Exchange Commission ("SEC") on January 29, 2015, in particular the risk factors discussed under the heading "Risk Factors" in Part I, Item IA.

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

Investors and others should note that we announce material financial information to our investors using our investor relations website (<http://ir.netflix.com>), SEC filings, press releases, public conference calls and webcasts. We use these channels, as well as social media, to communicate with our members and the public about our company, our services and other issues. It is possible that the information we post on social media could be deemed to be material information. Therefore, we encourage investors, the media, and others interested in our company to review the information we post on the United States ("U.S.") social media channels listed on our investor relations website.

## Overview

We are the world's leading Internet television network with over 69 million memberships in over 50 countries enjoying more than 100 million hours of TV shows and movies per day, including original series, documentaries and feature films. Members can watch as much as they want, anytime, anywhere, on nearly any Internet-connected screen. Members can play, pause and resume watching, all without commercials or commitments. Additionally, in the U.S., our members can receive DVDs delivered quickly to their homes.

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

Our core strategy is to grow our streaming membership business globally within the parameters of our consolidated net income and contribution profit (loss) targets. We are continuously improving our members' experience by expanding our streaming content with a focus on a programming mix of content that delights our members. In addition, we are perpetually enhancing our user interface and expanding our streaming service to more Internet-connected screens.

## Results of Operations

The following represents our consolidated performance highlights:

|  | Three Months Ended | Change |
|--|--------------------|--------|
|--|--------------------|--------|

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|                              | September 30,<br>2015              | September 30,<br>2014 | Q3'15 vs.<br>Q3'14 |    |
|------------------------------|------------------------------------|-----------------------|--------------------|----|
|                              | (in thousands, except percentages) |                       |                    |    |
| Global streaming memberships | 69,168                             | 53,062                | 30                 | %  |
| Revenues                     | \$1,738,355                        | \$1,409,432           | 23                 | %  |
| Operating income             | 73,641                             | 110,407               | (33)               | )% |
| Net income                   | 29,432                             | 59,295                | (50)               | )% |

Consolidated revenues for the three months ended September 30, 2015 increased \$328.9 million as compared to the three months ended September 30, 2014 due to growth in global streaming memberships, partially offset by the impacts of foreign currency exchange rate fluctuations. Cost of revenues and operating expenses increased due to increased expenses relating to our streaming content as well as to our international expansion. Net income decreased \$29.9 million in the three months ended September 30, 2015 as compared to the three months ended September 30, 2014 as a result of the decrease in operating income and a \$21.8 million increase in interest expense primarily related to our additional debt issued in February 2015.



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In the third quarter of 2015, we changed the amortization method of certain content given changes in estimated viewing patterns of this content. The effect of this change was a \$12.8 million increase in cost of revenues in the Domestic streaming segment, for the three and nine months ended September 30, 2015.

We offer three types of streaming membership plans. In the U.S. our basic plan is priced at \$7.99 per month and includes access to standard definition quality streaming on a single screen at a time. Our most popular streaming plan is priced at \$9.99 per month and includes access to high definition quality streaming on two screens concurrently. Our premium plan is priced at \$11.99 per month and includes access to high definition and ultra-high definition quality content on four screens concurrently. Internationally, the membership plans are structured similarly to the U.S. and range in price from the U.S. dollar equivalent of approximately \$4.00 per month to \$19.00 per month.

We expect that from time to time the prices of our membership plans in each country may change. For instance, we recently increased the price of our two-screen high definition plan in the U.S. and several European countries. In May 2014, in the U.S., we increased the price from \$7.99 per month to \$8.99 per month with existing memberships grandfathered for a two year period. In October 2015, in the U.S., we increased the price of this same high definition plan from \$8.99 per month to \$9.99 per month with existing memberships grandfathered for a one year period.

The following represents the key elements to our segment results of operations:

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

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

For the Domestic and International streaming segments, marketing expenses consist primarily of advertising expenses and payments made to our affiliates and device partners. Advertising expenses include promotional activities such as online and television advertising. Payments to our affiliates and device partners include fixed fee and/or revenue sharing payments. Marketing expenses are primarily incurred by our Domestic and International streaming segments given our focus on building consumer awareness of the streaming offerings. Marketing expenses incurred by our International streaming segment have been significant and will fluctuate dependent upon the number of international territories in which our streaming service is offered and the timing of the launch of new territories. We do not incur marketing expenses for the Domestic DVD segment.

▲We have demonstrated our ability to grow domestic streaming contribution margin as evidenced by the increase in contribution margin from 12% when we first began separately reporting Domestic streaming results in the fourth quarter of 2011 to 32% in the third quarter of 2015. As a result of our focus on growing the streaming segments,

contribution margins for the Domestic and International streaming segments are lower than for our Domestic DVD segment. Investments in content and marketing associated with the International streaming segment will continue to fluctuate dependent upon the number of international territories in which our streaming service is offered and the timing of the launch of new territories.

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## Domestic Streaming Segment

Three months ended September 30, 2015 as compared to the three months ended September 30, 2014

|   | As of/ Three Months Ended                                     |                       | Change          |    |       |
|---|---|-----------------------|-----------------|----|-------|
|   | September 30,<br>2015   | September 30,<br>2014 | Q3'15 vs. Q3'14 |    |       |
|   | (in thousands, except revenue per membership and percentages) |                       |                 |    |       |
| <b>Memberships:</b>                           |   |                       |                 |    |       |
| Net additions                                 | 881   | 975                   | (94             | )  | (10)% |
| Memberships at end of period                  | 43,181  | 37,219                | 5,962           | 16 | %     |
| Paid memberships at end of period             | 42,068  | 36,265                | 5,803           | 16 | %     |
| Average monthly revenue per paying membership | \$8.53  | \$8.20                | \$0.33          | 4  | %     |
| <b>Contribution profit:</b>                   |   |                       |                 |    |       |
| Revenues                                      | \$1,063,961   | \$877,150             | \$186,811       | 21 | %     |
| Cost of revenues                              | 644,914   | 565,251               | 79,663          | 14 | %     |
| Marketing                                     | 74,835  | 61,045                | 13,790          | 23 | %     |
| Contribution profit                           | 344,212   | 250,854               | 93,358          | 37 | %     |
| Contribution margin                           | 32  | % 29                  | %               |    |       |

In the Domestic streaming segment, we derive revenues from monthly membership fees for services consisting solely of streaming content. The increase in our domestic streaming revenues was primarily due to the 17% growth in the average number of paid memberships, as well as the 4% increase in average monthly revenue per paying membership resulting from our pricing changes and plan mix. Our two-screen high-definition plan continues to be the most popular plan choice for new memberships.

The increase in domestic streaming cost of revenues was primarily due to a \$50.2 million increase in content expenses relating to our existing and new streaming content, including more exclusive and original programming. In addition, streaming delivery expenses increased by \$16.1 million and other costs, such as payment processing fees and customer service call centers, increased \$13.4 million due to our growing member base.

Domestic marketing expenses increased primarily due to an increase in advertising and public relations spending. Our Domestic streaming segment had a contribution margin of 32% for the three months ended September 30, 2015, which increased as compared to the contribution margin of 29% for the three months ended September 30, 2014 due to growth in paid memberships and revenue which continued to outpace content spending.

Nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014

|   | As of/ Nine Months Ended                                      |                       | Change            |    |   |
|---|---|-----------------------|-------------------|----|---|
|   | September 30,<br>2015   | September 30,<br>2014 | YTD'15 vs. YTD'14 |    |   |
|   | (in thousands, except revenue per membership and percentages) |                       |                   |    |   |
| <b>Memberships:</b>                           |   |                       |                   |    |   |
| Net additions                                 | 4,067   | 3,799                 | 268               | 7  | % |
| Memberships at end of period                  | 43,181  | 37,219                | 5,962             | 16 | % |
| Paid memberships at end of period             | 42,068  | 36,265                | 5,803             | 16 | % |
| Average monthly revenue per paying membership | \$8.45  | \$8.10                | \$0.35            | 4  | % |
| <b>Contribution profit:</b>                   |   |                       |                   |    |   |
| Revenues                                      | \$3,074,406   | \$2,513,992           | \$560,414         | 22 | % |
| Cost of revenues                              | 1,840,134   | 1,628,568             | 211,566           | 13 | % |

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|                     |         |         |         |    |   |
|---------------------|---------|---------|---------|----|---|
| Marketing           | 237,813 | 206,030 | 31,783  | 15 | % |
| Contribution profit | 996,459 | 679,394 | 317,065 | 47 | % |
| Contribution margin | 32      | % 27    | %       |    |   |

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The increase in our domestic streaming revenues was primarily due to the 17% growth in the average number of paid memberships, as well as the 4% increase in average monthly revenue per paying membership resulting from our pricing changes and plan mix.

The increase in domestic streaming cost of revenues was primarily due to a \$153.7 million increase in content expenses relating to our existing and new streaming content, including more exclusive and original programming. In addition, streaming delivery expenses increased by \$29.7 million and other costs, such as payment processing fees and customer service call centers, increased \$28.2 million due to our growing member base.

Domestic marketing expenses increased primarily due to an increase in advertising and public relations spending.

Our Domestic streaming segment had a contribution margin of 32% for the nine months ended September 30, 2015, which increased as compared to the contribution margin of 27% for the nine months ended September 30, 2014 due to growth in paid memberships and revenue which continued to outpace content and marketing spending.

## International Streaming Segment

Three months ended September 30, 2015 as compared to the three months ended September 30, 2014

|   | As of /Three Months Ended                                     |                    | Change          |      |    |
|---|---|--------------------|-----------------|------|----|
|   | September 30, 2015  | September 30, 2014 | Q3'15 vs. Q3'14 |      |    |
|   | (in thousands, except revenue per membership and percentages) |                    |                 |      |    |
| <b>Memberships:</b>                           |   |                    |                 |      |    |
| Net additions                                 | 2,736   | 2,042              | 694             | 34   | %  |
| Memberships at end of period                  | 25,987  | 15,843             | 10,144          | 64   | %  |
| Paid memberships at end of period             | 23,951  | 14,389             | 9,562           | 66   | %  |
| Average monthly revenue per paying membership | \$7.56  | \$8.44             | \$(0.88)        | (10) | )% |
| <b>Contribution profit (loss):</b>            |   |                    |                 |      |    |
| Revenues                                      | \$516,870   | \$345,685          | \$171,185       | 50   | %  |
| Cost of revenues                              | 451,251   | 291,942            | 159,309         | 55   | %  |
| Marketing                                     | 133,267   | 84,609             | 48,658          | 58   | %  |
| Contribution loss                             | (67,648)  | (30,866)           | (36,782)        | 119  | %  |
| Contribution margin                           | (13)  | (9)                |                 |      | )% |

In the International streaming segment, we derive revenues from monthly membership fees for services consisting solely of streaming content. We launched our streaming service in Canada in September 2010 and have continuously expanded our services internationally with launches in Latin America in September 2011, the U.K. and Ireland in January 2012, Finland, Denmark, Sweden and Norway in October 2012, the Netherlands in September 2013, and Germany, Austria, Switzerland, France, Belgium and Luxembourg in September 2014. In the first quarter of 2015, we launched our service in Australia and New Zealand. In the third quarter of 2015 we launched in Japan. In keeping with our global strategy, we expect to launch in additional markets, including Spain, Portugal and Italy in October 2015. The increase in our international revenues was due to the 67% growth in the average number of paid international memberships offset partially by a 10% decrease in average monthly revenue per paying membership. The decrease in average monthly revenue per paying membership was due to the impact of exchange rate fluctuations and to a lesser extent the impact of absorbing higher VAT rates across our European markets beginning January 1, 2015. These decreases were partially offset by our pricing changes and plan mix. We believe international revenues in the third quarter of 2015 would have been approximately \$96 million higher if foreign exchange rates had remained consistent with the foreign exchange rates from the third quarter of 2014. Average paid international streaming memberships account for 35% of global average paid streaming memberships as of September 30, 2015, as compared to 28% of global average paid streaming memberships as of September 30, 2014.

The increase in international cost of revenues was primarily due to a \$130.7 million increase in content expenses relating to our existing and new streaming content, including streaming content for territories launched in the last twelve months as well as more exclusive and original programming. Other costs increased \$28.6 million primarily due to increases in our streaming delivery expenses, costs associated with our customer service call centers and payment processing fees, all driven by our growing member base, partially offset by decreases resulting from exchange rate fluctuations.

International marketing expenses for the three months ended September 30, 2015 increased as compared to the three months ended September 30, 2014 mainly due to expenses for territories launched in the last twelve months.

International contribution losses increased for the three months ended September 30, 2015 as compared to the three months ended September 30, 2014, due to increased spending for our international expansion and the impact of foreign currency exchange rate fluctuations.

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Had foreign exchange rates in the third quarter of 2015 remained consistent with foreign exchange rates from the third quarter of 2014, we believe international contribution losses would have been approximately \$42 million lower in the third quarter of 2015. Our International streaming segment does not benefit from the established member base that exists for the Domestic streaming segment. Therefore our investments in streaming content and marketing programs which drive membership growth and viewing in our International markets have been significant and are larger initially relative to revenues, in particular as new territories are launched.

Nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014

|   | As of/ Nine Months Ended                                      |                    | Change            |       |    |
|---|---|--------------------|-------------------|-------|----|
|   | September 30, 2015  | September 30, 2014 | YTD'15 vs. YTD'14 |       |    |
|   | (in thousands, except revenue per membership and percentages) |                    |                   |       |    |
| <b>Memberships:</b>                           |   |                    |                   |       |    |
| Net additions                                 | 7,710   | 4,913              | 2,797             | 57    | %  |
| Memberships at end of period                  | 25,987  | 15,843             | 10,144            | 64    | %  |
| Paid memberships at end of period             | 23,951  | 14,389             | 9,562             | 66    | %  |
| Average monthly revenue per paying membership | \$7.54  | \$ 8.35            | \$(0.81           | ) (10 | )% |
| <b>Contribution profit (loss):</b>            |   |                    |                   |       |    |
| Revenues                                      | \$1,387,030   | \$920,264          | \$466,766         | 51    | %  |
| Cost of revenues                              | 1,249,495   | 803,906            | 445,589           | 55    | %  |
| Marketing                                     | 362,106   | 197,485            | 164,621           | 83    | %  |
| Contribution loss                             | (224,571 )  | (81,127 )          | (143,444 )        | 177   | %  |
| Contribution margin                           | (16 )%  | (9 )%              |                   |       |    |

The increase in our international revenues was due to the 67% growth in the average number of paid international memberships offset partially by a 10% decrease in average monthly revenue per paying membership. The decrease in average monthly revenue per paying membership was due to the impact of exchange rate fluctuations and to a lesser extent the impact of absorbing higher VAT rates across our European markets beginning January 1, 2015. These decreases were partially offset by our pricing changes and plan mix. We believe international revenues would have been approximately \$225 million higher in the first three quarters of 2015 if foreign exchange rates had remained consistent with the foreign exchange rates from the first three quarters of 2014.

The increase in international cost of revenues was primarily due to a \$373.5 million increase in content expenses relating to expenses for territories launched in the last twelve months, coupled with existing and new streaming content, including more exclusive and original programming. Other costs increased \$72.1 million primarily due to increases in our streaming delivery expenses, costs associated with our customer service call centers and payment processing fees, all driven by our growing member base, partially offset by decreases resulting from exchange rate fluctuations.

International marketing expenses for the nine months ended September 30, 2015 increased as compared to the nine months ended September 30, 2014 mainly due to expenses for territories launched in the last twelve months.

International contribution losses increased for the nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014, due to our increased spending for our international expansion and to the impact of foreign currency exchange rate fluctuations. Had foreign exchange rates in the first three quarters of 2015 remained consistent with foreign exchange rates from the first three quarters of 2014, we believe international contribution losses would have been approximately \$84 million lower in the first three quarters of 2015.

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## Domestic DVD Segment

Three months ended September 30, 2015 as compared to the three months ended September 30, 2014

|   | As of/ Three Months Ended                                     |               | Change          |        |
|---|---|---------------|-----------------|--------|
|   | September 30,   | September 30, | Q3'15 vs. Q3'14 |        |
|   | 2015  | 2014          |                 |        |
|   | (in thousands, except revenue per membership and percentages) |               |                 |        |
| <b>Memberships:</b>                           |   |               |                 |        |
| Net losses                                    | (254 )  | (275 )        | (21 )           | (8 )%  |
| Memberships at end of period                  | 5,060   | 5,986         | (926 )          | (15 )% |
| Paid memberships at end of period             | 4,971   | 5,899         | (928 )          | (16 )% |
| Average monthly revenue per paying membership | \$10.31   | \$10.31       | \$—             | — %    |
| <b>Contribution profit:</b>                   |   |               |                 |        |
| Revenues                                      | \$157,524   | \$186,597     | \$(29,073 )     | (16 )% |
| Cost of revenues                              | 77,793  | 97,201        | (19,408 )       | (20 )% |
| Contribution profit                           | 79,731  | 89,396        | (9,665 )        | (11 )% |
| Contribution margin                           | 51  | % 48          | %               |        |

In the Domestic DVD segment, we derive revenues from our DVD-by-mail membership services. The price per plan for DVD-by-mail varies from \$4.99 to \$43.99 per month according to the plan chosen by the member. DVD-by-mail plans differ by the number of DVDs that a member may have out at any given point. Members electing access to high definition Blu-ray discs, in addition to standard definition DVDs, pay a surcharge ranging from \$2 to \$4 per month for our most popular plans.

The decrease in our domestic DVD revenues was due to a 16% decrease in the average number of paid memberships. The decrease in domestic DVD cost of revenues was primarily due to a \$6.9 million decrease in content expenses and an \$8.9 million decrease in delivery expenses resulting from a 20% decrease in the number of DVDs mailed to members. The decrease in shipments was driven by a decline in the number of DVD memberships coupled with a decrease in usage by these members. Other costs, primarily those associated with processing and customer service expenses, decreased \$3.6 million primarily due to a decrease in hub operation expenses resulting from the decline in DVD shipments.

Our Domestic DVD segment contribution margin was relatively flat for the three months ended September 30, 2015 as compared to the three months ended September 30, 2014.

Nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014

|   | As of/ Nine Months Ended                                      |               | Change            |        |
|---|---|---------------|-------------------|--------|
|   | September 30,   | September 30, | YTD'15 vs. YTD'14 |        |
|   | 2015  | 2014          |                   |        |
|   | (in thousands, except revenue per membership and percentages) |               |                   |        |
| <b>Memberships:</b>                           |   |               |                   |        |
| Net losses                                    | (707 )  | (944 )        | (237 )            | (25 )% |
| Memberships at end of period                  | 5,060   | 5,986         | (926 )            | (15 )% |
| Paid memberships at end of period             | 4,971   | 5,899         | (928 )            | (16 )% |
| Average monthly revenue per paying membership | \$10.30   | \$10.27       | \$0.03            | — %    |
| <b>Contribution profit:</b>                   |   |               |                   |        |
| Revenues                                      | \$494,742   | \$585,672     | \$(90,930 )       | (16 )% |
| Cost of revenues                              | 252,482   | 305,954       | (53,472 )         | (17 )% |



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|                     |         |         |           |        |
|---------------------|---------|---------|-----------|--------|
| Contribution profit | 242,260 | 279,718 | (37,458 ) | (13 )% |
| Contribution margin | 49      | % 48    | %         |        |

The decrease in our domestic DVD revenues was due to a 16% decrease in the average number of paid memberships.

The decrease in domestic DVD cost of revenues was primarily due to a \$13.1 million decrease in content expenses and a \$30.6 million decrease in delivery expenses resulting from a 21% decrease in the number of DVDs mailed to members. The decrease in shipments was driven by a decline in the number of DVD memberships coupled with a decrease in usage by these members. Other costs, primarily those

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associated with processing and customer service expenses, decreased \$9.8 million primarily due to a decrease in hub operation expenses resulting from the decline in DVD shipments.

Our Domestic DVD segment contribution margin was relatively flat for the nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014.

**Consolidated Operating Expenses****Technology and Development**

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

Three months ended September 30, 2015 as compared to the three months ended September 30, 2014

|                             | Three Months Ended                 |                    | Change          |    |   |
|-----------------------------|------------------------------------|--------------------|-----------------|----|---|
|                             | September 30, 2015                 | September 30, 2014 | Q3'15 vs. Q3'14 |    |   |
|                             | (in thousands, except percentages) |                    |                 |    |   |
| Technology and development  | \$171,762                          | \$120,953          | \$50,809        | 42 | % |
| As a percentage of revenues | 10                                 | % 9                | %               |    |   |

The increase in technology and development expenses was primarily due to a \$35.3 million increase in personnel-related costs, including stock-based compensation expense, resulting from an increase in compensation for our existing employees and a 20% growth in average headcount supporting continued improvements in our streaming service and our international expansion.

Nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014

|                             | Nine Months Ended                  |                    | Change            |    |   |
|-----------------------------|------------------------------------|--------------------|-------------------|----|---|
|                             | September 30, 2015                 | September 30, 2014 | YTD'15 vs. YTD'14 |    |   |
|                             | (in thousands, except percentages) |                    |                   |    |   |
| Technology and development  | \$469,929                          | \$346,445          | 123,484           | 36 | % |
| As a percentage of revenues | 9                                  | % 9                | %                 |    |   |

The increase in technology and development expenses was primarily due to a \$93.4 million increase in personnel-related costs, including stock-based compensation expense, resulting from an increase in compensation for our existing employees and a 19% growth in average headcount supporting continued improvements in our streaming service and our international expansion.

**General and Administrative**

General and administrative expenses consist of payroll and related expenses for corporate personnel, as well as professional fees and other general corporate expenses.

Three months ended September 30, 2015 as compared to the three months ended September 30, 2014

|                            | Three Months Ended                 |                    | Change          |    |   |
|----------------------------|------------------------------------|--------------------|-----------------|----|---|
|                            | September 30, 2015                 | September 30, 2014 | Q3'15 vs. Q3'14 |    |   |
|                            | (in thousands, except percentages) |                    |                 |    |   |
| General and administrative | \$110,892                          | \$78,024           | \$32,868        | 42 | % |

As a percentage of revenues

6 % 6 %

General and administrative expenses increased primarily due to a \$29.9 million increase in personnel-related costs, including stock-based compensation expense, resulting from a 52% increase in average headcount primarily to support our international and original content expansion, and an increase in compensation for existing employees.

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Nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014

|                             | Nine Months Ended                  |               | Change            |      |
|-----------------------------|------------------------------------|---------------|-------------------|------|
|                             | September 30,                      | September 30, | YTD'15 vs. YTD'14 |      |
|                             | 2015                               | 2014          |                   |      |
|                             | (in thousands, except percentages) |               |                   |      |
| General and administrative  | \$298,287                          | \$ 193,938    | 104,349           | 54 % |
| As a percentage of revenues | 6                                  | % 5           | %                 |      |

General and administrative expenses increased primarily due to an \$86.8 million increase in personnel-related costs, including stock-based compensation expense, resulting from a 53% increase in average headcount primarily to support our international and original content expansion, and an increase in compensation for existing employees.

## Interest Expense

Interest expense consists primarily of the interest associated with our outstanding long-term debt obligations, including the amortization of debt issuance costs, as well as interest on our lease financing obligations.

Three months ended September 30, 2015 as compared to the three months ended September 30, 2014

|                             | Three Months Ended                 |               | Change          |       |
|-----------------------------|------------------------------------|---------------|-----------------|-------|
|                             | September 30,                      | September 30, | Q3'15 vs. Q3'14 |       |
|                             | 2015                               | 2014          |                 |       |
|                             | (in thousands, except percentages) |               |                 |       |
| Interest expense            | \$(35,333 )                        | \$ (13,486 )  | \$(21,847)      | 162 % |
| As a percentage of revenues | 2                                  | % 1           | %               |       |

Nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014

|                             | Nine Months Ended                  |               | Change            |       |
|-----------------------------|------------------------------------|---------------|-------------------|-------|
|                             | September 30,                      | September 30, | YTD'15 vs. YTD'14 |       |
|                             | 2015                               | 2014          |                   |       |
|                             | (in thousands, except percentages) |               |                   |       |
| Interest expense            | \$(97,287 )                        | \$ (36,866 )  | (60,421 )         | 164 % |
| As a percentage of revenues | 2                                  | % 1           | %                 |       |

Interest expense primarily consisted of interest on our notes of \$33.8 million for the three months ended September 30, 2015 and \$93.2 million for the nine months ended September 30, 2015. The increase in interest expense for the three and nine months ended September 30, 2015 as compared to the three and nine months ended September 30, 2014 was primarily due to the higher aggregate principal of interest bearing notes outstanding.

## Interest and Other Income (Expense)

Interest and other income (expense) consists primarily of interest earned on cash, cash equivalents and short-term investments and foreign exchange gains and losses on foreign currency denominated balances.

Three months ended September 30, 2015 as compared to the three months ended September 30, 2014

|                                     | Three Months Ended                 |               | Change          |       |
|-------------------------------------|------------------------------------|---------------|-----------------|-------|
|                                     | September 30,                      | September 30, | Q3'15 vs. Q3'14 |       |
|                                     | 2015                               | 2014          |                 |       |
|                                     | (in thousands, except percentages) |               |                 |       |
| Interest and other income (expense) | \$3,930                            | \$ 616        | \$3,314         | 538 % |



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Nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014

|                                     | Nine Months Ended<br>September 30,<br>2015 | September 30,<br>2014 | Change<br>YTD'15 vs. YTD'14 |
|-------------------------------------|--|-----------------------|-----------------------------|
|                                     | (in thousands, except percentages)         |                       |                             |
| Interest and other income (expense) | \$(27,491 )                                | \$ 3,117              | (30,608 ) (982 )%           |
| As a percentage of revenues         | 1  | %                     | NM                          |

Interest and other income (expense) decreased for the nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014 due to a \$32.0 million foreign exchange loss, incurred primarily in the first quarter of 2015. The foreign exchange loss was primarily driven by the remeasurement of significant content liabilities denominated in currencies other than functional currencies in our European entities coupled with the strengthening of the U.S. dollar.

#### Provision for Income Taxes

The effective tax rates for the three months ended September 30, 2015 and 2014 were 30% and 39%, respectively. The effective tax rates for the three months ended September 30, 2015 and 2014 differed from the federal statutory rate primarily due to state taxes, foreign taxes and non-deductible expenses, partially offset by the California R&D credit. The effective tax rates for the nine months ended September 30, 2015 and 2014 were 34% and 40%, respectively. The effective tax rates for the nine months ended September 30, 2015 and 2014 differed from the federal statutory rate primarily due to state taxes, foreign taxes and non-deductible expenses, partially offset by the California R&D credit. The decrease in our effective tax rates for the three and nine months ended September 30, 2015 as compared to the three and nine months ended September 30, 2014 was primarily attributable to lower tax reserves on uncertain tax positions following an IRS Appeals settlement in the fourth quarter of 2014.

#### Liquidity and Capital Resources

Cash, cash equivalents and short-term investments were \$2,609.6 million and \$1,608.5 million as of September 30, 2015 and December 31, 2014, respectively. Long-term debt was \$2,400.0 million and \$900.0 million as of September 30, 2015 and December 31, 2014, respectively. In 2015, we issued \$1,500.0 million of long-term debt, and in February 2014 we issued \$400.0 million of long-term debt. See Note 5 to the consolidated financial statements for additional information.

Our primary uses of cash include the acquisition, licensing, and production of content, streaming delivery, marketing programs and payroll. Payment terms for certain content agreements require more upfront cash payments relative to the expense and therefore, future investments could impact our liquidity. We expect to significantly increase our investments in international expansion and in streaming content, particularly in original content.

Our ability to obtain any additional financing that we may choose to, or need to, obtain to finance our international expansion, our investment in original content or otherwise, will depend on, among other things, our development efforts, business plans, operating performance and the condition of the capital markets at the time we seek financing. We may not be able to obtain such financing on terms acceptable to us or at all. If we raise additional funds through the issuance of equity or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

As of September 30, 2015, \$170.7 million of cash and cash equivalents were held by our foreign subsidiaries. If these funds are needed for our operations in the U.S., we would be required to accrue and pay U.S. income taxes and foreign withholding taxes on the portion associated with undistributed earnings for certain foreign subsidiaries.

#### Free Cash Flow

We define free cash flow as cash provided by operating and investing activities excluding the non-operational cash flows from purchases, maturities and sales of short-term investments. We believe free cash flow is an important liquidity metric because it measures, during a given period, the amount of cash generated that is available to repay

debt obligations, make investments and for certain other activities. Free cash flow is considered a non-GAAP financial measure and should not be considered in isolation of, or as a substitute for, net income, operating income, cash flow (used in) provided by operating activities, or any other measure of financial performance or liquidity presented in accordance with GAAP.

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In assessing liquidity in relation to our results of operations, we compare free cash flow to net income, noting that the three major recurring differences are excess content payments over expense, non-cash stock-based compensation expense and other working capital differences. The excess content payments over expense is variable based on the payment terms of our content agreements and is expected to increase as we enter into more agreements with upfront cash payments, such as licensing and production of original content. Working capital differences include deferred revenue, taxes and semi-annual interest payments on our outstanding debt. Our receivables from members generally settle quickly and deferred revenue is a source of cash flow.

Three months ended September 30, 2015 as compared to the three months ended September 30, 2014

|   | Three Months Ended    |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2015 | September 30,<br>2014 |
|   | (in thousands)        |                       |
| Net cash used in operating activities     | \$ (195,969           | ) \$ (37,439          |
| Net cash used in investing activities     | (47,479               | ) (20,411             |
| Net cash provided by financing activities | 72,754                | 30,662                |
| Non-GAAP free cash flow reconciliation:   |                       |                       |
| Net cash used in operating activities     | (195,969              | ) (37,439             |
| Acquisition of DVD content library        | (14,467               | ) (15,530             |
| Purchases of property and equipment       | (37,820               | ) (21,032             |
| Other assets                              | (3,760                | ) 341                 |
| Non-GAAP free cash flow                   | \$ (252,016           | ) \$ (73,660          |

Cash used in operating activities increased \$158.5 million, primarily due to increased payments for content other than DVD library of \$347.8 million or 39%, as well as increased payments associated with higher operating expenses. The increased use of cash was partially offset by a \$328.9 million or 23% increase in revenues.

Cash used in investing activities increased \$27.1 million, primarily due to an increase in purchases of property and equipment of \$16.8 million, coupled with a decrease in the proceeds from the sale and maturities of short-term investments, net of purchases of \$7.2 million.

Cash provided by financing activities increased \$42.1 million primarily due to the \$25.2 million increase in proceeds from the issuance of common stock, coupled with a \$16.7 million increase in excess tax benefits from stock-based compensation.

Free cash flow was \$281.4 million lower than net income for the three months ended September 30, 2015 primarily due to \$326.7 million of content cash payments over expense coupled with \$15.5 million non-favorable other working capital differences, partially offset by \$32.8 million of non-cash stock-based compensation expense and \$28.0 million change in deferred revenue.

Free cash flow was \$133.0 million lower than net income for the three months ended September 30, 2014 primarily due to \$152.8 million of content cash payments over expense and \$10.1 million non-favorable other working capital differences, partially offset by \$29.9 million of non-cash stock-based compensation expense.



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Nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014

|   | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2015 | September 30,<br>2014 |
|   | (in thousands)        |                       |
| Net cash (used in) provided by operating activities | \$(504,694            | ) \$54,944            |
| Net cash (used in) provided by investing activities | (138,631              | ) 8,275               |
| Net cash provided by financing activities           | 1,657,735             | 517,321               |
| Non-GAAP free cash flow reconciliation:             |                       |                       |
| Net cash (used in) provided by operating activities | (504,694              | ) 54,944              |
| Acquisition of DVD content library                  | (57,159               | ) (51,425             |
| Purchases of property and equipment                 | (78,394               | ) (54,235             |
| Other assets  | (4,174                | ) 1,765               |
| Non-GAAP free cash flow                             | \$(644,421            | ) \$(48,951           |

Cash used in operating activities increased \$559.6 million, primarily due to increased payments for content other than DVD library of \$990.1 million or 40%, as well as increased payments associated with higher operating expenses. The increased use of cash was partially offset by a \$936.3 million or 23% increase in revenues.

Cash used in investing activities increased \$146.9 million, primarily due to a decrease in the proceeds from the sale and maturities of short-term investments, net of purchases of \$111.1 million coupled with an increase of \$24.2 million in the purchases of property and equipment as well as a \$5.7 million increase in acquisition of DVD content library, as more DVDs were obtained through direct purchase than through revenue sharing agreements.

Cash provided by financing activities increased \$1,140.4 million primarily due to the \$1,482.4 million net proceeds from the issuance of the 5.50% Notes and the 5.875% Notes in the nine months ended September 30, 2015 compared to the \$392.9 million net proceeds from the issuance of the 5.750% Notes in the nine months ended September 30, 2014.

Free cash flow was \$723.9 million lower than net income for the nine months ended September 30, 2015 primarily due to \$859.0 million of content cash payments over expense, partially offset by \$46.2 million favorable other working capital differences, and \$88.9 million of non-cash stock-based compensation expense.

Free cash flow was \$232.4 million lower than net income for the nine months ended September 30, 2014 primarily due to \$372.9 million of content cash payments over expense, partially offset by \$85.0 million of non-cash stock-based compensation expense, \$37.2 million change in deferred revenue and \$18.3 million favorable other working capital differences.

### Contractual Obligations

For the purpose of this table, contractual obligations for purchases of goods or services are defined as agreements that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. The expected timing of payment of the obligations discussed below is estimated based on information available to us as of September 30, 2015. Timing of payments and actual amounts paid may be different depending on the time of receipt of goods or services or changes to agreed-upon amounts for some obligations. The following table summarizes our contractual obligations as of September 30, 2015:

| Contractual obligations (in thousands): | Payments due by Period |                     |           |           |                      |
|---|------------------------|---------------------|-----------|-----------|----------------------|
|   | Total                  | Less than<br>1 year | 1-3 years | 3-5 years | More than<br>5 years |
|   |                        |                     |           |           |                      |

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|                                   |              |             |             |             |             |
|-----------------------------------|--------------|-------------|-------------|-------------|-------------|
| Streaming content obligations (1) | \$10,378,218 | \$4,535,209 | \$4,888,130 | \$908,111   | \$46,768    |
| Debt (2)                          | 3,485,188    | 152,000     | 270,750     | 270,750     | 2,791,688   |
| Lease obligations (3)             | 506,741      | 38,971      | 95,535      | 92,309      | 279,926     |
| Other purchase obligations (4)    | 336,266      | 183,046     | 151,066     | 1,795       | 359         |
| Total                             | \$14,706,413 | \$4,909,226 | \$5,405,481 | \$1,272,965 | \$3,118,741 |

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- (1) As of September 30, 2015, streaming content obligations were comprised of \$2.6 billion included in "Current content liabilities" and \$2.0 billion of "Non-current content liabilities" on the Consolidated Balance Sheets and \$5.8 billion of obligations that are not reflected on the Consolidated Balance Sheets as they do not yet meet the criteria for asset recognition.

Streaming content obligations increased \$0.9 billion from \$9.5 billion as of December 31, 2014 to \$10.4 billion as of September 30, 2015 primarily due to multi-year commitments primarily associated with the continued expansion of our exclusive and original programming.

A streaming content obligation is incurred at the time we enter into an agreement to obtain future titles. Once a title becomes available, a content liability is generally recorded on the Consolidated Balance Sheets. Certain agreements include the obligation to license rights for unknown future titles, the ultimate quantity and/or fees for which are not yet determinable as of the reporting date. Traditional film output deals, like the future output deal with Disney, or certain TV series license agreements where the number of seasons to be aired is unknown, are examples of these types of license agreements. The contractual obligations table above does not include any estimated obligation for the unknown future titles, payment for which could range from less than one year to more than five years. However, these unknown obligations are expected to be significant and we believe could include approximately \$3 billion to \$5 billion over the next three years, with the payments for the vast majority of such amounts expected to occur after the next twelve months. The foregoing range is based on considerable management judgments and the actual amounts may differ. Once we know the title that we will receive and the license fees, we include the amount in the contractual obligations table above.

- (2) Long-term debt obligations include our Notes consisting of principal and interest payments, see Note 5 to the consolidated financial statements for further details.

- (3) Lease obligations include lease financing obligations of \$21.8 million related to our current Los Gatos, California headquarters for which we are the deemed owner for accounting purposes, commitments of \$316.5 million for our expanded headquarters in Los Gatos, California, \$113.1 million for our new office space in Los Angeles, California and other commitments of \$55.3 million for facilities under non-cancelable operating leases. These leases have expiration dates varying through approximately 2025.

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

As of September 30, 2015, we had gross unrecognized tax benefits of \$41.1 million and an additional \$0.5 million for gross interest and penalties primarily classified as "Accrued expenses" on the Consolidated Balance Sheets. We expect to reach a final settlement with the IRS and the state of California within the next twelve months. However until a final settlement is reached, we can not reasonably estimate the amount of payments that will be made in the next twelve months and, therefore, such amounts associated with our unrecognized tax benefits are not included in the above contractual obligation table.

**Off-Balance Sheet Arrangements**

We do not have any transactions with unconsolidated entities, such as entities often referred to as structured finance or special purpose entities, whereby we have financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose us to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to us.

#### Indemnification

The information set forth under Note 9 to the consolidated financial statements under the caption “Indemnification” is incorporated herein by reference.

#### Critical Accounting Policies and Estimates

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

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### Streaming Content

We acquire, license and produce content, including Netflix originals, in order to offer our members unlimited viewing of TV shows and films. The content licenses are for a fixed fee and specific windows of availability. Payment terms for certain content licenses and the production of content require more upfront cash payments relative to the expense. For licenses we capitalize the fee per title and record a corresponding liability at the gross amount of liabilities when the license period begins, the cost of the title is known and the title is accepted and available for streaming. The portion available for streaming within one year is recognized as "Current content library, net" and the remaining portion as "Non-current content library, net" on the Consolidated Balance Sheets. The license of streaming content rights and the changes in related liabilities are classified within "Net cash (used in) provided by operating activities" on the Consolidated Statements of Cash Flows.

For productions we capitalize costs associated with the production, including development cost and direct costs. We include these amounts in "Non-current content library, net" on the Consolidated Balance Sheets. Participations and residuals are expensed in line with the amortization of production costs. Capitalized production costs and other expenses associated with our originals such as participations and residuals have not been material to date.

Based on factors including historical and estimated viewing patterns, we amortize the content library (licensed and produced) in "Cost of revenues" on the Consolidated Statements of Operations, on a straight line or on an accelerated basis over the shorter of each title's contractual window of availability or estimated period of use, beginning with the month of first availability. The amortization period typically ranges from six months to five years. For most of our content, we amortize on a straight-line basis. For certain content where we expect more upfront viewing, due to the additional merchandising and marketing efforts, we amortize on an accelerated basis. We review factors impacting the amortization of the content library on a regular basis, including changes in merchandising and marketing efforts. Our estimates related to these factors require considerable management judgment. Changes in our estimates could have a significant impact on our future results of operations. In the third quarter of 2015, we changed the amortization method of certain content given changes in estimated viewing patterns of this content. The effect of this change was a \$12.8 million increase in cost of revenues in the Domestic streaming segment, for the three and nine months ended September 30, 2015.

The content library is stated at the lower of unamortized cost or net realizable value which approximates fair value of the capitalized costs for produced content. Streaming content is reviewed in aggregate at the geographic region level for impairment when an event or change in circumstances indicates a change in the expected usefulness of the content. Currently the level of geographic aggregation is determined based on the streaming content rights which are generally specific to a geographic region inclusive of several countries (such as Latin America). Increasingly our streaming content rights include multiple geographies as we aspire to obtain global content rights to support our global expansion. Unamortized costs for titles or projects that have been or are expected to be abandoned are written off. No material write-down from unamortized cost to a lower net realizable value was recorded in any of the periods presented.

We have entered into certain licenses with collective management organizations ("CMOs"), and are currently involved in negotiations with other CMOs, that hold certain rights to music and other entertainment works "publicly performed" in connection with streaming content into various territories. Accruals for estimated license fees are recorded and then adjusted based on any changes in estimates. These amounts are included in the streaming content obligations. The results of these negotiations are uncertain and may be materially different from management's estimates.

### Income Taxes

We record a provision for income taxes for the anticipated tax consequences of our reported results of operations using the asset and liability method. Deferred income taxes are recognized by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts of existing assets and

liabilities and their respective tax bases as well as net operating loss and tax credit carryforwards. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance for any tax benefits for which future realization is uncertain.

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

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

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We did not recognize certain tax benefits from uncertain tax positions within the provision for income taxes. We may recognize a tax benefit only if it is more likely than not the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such positions are then measured based on the largest benefit that has a greater than 50% likelihood of being realized upon settlement. At September 30, 2015, our estimated gross unrecognized tax benefits were \$41.1 million of which \$33.7 million, if recognized, would favorably impact our future earnings. Due to uncertainties in any tax audit outcome, our estimates of the ultimate settlement of our unrecognized tax positions may change and the actual tax benefits may differ significantly from the estimates. See Note 8 to the consolidated financial statements for further information regarding income taxes.

### Stock-Based Compensation

Stock-based compensation expense at the grant date is based on the total number of options granted and an estimate of the fair value of the awards.

We calculate the fair value of our stock option grants using a lattice-binomial model. This model requires the input of highly subjective assumptions. Changes in the subjective input assumptions can materially affect the estimate of fair value of options granted and our results of operations could be impacted.

**Expected Volatility:** Prior to January 1, 2015, our computation of expected volatility was based on a blend of historical volatility of our common stock and implied volatility of tradable forward call options to purchase shares of our common stock, as low trade volume of our tradable forward call options prior to 2011 precluded sole reliance on implied volatility. Beginning on January 1, 2015, expected volatility is based solely on implied volatility. We believe that implied volatility of publicly traded options in our common stock is more reflective of market conditions and, given consistently high trade volumes of the options, can reasonably be expected to be a better indicator of expected volatility than historical volatility of our common stock. An increase/decrease of 10% in our computation of expected volatility would increase/decrease the total stock-based compensation expense by approximately \$2.4 million for the three months ended September 30, 2015.

**Suboptimal Exercise Factor:** Our computation of the suboptimal exercise factor is based on historical and estimated option exercise behavior. Prior to January 1, 2015, the Company bifurcated its option grants into two employee groupings (executive and non-executive) to determine the suboptimal exercise factor. Beginning on January 1, 2015, the Company began aggregating employee groupings for its determination of the suboptimal exercise factor as the previous bifurcation into two groupings did not have a material impact on the fair value of the options granted. An increase/decrease in the suboptimal exercise factor of 10% would increase/decrease the total stock-based compensation expense by approximately \$1.2 million for the three months ended September 30, 2015.

### Recent Accounting Pronouncements

The information set forth under Note 1 to the consolidated financial statements under the caption “Basis of Presentation and Summary of Significant Accounting Policies” is incorporated herein by reference.

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### Item 3. Quantitative and Qualitative Disclosures About Market Risk

For financial market risks related to changes in interest rates, reference is made to Item 7A “Quantitative and Qualitative Disclosures About Market Risk” contained in Part II of our Annual Report on Form 10-K for the year ended December 31, 2014. Our exposure to market risk has not changed significantly since December 31, 2014.

#### Foreign Currency Risk

International revenues and cost of revenues account for 28% and 37%, respectively of consolidated amounts for the first nine months of 2015. The majority of international revenues and a smaller portion of expenses are denominated in currencies other than the U.S. dollar and we therefore have foreign currency risk related to these currencies, which are primarily the euro, the British pound, the Canadian dollar, the Australian dollar, the Japanese Yen and the Brazilian real.

Accordingly, changes in exchange rates, and in particular a weakening of foreign currencies relative to the U.S. dollar may negatively affect our revenue and contribution profit (loss) of our International streaming segment as expressed in U.S. dollars. In the first nine months of 2015, we believe our international revenues would have been approximately \$225 million higher and our international contribution loss would have been approximately \$84 million lower had foreign currency exchange rates been consistent with those in the first nine months of 2014.

We have also experienced and will continue to experience fluctuations in our net income as a result of gains (losses) on the settlement and the remeasurement of monetary assets and liabilities denominated in currencies that are not the functional currency. In the first nine months of 2015, we recognized a \$32.0 million foreign exchange loss which resulted primarily from the remeasurement of significant content liabilities denominated in currencies other than functional currencies in our European entities coupled with the strengthening of the U.S. dollar.

We do not use foreign exchange contracts or derivatives to hedge any foreign currency exposures. The volatility of exchange rates depends on many factors that we cannot forecast with reliable accuracy. Our continued international expansion increases our exposure to exchange rate fluctuations and as a result such fluctuations could have a significant impact on our future results of operations.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q were effective in providing reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected.

#### Changes in Internal Control Over Financial Reporting



There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

The information set forth under Note 9 in the notes to the consolidated financial statements under the caption “Legal Proceedings” is incorporated herein by reference.

## Item 1A. Risk Factors

There have been no material changes from the risk factors as previously disclosed under the heading “Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

## Item 6. Exhibits

## (a) Exhibits:

| ExhibitNumber | Exhibit Description  | Incorporated by Reference |           |         |                   | Filed<br>Herewith |
|---------------|--|---------------------------|-----------|---------|-------------------|-------------------|
|               |  | Form                      | File No.  | Exhibit | Filing Date       |                   |
| 3.1           | Restated Certificate of Incorporation  | 10-Q                      | 001-35727 | 3.1     | July 17, 2015     |                   |
| 3.2           | Amended and Restated Bylaws  | 8-K                       | 000-49802 | 3.1     | March 20, 2009    |                   |
| 4.1           | Form of Common Stock Certificate   | S-1/A                     | 333-83878 | 4.1     | April 16, 2002    |                   |
| 4.2           | Indenture, dated as of February 1, 2013, by and between the Company and Wells Fargo Bank, National Association, as Trustee.  | 8-K                       | 001-35727 | 4.1     | February 1, 2013  |                   |
| 4.3           | Indenture, dated as of February 19, 2014, by and between the Company and Wells Fargo Bank, National Association, as Trustee. | 8-K                       | 001-35727 | 4.1     | February 19, 2014 |                   |
| 4.4           | Indenture, dated as of February 5, 2015, by and between the Company and Wells Fargo Bank, National Association, as Trustee.  | 8-K                       | 001-35727 | 4.1     | February 5, 2015  |                   |
| 4.5           | Indenture, dated as of February 5, 2015, by and between the Company and Wells Fargo Bank, National Association, as Trustee.  | 8-K                       | 001-35727 | 4.2     | February 5, 2015  |                   |
| 10.1†         | Form of Indemnification Agreement entered into by the registrant with each of its executive officers and directors           | S-1/A                     | 333-83878 | 10.1    | March 20, 2002    |                   |
| 10.2†         | Amended and Restated 2002 Stock Plan   | Def 14A                   | 000-49802 | A       | March 31, 2006    |                   |

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|       |  |         |           |      |                   |   |
|-------|--|---------|-----------|------|-------------------|---|
| 10.3† | 2011 Stock Plan  | Def 14A | 000-49802 | A    | April 20, 2011    |   |
| 10.4† | Amended and Restated Executive Severance and Retention Incentive Plan  | 10-K    | 001-35727 | 10.7 | January 31, 2013  |   |
| 10.5  | Registration Rights Agreement, dated as of February 19, 2014, by and among the Company and Morgan Stanley & Co. LLC, as representative of the Initial Purchasers listed in Schedule 1 thereto  | 8-K     | 001-35727 | 10.1 | February 19, 2014 |   |
| 10.6† | Performance Bonus Plan   | Def 14A | 001-35727 | A    | April 28, 2014    |   |
| 10.7  | Registration Rights Agreement, dated as of February 5, 2015, by and among the Company and Morgan Stanley & Co. LLC, as representative of the Initial Purchasers listed in Schedule 1 thereto   | 8-K     | 001-35727 | 10.1 | February 5, 2015  |   |
| 10.8  | Registration Rights Agreement, dated as of February 5, 2015, by and among the Company and Morgan Stanley & Co. LLC, as representative of the Initial Purchasers listed in Schedule 1 thereto   | 8-K     | 001-35727 | 10.2 | February 5, 2015  |   |
| 10.9  | Purchase Agreement between Morgan Stanley & Co. LLC, as representative of several initial purchasers, and Netflix, Inc. dated February 2, 2015   | 10-Q    | 001-35727 | 10.9 | April 17, 2015    |   |
| 31.1  | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |         |           |      |                   | X |
| 31.2  | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |         |           |      |                   | X |
| 32.1* | Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |         |           |      |                   | X |
| 101   | The following financial information from Netflix, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2015 filed with the SEC on October 16, 2015, formatted in XBRL includes: (i) Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2015 and |         |           |      |                   | X |

2014, (ii) Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2015 and 2014 (iii) Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014, (iv) Consolidated Statements of Cash Flows for the Three and Nine Months Ended September 30, 2015 and 2014 and (v) the Notes to the Consolidated Financial Statements.

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

†Indicates a management contract or compensatory plan.

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SIGNATURES

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

Dated: October 16, 2015

NETFLIX, INC.  
By: /s/ REED HASTINGS  
Reed Hastings  
Chief Executive Officer  
(Principal executive officer)

Dated: October 16, 2015

By: /s/ DAVID WELLS  
David Wells  
Chief Financial Officer  
(Principal financial and accounting officer)

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## EXHIBIT INDEX

| ExhibitNumber | Exhibit Description   | Incorporated by Reference |           |         |                   | Filed<br>Herewith |
|---------------|---|---------------------------|-----------|---------|-------------------|-------------------|
|               |   | Form                      | File No.  | Exhibit | Filing Date       |                   |
| 3.1           | Restated Certificate of Incorporation   | 10-Q                      | 001-35727 | 3.1     | July 17, 2015     |                   |
| 3.2           | Amended and Restated Bylaws   | 8-K                       | 000-49802 | 3.1     | March 20, 2009    |                   |
| 4.1           | Form of Common Stock Certificate  | S-1/A                     | 333-83878 | 4.1     | April 16, 2002    |                   |
| 4.2           | Indenture, dated as of February 1, 2013, by and between the Company and Wells Fargo Bank, National Association, as Trustee.   | 8-K                       | 001-35727 | 4.1     | February 1, 2013  |                   |
| 4.3           | Indenture, dated as of February 19, 2014, by and between the Company and Wells Fargo Bank, National Association, as Trustee.  | 8-K                       | 001-35727 | 4.1     | February 19, 2014 |                   |
| 4.4           | Indenture, dated as of February 5, 2015, by and between the Company and Wells Fargo Bank, National Association, as Trustee.   | 8-K                       | 001-35727 | 4.1     | February 5, 2015  |                   |
| 4.4           | Indenture, dated as of February 5, 2015, by and between the Company and Wells Fargo Bank, National Association, as Trustee.   | 8-K                       | 001-35727 | 4.2     | February 5, 2015  |                   |
| 10.1†         | Form of Indemnification Agreement entered into by the registrant with each of its executive officers and directors  | S-1/A                     | 333-83878 | 10.1    | March 20, 2002    |                   |
| 10.2†         | Amended and Restated 2002 Stock Plan  | Def 14A                   | 000-49802 | A       | March 31, 2006    |                   |
| 10.3†         | 2011 Stock Plan   | Def 14A                   | 000-49802 | A       | April 20, 2011    |                   |
| 10.4†         | Amended and Restated Executive Severance and Retention Incentive Plan   | 10-K                      | 001-35727 | 10.7    | February 1, 2013  |                   |
| 10.5          | Registration Rights Agreement, dated as of February 19, 2014, by and among the Company and Morgan Stanley & Co. LLC, as representative of the Initial Purchasers listed in Schedule I thereto | 8-K                       | 001-35727 | 10.1    | February 19, 2014 |                   |

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|       |  |         |           |      |                  |   |
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