

strong ties with various entertainment video providers and leveraging those ties to both expand its content library and gain access to new releases as early as possible. The company acquired new content from movie studios and distributors through direct purchases, revenue-sharing agreements, and licensing. During 2010, Netflix entered into agreements with such content providers as Universal Studios, Twentieth Century Fox, Warner Bros., Indie Films, Relativity Media, and Epix that expanded the number of movie and TV episodes in Netflix's library and, in particular, broadened the company's ability to stream movies and TV shows to subscribers. A free Netflix App for iPads became available at Apple's App Store at www.itunes.com in April 2010, allowing Netflix subscribers to instantly watch an unlimited number of TV episodes and movies streamed from Netflix to their iPads. Netflix management was firmly committed to continuing the company's longstanding strategy to expand the content options offered to subscribers; the emphasis in 2010 had been on acquiring the rights to stream greater numbers of movies and TV episodes and on expanding the number of devices to which content could be streamed. Analysts expected such emphasis would be ongoing.

Netflix acquired many of its new-release movie DVDs from studios for a low up-front fee in exchange for a commitment for a defined period either to share a percentage of its subscription revenues or to pay a fee based on content utilization. After the revenue-sharing period expired for a title, Netflix generally had the option of returning the title to the studio, purchasing the title, or destroying its copies of the title. On occasion, Netflix also purchased DVDs for a fixed fee per disc from various studios, distributors, and other suppliers. In the case of movie titles and TV episodes that were delivered to subscribers via the Internet for instant viewing, Netflix generally paid a fee to license the content for a defined period. Following expiration of the license term, Netflix either removed the content from its library of streamed offerings or negotiated extension or renewal of the license agreement.

The company's December 31, 2009, balance sheet indicated that its content had a net value of \$108.8 million (after depreciation). New-release DVDs were amortized over one year; the useful life of back-library titles (some of which qualified

as classics) was amortized over three years (since the personalized movie recommendation software generated significant rentals of older titles). Some directly purchased DVDs could be sold at the end of their useful lives, but most had a salvage value of zero; during 2005–2009, Netflix's losses on the disposal of used DVDs ranged between \$2 and \$7 million annually.

Netflix's Convenient, Easy-to-Use Movie Selection Software

Netflix had developed proprietary software that enabled it to provide subscribers with detailed information about each title in the Netflix library as well as personalized movie recommendations every time they visited the Netflix website. The information for each title included length, rating, cast and crew, screen formats, movie trailers, plot synopses, and reviews written by Netflix editors, third parties, and subscribers. The personalized recommendations were based on a subscriber's individual likes and dislikes (determined by their rental or streaming history, their personal ratings of movies viewed, and movies on the subscriber's lists for future streamed viewing and/or mail delivery), the ratings of movie critics and other rating services, and the ratings submitted by other Netflix subscribers. Subscribers often began their search for movie titles by starting from a familiar title and then using the recommendations tool to find other titles they might enjoy.

The recommendation software had an Oracle database platform and used proprietary algorithms that organized Netflix's library of movies into clusters of similar movies and then sorted the movies in each cluster from most liked to least liked according to ratings provided by subscribers. In 2010, Netflix had more than 3 billion movie ratings from subscribers in its database and was adding new movie ratings from subscribers at the rate of about 20 million per week. Those subscribers who rated similar movies in similar clusters were categorized as like-minded viewers. When a subscriber was online and browsing through the movie selections, the software was programmed to check the clusters the subscriber had rented/viewed in the past, determine which movies the customer had yet to rent/view in that cluster, and recommend only those movies in the cluster that had been highly rated by viewers. Viewer ratings determined which available titles