BLOCKBUSTER INC
Form 10-K
March 29, 2002

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2001

OR

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ________

Commission File Number 001-15153

BLOCKBUSTER INC.
(Exact name of registrant as specified in its charter)

DELAWARE	52-1655102
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

1201 Elm Street
Dallas, Texas 75270
(214) 854-3000
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Class A Common Stock, $.01 par value per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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 [X] No [_]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [_]

As of March 8, 2002, 34,019,354 shares of class A common stock, $.01 par value per share, and 144,000,000 shares of class B common stock, $.01 par value per share, were outstanding. The aggregate market value of the registrant's common stock held by non-affiliates was about $802,078,371, based on the closing price of $23.69 per share of class A common stock as reported on the New York Stock Exchange composite tape on that date.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the proxy statement for the annual meeting of stockholders of the registrant to be held during 2002 are incorporated by reference into Part III of this Form 10-K.

BLOCKBUSTER INC.

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PART I

Item 1. Business

BLOCKBUSTER OVERVIEW

Blockbuster Inc. is the world's leading provider of rentable home videocassettes, DVDs and video games, with nearly 8,000 stores in the United States, its territories and 26 other countries as of December 31, 2001. According to research conducted for Blockbuster, our BLOCKBUSTER(R) brand achieves nearly 100% recognition with active movie renters in the United States. During 2001, we implemented a number of key initiatives to strengthen our core business and drive growth in profitability, while continuing to make progress with initiatives designed to leverage our brand and capitalize on new revenue streams. Reflecting these improvements, our worldwide revenues increased to over $5.1 billion in 2001. Of these revenues, 80.0% were generated in the United States and 20.0% were generated outside of the United States.

INDUSTRY OVERVIEW

Domestic Home Video--Movies

According to Paul Kagan Associates, at-home movie consumer spending in the United States increased from about $21.3 billion in 2000 to about $22.2 billion in 2001 and is projected to increase to about $38.6 billion by 2010. The U.S. retail home video industry, which includes the rental and sale of movies on videocassette ("VHS") and DVD, represented about $20.3 billion of the 2001 revenues. The remainder of the revenues were generated by consumer purchases of movies through pay-per-view and other specialized cable and satellite services. Although Kagan expects the U.S. retail home video industry to decline as a percentage of overall at-home movie consumer spending over the next ten years, we believe that the DVD format, with its superior sound and picture quality, will drive continued growth in the industry. According to Kagan estimates, the number of U.S. DVD households nearly doubled during 2001 to close to a quarter of U.S. television households. Kagan projects that this will increase to nearly 49% of U.S. television households by the end of 2003 and over 75% of U.S. television households by the end of 2009.

We believe that the combination of the following factors, among others, continue to make VHS and DVD rental a preferred medium of entertainment for millions of customers:

- the value gained through the ability to entertain people at home for a reasonable price;
- the opportunity to browse among a very broad selection of movies; and
- the ability to control the viewing experience, such as the ability to start, stop, pause, fast-forward and rewind.

In addition, some DVDs offer extra features such as outtakes, director commentary and the ability to skip directly to scenes, rather than fast-forwarding and rewinding. The DVD format, unlike the VHS format, also allows for several language tracks on the same disk.

A competitive advantage that the U.S. retail home video industry currently enjoys over most other movie distribution channels, except theatrical release, is the early timing of its "distribution window." As discussed below under "--Movie Studio Dependence on the Retail Home Video Industry," the retail home video industry is a critical source of revenue to U.S. movie distributors. In order to maximize this revenue, studios make their movies available to home video retailers, including Blockbuster, for specified periods of time after their initial theatrical release. This distribution window is typically exclusive against most other forms of non-theatrical movie distribution, such

as pay-per-view, premium television, basic cable and network and syndicated television.

The length of this exclusive distribution window for home video retailers varies, but has typically ranged from about 45 to 60 days for domestic video retailers. Thereafter, movies are made sequentially available to television distribution channels.

Currently, there is also a "rental window" for most VHS titles. Studios have traditionally released VHS titles that they want to promote primarily for rental at relatively high wholesale prices. As rental demand subsides, the studios reduce the pricing in order to promote sales to consumers. The period during which the VHS titles are released at higher prices is commonly referred to as the "rental window," because the prices are too high to generate consumer demand for purchasing them. In contrast, although studios are releasing movies to home video retailers on DVD at the same time as they are releasing the same movies on VHS, studios have not created a rental window for movies released on DVD. Rather, the studios are releasing movies on DVD at relatively low initial prices, called "sell-through" pricing, and are promoting DVDs for both purchase and rental from the beginning of the distribution window. Studios have traditionally reserved sell-through pricing on VHS product for titles that have mass ownership appeal, such as children's movies or movies that generate high box office returns.

The traditionally higher wholesale pricing of VHS product promoted for rental has made it difficult for video retailers to purchase enough copies of new VHS releases to satisfy consumer demand. As a result, major studios have entered into VHS revenue-sharing and copy depth arrangements directly with several video retailers, including us. These arrangements, which are discussed under "Our Business--Merchandising," have enabled participating home video retailers to minimize up-front costs and thereby substantially increase the quantity and selection of newly released VHS movies that they are able to stock. In exchange, video stores generally share with the studios an agreed-upon percentage of the video stores' VHS rental revenues on a per transaction basis for a limited period of time. Although some studios have begun entering into DVD revenue-sharing arrangements, the current sell-through pricing for DVDs has enabled video retailers such as Blockbuster to purchase substantial quantities of DVDs with or without these arrangements.

We believe that the studios' promotion of DVDs for both sale and rental has served to accelerate consumer interest in the format. However, it has also served to increase competition from mass merchant retailers, as discussed under "Cautionary Statements--Cautionary Statements Relating to Our Video Store Business--Our Business Could be Negatively Affected by Changes in the Studios' Pricing Policies."

International Home Video--Movies

According to Kagan, the international retail home video industry has also significantly benefited from consumer interest in the DVD format and its multiple language capabilities. Some of the attributes of the home video industry outside of the United States are similar to those of the home video industry within the United States. For example, the major studios generally release movies outside of the United States according to sequential distribution windows. However, other attributes of the home video industry outside of the United States do not necessarily mirror the home video industry within the United States. For example, most countries have different systems of supply and distribution of movie titles. In addition, competition in many of

our international markets tends to be more fragmented.

Movie Studio Dependence on the Retail Home Video Industry

According to Kagan estimates, the retail home video industry is the largest source of U.S. revenue to U.S. movie distributors, representing about $9.3 billion, or 46.5%, of the $20.0 billion of revenue in 2001. The following table represents Kagan's estimates of total movie distributor revenue, including revenues from theatrical releases.

	Year Ended December 31,				
	1997	1998	1999	2000	2001
	(in millions)				
U.S. retail home video revenue (rental and sale)	$ 6,306	$ 6,811	$ 7,206	$ 8,146	$ 9,305
U.S. theatrical revenue	2,937	3,275	3,790	4,175	4,416
Other U.S. revenue*	4,456	4,792	5,339	5,767	6,293
Total U.S. revenue	13,699	14,878	16,335	18,088	20,014
International retail home video revenue (rental and sale)	$ 4,406	$ 4,436	$ 4,650	$ 4,957	$ 5,363
International theatrical revenue	3,289	3,684	3,608	3,464	3,325
Other international revenue*	4,545	5,265	5,989	6,483	7,105
Total international revenue	12,240	13,385	14,247	14,904	15,793
Total revenue	$25,939	$28,263	$30,582	$32,992	$35,807

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* Includes revenues from network TV and syndication, pay TV, basic cable, pay-per-view, direct broadcast satellite, video-on-demand, and hotels and airlines, as well as revenues from merchandise licensing.

Of the many movies produced by major studios and released in the United States each year, relatively few are profitable for the studios based on box office revenues alone. In addition to purchasing box office hits, video rental stores, including those operated by us, purchase movies on VHS and DVD that were not successful at the box office, thus providing the movie studios with a reliable source of revenue for almost all of their movies. We believe that the consumer is more likely to view movies that were not box office hits on a rented videocassette or DVD than through most other post-theatrical distribution channels because video rental stores provide an inviting opportunity to browse and make an impulse choice among a very broad selection of movie titles. In addition, we believe the relatively low cost of VHS and DVD rentals encourages consumers to rent films they might not pay to view at a theater or desire to own.

Retail Home Video Game Rental Industry

The retail home video game rental industry has traditionally been affected by changing technology, limited hardware platform lifecycles and consumer

interest in software titles. The industry typically grows with the introduction of new hardware platforms and games, but tends to slow prior to the introduction of new platforms, as consumers hold back their purchases in anticipation of new platform and game enhancements. This pattern was evidenced over the last two years with the anticipated launches of Sony PlayStation 2 in 2000 and Nintendo GameCube and Microsoft Xbox in 2001. According to VidTrac, domestic game rental revenues grew only 4.3% in 2000 and declined 31.0% in 2001, reflecting the impact of shortages of Sony PlayStation 2 hardware upon its release in the fourth quarter of 2000 and delayed launches of the Nintendo GameCube and Microsoft Xbox hardware platforms to the fourth quarter of 2001. However, industry experts predict that the introduction of these platforms will now contribute to a growth cycle. We believe the game rental industry will play an important role in this growth cycle, due in part to the relatively high purchase prices for games and hardware. Video games typically generate most of their rental revenue during the first twelve months after their release. We believe that during this time period, the difference between the retail price and the rental price of a new video game is typically high enough to make rentals an attractive alternative for customers.

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OUR BUSINESS

Blockbuster is the world's leading provider of rentable home videocassettes, DVDs and video games, with nearly 8,000 stores in the United States, its territories and 26 other countries as of December 31, 2001. Our BLOCKBUSTER brand achieves nearly 100% recognition with active movie renters in the United States. This brand recognition and leading market position have allowed us to create one of the strongest entertainment franchises in the United States. During 2001, we implemented initiatives designed to strengthen our core business, drive growth in profitability, leverage our brand and capitalize on new revenue streams. We also continued to increase our market share of the domestic video rental business. Reflecting these improvements, our 2001 worldwide revenues increased about 4.0% from 2000, with 80.0% of the worldwide revenues generated in the United States and 20.0% generated outside of the United States.

Business Model

Our business model is designed to deliver long-term sustainable growth in our core business and to use our capital and resources in areas of business that we believe will provide incremental growth and return on investment. We have had four consecutive years of same store revenue growth and believe that our unique combination of core assets, such as our highly recognized global brand, our expansive customer and store base and our substantial marketing skills, position us for continued growth. The key elements of our business model are discussed below.

Continued Profitable Growth in Our Core Business

During 2001, we undertook a number of key initiatives to strengthen our core business and drive growth in profitability, including re-merchandising our stores to capitalize on the higher margin, fast-growing DVD format and dedicating more of our sales area to the next generation of video games and new business initiatives.

DVD. Our goal is to exploit every opportunity to deliver increased revenues as a result of the high-growth DVD format and to solidify our position as the world's leading renter of DVDs. Currently, our average DVD rental margin is higher than our average VHS rental margin.

In order to promote the DVD format, during 2001, we began selling DVD players in our stores worldwide and introduced innovative DVD marketing promotions, such as guaranteeing key title availability on DVD, packaging rental cards with the purchase of a DVD player and offering DVD rental passes. We intend to continue promoting the DVD format through direct mail, advertising and online efforts.

Games. Our goal is to capitalize on the next generation of video games. We believe that the introduction of three new platforms, the growing consumer base and the multi-functionality of some of the new systems provide a significant growth opportunity. We plan to continue to expand our copy depth and title selection, with the goal of not only being the leading provider of rentable games, but also becoming a leading game destination. As the nation's leading renter of games, we believe that our brand, marketing ability, physical store presence and extensive database will enable us to enter into new gaming areas.

In order to increase game rental awareness in our stores, we have offered numerous game promotions, including game rental passes, free game rentals with proof of purchase on any new game system, and sweepstakes for new game systems. We have also begun guaranteeing availability of selected new games. In addition, we have begun selling games hardware in approximately 3,000 of our U.S. stores and in some international markets.

Other Initiatives. We continue to explore other ways to maximize the use of our store space to generate incremental profit. We have established ourselves as one of the leading retailers of DIRECTV System equipment and DIRECTV(R) programming packages in the United States. At the same time, through our marketing programs, we have used this business to generate incremental traffic to our stores. In addition, during 2001, we introduced a third-party store-within-a-store concept in approximately 130 of our stores.

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Although we decided not to proceed with a national roll-out of the concept, we were able to evaluate customer receptiveness to a consumer entertainment products offering. As a result of this evaluation and our experience with sales of DVD players and other consumer entertainment products, we are developing a plan to offer an assortment of consumer entertainment products that complement our core business, leverage the use of our store space and require minimal capital investment.

Disciplined Store Growth

Our expansive store presence, strong market share and customer transaction and real estate databases enable us to grow our store base in a disciplined manner. We plan to add most of our new stores in markets that we believe provide the greatest opportunity for incremental growth. Our databases allow our store development team to assess:

- which markets are most likely to offer growth opportunities with minimal cannibalization of our existing stores;
- whether the store growth in any particular market should be effected through new or franchised stores or through acquisition; and
- the appropriate store format, in the case of new company-operated stores.

We believe that through our site selection process and flexible store

formats, our new stores will generate sufficient revenue to recover our capital investment in a short period of time without significantly reducing the revenues of our existing stores.

Leveraging of Our Core Assets

We have attained a strong store presence throughout the United States, with an estimated 64% of the U.S. population living within a ten-minute drive of one of our stores. Our extensive advertising and marketing capabilities allow us to promote awareness of the BLOCKBUSTER brand and our initiatives to satisfy consumer demands. Our ultimate objective is to make our name so recognizable and our strengths so visible that consumers will see no reason to go elsewhere for the products and services that we offer. During 2001, we established our brand in the pay-per-view business when we began co-branding pay-per-view movie channels on DIRECTV. We intend to continue to leverage our core business assets to extend our brand to new home entertainment distribution channels that position us to share in the projected growth in the overall home entertainment industry.

Merchandising

We offer a wide selection of movies and video games for rent and purchase. Our goal is to stock each of our stores with a selection, quantity and format of merchandise that is customized for that store. Using our customer transaction database, we determine on a store-by-store basis the number of copies of each newly released movie that is to be offered by each U.S. store. We also offer a broad selection of time-tested popular movies, or "BLOCKBUSTER FAVORITES," and a wide variety of independent movies. In response to consumer demand, during 2001, we re-merchandised our stores to accommodate an expanded DVD selection. DVD rental revenues represented 18.5% of our rental revenues in 2001, compared to 6.9% in 2000, and increased to 23.4% of our rental revenues in the fourth quarter of 2001. We also expanded our quantity and selection of games. Game rental revenues represented 10.6% of our rental revenues in 2001, compared to 11.6% in 2000, but increased to 11.7% of our rental revenues in the fourth quarter of 2001. We expect DVD and game rental revenues to contribute to revenue growth and increase as a percentage of our overall rental revenues.

Our customer transaction database allows us to periodically review each store's inventory of BLOCKBUSTER FAVORITES and identify movie titles within this category that have not been rented for a period of time. We offer these previously rented movies for sale and replace them with movies that we believe our customers are more interested in renting. We also sell some previously rented new release movies.

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We rent video games for use with Sony PlayStation and PlayStation 2, Nintendo 64, Microsoft Xbox, Nintendo GameCube and Game Boy Advance and other video game platforms in the majority of our domestic stores and many of our international stores. In these stores, we also sell previously rented video games. In addition, we sell new video games in most of our stores in markets outside of the United States and anticipate selling new games domestically later this year. We also rent video game consoles, as well as DVD players, in most of our domestic company-operated stores and sell other complementary products. In addition, during 2001, we began selling DVD players in stores worldwide.

Stores and Store Operations

Site Selection. We have developed a comprehensive model that we use to find

suitable locations for company-operated stores and markets for franchise stores. We seek to locate our stores in geographic areas with population and customer concentrations that enable us to better allocate available resources and manage operating efficiencies in inventory management, advertising, marketing, distribution, training and store supervision. Our franchise program provides us with an additional avenue for expanding our consumer reach. Outside the United States, we plan to open most of our new company-operated stores in markets in which we already have a significant presence, as discussed under "--International Operations," below. In addition, we plan to add franchise and/or joint venture stores in other international markets.

Within each targeted market, we identify potential sites for new and replacement stores by evaluating market dynamics, some of which include population demographics, psychographics, customer concentration levels and competition. We use our extensive real estate database and customer transaction database to continuously monitor market conditions and select strategic store locations.

Store Development. During 2001, we opened 277 company-operated stores (including 181 domestically and 96 internationally) and closed or sold 119 company-operated stores (including 61 domestically and 58 internationally), for a net addition of 158 company-operated stores worldwide. We also opened or purchased 178 franchise or joint venture stores (including 88 domestically and 90 internationally) and closed or sold 32 franchise or joint venture stores (including 25 domestically and 7 internationally), for a net addition of 146 franchise and joint venture stores worldwide. Overall, domestically and internationally, we had a net addition of 304 stores.

Store Format. We seek to place stores in locations that are convenient and visible to the public. We intend to continue to conveniently locate our stores by incorporating an appropriate store format using our extensive customer transaction and real estate databases to maximize revenues without significantly decreasing the revenues of our nearby stores. To do so, we generally operate one of three store formats. Our traditional store format is more than 4,000 square feet and is used in markets in which store-to-population ratios are low and in which we believe market conditions are optimal. We use a smaller store format to compete (i) primarily in rural areas or (ii) in markets that are located between our traditional stores without significantly decreasing the market shares of those traditional stores. We also use a store-in-store format within department stores, supermarkets and other stores in order to further expand our presence and meet demand in mature markets in which we already have a strong presence. We also periodically examine whether the formats of our existing stores are optimal for their location and may downsize or relocate existing stores as opportunities arise.

Store Operations. Our U.S. company-operated stores generally operate under substantially similar hours of operation. Domestic stores are generally open 365 days a year, with daily hours generally from 10:00 a.m. to 12:00 midnight. The hours of operation for franchised stores may vary depending on the franchise but, generally, the franchisees follow corporate store hours. Our U.S. stores employ an average of 14 people, including two assistant store managers and one store manager. International store operations vary by country.

Store Locations. At December 31, 2001, in the United States and its territories, we operated 4,393 stores and our franchisees operated 981 stores. The following map sets forth the number of domestic stores we operated, including stores operated by our franchisees, as of December 31, 2001.

[Map of U.S.A. and its territories showing our total number of stores (company-operated and franchised stores) in each state and territory as follows:

STATE OF TERRITORY	TOTAL STORES
ALABAMA	64
ALASKA	16
ARIZONA	120
ARKANSAS	21
CALIFORNIA	668
COLORADO	122
CONNECTICUT	57
DELAWARE	12
DISTRICT OF COLUMBIA	7
FLORIDA	393
GEORGIA	186
HAWAII	22
IDAHO	12
ILLINOIS	251
INDIANA	103
IOWA	27
KANSAS	57
KENTUCKY	71
LOUISIANA	81
MAINE	5
MARYLAND	134
MASSACHUSETTS	123
MICHIGAN	176
MINNESOTA	58
MISSISSIPPI	41
MISSOURI	103
MONTANA	11
NEBRASKA	32
NEW HAMPSHIRE	19
NEW JERSEY	135
NEW MEXICO	31
NEW YORK	278
NEVADA	55
NORTH CAROLINA	124
NORTH DAKOTA	6
OHIO	182
OKLAHOMA	69
OREGON	96
PENNSYLVANIA	193
PUERTO RICO	39
RHODE ISLAND	26
SOUTH CAROLINA	71
SOUTH DAKOTA	8
TENNESSEE	92
TEXAS	536
UTAH	55
VERMONT	5
VIRGINIA	132
VIRGIN ISLANDS	2
WASHINGTON	142
WEST VIRGINIA	17
WISCONSIN	79
WYOMING	6
GUAM	3]

At December 31, 2001, outside of the United States, we operated 2,019 stores, and our franchisees and joint venture in which we own a minority interest operated 588 stores. The following table sets forth, by country, the number of stores operated by us and stores operated by our franchisees and joint venture as of December 31, 2001.

COUNTRY (1)	Number of Company-Operated Stores	Number of Franchised and/or Joint Venture Stores	Total(1)(2)
Great Britain	678	--	678
Canada	361	--	361
Australia	127	145	272
Mexico	224	5	229
Ireland (Republic) and Northern Ireland	203	--	203
Italy	--	182	182
Spain	108	7	115
Taiwan	80	21	101
Brazil	--	84	84
Argentina	81	1	82
Chile	73	--	73
Denmark	60	--	60
Thailand	--	24	24
New Zealand	--	23	23
China (Hong Kong)	21	--	21
Portugal	--	18	18
Colombia	--	14	14
Venezuela	--	14	14
Israel	--	13	13
Panama	--	10	10
Peru	--	10	10
El Salvador	--	8	8
Ecuador	--	5	5
Guatemala	--	3	3
Uruguay	3	--	3
Costa Rica	--	1	1
International Store Total	2,019	588	2,607

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(1) This does not include non-operating stores that are leased or owned.

(2) In addition to the stores listed in the chart, as of December 31, 2001, there were 96 video vending machines in Great Britain and Spain.

Marketing and Advertising

We design our marketing and advertising campaigns to take advantage of opportunities in the marketplace, thereby maximizing the leverage of our marketing and advertising expenditures. We obtain information from our customer transaction database, our real estate database and outside research agencies to formulate and adjust our marketing and advertising campaigns based on:

. our market share;

. our level of store development and brand awareness relative to our competitors within the relevant market;

. our evaluation of new industry trends;

. local demographics; and

. other local competitive issues.

This enables us to focus our resources in areas that generate the best return on investment. In addition, our large store base and leading brand awareness allow us to implement programs such as BLOCKBUSTER REWARDS, BLOCKBUSTER GIFTCARDS, cross-promotional marketing programs and national promotional events.

Worldwide, in the year ended December 31, 2001, we incurred $220.4 million in advertising expenses, which includes $172.2 million in the United States and $48.2 million internationally. In addition, some of our business alliances, including the studios, allow us to direct a significant amount of their home video advertising expenditures. Furthermore, the studios also incur additional expenditures to promote their newly released movies, which we believe drives consumers to our stores.

Franchise Operations

We believe our franchising program is an effective way to expand our consumer reach. At December 31, 2001, our franchisees operated 981 stores in the United States and our franchisees and joint venture in which we own a minority interest operated 588 stores internationally. Our franchisees generally are responsible for obtaining their own supplies and coordinating their own distribution system unless they participate under our U.S. VHS revenue-sharing arrangements. Accordingly, the franchisees participating in a U.S. VHS revenue-sharing arrangement may rely upon our distribution center to receive some portion of their VHS products.

Under our current U.S. franchising program, we enter into a development agreement and subsequent franchise agreement(s) with the franchisee. Pursuant to the terms of a typical development agreement, we grant the franchisee the right to develop one or a specified number of stores at a permitted location or locations within a defined geographic area and within a specified time. We generally charge the franchisee a development fee at the time of execution of the development agreement for each store to be developed during the term of the development agreement. The typical franchise agreement is a long-term agreement that governs the operations of the store. We generally require the franchisee to pay us a one-time franchise fee and continuing royalty fees, service fees and monthly payments for, among other things, maintenance of our proprietary software. In addition, we provide optional programs and product and support services to our franchisees for which we sometimes receive fees. We require our franchisees to contribute funds for national advertising and marketing programs and also require that franchisees spend an additional amount for local advertising. Each franchisee has sole responsibility for all financial commitments relating to the development, opening and operation of its stores, including rent, utilities, payroll and other capital and incidental expenses. We cannot assure you that our franchisees will be able to achieve profitability levels in their businesses sufficient to pay our franchise fees. Furthermore, we cannot assure you that we will be successful in marketing and selling new

franchises or that any new franchisees will be able to obtain desirable locations and acceptable leases.

International Operations

We are the leading international provider of rentable home movies and video games. As of December 31, 2001, we had 2,607 stores operating under the BLOCKBUSTER brand and other brand names owned by us located throughout 26 markets outside of the United States. Of these stores, 588 were operated through our franchisees and our joint venture in which we own a minority interest. In 2001, 20.0% of our worldwide revenues were generated outside the United States, compared to 19.3% in 2000 and 19.4% in 1999. During 2001, we expanded our presence in Central America through franchising arrangements in Costa Rica and Guatemala. We expect our international store growth over the next several years to approach our domestic store growth.

Our global presence allows us to capitalize on opportunities worldwide, as we continue to extend our U.S. concepts to our international markets. We believe this gives us an advantage over competitors that are solely

dependent on their domestic business. During 2001, our international business continued to grow, with Canada, Ireland, the United Kingdom and Mexico accomplishing double digit or near double digit same store revenue growth. We intend to focus our store growth in these major markets. As with our U.S. operations, we are also implementing initiatives designed to increase existing store profitability.

We maintain offices for each major region and most of the countries in which we operate in order to manage, among other things:

- store development and operations;
- marketing; and
- the purchasing, supplying and distribution of each store's products.

Blockbuster.com

Our primary focus for blockbuster.com is to support our stores and drive store revenues through promotional offers. During 2001, we reduced the site's e-commerce offerings and instead focused on other features such as:

- information about movies;
- integrated promotions between our in-store and online businesses; and
- suggestions of movies based upon a customer's evaluation of selected films.

As part of a cost reduction initiative, we are outsourcing some of our infrastructure services, including our e-commerce function, to third-party providers.

Suppliers and Purchasing Arrangements

The following is a description of the suppliers to our domestic company-operated and franchised stores and our purchasing arrangements. Our international stores are supplied by a variety of suppliers.

Company-Operated Stores. Our U.S. company-operated stores receive a substantial portion of their VHS rental product under our revenue-sharing arrangements. For titles acquired under our U.S. VHS revenue-sharing arrangements, we share an agreed upon percentage of our U.S. VHS rental revenues with the studios for a limited period of time, generally 26 weeks, in exchange for minimal fixed payments. This percentage may decline over a period of weeks following the initial release of the movie. In addition to this revenue-sharing component, common to each arrangement is some provision for the disposition of the VHS products at the conclusion of the rental period. This may involve sale of the product by us as a previously rented videotape, return of the videotape to the studio, destruction of the videotape, or some combination of these elements. In addition, we may be required to purchase a minimum amount of a studio's output. Because VHS rental product that is not subject to revenue-sharing is typically released to video retailers at higher wholesale prices, revenue-sharing enables us to substantially increase the quantity and selection of newly released VHS titles that we would otherwise be able to stock. Most of the international countries in which we operate have different systems of supply and distribution of movie titles. VHS revenue-sharing arrangements are not as significant to our business as they have been historically, due to the increasing importance of DVD product to our business.

Historically, we have typically purchased DVDs directly from the studios through normal purchasing arrangements due to their lower sell-through pricing; however, we have begun purchasing some DVD product through revenue-sharing arrangements.

We purchase our video game hardware and software, as well our VCRs, DVD players and other complementary products, from a variety of suppliers.

Franchised Stores. We require each franchisee to comply with guidelines that set forth the minimum amount and selection of movies to be kept in its store's inventory. Franchisees typically obtain videocassettes and DVDs from their own suppliers and are also responsible for obtaining some of the other complementary products from their own suppliers. However, if we have purchased the exclusive distribution rights to a movie or if a franchisee participates with us under our VHS revenue-sharing arrangements, the franchisee may obtain that movie from us. During 2001, some of our franchisees also began participating in our DIRECTV offering.

Distribution and Inventory Management

We receive substantially all of our movies and video games at our 850,000 square foot state-of-the-art distribution center in McKinney, Texas. The distribution center is a highly automated, centralized facility that we use to mechanically repackage newly released movies to make them suitable for rental at our stores. We also use our distribution center to restock products and process returns, as well as to provide some office space. We use a network of third-party delivery agents for delivery of products to our U.S. stores. We ship our products to these delivery agents, located strategically throughout the United States, which in turn deliver them to our stores.

We believe our distribution center gives us a significant advantage over our competitors that use third-party distributors because we are able to process and distribute a greater quantity of products while reducing costs and improving services to our stores. The distribution center supports all of our company-operated stores in the United States and operates six days a week, 24 hours a day. As of December 31, 2001, we employed about 850 employees at our

distribution center.

Franchisees generally obtain their products directly from their suppliers, except for some accessories, supplies and movies for which we have exclusive distribution rights, which domestic franchisees receive from our distribution center. Distribution of our products to our stores in markets outside the United States is coordinated through our international offices.

Management Information Systems

We believe that the accurate and efficient management of purchasing, inventory and sales records is important to our future success. We maintain information, updated daily, regarding revenues, current and historical sales and rental activity, demographics of store customers and rental patterns. This information can be organized by store, region, state, country or for all operations.

All of our U.S. company-operated stores and franchisees use our point-of-sale system and most of our international stores use our point-of-sale system. Our national point-of-sale system in the United States is linked with a data center located in our distribution center. The point-of-sale system tracks all of our products distributed from the distribution center to each U.S. store using scanned bar code information. All domestic rental and sales transactions are recorded by the point-of-sale system when scanned at the time of customer checkout. At the end of each day, the point-of-sale system transmits store data from operations to the data center and the customer transaction database.

Competition

We operate in a highly competitive environment. We believe our most significant competition comes from (a) video stores and other retailers that rent or sell movies and (b) providers of direct delivery home viewing entertainment.

Competition with Video Stores and Other Retailers that Rent or Sell Movies. These retailers include, among others:

- local, regional and national video stores;

- mass merchant retailers;

- toy and entertainment retailers;

- supermarkets, pharmacies and convenience stores; and

- Internet sites.

We believe that the principal factors we face in competing with video stores are:

- convenience and visibility of store locations;

- quality, quantity and variety of titles in the desired format;

- pricing; and

- customer service.

As discussed under "Cautionary Statements--Cautionary Statements Relating to Our Video Store Business--Our Business Could be Negatively Affected by Changes in the Studios' Pricing Policies," the studios' promotion of DVDs for both sale and rental has served to increase competition from mass merchant retailers.

Competition with Providers of Direct Delivery Home Viewing Entertainment. These providers include direct broadcast satellite, cable, digital terrestrial, network and syndicated television. We believe that a competitive risk to our video store business comes from direct broadcast satellite, digital cable television and high-speed Internet access. In response to this competition, we have entered the direct broadcast satellite market through our alliance with DIRECTV and have tested an entertainment-on-demand service. Further growth in the direct broadcast satellite and digital cable subscriber bases could cause a smaller number of movies to be rented if viewers were to favor the expanded number of conventional channels and expanded programming, including sporting events, offered through these services. Direct broadcast satellite, digital cable and "traditional" cable providers not only offer numerous channels of conventional television, they also offer pay-per-view movies, which permit a subscriber to pay a fee to see a selected movie, and other specialized movie services. See "Cautionary Statements--Cautionary Statements Relating to Our Video Store Business--The widespread availability of additional channels on satellite and digital cable systems may significantly reduce public demand for our products."

Other Competition. In some markets, we also compete against the illegal duplication and sale of movies and video games. In addition to all of the modes of competition discussed above, we compete for the general public's entertainment dollar and leisure time activities with, among others, movie theaters, Internet-related activities, live theater and sporting events.

We cannot assure you that competing pressures we face will not have a material adverse effect on our company.

Regulation

Domestic Regulation

We are subject to various federal, state and local laws that govern the access and use of our video stores by disabled people and the disclosure and retention of video rental records. We also must comply with various regulations affecting our business, including state and local advertising, consumer protection, credit protection, licensing, zoning, land use, construction, environmental and minimum wage and other labor and employment regulations.

We are also subject to the Federal Trade Commission's Trade Regulation Rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" and state laws and regulations that govern (1) the offer and sale of franchises and (2) franchise relationships. If we want to offer and sell a franchise, we are required by the rule mentioned above to furnish to each prospective franchisee a current

franchise offering circular prior to the offer or sale of a franchise. In addition, a number of states require that we, as a franchisor, comply with that state's registration or filing requirements prior to offering or selling a franchise in the state and to provide a prospective franchisee with a current franchise offering circular complying with the state's laws, prior to the offer or sale of the franchise. Although we cannot make any assurances, we intend to maintain a franchise offering circular that complies with all applicable

federal and state franchise sales and other applicable laws. However, if we are unable to comply with federal franchise sales and disclosure laws and regulations, we will be unable to offer and sell franchises anywhere in the United States. In addition, if we are unable to comply with the franchise sales and disclosure laws and regulations of any state that regulates the offer and sale of franchises, we will be unable to offer and sell franchises in that state.

We are required to update our franchise offering circular annually, as well as to amend it during the course of the year, to reflect material changes regarding our franchise offering and to comply with changes in disclosure requirements. The occurrence of any such material changes may, from time to time, require us to stop offering and selling franchises until our franchise offering circular is updated and amended. We cannot assure you that our franchising program will not be adversely affected because compliance with applicable law necessitates that we cease offering and selling franchises in some states until our franchise offering circular is revised, updated and approved by the applicable authorities, or because of our failure or inability to comply with existing or future franchise sales and disclosure laws.

We are also subject to a number of state laws and regulations that regulate some substantive aspects of the franchisor-franchisee relationship, including:

- those governing the termination or non-renewal of a franchise agreement, such as requirements that:

  (a) "good cause" exist as a basis for such termination; and

  (b) a franchisee be given advance notice of, and a right to cure, a default prior to termination;

- requirements that the franchisor deal with its franchisees in good faith;

- prohibitions against interference with the right of free association among franchisees; and

- those regulating discrimination among franchisees in charges, royalties or fees.

Compliance with federal and state franchise laws is costly and time-consuming, and we cannot assure you that we will not encounter difficulties or delays in this area or that we will not require significant capital for franchising activities.

International Regulation

We are subject to various international laws that govern the disclosure and retention of video rental records. For example, the laws pertaining to the use of our customer transaction database in some markets outside of the United States are more restrictive than the relevant laws in the United States.

We must comply with various regulations affecting our business, including advertising, consumer protection, credit protection, franchising, licensing, zoning, land use, construction, environmental, and labor and employment regulations.

Similar to the United States, some foreign countries have franchise registration and disclosure laws affecting the offer and sale of franchises within their borders and to their citizens. They are not often as extensive and onerous as laws and regulations applicable in the United States. However, as in the United States, failure to comply with such laws could limit or preclude our ability to expand through franchising in those countries.

Historical Information

Our business and operations were previously conducted by Blockbuster Entertainment Corporation, which was incorporated in Delaware in 1982 and entered the movie rental business in 1985. On September 29, 1994, Blockbuster Entertainment Corporation was merged with and into Viacom Inc. Subsequent to the merger, our business and operations were conducted by various indirect subsidiaries of Viacom. Over the year and one-half period prior to our initial public offering in August 1999, our business and operations were either (1) merged into Blockbuster Inc. or (2) purchased by Blockbuster Inc. and/or one of its subsidiaries. Blockbuster Inc., an indirect subsidiary of Viacom, was incorporated under a different name on October 16, 1989 in Delaware. As of March 8, 2002, Viacom, through its ownership of 144 million shares of our class B common stock, owned common stock representing about 81% of our equity value and about 95% of the combined voting power of our outstanding common stock.

Intellectual Property

We own, or have applications pending with respect to, various trademarks, trade names and service marks, including, among others, BLOCKBUSTER(R), BLOCKBUSTER VIDEO(R), BLOCKBUSTER FAVORITES(R), BLOCKBUSTER GIFTCARD(R), BLOCKBUSTER GIFTCARDS(TM), BLOCKBUSTER REWARDS(R), blockbuster.com(R), BLOCKBUSTER PRE-VIEWED(R), BRINGING ENTERTAINMENT HOME(R), THE GIFT OF ENTERTAINMENT(R), KIDPRINT(R), MAKE IT A BLOCKBUSTER NIGHT(R), QUIK DROP(R), XTRA-VISION(R), our Torn Ticket design in blue and yellow and in black and white, and the blue and yellow awning outside our stores. In addition, we own the rights to the "blockbuster.com" Internet domain name, among others. We consider our intellectual property rights to be among our most valuable assets.

Employees

As of December 31, 2001, we employed about 89,100 persons, including about 65,100 persons employed within the United States and about 24,000 persons employed outside of the United States. Of the total number of U.S. employees, about 20,900 were full-time and about 44,200 were part-time. We believe that our employee relations are good.

Executive Officers of the Registrant

The following information regarding our executive officers is as of March 8, 2002.

Name	Age	Position
John F. Antioco.................	52	Chairman of the Board of Directors and Chief Executive Offic
James Notarnicola...............	50	Executive Vice President and Chief Marketing Officer
Michael K. Roemer...............	53	Executive Vice President and Chief Operations Officer, North America Operations
Nick Shepherd...................	43	Executive Vice President, Merchandising and Chief Concept Officer
Edward B. Stead.................	55	Executive Vice President, General Counsel and Secretary
Nigel Travis....................	52	President and Chief Operating Officer
Dean M. Wilson..................	44	Executive Vice President Content, Worldwide
Chris Wyatt.....................	45	Executive Vice President and President, International

Larry J. Zine..................	47	Executive Vice President, Chief Financial Officer and Chief Administrative Officer

John F. Antioco has served as our chairman of the board of directors and chief executive officer since 1997 and served as our president from 1997 until September 2001. From 1996 until 1997, Mr. Antioco served as president and chief executive officer for Taco Bell Corporation. Mr. Antioco serves as chairman of the board of

directors of Main Street & Main Incorporated and, through March 31, 2002, as a director for CSK Auto Corporation. Mr. Antioco is also a member of the board of governors of the Boys & Girls Clubs of America.

James Notarnicola has served as our executive vice president and chief marketing officer since June 1998 and served as our executive vice president of marketing and administration from 1997 until 1998. From 1978 until 1997, Mr. Notarnicola served in many capacities at 7-Eleven Inc., which was formerly known as The Southland Corporation, including vice president of marketing from 1995 until 1997.

Michael K. Roemer has served as our executive vice president and chief operations officer, North America operations, since 2001 and served as our executive vice president and chief operations officer, USA store operations, from December 1999 until 2001. Mr. Roemer also served as our executive vice president, domestic video operations, from 1998 until 1999. From 1997 until 1998, Mr. Roemer served as our senior vice president, domestic video operations. From 1995 until 1997, Mr. Roemer served as an independent consultant for such major companies as Frito Lay, where he assisted with new product development, distribution and business process planning. Mr. Roemer serves on the Board of Governors for the Children's Miracle Network.

Nick Shepherd has served as our executive vice president, merchandising, and chief concept officer since October 2001 and served as our senior vice president and chief concept officer from April 2001 until September 2001. Mr. Shepherd, a British national, also served as our senior vice president, international, from 1998 until 2001 and as vice president and managing director of our U.K. business from 1995 until 1998.

Edward B. Stead has served as our executive vice president and general counsel since 1997 and as our secretary since 1999. Mr. Stead has also served as our executive vice president, business development, since September 2001. From 1988 until 1996, Mr. Stead served in various capacities with Apple Computer, Inc., including senior vice president, general counsel and secretary. Mr. Stead is a member of the legal advisory board of the New York Stock Exchange.

Nigel Travis has served as our president and chief operating officer since September 2001 and served as our executive vice president and president, worldwide stores division, from December 1999 until 2001. Mr. Travis served as our executive vice president and president, worldwide retail operations, from 1998 until 1999 and as our president, international operations, from 1997 until 1998. From 1994 until 1997, Mr. Travis served in various other capacities for us, including senior vice president, Europe. Mr. Travis, a British national, serves as a director of The Bombay Company, Inc. and is also a director of the Video Software Dealers Association.

Dean M. Wilson has served as our executive vice president content,

worldwide, since 2001 and served as our executive vice president and chief merchandising officer, worldwide, from December 1999 until 2001. Mr. Wilson served as our executive vice president, merchandising, from 1998 until 1999. From 1995 until 1998, Mr. Wilson held a number of positions with us, including senior vice president-general merchandise manager, vice president-retail and director of product international.

Chris Wyatt has served as our executive vice president and president, international, since October 2001 and served as our president, international, from March 2001 until October 2001. Mr. Wyatt, a British national, served as our senior vice president, international, from 1999 until 2001, and as our senior vice president, international finance, from 1998 until 1999. Mr. Wyatt also served as our finance director, Europe, from 1996 until 1998.

Larry J. Zine has served as our executive vice president and chief financial officer since 1999 and as our chief administrative officer since September 2001. From 1996 until 1999, Mr. Zine served as chief financial officer for Petro Stopping Centers, L.P., where he was responsible for all operations. During 1999, Mr. Zine also served as president of Petro. Mr. Zine currently serves as a director of Petro.

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Item 2. Properties

Our corporate headquarters are located at 1201 Elm Street, Dallas, Texas 75270 and consist of about 240,000 square feet of space leased pursuant to an agreement that expires on June 30, 2007. The distribution center is located at 3000 Redbud Blvd., McKinney, Texas 75069 and consists of about 850,000 square feet of space leased pursuant to an agreement that expires on December 31, 2012. We have set up our payroll and benefits center in Spartanburg, South Carolina.

We have an office in Uxbridge, England that manages most of our international operations. We also have country head offices in Dublin, Ireland; Toronto, Canada; Melbourne, Australia; Taipei, Taiwan; and Mexico City, Mexico. In addition, for most countries in which we have company-operated stores, we maintain an office to coordinate our operations within that country.

We lease substantially all of our existing store sites. These leases generally have a term of five to fifteen years and provide options to renew for between five and fifteen additional years. We expect that most future stores will also occupy leased properties.

Item 3. Legal Proceedings

On July 21, 1999, Ruben Loredo, doing business as Five Palms Video, purporting to act as a class representative on behalf of himself and all others similarly situated, filed a complaint in the District Court of Bexar County, Texas, against Blockbuster. The plaintiff asserted, among other things, that by entering into and operating under its revenue-sharing arrangements with the major motion picture studios, Blockbuster has attempted to and conspired with the studios to monopolize and restrain competition in the market for the retail rental of videocassettes in violation of Texas law. In addition, three other parties, purporting to act as class representatives on behalf of themselves and all others similarly situated, filed a substantially similar complaint in the United States District Court for the Western District of Texas against Viacom and major motion picture studios and their home video subsidiaries that have operated under these revenue-sharing arrangements with Blockbuster. These plaintiffs sought triple the amount of the alleged actual damages to themselves

and triple the amount of alleged actual damages of those similarly situated, as well as preliminary and permanent injunctive relief prohibiting any unlawful attempt or conspiracy to monopolize the market for the retail rental of videocassettes. In April 2000, Ruben Loredo voluntarily dismissed the state court action without prejudice, and Ruben Loredo and Blockbuster were added as parties plaintiff and defendant, respectively, in the federal court action. In January 2000, the federal court plaintiffs added California state law claims to the pending federal antitrust claims. In March 2001, the federal judge in the United States District Court for the Western District of Texas denied the plaintiffs' request for class certification of both the federal and California claims. One of the plaintiffs has voluntarily dismissed his claims, leaving three plaintiffs in the Texas federal court action. They assert, among other things, that Blockbuster, Viacom, and the studios conspired to fix the prices of videos to retailers and distributors, engaged in discriminatory pricing, and conspired to restrain competition. They are seeking triple the amount of the alleged actual damages to themselves. In January 2001, the same plaintiffs, in addition to other individual plaintiffs, filed a similar complaint in California in a Los Angeles County Superior Court seeking class certification and monetary damages. In January 2002, the California court also denied the plaintiffs' request for class certification. In addition to any damage award to which Blockbuster might be directly subject, if Viacom is required to pay any damage award as a result of the federal or state court action, Viacom may seek indemnification for its losses from Blockbuster under the release and indemnification agreement entered into between Viacom and Blockbuster. Blockbuster believes the plaintiffs' positions in both actions are without merit and intends to vigorously defend itself in each litigation.

On May 7, 1999, Lynn Adams, Khristine Schoggins, and Debbie Lenke, purporting to act as class representatives on behalf of themselves and for a class comprised of certain Blockbuster store managers who worked in California, filed a complaint in District Court in Orange County, California against Blockbuster. The plaintiffs claim that they should be classified as non-exempt and are thus owed overtime payments under

California law. The dollar amount that plaintiffs sought as damages to themselves and those similarly situated was not set forth in the complaint. In January 2001, the trial court judge certified a class. In January 2002, the court entered a final order approving the parties' proposed settlement agreement, which provides for a California state class and does not admit liability by any party. Under the settlement, the maximum settlement amount Blockbuster will be required to pay is $12 million.

Blockbuster is a defendant in over 23 putative class action lawsuits filed by customers in state courts in Illinois, California, Ohio, Maryland, Texas, New York, New Jersey, Delaware, Massachusetts, Washington, D.C., Florida and Pennsylvania between February 1999 and December 2001. These cases allege common law and statutory claims for fraud and/or deceptive practices and/or unlawful business practices regarding Blockbuster's policies for customers who choose to keep rental product beyond the initial rental term. Some of the cases also allege that these policies impose unlawful penalties and/or result in unjust enrichment. The dollar amounts that plaintiffs seek as damages to themselves and those similarly situated are not set forth in the complaints. In April 2001, Blockbuster reached a preliminary settlement in two of the Texas cases which provides for a national settlement class and does not admit liability. The Texas court signed an order approving an addendum to the settlement agreement on May 30, 2001, and on January 22, 2002 entered a final judgment approving the settlement. Under the approved settlement, Blockbuster will make certificates available to class members for rentals and discounts and would pay

up to $9.25 million in attorneys' fees in connection with the settlement. Notices of Appeal were filed by two different parties objecting to the settlement. On April 23, 2001, an Illinois state court denied Blockbuster's motion to stay the case before it based on the settlement in Texas. On April 25, 2001, the same Illinois state court entered a provisional order, subject to further review and final determination, certifying plaintiff and defendant classes in order that putative class counsel in Illinois would have an opportunity to be heard regarding the national class settlement. On September 13, 2001, the Illinois Supreme Court denied Blockbuster's petition for leave to appeal the Illinois trial court's denial of the motion to stay. On January 22, 2002, the plaintiffs in the Illinois action filed an amended complaint. On February 6, 2002, Blockbuster filed a motion to dismiss the complaint. Blockbuster believes the plaintiffs' positions in these cases are without merit and, if the settlement reached in Texas is not approved, Blockbuster intends to vigorously defend itself in any litigation.

We are subject to various other legal proceedings in the course of conducting our business, including our business as a franchiser. However, we believe that these proceedings are not likely to result in judgments that will have a material adverse effect on our business.

Item 4. Submission of Matters to a Vote of Security Holders

None.

PART II

Item 5. Market for Our Common Equity and Related Stockholder Matters

The shares of Blockbuster class A common stock are listed and traded on the NYSE under the symbol "BBI." Our class A common stock began trading on August 11, 1999, following our initial public offering. The following table contains, for the periods indicated, the high and low sales prices per share of our class A common stock as reported on the NYSE composite tape and the cash dividends per share of our class A common stock:

	High	Low	Cash Dividends(1)
Year Ended December 31, 2000			
Quarter Ended March 31, 2000........	$14.8750	$ 9.2500	$0.02
Quarter Ended June 30, 2000.........	$11.6250	$ 8.8750	$0.02
Quarter Ended September 30, 2000....	$12.0625	$ 8.4375	$0.02
Quarter Ended December 31, 2000.....	$ 9.9375	$ 6.8750	$0.02

	High	Low	Cash Dividends(1)
Year Ended December 31, 2001			
Quarter Ended March 31, 2001........	$15.1000	$ 8.1875	$0.02
Quarter Ended June 30, 2001.........	$22.0000	$14.0000	$0.02
Quarter Ended September 30, 2001....	$23.1500	$15.0500	$0.02
Quarter Ended December 31, 2001.....	$28.6600	$21.0000	$0.02

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(1) We have paid and currently intend to pay a quarterly dividend of $0.02 per share on our common stock. Our board of directors is free to change our dividend practices from time to time and to decrease or increase the dividend paid, or to not pay a dividend, on our common stock on the basis of results of operations, financial condition, cash requirements and future prospects and other factors deemed relevant by our board of directors. Furthermore, our credit agreement limits our ability to pay dividends to $90 million, $115 million, $130 million, $145 million and $160 million in the first five years beginning in August 1999.

The number of holders of record of shares of our class A common stock as of March 8, 2002 was 277. Viacom currently owns all of the outstanding shares of our class B common stock and about 81% of the equity value of Blockbuster. The shares of our class B common stock are not listed nor traded on any stock exchange or other market.

Item 6. Selected Financial Data

The following table sets forth Blockbuster's selected consolidated historical financial and operating data as of the dates and for the periods indicated. The selected statement of operations and balance sheet data for the years ended December 31, 1997 through 2001 are derived from Blockbuster's audited consolidated financial statements. The financial information herein may not necessarily reflect Blockbuster's results of operations, financial position and cash flows in the future or what its results of operations, financial position and cash flows would have been had it been a separate, stand-alone entity during the periods presented.

BLOCKBUSTER SELECTED CONSOLIDATED HISTORICAL
FINANCIAL AND OPERATING DATA

The following data should be read in conjunction with, and is qualified by reference to, the consolidated financial statements and related notes, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this document.

	Year Ended or At December 31			
	1997(1)	1998(2)	1999	2000
	(In millions, except per share amounts and			
Statement of Operations Data:				
Revenues	$3,313.6	$3,893.4	$4,463.5	$4,96
Operating income (loss)	$ (214.6)	$ (359.2)	$ 121.7	$ 7
Net loss	$ (318.2)	$ (336.6)	$ (69.2)	$ (7
Net loss per share--basic and diluted(5)	$ (2.21)	$ (2.34)	$ (0.44)	$ (0
Dividends per share	$ --	$ --	$ 0.02	$ 0
Weighted average shares outstanding--basic and diluted (5)	144.0	144.0	156.1	17
Balance Sheet Data:				
Cash and cash equivalents	$ 129.6	$ 99.0	$ 119.6	$ 19
Total assets	$8,731.0	$8,274.8	$8,540.8	$8,54
Long-term debt, including capital leases, less current portion	$ 331.3	$1,715.2	$1,138.4	$1,13

Stockholders' equity	$7,617.6	$5,637.9	$6,125.0	$6,00

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(1) During 1997, we recognized charges totaling $250 million primarily related to merchandise inventory write-downs, closure of under-performing stores, write-offs attributable to international joint ventures and additional expenses incurred in connection with our corporate relocation.

(2) During 1998, we changed our method of amortizing our videocassette and video game rental inventory. This newly adopted method represented a more accelerated method of amortization. The adoption of this new method of amortization was accounted for as a change in accounting estimate effected by a change in accounting principle and, accordingly, we recorded a non-cash charge of $424.3 million recognized in cost of rental revenues. Additionally, during 1998 we declared a $1.4 billion dividend payable to Viacom International Inc., in the form of an interest-bearing promissory note, which was paid off in 1999 with proceeds from long-term borrowings and is reflected in long-term debt and stockholders' equity.

(3) As described in Note 3 to our consolidated financial statements, we recognized a non-cash charge of $31.6 million in the fourth quarter of 2000, related to the impairment of certain hardware and capitalized software costs in our new media segment. This charge is reflected in depreciation expense.

(4) As described in Notes 3 and 11 to our consolidated financial statements, in 2001 we recognized charges of $195.9 million in cost of sales, $54.5 million in incremental selling, general and administrative expenses, $2.6 million in depreciation expense and $1.9 million in equity in income (loss) of affiliated companies related to the execution of a strategic re-merchandising plan to allow for an expansion of store space for DVD and other strategic product offerings. Additionally, as described in Note 4 to our consolidated financial statements, in 2001 we changed our accounting estimates related to our rental library. As a result of the changes in estimate, cost of rental revenues was $141.7 million higher during 2001 then it would have been under the previous method.

(5) As described in Note 1 to our consolidated financial statements, we were recapitalized to provide for class A common stock and class B common stock in 1999. In accordance with SEC Staff Accounting Bulletin No. 98, the capitalization of the class B common stock has been retroactively reflected for the purposes of presenting historical net income (loss) per share for periods prior to the initial public offering.

CAUTIONARY STATEMENTS

This annual report on Form 10-K contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Specific forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts and include, without limitation, words such as "expect," "may," "estimate," "anticipate," "will," "believe," "intend," "plan," "future," "could," and similar expressions and variations thereof. Similarly, statements that describe our objectives, plans or goals are forward-looking. Our forward-looking statements are based on management's current intent, belief, expectations, estimates and projections regarding our company and our industry. Forward-looking statements are not guarantees of future performance and involve risks, uncertainties, assumptions and other factors that are difficult to predict, including those discussed below. Therefore, actual results may vary materially from what is expressed in or indicated by our forward-looking statements. We undertake no obligation to update publicly any forward-looking statement for any reason, even if new

information becomes available or other events occur in the future.

CAUTIONARY STATEMENTS RELATING TO OUR VIDEO STORE BUSINESS

Our Video Business Would Lose a Competitive Advantage if the Movie Studios Were to Adversely Change Their Current Distribution Practices.

A competitive advantage that home video retailers currently enjoy over most other movie distribution channels, except theatrical release, is the early timing of the video retailer "distribution window." After the initial theatrical release, studios make their movies available to video retailers for specified periods of time. This distribution window is exclusive against most other forms of non-theatrical movie distribution, such as pay-per-view, video-on-demand, premium television, basic cable and network and syndicated television. The length of this exclusive distribution window for home video retailers varies, but has typically ranged from 45 to 60 days for domestic video stores. Thereafter, movies are made sequentially available to television distribution channels.

Our business could be negatively affected if:

- the video retailer distribution windows were no longer the first following the theatrical release;
- the length of the video retailer distribution windows were shortened; or
- the video retailer distribution windows were no longer as exclusive as they are now;

because newly released movies would be made available earlier on these other forms of non-theatrical movie distribution. As a result, consumers would no longer need to wait until after the video retailer distribution window to view a newly released movie on these other distribution channels. According to Kagan, an increasing number of movies are being released to pay-per-view at the shorter end of the distribution window.

We believe that the studios have a significant interest in maintaining a viable video rental industry. However, because the order, length and exclusivity of each window for each distribution channel is determined solely by the studio releasing the movie, we cannot predict the impact, if any, of any future decisions by the studios.

Our Business Could be Negatively Affected by Changes in the Studios' Pricing Policies.

We cannot control or predict with certainty studio pricing policies. As discussed under "Business--Industry Overview--Domestic Home Video--Movies," studios have traditionally released VHS titles that they want to promote primarily for rental at relatively high wholesale prices. The period during which VHS titles are released at higher prices, or "rental window," has benefited the rental industry because the prices are too high to generate consumer demand for purchasing them.

The studios have not created a rental window for movies released on DVD. Rather, the studios release DVDs at lower sell-through prices, which we believe has served to accelerate consumer interest in the format. It has also generated higher margins for us than VHS revenue-sharing product, due to the lower cost associated with DVDs. However, this pricing has resulted in competition from

mass merchant retailers at an earlier stage than is the case for VHS product, as mass merchant retailers are able to purchase DVDs for sale to consumers at the same time as video retailers purchase both DVDs and videocassettes for rental. This has increased consumer interest in purchasing movies on DVD and has reduced the advantage to home video retailers of the VHS rental window. We believe the increased consumer interest is due in part to consumer interest in building their DVD libraries of classic films and that studios will remain dependent on the rental industry for titles that are not box office hits. However, our business could be negatively affected if consumers desire to purchase, rather than rent, movies. We believe our profitability could be negatively affected if we did not derive most of our revenues from our rental business, as our sell-through margins are generally lower than our rental margins. Some of our competitors may sell movies at lower, or even below wholesale, prices and/or may operate at lower margins than we do. As a result, our U.S. sell-through business represented only 14.3% of our revenues for 2001.

If the Average Sales Price for Our Previously Rented Product is Not at or Above an Expected Price, Our Expected Gross Margins May Be Adversely Affected.

To achieve our expected gross margins, we need to sell our previously rented product at or above an expected price. If the average sales price of our previously rented product is not at or above this expected price, our gross margins may be adversely affected. At the same time, it is important that we maximize our overall rental stream through our allocation of store space. We may need to turn our inventory of previously rented product more quickly in the future in order to make room in our stores for additional DVDs and other initiatives, such as our consumer entertainment products offerings. Therefore, we cannot assure you that in the future we will be able to sell, on average, our previously rented product at or above the expected price.

Other factors that could affect our ability to sell our previously rented product at expected prices include:

- consumer desire to own the particular movie; and
- the amount of previously rented product available for sale by others to the public.

In addition, our sales of previously rented DVDs compete with sales of newly released DVDs that are priced for sell-through.

We Are Dependent on the Introduction of New and Enhanced Game Platforms and Software to Attract and Retain our Video Game Rental Customers

The home video game industry has traditionally been very cyclical. Historically, the lifestyle for game platforms has been about five years, with a limited number of platforms achieving success at any given time. The industry typically grows with the introduction of new hardware platforms and games, but tends to slow prior to the introduction of new platforms, as consumers hold back their purchases in anticipation of new platform and game enhancements. Our video games business is therefore dependent on the introduction of new and enhanced game platforms and software in order to attract and retain our video game customers. Delays in introduction or slower than expected hardware or software shipments could negatively affect our business.

We Cannot Predict the Impact That New or Improved Technologies May Have on Our Video Store Business.

New digital technologies, such as video-on-demand and other new technologies, could have a negative effect on our video store business. In particular, our video store business could be impacted if:

- newly released movies are made widely available by the studios to these technologies at the same time or before they are made available to home video retailers for rental; and

- these technologies are widely accepted by consumers.

The widespread availability of additional channels on satellite and digital cable systems may significantly reduce public demand for our products. Advances in direct broadcast satellite and cable technologies may adversely affect public demand for video store rentals. If direct broadcast satellite and digital cable were to become more widely available and accepted, this could cause a smaller number of movies to be rented if viewers were to favor the expanded number of conventional channels and expanded content, including movies, specialty programming and sporting events, offered through these services. If this were to occur, it could have a negative effect on our video store business. Direct broadcast satellite providers transmit numerous channels of programs by satellite transmission into subscribers' homes. In addition, cable providers are taking advantage of digital technology to transmit many additional channels of television programs over cable lines to subscribers' homes.

Because of the increased availability of channels, direct broadcast satellite and digital cable providers have been able to enhance their pay-per-view business by:

- substantially increasing the number and variety of movies they can offer their subscribers on a pay-per-view basis; and

- providing more frequent and convenient start times for the most popular movies.

If these enhanced pay-per-view services become more widely available and accepted, pay-per-view purchases could significantly increase. Pay-per-view allows the consumer to avoid trips to the video store for rentals and returns of movies, which also eliminates the chance they will incur additional costs for keeping a movie beyond its initial rental term. However, newly released movies are currently made available by the studios for rental prior to being made available on a pay-per-view basis. Pay-per-view also does not allow the consumer to start, stop and rewind the movie or fully control start times. Increases in the size of the pay-per-view market could lead to an earlier distribution window for movies on pay-per-view if the studios perceive this to be a better way to maximize their revenue.

Our video store business may eventually have to compete with the widespread availability of video-on-demand and similar technologies, which may significantly reduce the demand for our products. Some digital cable providers and a limited number of Internet content providers have begun implementing technology referred to as "video-on-demand." This technology transmits movies and other entertainment content on demand with interactive capabilities such as start, stop and rewind. In addition, some cable providers are introducing subscription video-on-demand, which allows consumers to pay a flat fee per month for access to a selection of content with fast-forward, stop and rewind capabilities. In addition to being available from a small number of cable providers, video-on-demand has been introduced over the Internet, as high-speed Internet access has greatly increased the speed and quality of viewing content, including feature-length films, on personal computers. We have previously tested an entertainment-on-demand service, which delivered video-on-demand to consumers' television sets via digital subscriber lines and fiber optic

connections. The future of video-on-demand services, including services provided by us, is uncertain, however. Video-on-demand could have a negative effect on our video store business if:

. video-on-demand could be profitably provided at a reasonable price; and

. newly released movies were made available at the same time, or before, they were made available to the home video retailers for rental.

Another new technology that could have an effect on our video store business is the personal video recorder. A personal video recorder allows consumers to automatically and digitally record programs to create a customized television line-up for viewing at any time. This technology also enables consumers to pause, rewind, instant replay and playback in slow motion any live television broadcast. We cannot predict the impact that this new technology will have on our business.

We Have Had Limited Experience with Our New Store Initiatives and Cannot Assure You When or If These Initiatives Will Have a Positive Impact on Our Profitability.

We have added an expanded selection of products and services in our stores such as DIRECTV and consumer electronics. The implementation of these and other similar initiatives in our stores may involve significant investments by us of time and money. Because we have limited experience with these new initiatives, we cannot assure you that they will be successful or profitable either over the short or long term.

Newly Opened Stores May Adversely Affect the Profitability of Pre-existing Stores.

We expect to open smaller company-operated stores in markets where we already have significant operations in order to maximize our market share within these markets. Although we have a customized store development approach, we cannot assure you that these smaller newly opened stores will not adversely affect the revenues and profitability of those pre-existing stores in any given market.

We May Be Liable for Lease Payments Related to BLOCKBUSTER MUSIC Stores.

In October 1998, about 380 BLOCKBUSTER MUSIC stores were sold to Wherehouse Entertainment Inc. Some of the leases transferred in connection with this sale had previously been guaranteed either by Viacom or its affiliates. If Wherehouse defaults with respect to these leases, related losses could adversely affect our future operating income because we have agreed to indemnify Viacom with respect to any amount paid under these guarantees. We estimate that, as of the time of the sale to Wherehouse, we were contingently liable for about $84 million with respect to base rent for the remaining initial terms of these leases if Wherehouse defaults on all of these leases. This amount has not been discounted to present value. Our contingent liability will vary over time depending on the lease terms remaining. Certain leases may be extended beyond the initial term and remain subject to the guarantee. We are therefore dependent upon Wherehouse's ability to satisfy the terms and conditions of the leases, which is based in part upon the overall financial condition of Wherehouse. Adverse changes in the financial condition of Wherehouse would increase the risk that we would be required to honor the guarantees. We have not recognized any reserves related to this contingent liability in our consolidated financial statements.

Our Business Model is Substantially Dependent on the Functionality of Our Centralized Domestic Distribution Center.

Our domestic distribution system is centralized. This means that we ship nearly all of the products to our U.S. company-operated stores through our distribution center. If our distribution center were to become non-operational for any reason, we could incur significantly higher costs and longer lead times associated with distributing our movies and other products to our stores.

As a Participant in the Retail Home Video Industry, We Are Subject to Governmental Regulation Particular to Our Industry.

Any finding that we have been, or are in, noncompliance with respect to the laws affecting our business could result in, among other things, governmental penalties or private litigant damages, which could have a material adverse effect on us. We are subject to various international, U.S. federal and state laws that govern the offer and sale of our franchises because we act as a franchisor. In addition, because we operate video stores and develop new video stores, we are subject to various international, U.S. federal and state laws that govern, among other things, the disclosure and retention of our video rental records and access and use of our video stores by disabled persons, and are subject to various state and local licensing, zoning, land use, construction and environmental regulations. The international home video and video game industry varies from country to country due to, among other things, legal standards and regulations, such as those relating to foreign ownership rights, unauthorized copying, intellectual property rights, labor and employment matters, trade regulation and business

practices, franchising and taxation, and format and technical standards. Furthermore, changes in existing laws, including environmental and employment laws, new laws or increases in the minimum wage may increase our costs. Our obligation to comply with, and the effects of, the above governmental regulations are increased by the magnitude of our operations.

CAUTIONARY STATEMENTS RELATING TO OUR RELATIONSHIP WITH VIACOM

We Will Be Controlled by Viacom As Long as It Owns a Majority of the Combined Voting Power of Our Two Classes of Common Stock, and Our Other Stockholders Will Be Unable to Affect the Outcome of Stockholder Voting During This Time.

We are currently controlled by Viacom. We have two classes of common stock:

- class A common stock, which entitles the holder to one vote per share; and
- class B common stock, which entitles the holder to five votes per share,

on all matters submitted to our stockholders. Viacom owns in excess of a majority of the combined voting power of our outstanding common stock. As a result, Viacom is able to determine the outcome of all corporate actions requiring stockholder approval. Because Viacom has the ability to control us, it has the power to act without taking the best interests of our other stockholders into consideration. For example, Viacom can control decisions with respect to:

- the direction and policies of our company, including the election and removal of directors;

- mergers or other business combinations involving us;
- the acquisition or disposition of assets by us;
- future issuances of our common stock or other securities;
- the incurrence of debt by us;
- the payment of dividends, if any, on our common stock; and
- amendments to our certificate of incorporation and bylaws.

Any of these provisions could be used by Viacom for its own advantage to the detriment of our other stockholders. This in turn may have an adverse effect on the price of our class A common stock.

There Are Potential Conflicts of Interest with Respect to Our Relationship with Viacom Because Viacom Controls Us and Our Business Objectives May Differ.

Because Viacom controls us and our business objectives may differ, there are potential conflicts of interest between Viacom and us regarding, among other things:

- our past and ongoing relationship with Viacom, including, but not limited to, the acquisition of movies from Paramount Pictures Corporation, an indirect subsidiary of Viacom, Viacom's control of our tax matters for years in which we are consolidated with Viacom for tax purposes and the agreements between Viacom and us that would apply in the event we are split off from Viacom;
- potential competitive business activities; and
- sales or distributions by Viacom of all or part of its ownership interest in our company.

We cannot assure you that we will be able to resolve any potential conflicts or that, if resolved, we would not be able to receive a more favorable resolution if we were dealing with someone who was not controlling us.

Four of Our Directors May Have Conflicts of Interest Because They Are Also Directors or Executive Officers of Viacom.

Four members of our board of directors are directors and/or executive officers of Viacom. These directors have obligations to us as well as to Viacom and may have conflicts of interest with respect to matters potentially or actually involving or affecting us. Our certificate of incorporation contains provisions designed to facilitate resolution of these potential conflicts, which we believe will assist our directors in fulfilling their fiduciary duties to our stockholders. These provisions do not, however, eliminate or limit the fiduciary duty of loyalty of our directors under applicable Delaware law. Subject to applicable Delaware law, stockholders in our company are deemed to have notice of and have consented to these provisions of our certificate of incorporation. Although these provisions are designed to resolve such conflicts between us and Viacom fairly, we cannot assure you that any conflicts will be so resolved.

There May Be an Adverse Effect on the Price of Our Class A Common Stock Due to Disparate Voting Rights of Our Class A Common Stock and Our Class B Common

Stock and, Possibly, Differences in the Liquidity of the Two Classes.

The differential in the voting rights of the class A common stock and class B common stock could adversely affect the price of the class A common stock to the extent that investors or any potential future purchaser of our common stock ascribe value to the superior voting rights of the class B common stock. The holders of class A common stock and class B common stock generally have identical rights except that holders of class A common stock are entitled to one vote per share while holders of class B common stock are entitled to five votes per share on all matters to be voted on by stockholders. Holders of class A common stock and class B common stock are entitled to separate class votes on amendments to our certificate of incorporation that would alter or adversely affect the powers, preferences or special rights of the shares of their respective classes. In addition, it is possible that differences in the liquidity between the two classes may develop, which could result in price differences.

Our Anti-takeover Provisions May Delay or Prevent a Change of Control of Our Company, Which Could Adversely Affect the Price of Our Common Stock.

The existence of some provisions in our corporate documents and Delaware law may delay or prevent a change in control of our company, which could adversely affect the price of our common stock. Our certificate of incorporation and bylaws contain some provisions that may make the acquisition of control of our company more difficult, including provisions relating to the nomination, election and removal of directors and limitations on actions by our stockholders. In addition, Delaware law also imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding common stock. Viacom, however, is generally exempted from these provisions and will have special rights so long as it owns at least a majority of the combined voting power of our two outstanding classes of common stock.

In addition, we have entered into a tax matters agreement with Viacom, which requires, among other things, that we cannot voluntarily enter into certain transactions, including any merger transaction or any transaction involving the sale of our capital stock, without the consent of Viacom.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes appearing elsewhere in this document.

General

Blockbuster Inc. is the world's leading provider of rentable home videocassettes, DVDs and video games, with nearly 8,000 stores in the United States, its territories and 26 other countries as of December 31, 2001. We

strive to be the leader in satisfying customer demand by stocking each of our stores with the selection, quantity and format of merchandise desired by our customers. During 2001, we implemented a number of key initiatives to strengthen our core business and drive growth in profitability, while continuing to make progress with initiatives designed to strengthen and leverage our brand and capitalize on new revenue streams.

Our business during 2001 was impacted by trends in the DVD and games industries. According to Kagan estimates, the number of U.S. DVD households nearly doubled during 2001. In addition, DVD was officially declared the fastest growing consumer electronics device in the history of consumer electronics by the Consumer Electronics Association. The continuing trend with respect to the DVD format translated into significant growth in our DVD rental business during 2001. During the fourth quarter of 2000, DVD rental revenues were 9.5% of total rental revenues. By the fourth quarter of 2001, DVD rental revenues had increased to 23.4% of total rental revenues. We expect that the DVD format will continue to gain market acceptance, and that the industry trend will continue to positively impact our DVD rental revenues, as we believe that DVD will follow the historical pattern of VHS and increasingly become a rental format. The retail home video game rental industry has traditionally been affected by changing technology, limited hardware platform lifecycles and consumer interest in software titles. The introduction of three new game platforms began to have an impact on our game rental revenues in the fourth quarter of 2001. Game rentals at the end of 2001 increased significantly from 2000, driven by rentals of Nintendo GameCube, Microsoft Xbox and Sony PlayStation 2 games. We expect the new game platforms to continue to have a positive impact on our game rental revenues; however, we expect revenues generated by older game platforms to decline, as the newer platforms support games that generally have much better graphics and functionality than the previous generation of games. Overall, we expect game rental revenues, which were 10.6% of our total rental revenues during 2001, to contribute to revenue growth and grow as a percentage of rental revenue during 2002.

During 2001, to capitalize on the higher margin and rapidly growing DVD rental format, as well as the opportunities provided by new game platforms and other strategic product offerings, we completed a re-merchandising of our stores. The re-merchandising plan included an expansion in DVD copy depth and selection and a reconfiguration of our stores to highlight the digital format, as well as other strategic product offerings. To accommodate the increase in DVDs and other products in our stores, we disposed of approximately 30% of our VHS rental library in our stores, certain VHS merchandise inventory primarily located in our distribution center and certain games from our rental library in our stores. This initiative was designed to maintain customer satisfaction and is intended to solidify our DVD leadership position. In addition, we believe our overall rental margins should be enhanced by this plan, as currently, our average DVD rental margin is higher than our average VHS rental margin. Currently, we purchase the majority of our DVDs under a sell-through pricing model. However, we are also currently purchasing some DVDs pursuant to DVD revenue-sharing arrangements, and we may enter into additional revenue-sharing arrangements during 2002. If more of our DVDs are purchased under revenue-sharing arrangements, we expect that our DVD rental revenues and gross profit would continue to increase, while our DVD rental gross margin would decline. With our anticipated growth in DVD rental revenues as a percentage of total rental revenues, we expect VHS rental revenues to decline as a percentage of total rental revenues. We continually evaluate our product mix in our stores in order to optimize revenues and gross profits from our stores.

We continue to explore other ways to maximize the use of our store space to generate incremental profit. We have established ourselves as one of the leading retailers of DIRECTV System equipment and DIRECTV(R) programming packages in the United States. At the same time, through our marketing programs, we have used this business to generate traffic in our stores. In addition, during 2001, we introduced a third party store-within-a-store concept in approximately 130 of our stores. Although we decided not to proceed with a national rollout of the concept, we were able to evaluate customer receptiveness to a consumer electronics offering. As a result of this evaluation and our experience with sales of DVD players and other entertainment products, we are developing a plan to offer an assortment of consumer entertainment products that complement our core business, leverage the use of

our store space and require minimal capital investment.

Critical Accounting Policies

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

Our accounting policies are generally straightforward. We believe the following accounting policies, among others, require our more significant judgments and estimates:

- Rental revenues and merchandise sales are generally recognized at the time of rental or sale. Rental revenues are generated from the rental of VHS tapes, DVDs, video games and from any eventual sale of previously rented VHS tapes, DVDs and video games. Revenues generated from rental transactions include revenues received in connection with the initial rentals of product, as well as revenues received in connection with any continuations of such rentals past the initial rental period, as contemplated by our membership agreement. Under our convenience policy, which we implemented in February 2000, a customer pays for the initial rental at the time the product is rented and agrees to pay for any continuation of the rental beyond the initial rental period. Generally, when a customer elects to keep rental product beyond the initial rental period, the customer's rental is successively continued for the same number of days and at the same price as the initial rental period, until such point as the product is purchased under the terms of the membership agreement or is returned.

  We have agreements with certain companies that allow these companies to purchase free rental cards from us, which can then be awarded at their discretion. We analyze our historical redemption rates for similar award programs as a basis for the estimate of the rentals that will not be redeemed on a program- by-program basis. We defer revenue for the estimated number of free rental cards that will ultimately be redeemed and recognize the amount deferred as revenue upon redemption. Revenue for estimated non-redemptions are generally recognized when the cards are issued. If the actual number of free rentals redeemed is significantly different than our estimate, an adjustment to the revenue recorded may be required.

  Blockbuster's premium membership program is designed to enhance customer loyalty by encouraging customers to rent movies only from Blockbuster. For an annual fee, a customer can join the BLOCKBUSTER REWARDS program and earn free movie or video game rentals. The fee, less direct costs, is

recognized ratably as revenue over the membership period.

From time to time, we sell multiple goods and or services as a bundled package. We allocate revenue under such arrangements based on the fair value of each element, to the extent objectively determinable, and recognize revenue upon delivery or consummation of the separable earnings process attributable to each element.

. We amortize the cost of our rental library, which includes videocassettes, DVDs and games, over periods ranging from three months to twelve months to an estimated residual value ranging from $2 to $5 per unit, according to the product category. We continually evaluate the estimates surrounding the useful lives and residual values used in amortizing our rental library. Changes to these estimates resulting from changes in consumer demand may impact the carrying value of our rental library and our rental margins.

For instance, during the current year, consumers increased their rentals of DVDs while their demand for VHS rental product declined. In addition, new game platforms made games formatted for older game platforms obsolete. As a result, we shifted our product mix within our stores toward a much higher proportion of DVDs, while we reduced the proportion of VHS product. We also shifted our mix of game products by increasing the proportion of games made for newer game platforms and decreasing the proportion of games made for older game platforms. Accordingly, and as discussed below in Notes 3 and 4 to our consolidated financial statements, we changed our estimates regarding useful lives and residual values for VHS products and game products, which resulted in increased amortization expense during 2001.

. The costs of rental product purchased pursuant to revenue-sharing arrangements typically include a lower initial product cost and a percentage of the net rental revenues to be shared with the studios over an agreed period of time. Additionally, certain titles have performance guarantees. The up-front costs are amortized on an accelerated basis and revenue-sharing payments pursuant to the applicable arrangement are expensed as the related revenue is earned. We analyze titles that are subject to performance guarantees and recognize an estimated expense for under-performing titles throughout the applicable period based upon our analysis of the estimated shortfall. These estimates are revised monthly upon actual results, which can differ from our estimates and result in an adjustment to cost of sales.

. Our merchandise inventory is stated at the lower of cost or market. We include an allocation of costs incurred in our distribution center to prepare products for our stores in the cost of our merchandise inventory. We record adjustments to the value of inventory primarily for estimated obsolete or excess inventory equal to the difference between the carrying value of inventory and the estimated market value based upon assumptions about future demand and market conditions. If future demand or actual market conditions are less favorable than those projected by management, additional inventory adjustments may be required. Our accrual for shrink is based on the actual historical shrink results of our most recent physical inventories adjusted, if necessary, for current economic conditions. These estimates are compared to actual results as physical inventory counts are taken and reconciled to the general ledger. We have not experienced significant fluctuations in our historical shrink rates, however, shrink has increased with the introduction and increased demand

for DVD product. DVD product is more susceptible to shrink due to its portability and popularity. We continue to design and implement controls at our stores to lower our shrink results, especially in relation to our DVD product.

- We record valuation allowances to reduce our deferred tax assets to an amount that is more likely than not to be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that our estimates regarding future taxable income or the results of our tax planning strategies differ from actual results, we would adjust our deferred tax assets with an offsetting amount recorded to our income tax provision in the period such determination was made. As noted below, and in Note 10 to our consolidated financial statements, during the fourth quarter of 2001 we reduced our valuation allowance relating to deferred tax assets in Mexico. We changed our estimate during the year regarding their realization, since Mexico was profitable during 2000 and 2001 after several years of losses, and we expect continued profitability in the future.

- On a monthly basis, we estimate certain material expenses in an effort to record those expenses in the period incurred. Our most material estimates relate to self insurance expenses, store level operating expenses and bonuses. Our self insurance accruals are recorded based on actuarial valuation methods performed by third-party actuaries. These actuarial valuations are estimates based on historical loss development factors. Accrued store level operating expenses are estimated based on current activity and historical results. Bonuses are based on performance to date and projected performance for the remaining bonus period. If actual results are significantly different than our expectations, an adjustment to expenses may be required.

- We assess our long-lived assets, primarily property and equipment and goodwill, for impairment whenever there is an indication that the carrying amount of the assets may not be recoverable.

Recoverability is determined by comparing the forecasted undiscounted cash flows generated by a long-lived asset to its net book value. If the forecasted undiscounted cash flows for the asset are less than its net book value, then we measure the amount of impairment loss as the difference between the net book value of the asset and its estimated fair value. Any impairment determined is recorded as an increase to depreciation expense in the period of impairment. We perform impairment reviews of long-lived assets associated with our stores domestically on a market-by-market basis and internationally on a country-by-country basis.

- We establish reserves for our store closures by accruing the present value of the remaining lease obligation, adjusted for estimated subtenant agreements or lease buyouts, if any. Expenses associated with the establishment of these reserves are reflected in general and administrative expense. The future lease obligation is inclusive of the net future minimum lease payments plus estimated common area maintenance charges, less any remaining accrual for straight-line average rent. Store furniture and equipment are either transferred at historical cost to another location or written down to their net realizable value and sold.

Results of Operations

Consolidated Results

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

	Year Ended December 31,		
	1999	2000	2001
	(In millions, except margin and worldwide store data)		
Statement of Operations Data:			
Revenues	$ 4,463.5	$ 4,960.1	$5,156.7
Cost of sales	1,762.5	2,036.0	2,420.7
Gross profit	2,701.0	2,924.1	2,736.0
Operating expenses	2,579.3	2,848.4	2,955.6
Operating income (loss)	121.7	75.7	(219.6)
Interest expense	(119.3)	(116.5)	(78.2)
Interest income	3.2	7.3	6.1
Other items, net	(0.2)	1.7	(5.2)
Income (loss) before income taxes	5.4	(31.8)	(296.9)
Benefit (provision) for income taxes	(71.8)	(45.4)	56.1
Equity in income (loss) of affiliated companies, net of tax	(2.8)	1.3	0.5
Net loss	$ (69.2)	$ (75.9)	$ (240.3)
Cash Flow Data:			
Cash flows provided by operating activities	$ 1,142.8	$ 1,320.8	$1,395.1
Cash flows used for investing activities	$(1,258.1)	$(1,056.8)	$ (945.2)
Cash flows provided by (used in) financing activities	$ 137.2	$ (187.2)	$ (441.2)
Other Data:			
Depreciation	$ 220.5	$ 279.0	$ 246.6
Amortization of intangibles	$ 171.8	$ 180.1	$ 177.1
EBITDA(1)	$ 514.0	$ 534.8	$ 204.1
Net loss plus intangible amortization, net of tax(1)(2)	$ 94.8	$ 93.3	$ (72.7)
Margins:			
Rental margin(3)	66.0%	64.4%	57.7%
Merchandise margin(4)	21.0	21.4	18.9
Gross margin(5)	60.5	59.0	53.1
Worldwide Store Data:			
Same store revenues increase(6)	8.3%	5.6%	2.5%
Company-operated stores at end of year	5,879	6,254	6,412
Franchised and joint venture stores at end of year	1,274	1,423	1,569
Total stores at end of year	7,153	7,677	7,981

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(1) "EBITDA" and "Net loss plus intangible amortization, net of tax" are presented here to provide additional information about our operations. These items should be considered in addition to, but not as a substitute for, or superior to, operating income (loss), net income (loss), cash flow and other measures of financial performance prepared in accordance with generally accepted accounting principles. EBITDA may differ in the method

of calculation from similarly titled measures used by other companies.

(2) Intangible amortization, net of tax included in this item is primarily related to goodwill.

(3) Rental gross profit as a percentage of rental revenues.

(4) Merchandise gross profit as a percentage of merchandise sales.

(5) Gross profit as a percentage of total revenues.

(6) A store is included in the same store revenues calculation after it has been opened and operated by us for more than 52 weeks. An acquired store becomes part of the same store base in the 53rd week after its acquisition and conversion. The percentage change is computed by comparing total net revenues for stores at the end of the applicable reporting period with total net revenues from these same stores for the comparable period in the prior year.

Change in Accounting Estimates for Rental Library and Special Item Charges

During the third quarter of 2001, we announced that we would execute a strategic re-merchandising plan to capitalize on the higher margin and rapidly growing DVD rental market. Our plan included an expansion in DVD copy depth and selection and a reconfiguration of our stores to highlight the digital format. This initiative was designed to maintain customer satisfaction and is intended to solidify our DVD leadership position. In addition, we believe our overall rental margins should be enhanced by this plan. To accommodate the increase in DVD and other products in our stores, we disposed of approximately 30% of our VHS rental library in our stores, certain VHS merchandise inventory primarily located in our distribution center, and certain games from our rental library in our stores. As a result of this disposal, during 2001 we recorded a non-cash charge of $195.9 million in cost of sales. The full year charge of $195.9 million reflects a reduction of $13.9 million to amounts reported in the third quarter. These reductions represent the actual results of the plan. We also recorded $26.9 million in incremental selling, general and administrative expenses, primarily related to labor, supply and disposal costs to execute the plan and severance associated with the reorganization of several of our corporate departments. We also recorded charge