

WESTERN DIGITAL CORP  
Form 10-Q  
February 01, 2013  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended December 28, 2012

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: 1-8703

**WESTERN DIGITAL CORPORATION**

Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**33-0956711**  
(I.R.S. Employer  
Identification No.)

**3355 Michelson Drive, Suite 100**

**Irvine, California**  
(Address of principal executive offices)

**92612**  
(Zip Code)

**Registrant's telephone number, including area code: (949) 672-7000**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of the close of business on January 23, 2013, 240,665,370 shares of common stock, par value \$.01 per share, were outstanding.

**Table of Contents****WESTERN DIGITAL CORPORATION****INDEX**

	<b>PAGE NO.</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<u>Item 1. Financial Statements (unaudited)</u>	3
<u>Condensed Consolidated Balance Sheets December 28, 2012 and June 29, 2012</u>	3
<u>Condensed Consolidated Statements of Income Three and Six Months Ended December 28, 2012 and December 30, 2011</u>	4
<u>Condensed Consolidated Statements of Comprehensive Income Three and Six Months Ended December 28, 2012 and December 30, 2011</u>	5
<u>Condensed Consolidated Statements of Cash Flows Six Months Ended December 28, 2012 and December 30, 2011</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	34
<u>Item 4. Controls and Procedures</u>	36
<b><u>PART II. OTHER INFORMATION</u></b>	
<u>Item 1. Legal Proceedings</u>	36
<u>Item 1A. Risk Factors</u>	36
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
<u>Item 6. Exhibits</u>	54

Our fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every five years, we report a 53-week fiscal year to align our fiscal year with the foregoing policy. Our fiscal second quarters ended December 28, 2012 and December 30, 2011 both consisted of 13 weeks. Fiscal year 2012 was comprised of 52 weeks and ended on June 29, 2012. Fiscal year 2013 will be comprised of 52 weeks and will end on June 28, 2013. Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters, and references to financial information are on a consolidated basis. As used herein, the terms we, us, our, the Company, WDC and Western Digital refer to Western Digital Corporation and its subsidiaries.

WDC, a Delaware corporation, is the parent company of our storage business, which operates under two independent subsidiaries WD and HGST.

Our principal executive offices are located at 3355 Michelson Drive, Suite 100, Irvine, California 92612. Our telephone number is (949) 672-7000 and our Web site is [www.westerndigital.com](http://www.westerndigital.com). The information on our Web site is not incorporated in this Quarterly Report on Form 10-Q.

Western Digital, WD and the WD logo are trademarks of Western Digital Technologies, Inc. and/or its affiliates. All other trademarks mentioned are the property of their respective owners.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS**

**WESTERN DIGITAL CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in millions, except par values; unaudited)

	Dec. 28, 2012	Jun. 29, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 3,816	\$ 3,208
Accounts receivable, net	1,732	2,364
Inventories	1,204	1,210
Other current assets	423	359
<b>Total current assets</b>	<b>7,175</b>	<b>7,141</b>
Property, plant and equipment, net	3,938	4,067
Goodwill	1,907	1,975
Other intangible assets, net	709	799
Other non-current assets	200	224
<b>Total assets</b>	<b>\$ 13,929</b>	<b>\$ 14,206</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,185	\$ 2,773
Accrued expenses	722	858
Accrued warranty	131	171
Current portion of long-term debt	288	230
<b>Total current liabilities</b>	<b>3,326</b>	<b>4,032</b>
Long-term debt	1,840	1,955
Other liabilities	516	550
<b>Total liabilities</b>	<b>5,682</b>	<b>6,537</b>
Commitments and contingencies (Notes 4 and 5)		
Shareholders' equity:		
Preferred stock, \$.01 par value; authorized 5 shares; issued and outstanding none		
Common stock, \$.01 par value; authorized 450 shares; issued 261 shares; outstanding 241 and 246 shares, respectively	3	3
Additional paid-in capital	2,224	2,223
Accumulated other comprehensive income (loss)	8	(15)
Retained earnings	6,744	6,012
Treasury stock - common shares at cost; 20 shares and 15 shares, respectively	(732)	(554)
<b>Total shareholders' equity</b>	<b>8,247</b>	<b>7,669</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 13,929</b>	<b>\$ 14,206</b>

Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

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

**Table of Contents****WESTERN DIGITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(in millions, except per share amounts; unaudited)

	Three Months Ended		Six Months Ended	
	Dec. 28, 2012	Dec. 30, 2011	Dec. 28, 2012	Dec. 30, 2011
Revenue, net	\$ 3,824	\$ 1,995	\$ 7,859	\$ 4,689
Cost of revenue	2,765	1,347	5,607	3,500
Gross margin	1,059	648	2,252	1,189
Operating expenses:				
Research and development	378	191	774	384
Selling, general and administrative	162	96	341	185
Employee termination benefits and other charges	41		67	
Charges related to flooding		199		199
Total operating expenses	581	486	1,182	768
Operating income	478	162	1,070	421
Other income (expense):				
Interest income	3	3	5	6
Interest and other expense	(13)	(5)	(29)	(9)
Total other expense, net	(10)	(2)	(24)	(3)
Income before income taxes	468	160	1,046	418
Income tax provision	133	15	192	34
Net income	\$ 335	\$ 145	\$ 854	\$ 384
<b>Income per common share:</b>				
Basic	\$ 1.38	\$ 0.62	\$ 3.50	\$ 1.64
Diluted	\$ 1.36	\$ 0.61	\$ 3.43	\$ 1.62
<b>Weighted average shares outstanding:</b>				
Basic	242	234	244	234
Diluted	246	237	249	237

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

**Table of Contents**

**WESTERN DIGITAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(in millions; unaudited)

	Three Months Ended		Six Months Ended	
	Dec. 28, 2012	Dec. 30, 2011	Dec. 28, 2012	Dec. 30, 2011
Net income	\$ 335	\$ 145	\$ 854	\$ 384
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on cash flow hedges	(2)	10	26	(9)
Change in net actuarial losses			1	
Translation loss	(4)		(4)	
Other comprehensive income (loss)	(6)	10	23	(9)
Total comprehensive income	\$ 329	\$ 155	\$ 877	\$ 375

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

**Table of Contents**

**WESTERN DIGITAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in millions; unaudited)

	<b>Six Months Ended</b>	
	<b>Dec.</b>	<b>Dec.</b>
	<b>28,</b>	<b>30,</b>
	<b>2012</b>	<b>2011</b>
<b>Cash flows from operating activities</b>		
Net income	\$ 854	\$ 384
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	622	298
Stock-based compensation	71	41
Deferred income taxes	68	18
Non-cash portion of employee termination benefits and other charges	15	
Non-cash portion of charges related to flooding		109
Changes in:		
Accounts receivable, net	633	459
Inventories	7	111
Accounts payable	(352)	(675)
Accrued expenses	(169)	(2)
Other assets and liabilities	(41)	(13)
<b>Net cash provided by operating activities</b>	<b>1,708</b>	<b>730</b>
<b>Cash flows from investing activities</b>		
Purchases of property, plant and equipment	(628)	(253)
Acquisitions, net of cash acquired	(27)	
Purchase of investment	(15)	
<b>Net cash used in investing activities</b>	<b>(670)</b>	<b>(253)</b>
<b>Cash flows from financing activities</b>		
Issuance of stock under employee stock plans	86	23
Taxes paid on vested stock awards under employee stock plans	(8)	(5)
Excess tax benefits from employee stock plans	35	2
Repurchases of common stock	(364)	
Dividends to shareholders	(121)	
Repayment of debt	(58)	(63)
<b>Net cash used in financing activities</b>	<b>(430)</b>	<b>(43)</b>
<b>Net increase in cash and cash equivalents</b>	<b>608</b>	<b>434</b>
Cash and cash equivalents, beginning of period	3,208	3,490
<b>Cash and cash equivalents, end of period</b>	<b>\$ 3,816</b>	<b>\$ 3,924</b>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for income taxes	\$ 95	\$ 8
Cash paid for interest	\$ 21	\$ 1

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





**Table of Contents****WESTERN DIGITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)****1. Basis of Presentation**

The accounting policies followed by Western Digital Corporation (the Company) are set forth in Part II, Item 8, Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended June 29, 2012. In the opinion of management, all adjustments necessary to fairly state the unaudited condensed consolidated financial statements have been made. All such adjustments are of a normal, recurring nature. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended June 29, 2012. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year.

Company management has made estimates and assumptions relating to the reporting of certain assets and liabilities in conformity with U.S. GAAP. These estimates and assumptions have been applied using methodologies that are consistent throughout the periods presented. However, actual results could differ materially from these estimates.

**2. Supplemental Financial Statement Data**

*Inventories; Property, Plant and Equipment; and Other Intangible Assets*

	Dec. 28, 2012	Jun. 29, 2012
	(in millions)	
<b>Inventories:</b>		
Raw materials and component parts	\$ 193	\$ 245
Work-in-process	581	552
Finished goods	430	413
<b>Total inventories</b>	<b>\$ 1,204</b>	<b>\$ 1,210</b>
<b>Property, plant and equipment:</b>		
Property, plant and equipment	\$ 7,490	\$ 7,173
Accumulated depreciation	(3,552)	(3,106)
<b>Property, plant and equipment, net</b>	<b>\$ 3,938</b>	<b>\$ 4,067</b>
<b>Other intangible assets:</b>		
Other intangible assets	\$ 948	\$ 933
Accumulated amortization	(239)	(134)
<b>Other intangible assets, net</b>	<b>\$ 709</b>	<b>\$ 799</b>

**Table of Contents***Warranty*

The Company records an accrual for estimated warranty costs when revenue is recognized. The Company generally warrants its products for a period of one to five years. The warranty provision considers estimated product failure rates and trends, estimated replacement costs, estimated repair costs which include scrap costs, and estimated costs for customer compensatory claims related to product quality issues, if any. A statistical warranty tracking model is used to help prepare estimates and assist the Company in exercising judgment in determining the underlying estimates. The statistical tracking model captures specific detail on hard drive reliability, such as factory test data, historical field return rates, and costs to repair by product type. Management's judgment is subject to a greater degree of subjectivity with respect to newly introduced products because of limited field experience with those products upon which to base warranty estimates. Management reviews the warranty accrual quarterly for products shipped in prior periods and which are still under warranty. Any changes in the estimates underlying the accrual may result in adjustments that impact current period gross margin and income. Such changes are generally a result of differences between forecasted and actual return rate experience and costs to repair. If actual product return trends, costs to repair returned products or costs of customer compensatory claims differ significantly from estimates, future results of operations could be materially affected. Changes in the warranty accrual were as follows (in millions):

	Three Months Ended		Six Months Ended	
	Dec. 28, 2012	Dec. 30, 2011	Dec. 28, 2012	Dec. 30, 2011
Warranty accrual, beginning of period	\$ 230	\$ 173	\$ 260	\$ 170
Charges to operations	44	24	90	69
Utilization	(51)	(42)	(111)	(84)
Changes in estimate related to pre-existing warranties	(12)	1	(28)	1
Warranty accrual, end of period	\$ 211	\$ 156	\$ 211	\$ 156

The long-term portion of the warranty accrual classified in other liabilities was \$80 million at December 28, 2012 and \$89 million at June 29, 2012.

**3. Income per Common Share**

The Company computes basic income per common share using net income and the weighted average number of common shares outstanding during the period. Diluted income per common share is computed using net income and the weighted average number of common shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include certain dilutive outstanding employee stock options, rights to purchase shares of common stock under the Company's Employee Stock Purchase Plan ( ESPP ) and restricted stock unit awards ( RSUs ).

**Table of Contents**

The following table illustrates the computation of basic and diluted income per common share (in millions, except per share data):

	Three Months Ended		Six Months Ended	
	Dec. 28, 2012	Dec. 30, 2011	Dec. 28, 2012	Dec. 30, 2011
Net income	\$ 335	\$ 145	\$ 854	\$ 384
Weighted average shares outstanding:				
Basic	242	234	244	234
Employee stock options and other	4	3	5	3
Diluted	246	237	249	237
Income per common share:				
Basic	\$ 1.38	\$ 0.62	\$ 3.50	\$ 1.64
Diluted	\$ 1.36	\$ 0.61	\$ 3.43	\$ 1.62
Anti-dilutive potential common shares excluded*	7	7	6	5

\* For purposes of computing diluted income per common share, certain potentially dilutive securities have been excluded from the calculation because their effect would have been anti-dilutive.

**4. Debt**

On March 8, 2012 (the Closing Date), the Company, in its capacity as the parent entity and guarantor, Western Digital Technologies, Inc. ( WDT ), a wholly owned subsidiary of the Company, and Western Digital Ireland, Ltd. ( WDI ), an indirect wholly owned subsidiary of the Company, entered into a five-year credit agreement (the Credit Facility) with Bank of America, N.A., as administrative agent, swing line lender and letter of credit issuer, and certain other participating lenders (collectively, the Lenders). The Credit Facility provides for \$2.8 billion of unsecured loan facilities consisting of a \$2.3 billion term loan facility and a \$500 million revolving credit facility. The only borrower under the term loan facility is WDI and the revolving credit facility is available to both WDI and WDT (WDI and WDT are referred to as the Borrowers). The Borrowers may elect to expand the Credit Facility by up to an additional \$500 million if existing or new lenders provide additional term or revolving commitments. The obligations of the Borrowers under the Credit Facility are guaranteed by the Company and the Company's material domestic subsidiaries, and the obligations of WDI under the Credit Facility are also guaranteed by WDT.

The term loans and the revolving credit loans may be prepaid in whole or in part at any time without premium or penalty, subject to certain conditions. As of December 28, 2012, the term loan facility had a variable interest rate of 2.21% and a remaining balance of \$2.1 billion. The Company is required to make principal payments on the term loan facility totaling \$230 million a year for fiscal 2013 through fiscal 2016, and the remaining \$1.3 billion balance (subject to adjustment to reflect prepayments or an increase to its term loan facility) due and payable in full in fiscal 2017 on March 8, 2017. As of December 28, 2012, \$500 million was available for future borrowings on the revolving credit facility.

The Credit Facility requires the Company to comply with a leverage ratio and an interest coverage ratio calculated on a consolidated basis for the Company and its subsidiaries. In addition, the Credit Facility contains customary covenants, including covenants that limit or restrict, subject to certain exceptions, the Company's and its subsidiaries' ability to incur liens, incur indebtedness, make certain restricted payments, merge, consolidate or dispose of substantially all of its assets, and enter into certain speculative hedging arrangements and make any material change in the nature of its business. Upon the occurrence of an event of default under the Credit Facility, the administrative agent at the request, or with the consent, of the Required Lenders (as defined in the Credit Facility) may cease making loans, terminate the Credit Facility and declare all amounts outstanding to be immediately due and payable, require the cash collateralization of letters of credit and/or exercise all other rights and remedies available to it, the Lenders and the letter of credit issuer. The Credit Facility specifies a number of events of default (some of which are subject to applicable grace or cure periods), including, among other things, non-payment defaults, covenant defaults, cross-defaults to other material indebtedness, bankruptcy and insolvency defaults, material judgment defaults and a change of control default. As of December 28,

2012, the Company was in compliance with all covenants.

**Table of Contents****5. Legal Proceedings**

When the Company becomes aware of a claim or potential claim, the Company assesses the likelihood of any loss or exposure. The Company discloses information regarding each material claim where the likelihood of a loss contingency is probable or reasonably possible. If a loss contingency is probable and the amount of the loss can be reasonably estimated, the Company records an accrual for the loss. In such cases, there may be an exposure to potential loss in excess of the amount accrued. Where a loss is not probable but is reasonably possible or where a loss in excess of the amount accrued is reasonably possible, the Company discloses an estimate of the amount of the loss or range of possible losses for the claim if a reasonable estimate can be made, unless the amount of such reasonably possible losses is not material to the Company's financial position, results of operations or cash flows. Unless otherwise stated below, for each of the matters described below, the Company has either recorded an accrual for losses that are probable and reasonably estimable or has determined that, while a loss is reasonably possible (including potential losses in excess of the amounts accrued by the Company), a reasonable estimate of the amount of loss or range of possible losses with respect to the claim or in excess of amounts already accrued by the Company cannot be made. The ability to predict the ultimate outcome of such matters involves judgments, estimates and inherent uncertainties. The actual outcome of such matters could differ materially from management's estimates.

Solely for purposes of this footnote, "WD" refers to Western Digital Corporation or one or more of its subsidiaries prior to the acquisition of Viviti Technologies Ltd., until recently known as Hitachi Global Storage Technologies Holdings Pte. Ltd. ("HGST"), "HGST" refers to HGST or one or more of its subsidiaries as of the Closing Date, and "the Company" refers to Western Digital Corporation and all of its subsidiaries on a consolidated basis including HGST.

*Intellectual Property Litigation*

On June 20, 2008, plaintiff Convole, Inc. ("Convole") filed a complaint in the Eastern District of Texas against WD, HGST, and one other company alleging infringement of U.S. Patent Nos. 6,314,473 and 4,916,635. The complaint sought unspecified monetary damages and injunctive relief. On October 10, 2008, Convole amended its complaint to allege infringement of only the 473 patent. The 473 patent allegedly relates to interface technology to select between certain modes of a disk drive's operations relating to speed and noise. A trial in the matter began on July 18, 2011 and concluded on July 26, 2011 with a verdict against WD and HGST in an amount that is not material to the Company's financial position, results of operations or cash flows. WD and HGST have filed post-trial motions challenging the verdict and will evaluate their options for appeal after the Court rules on the post-trial motions.

On December 8, 2008, plaintiffs MagSil Corporation and the Massachusetts Institute of Technology (collectively, "MagSil") filed a complaint in the District of Delaware against WD, HGST and six other companies in the disk drive industry alleging infringement of U.S. Patent Nos. 5,629,922 and 5,835,314. The complaint seeks unspecified monetary damages and injunctive relief. The asserted patents allegedly relate to tunneling magneto resistive technology. In January 2010, MagSil amended its complaint to allege infringement of only the 922 patent. As disclosed in the Company's Annual Report on Form 10-K, filed with the SEC on August 13, 2010, MagSil and WD settled the matter for an amount that was not material to the Company's financial position, results of operations or cash flows. With respect to the claim pending against HGST, in February 2011, HGST obtained a ruling invalidating the patent on summary judgment, which MagSil appealed. In 2012, the Federal Circuit Court upheld the ruling. If MagSil appeals this decision, HGST intends to continue to defend itself vigorously in this matter.

On December 7, 2009, plaintiff Nazomi Communications ("Nazomi") filed a complaint in the Eastern District of Texas against WD and seven other companies alleging infringement of U.S. Patent Nos. 7,080,362 and 7,225,436. Nazomi dismissed the Eastern District of Texas suit after filing a similar complaint in the Central District of California on February 8, 2010. The case was subsequently transferred to the Northern District of California on October 14, 2010. The complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to processor cores capable of Java hardware acceleration. In August 2012, the Court dismissed WD on summary judgment for non-infringement. If Nazomi appeals this decision, WD intends to continue to defend itself vigorously in this matter.

**Table of Contents**

On January 5, 2010, plaintiff Enova Technology Corporation ( Enova ) filed a complaint in the District of Delaware against WD and Initio Corporation alleging infringement of U.S. Patent Nos. 7,136,995 and 7,386,734. Enova subsequently amended its complaint to include an additional party and additionally allege infringement of U.S. Patent No. 7,900,057. The amended complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to real time full disk encryption application specific integrated circuits, or ASICs. A trial in the matter is scheduled to begin on February 25, 2013. WD intends to defend itself vigorously in this matter.

On November 10, 2010, plaintiff Rembrandt Data Storage ( Rembrandt ) filed a complaint in the Western District of Wisconsin against WD alleging infringement of U.S. Patent Nos. 5,995,342 and 6,195,232. The complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to specific thin film heads having solenoid coils. After a favorable claim construction ruling by the court, WD secured a stipulation from Rembrandt to dismiss the case. Rembrandt appealed the Court's claim construction ruling, and the Federal Circuit issued a summary affirmance in favor of WD in December 2012. If Rembrandt appeals the decision, WD intends to continue to defend itself vigorously in this matter.

On December 1, 2010, Rambus, Inc. ( Rambus ) filed a complaint with the U.S. International Trade Commission pursuant to 19 U.S.C. Section 1337 alleging that six Primary Respondent semiconductor chip companies and twenty-seven Customer Respondents, including HGST, infringe various U.S. patents. On December 29, 2010, the U.S. International Trade Commission ( ITC ) initiated an investigation into Rambus's allegations in response to the complaint. HGST is accused of infringing U.S. Patent Nos. 6,591,353; 7,287,109; 7,602,857; 7,602,858; and 7,715,494. The complaint alleges that certain of HGST's hard drives that contain Double data rate-type memory controllers, Serial Advanced Technology Attachment interfaces, Peripheral Component Interconnect Express interfaces, DisplayPort interfaces, or Serial Attached SCSI interfaces infringe the patents. The complaint seeks to enjoin the importation into the U.S. of the allegedly infringing semiconductor chips and products. It also requests a cease-and-desist order preventing the parties from exhausting allegedly infringing inventory in the U.S. The ITC has found in favor of the respondents in all matters and Rambus has appealed to the Federal Circuit. HGST intends to continue to defend itself vigorously in this matter.

On August 1, 2011, plaintiff Guzik Technical Enterprises ( Guzik ) filed a complaint in the Northern District of California against WD and various of its subsidiaries alleging infringement of U.S. Patent Nos. 6,023,145 and 6,785,085, breach of contract and misappropriation of trade secrets. The complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The patents asserted by Guzik allegedly relate to devices used to test hard disk drive heads and media. WD has filed counterclaims against Guzik or patent infringement of U.S. Patent Nos. 5,844,420; 5,640,089; 6,891,696; and 7,480,116. The patents asserted by WD relate to devices and methods used in the testing of hard disk drive heads and media. WD intends to defend itself vigorously in this matter.

*Seagate Matter*

On October 4, 2006, plaintiff Seagate Technology LLC ( Seagate ) filed an action in the District Court of Hennepin County, Minnesota, naming as defendants WD and one of its now former employees previously employed by Seagate. The complaint in the action alleged claims based on supposed misappropriation of trade secrets and sought injunctive relief and unspecified monetary damages, fees and costs. On June 19, 2007, WD's former employee filed a demand for arbitration with the American Arbitration Association. A motion to stay the litigation as against all defendants and to compel arbitration of all Seagate's claims was granted on September 19, 2007. On September 23, 2010, Seagate filed a motion to amend its claims and add allegations based on the supposed misappropriation of additional confidential information, and the arbitrator granted Seagate's motion. The arbitration hearing commenced on May 23, 2011 and concluded on July 11, 2011.

On November 18, 2011, the sole arbitrator ruled in favor of WD in connection with five of the eight alleged trade secrets at issue, based on evidence that such trade secrets were known publicly at the time the former employee joined WD. Based on a determination that the employee had fabricated evidence, the arbitrator then concluded that WD had to know of the fabrications. As a sanction, the arbitrator precluded any evidence or defense by WD disputing the validity, misappropriation, or use of the three remaining alleged trade secrets by WD, and entered judgment in favor of Seagate with respect to such trade secrets. Using an unjust enrichment theory of damages, the arbitrator issued an interim award against WD in the amount of \$525 million plus pre-award interest at the Minnesota statutory rate of 10% per year. In his decision with respect to these three trade secrets, the arbitrator did not question the relevance, veracity or credibility of any of WD's ten expert and fact witnesses (other than WD's former employee), nor the authenticity of any other evidence WD presented. On January 23, 2012, the arbitrator issued a final award adding pre-award interest in the amount of \$105.4 million for a total final award of \$630.4 million. On January 23, 2012, WD filed a petition in the District Court of Hennepin County, Minnesota to have the final arbitration award vacated. A hearing on the petition to vacate was held on March 1, 2012.

---

**Table of Contents**

On October 12, 2012, the District Court of Hennepin County, Minnesota vacated, in full, the \$630.4 million final arbitration award. Specifically, the Court confirmed the arbitration award with respect to each of the five trade secret claims that WD and the former employee had won at the arbitration and vacated the arbitration award with respect to the three trade secret claims that WD and the former employee had lost at the arbitration. The Court ordered that a rehearing be held concerning those three alleged trade secret claims before a new arbitrator.

On October 30, 2012, Seagate initiated an appeal of the Court's decision with the Minnesota Court of Appeals. The Company strongly believes that the Court's decision was correct and intends to vigorously oppose Seagate's efforts to appeal the decision. Nevertheless, the Company cannot be certain it will be successful in a new arbitration of the three trade secret claims or in Seagate's efforts to appeal the decision. In the event Seagate is successful in its efforts to appeal the Court's decision, the original arbitration award could be reinstated. The statutory interest rate of 10% would apply from the date of the original arbitration award if the award should be reinstated.

*Other Matters*

In the normal course of business, the Company is subject to other legal proceedings, lawsuits and other claims. Although the ultimate aggregate amount of probable monetary liability or financial impact with respect to these other matters is subject to many uncertainties and is therefore not predictable with assurance, management believes that any monetary liability or financial impact to the Company from these other matters, individually and in the aggregate, would not be material to the Company's financial condition, results of operations or cash flows. However, there can be no assurance with respect to such result, and monetary liability or financial impact to the Company from these other matters could differ materially from those projected.

**6. Income Taxes**

The Company's income tax provision for the three months ended December 28, 2012 was \$133 million as compared to \$15 million in the prior-year period. The Company's income tax provision for the six months ended December 28, 2012 was \$192 million as compared to \$34 million in the prior-year period. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia, the Philippines, Singapore and Thailand that expire at various dates from 2013 through 2025, the current year generation of income tax credits and the effect of California Proposition 39 which was passed in November 2012.

On November 6, 2012, California voters approved California Proposition 39, which affects California state income tax apportionment for most multi-state taxpayers for tax years beginning on or after January 1, 2013. This proposition would reduce the Company's future income apportioned to California, making it less likely for the Company to realize certain California deferred tax assets. As a result, the Company recorded an \$88 million charge to reduce its previously recognized California deferred tax assets as of December 28, 2012.

In the three months ended December 28, 2012, the Company did not record a change in its liability for unrecognized tax benefits. In the six months ended December 28, 2012, the Company recorded a net decrease of \$4 million in its liability for unrecognized tax benefits. As of December 28, 2012, the Company had a recorded liability for unrecognized tax benefits of approximately \$276 million. Interest and penalties recognized on such amounts were not material.

The Internal Revenue Service ( IRS ) has completed its field examination of the federal income tax returns for fiscal years 2006 and 2007 for the Company. The Company has received Revenue Agent Reports ( RARs ) from the IRS that seek adjustments to income before income taxes of approximately \$970 million in connection with unresolved issues related primarily to transfer pricing and certain other intercompany transactions. The Company disagrees with the proposed adjustments. In May 2011, the Company filed a protest with the IRS Appeals Office regarding the proposed adjustments. Meetings with the Appeals Office began in February 2012. In January 2012, the IRS commenced an examination of the Company's fiscal years 2008 and 2009 and of the 2007 fiscal period ended September 5, 2007 of Komag, Incorporated ( Komag ), which was acquired by the Company on September 5, 2007.



**Table of Contents**

The Company believes that adequate provision has been made for any adjustments that may result from tax audits. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs. As of December 28, 2012, the Company believes that it is reasonably possible the liability for unrecognized tax benefits will decrease by \$54 million within the next twelve months. Any significant change in the amount of the Company's liability for unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of the Company's tax returns.

**7. Fair Value Measurements**

Financial assets and liabilities that are remeasured and reported at fair value at each reporting period are classified and disclosed in one of the following three levels:

*Level 1.* Quoted prices in active markets for identical assets or liabilities.

*Level 2.* Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

*Level 3.* Inputs that are unobservable for the asset or liability and that are significant to the fair value of the assets or liabilities.

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of December 28, 2012, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

	Fair Value Measurements at Reporting Date Using			Total
	Level 1	Level 2	Level 3	
<b>Assets:</b>				
Cash equivalents:				
Money market funds	\$ 951	\$	\$	\$ 951
Foreign exchange contracts		15		15
Auction-rate securities			14	14
Total assets at fair value	\$ 951	\$ 15	\$ 14	\$ 980
<b>Liabilities:</b>				
Foreign exchange contracts		3		3
Total liabilities at fair value	\$	\$ 3	\$	\$ 3

**Table of Contents**

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of June 29, 2012, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

	Fair Value Measurements at Reporting Date Using			Total
	Level 1	Level 2	Level 3	
<b>Assets:</b>				
Cash equivalents:				
Money market funds	\$ 721	\$	\$	\$ 721
U.S. Treasury securities		61		61
U.S. Government agency securities		62		62
Total cash equivalents	721	123		844
Foreign exchange contracts		1		1
Auction-rate securities			14	14
Total assets at fair value	\$ 721	\$ 124	\$ 14	\$ 859
<b>Liabilities:</b>				
Foreign exchange contracts		22		22
Total liabilities at fair value	\$	\$ 22	\$	\$ 22

*Money Market Funds.* The Company's money market funds are funds that invest in U.S. Treasury securities and are recorded within cash and cash equivalents in the condensed consolidated balance sheets. Money market funds are valued based on quoted market prices.

*U.S. Treasury Securities.* The Company's U.S. Treasury securities are investments in Treasury bills with original maturities of three months or less, are held in custody by a third party and are recorded within cash and cash equivalents in the condensed consolidated balance sheets. U.S. Treasury securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

*U.S. Government Agency Securities.* The Company's U.S. Government agency securities are investments in fixed income securities sponsored by the U.S. Government with original maturities of three months or less, are held in custody by a third party and are recorded within cash and cash equivalents in the condensed consolidated balance sheets. U.S. Government agency securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

*Auction-Rate Securities.* The Company's auction-rate securities have maturity dates through 2050, are primarily backed by insurance products and are accounted for as available-for-sale securities. These investments are classified as long-term investments and recorded within other non-current assets in the condensed consolidated balance sheets. Auction-rate securities are valued by a third party using trade information related to the secondary market.

*Foreign Exchange Contracts.* The Company's foreign exchange contracts are short-term contracts to hedge the Company's foreign currency risk. Foreign exchange contracts are classified within other current assets and liabilities in the condensed consolidated balance sheets. Foreign exchange contracts are valued using an income approach that is based on a present value of future cash flows model. The market-based observable inputs for the model include forward rates and credit default swap rates.

In the six months ended December 28, 2012, there were no changes in Level 3 financial assets measured on a recurring basis.

The carrying amounts of cash, accounts receivable, accounts payable and accrued expenses approximate fair value for all periods presented because of the short-term maturity of these assets and liabilities. The carrying amount of debt approximates fair value because of its variable interest rate.



**Table of Contents****8. Foreign Exchange Contracts**

Although the majority of the Company's transactions are in U.S. dollars, some transactions are based in various foreign currencies. The Company purchases short-term, foreign exchange contracts to hedge the impact of foreign currency exchange fluctuations on certain underlying assets, revenue, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedging transactions is to minimize the impact of foreign currency fluctuations on the Company's results of operations. These contract maturity dates do not exceed 12 months. All foreign exchange contracts are for risk management purposes only. The Company does not purchase foreign exchange contracts for trading purposes. As of December 28, 2012, the Company had outstanding foreign exchange contracts with commercial banks for British Pound Sterling, Euro, Japanese Yen, Malaysian Ringgit, Philippine Peso, Singapore Dollar and Thai Baht, all of which were designated as either cash flow or fair value hedges.

If the derivative is designated as a cash flow hedge, the effective portion of the change in fair value of the derivative is initially deferred in other comprehensive income (loss), net of tax. These amounts are subsequently recognized into earnings when the underlying cash flow being hedged is recognized into earnings. Recognized gains and losses on foreign exchange contracts entered into for manufacturing-related activities are reported in cost of revenue. Hedge effectiveness is measured by comparing the hedging instrument's cumulative change in fair value from inception to maturity to the underlying exposure's terminal value. The Company determined the ineffectiveness associated with its cash flow hedges to be immaterial to the condensed consolidated financial statements for the three and six months ended December 28, 2012 and December 30, 2011.

A change in the fair value of fair value hedges is recognized in earnings in the period incurred and is reported as a component of operating expenses. All fair value hedges were determined to be effective. The fair value and the changes in fair value on these contracts were not material to the condensed consolidated financial statements during the three and six months ended December 28, 2012 and December 30, 2011.

As of December 28, 2012, the net amount of unrealized gains with respect to the Company's foreign exchange contracts that is expected to be reclassified into earnings within the next 12 months was \$10 million. In addition, as of December 28, 2012, the Company did not have any foreign exchange contracts with credit-risk-related contingent features. The Company opened \$647 million and \$1.4 billion, and closed \$923 million and \$2.0 billion, in foreign exchange contracts in the three and six months ended December 28, 2012, respectively. The Company opened \$391 million and \$1.3 billion, and closed \$815 million and \$1.7 billion, in foreign exchange contracts in the three and six months ended December 30, 2011, respectively. The fair value and balance sheet location of such contracts were as follows (in millions):

Derivatives Designated as	Asset Derivatives				Liability Derivatives			
	Dec. 28, 2012		Jun. 29, 2012		Dec. 28, 2012		Jun. 29, 2012	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Hedging Instruments								
Foreign exchange contracts	Other current assets	\$ 15	Other current assets	\$ 1	Accrued expenses	\$ 3	Accrued expenses	\$ 22

The impact on the condensed consolidated financial statements was as follows (in millions):

Derivatives in Cash	Amount of Gain (Loss) Recognized in Accumulated OCI on Derivatives				Location of Gain (Loss) Reclassified from Accumulated OCI into Income	Amount of Gain (Loss) Reclassified From Accumulated OCI into Income							
	Three Months Ended	Six Months Ended	Three Months Ended	Six Months Ended		Three Months Ended	Six Months Ended	Three Months Ended	Six Months Ended				
Flow Hedging Relationships													
Foreign exchange contracts					Cost of revenue	\$ 14	\$ 45	\$ 2	\$ (6)	\$ 16	\$ 19	\$ (8)	\$ 3

The total net realized transaction and foreign exchange contract currency gains and losses were not material to the condensed consolidated financial statements during the three and six months ended December 28, 2012 and December 30, 2011.



**Table of Contents****9. Stock-Based Compensation***Stock-based Compensation Expense*

During the three and six months ended December 28, 2012, the Company recognized in expense \$24 million and \$49 million, respectively, for stock-based compensation related to the vesting of options issued under the Company's stock option plans and the ESPP, which includes \$2 million of accelerated expense associated with the employee termination benefits and other charges disclosed in Note 12 below. In the prior-year periods, the Company recognized in expense \$15 million and \$24 million, respectively, for stock-based compensation related to the vesting of options issued under the Company's stock option plans and the ESPP. As of December 28, 2012, total compensation cost related to unvested stock options and ESPP rights issued to employees but not yet recognized was \$140 million and will be amortized on a straight-line basis over a weighted average service period of approximately 2.4 years.

For purposes of this footnote, references to RSUs include performance stock unit awards ( PSUs ). During the three and six months ended December 28, 2012, the Company recognized in expense \$12 million and \$25 million, respectively, related to the vesting of awards of RSUs compared to \$9 million and \$17 million in the respective prior-year periods. As of December 28, 2012, the aggregate unamortized fair value of all unvested RSUs was \$95 million, which will be recognized on a straight-line basis over a weighted average vesting period of approximately 1.6 years.

During the three and six months ended December 28, 2012, the Company recognized in expense \$4 million and \$16 million, respectively, related to adjustments to market value as well as the vesting of cash-settled stock appreciation rights ( SARs ). As of December 28, 2012, the Company had a total liability of \$33 million related to SARs included in accrued liabilities in the condensed consolidated balance sheet. As of December 28, 2012, total compensation cost related to unvested SARs issued to employees but not yet recognized was \$16 million and will be accrued on a straight-line basis over a weighted average service period of approximately 1.3 years.

*Stock Option Activity*

The following table summarizes activity under the Company's stock option plans (in millions, except per share amounts and remaining contractual lives):

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
<b>Options outstanding at June 29, 2012</b>	15.8	\$ 21.89		
Granted	3.0	43.10		
Exercised	(2.2)	16.18		
Canceled or expired	(0.1)	23.00		
<b>Options outstanding at September 28, 2012</b>	16.5	\$ 26.52		
Granted	0.1	37.04		
Exercised	(1.2)	18.56		
Canceled or expired	(0.1)	33.88		
<b>Options outstanding at December 28, 2012</b>	15.3	\$ 27.14	4.6	\$ 224
<b>Exercisable at December 28, 2012</b>	6.0	\$ 23.22	3.2	\$ 110
<b>Vested and expected to vest after December 28, 2012</b>	15.1	\$ 27.00	4.6	\$ 223

If an option has an exercise price that is less than the quoted price of the Company's common stock at the particular time, the aggregate intrinsic value of that option at that time is calculated based on the difference between the exercise price of the underlying options and the quoted price of

## Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

the Company's common stock at that time. As of December 28, 2012, the Company had options outstanding to purchase an aggregate of 12.3 million shares with an exercise price below the quoted price of the Company's stock on that date resulting in an aggregate intrinsic value of \$224 million at that date. During the three and six months ended December 28, 2012, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$25 million and \$79 million, respectively, determined as of the date of exercise, compared to \$3 million and \$8 million in the respective prior-year periods.

**Table of Contents***SARs Activity*

The share-based compensation liability for SARs is recognized for the portion of fair value for which service has been rendered at the reporting date. The share-based liability is remeasured at each reporting date, using a binomial option-pricing model, through the requisite service period. As of December 28, 2012, 1.4 million SARs were outstanding with a weighted average exercise price of \$7.82. There were no SARs granted and all other SARs activity was immaterial to the condensed consolidated financial statements for the three and six months ended December 28, 2012.

*Fair Value Disclosure Binomial Model*

The fair value of stock options granted is estimated using a binomial option-pricing model. The binomial model requires the input of highly subjective assumptions. The Company uses historical data to estimate exercise, employee termination, and expected stock price volatility within the binomial model. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The fair value of stock options granted was estimated using the following weighted average assumptions:

	Three Months Ended		Six Months Ended	
	Dec. 28, 2012	Dec. 30, 2011	Dec. 28, 2012	Dec. 30, 2011
Suboptimal exercise factor	1.92	1.80	1.90	1.81
Range of risk-free interest rates	0.16% to 1.18%	0.12% to 1.35%	0.16% to 1.18%	0.12% to 1.43%
Range of expected stock price volatility	0.42 to 0.52	0.45 to 0.55	0.42 to 0.53	0.41 to 0.55
Weighted average expected volatility	0.47	0.49	0.49	0.48
Post-vesting termination rate	2.41%	2.48%	2.09%	2.62%
Dividend yield	2.41%		2.58%	
Fair value	\$13.08	\$10.79	\$15.56	\$11.90

The weighted average expected term of the Company's stock options granted during the three and six months ended December 28, 2012 was 4.2 years and 4.0 years, respectively, compared to 4.9 years in both the respective prior-year periods.

*Fair Value Disclosure Black-Scholes-Merton Model*

The fair value of ESPP purchase rights issued is estimated at the date of grant of the purchase rights using the Black-Scholes-Merton option-pricing model. The Black-Scholes-Merton option-pricing model requires the input of highly subjective assumptions such as the expected stock price volatility and the expected period until options are exercised. Purchase rights under the current ESPP provisions are granted on either June 1st or December 1st. ESPP activity was immaterial to the condensed consolidated financial statements for the three and six months ended December 28, 2012 and December 30, 2011.

*RSU Activity*

The following table summarizes RSU activity (in millions, except weighted average grant date fair value):

	Number of Shares	Weighted Average Grant-Date Fair Value
<b>RSUs outstanding at June 29, 2012</b>	3.7	\$ 33.19
Granted	1.5	43.06
Vested	(0.5)	35.32
<b>RSUs outstanding at September 28, 2012</b>	4.7	\$ 36.12
Granted	0.1	35.56
Vested	(0.1)	30.18
<b>RSUs outstanding at December 28, 2012</b>	4.7	\$ 35.24



Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

<b>Expected to vest after December 28, 2012</b>	4.5	\$	35.24
---	-----	----	-------

**Table of Contents**

The fair value of each RSU is the market price of the Company's stock at the date of grant. RSUs are generally payable in an equal number of shares of the Company's common stock at the time of vesting of the units. The grant-date fair value of the shares underlying the RSU awards at the date of grant was \$3 million and \$68 million for the three and six months ended December 28, 2012, respectively. These amounts are being recognized to expense over the corresponding vesting periods. For purposes of valuing these awards, the Company has assumed a forfeiture rate of 3.4%, based on a historical analysis indicating forfeitures for these types of awards. The effect of the PSU activity was immaterial to the Company's condensed consolidated financial statements for the three and six months ended December 28, 2012.

*Dividends*

On September 13, 2012, the Company announced that its Board of Directors had authorized the adoption of a quarterly cash dividend policy. Under the cash dividend policy, holders of the Company's common stock will receive dividends when and as declared by the Company's Board of Directors. On December 3, 2012 and September 13, 2012, the Board of Directors declared a cash dividend of \$0.25 per share of the Company's common stock, which was paid on December 26, 2012 and October 15, 2012, respectively, to shareholders of record as of the close of business on December 14, 2012 and September 28, 2012, respectively. The Company may modify, suspend or cancel its cash dividend policy in any manner and at any time.

**10. Pensions and Other Post-retirement Benefit Plans**

The Company's principal pension and other post-retirement benefit plans are in Japan. All pension and other post-retirement benefit plans outside of the Company's Japanese plans were immaterial to the Company's condensed consolidated financial statements. The expected long-term rate of return on the Japanese plan assets is 3.5%.

The following table presents the unfunded status of the benefit obligations and Japanese plan assets as of December 28, 2012 and June 29, 2012 (in millions):

	Dec. 28, 2012	Jun. 29, 2012
Benefit obligation	\$ 270	\$ 286
Fair value of plan assets	(161)	(167)
<b>Unfunded status</b>	<b>\$ 109</b>	<b>\$ 119</b>

The following table presents the unfunded amounts as recognized on the Company's condensed consolidated balance sheets as of December 28, 2012 and June 29, 2012 (in millions):

	Dec. 28, 2012	Jun. 29, 2012
Current liabilities	\$ 3	\$ 3
Non-current liabilities	106	116
<b>Net amount recognized</b>	<b>\$ 109</b>	<b>\$ 119</b>

**Table of Contents**

The net periodic benefit cost of the Company's pension plans was not material to the condensed consolidated financial statements for the three and six months ended December 28, 2012. The Company's expected employer contribution for its Japanese defined benefit pension plans is \$14 million in fiscal 2013.

**11. HGST Acquisition**

On the Closing Date, the Company completed its acquisition (the Acquisition) of all the issued and outstanding paid-up share capital of HGST from Hitachi Ltd. (Hitachi). HGST is a developer and manufacturer of storage devices. As a result of the Acquisition, HGST became an indirect wholly owned subsidiary of the Company. The preliminary, aggregate purchase price of the Acquisition was approximately \$4.7 billion, which was paid on the Closing Date and funded with \$3.7 billion of existing cash and cash from new debt, as well as 25 million newly issued shares of the Company's common stock with a fair value of \$877 million. The fair value of the newly issued shares of the Company's common stock was determined based on the closing market price of the Company's shares of common stock on the date of the Acquisition, less a 10% discount for lack of marketability as the shares issued are subject to a restriction that limits their trade or transfer for one year from the Closing Date.

The total preliminary purchase price for HGST was approximately \$4.7 billion and was comprised of (in millions):

	<b>Mar. 8, 2012</b>
Acquisition of all issued and outstanding paid-up share capital of HGST	\$ 4,575
Fair value of stock options, restricted stock-based awards and SARs assumed	102
<b>Total</b>	<b>\$ 4,677</b>

The purchase price consideration remains subject to adjustment based on resolution of a post-closing assumed pension adjustment. The Company identified and recorded the assets acquired and liabilities assumed at their estimated fair values at the Closing Date, and allocated the remaining value of approximately \$1.8 billion to goodwill. The purchase price consideration originally included preliminary estimates of the working capital assets acquired and liabilities assumed. During the three months ended December 28, 2012, the Company finalized the post-closing adjustment for changes in the working capital of HGST which decreased the purchase price by \$37 million. The values assigned to certain acquired assets and liabilities are preliminary, are based on information available as of the date of this Quarterly Report on Form 10-Q, and may be adjusted as further information becomes available during the measurement period of up to 12 months from the date of the Acquisition. The primary areas of the preliminary purchase price allocation that are not yet finalized due to information that may become available subsequently and may result in changes in the values allocated to various assets and liabilities include contingencies and income taxes. Any changes in the fair values of the assets acquired and liabilities assumed during the measurement period may result in material adjustments to goodwill. The preliminary purchase price allocation was as follows (in millions):

	<b>Mar. 8, 2012</b>
<b>Tangible assets acquired and liabilities assumed:</b>	
Cash and cash equivalents	\$ 194
Accounts receivable	1,290
Inventories	721
Other current assets	219
Property, plant and equipment	1,813
Other non-current assets	103
Accounts payable	(841)
Accrued liabilities	(594)
Debt assumed	(585)
Pension and other post-retirement benefit liabilities	(130)
Other liabilities	(102)
Intangible assets	833
Goodwill	1,756

Total	\$ 4,677
-------	----------

**Table of Contents**

During the three months ended December 28, 2012, the Company recorded a \$37 million decrease in goodwill as a result of the completion of the post-closing adjustment for changes in the working capital of HGST. During the three months ended September 28, 2012, the Company recorded a \$31 million net decrease in goodwill, consisting of a \$32 million increase in deferred income taxes, offset by a \$1 million decrease in intangible assets. The adjustment to amortization expense as a result of these changes was not material to the Company's condensed consolidated financial statements.

*Toshiba Transactions*

In connection with the regulatory approval process, the Company announced on May 15, 2012 that it had closed a transaction with Toshiba to divest certain 3.5-inch hard drive assets and to purchase Toshiba Storage Device (Thailand) Company Limited, a wholly-owned subsidiary of Toshiba which manufactured hard drives prior to the recent Thailand flooding. The net impact of these two transactions was immaterial to the Company's condensed consolidated financial statements.

*Maintenance of Competitive Requirement*

In connection with the regulatory approval process of the Acquisition, the Company agreed to certain conditions required by the Ministry of Commerce of the People's Republic of China (MOFCOM), including adopting measures to maintain HGST as an independent competitor until MOFCOM agrees otherwise (with the minimum period being two years). The Company has worked closely with MOFCOM to finalize an operations plan that outlines in more detail the conditions of the competitive requirement.

**12. Employee Termination Benefits and Other Charges**

During the three and six months ended December 28, 2012, the Company incurred charges to realign its operations with anticipated market demand. Total charges of \$41 million and \$67 million, respectively, were classified as operating expenses and included in employee termination benefits and other charges in the condensed consolidated statements of income for the three and six months ended December 28, 2012. The following table summarizes the Company's employee termination benefits and other charges for the three and six months ended December 28, 2012 (in millions):

	Employee Termination Benefits	Impairment of Assets	Contract and Other Termination Costs	Total
<b>Accrual at June 29, 2012</b>	\$	\$	\$ 16	\$ 16
Charges	25		1	26
Cash payments	(22)		(1)	(23)
<b>Accrual at September 28, 2012</b>	\$ 3	\$	\$ 16	\$ 19
Charges	26	12	3	41
Cash payments	(13)		(11)	(24)
Non-cash charges	(3)	(12)		(15)
<b>Accrual at December 28, 2012</b>	\$ 13	\$	\$ 8	\$ 21

The employee termination benefits relate to headcount reductions at various worldwide locations. The impairment of assets relates to machinery and equipment and an intangible asset at various locations worldwide. The liabilities for employee termination benefits and contract and other termination costs are expected to be relieved by the fourth quarter of fiscal 2013.

**Table of Contents****13. Recent Accounting Pronouncements**

In June 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2011-05 Presentation of Comprehensive Income ( ASU 2011-05 ). The new standard requires that all non-owner changes in shareholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but continuous statements. If presented in two separate statements, the first statement should present total net income and its components followed immediately by a second statement of total other comprehensive income, its components and the total comprehensive income. In December 2011, the FASB deferred certain changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. The new standard is effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2011. The Company adopted this pronouncement in its first quarter of fiscal 2013. The adoption of ASU 2011-05 resulted in an additional financial statement which increases the prominence of items reported in other comprehensive income but did not have an impact on the Company's financial position or results of operations.

In September 2011, the FASB issued ASU 2011-08, Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment ( ASU 2011-08 ). The new standard permits an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test in accordance with Accounting Standards Codification 350-30, Intangibles-Goodwill and Other-General Intangibles Other than Goodwill. The new standard is effective for fiscal years beginning after December 15, 2011. The Company adopted this pronouncement in its first quarter of fiscal 2013. The adoption of ASU 2011-08 did not have a material impact to the Company's condensed consolidated financial statements in the first quarter of fiscal 2013.

**14. Subsequent Events***Voluntary Separation Program*

On January 23, 2013, the Company announced a voluntary separation program (the Program) for the U.S.-based employees of its WD subsidiary. The Program is intended to help realign the Company's cost structure with a softer demand environment. As the Company does not know the number or job levels of employees that will participate in the Program, at this time, the Company is unable to estimate the charges it will incur in connection with the Program, although it expects charges will consist of cash severance and other related termination benefits. The Company expects to complete the Program by the first quarter of fiscal 2014.

*American Taxpayer Relief Act of 2012*

On January 2, 2013, the American Taxpayer Relief Act of 2012 ( the Act ) was signed into law. One of the provisions of the Act provides a retroactive extension of the research and experimentation tax credit ( R&D credit ) through December 31, 2013, which had expired on December 31, 2011. The Company expects that it will recognize a tax benefit of between \$30 and \$40 million during the third quarter of fiscal 2013 as a result of the retroactive extension of the R&D credit.

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This information should be read in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included in this Quarterly Report on Form 10-Q, and the audited consolidated financial statements and notes thereto and Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in our Annual Report on Form 10-K for the year ended June 29, 2012.

Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters. As used herein, the terms we, us, our, the Company and WD refer to Western Digital Corporation and its subsidiaries.

## **Table of Contents**

### **Forward-Looking Statements**

*This document contains forward-looking statements within the meaning of the federal securities laws. Any statements that do not relate to historical or current facts or matters are forward-looking statements. You can identify some of the forward-looking statements by the use of forward-looking words, such as may, will, could, would, project, believe, anticipate, expect, estimate, continue, potential, plan, forecast, and the like, or the use of future tense. Statements concerning current conditions may also be forward-looking if they imply a continuation of current conditions. Examples of forward-looking statements include, but are not limited to, statements concerning:*

*expectations regarding industry demand and pricing in the March quarter and the ability of the industry to support this demand;*

*expectations concerning the anticipated benefits of our acquisition of Viviti Technologies Ltd., until recently known as Hitachi Global Storage Technologies Holdings Pte. Ltd.;*

*demand for hard drives and solid-state drives in the various markets and factors contributing to such demand;*

*our plans to continue to develop new products and expand into new storage markets and into emerging economic markets;*

*emergence of new storage markets for hard drives;*

*emergence of competing storage technologies;*

*our quarterly cash dividend policy;*

*our share repurchase plans;*

*our stock price volatility;*

*our belief regarding our compliance with environmental laws and regulations;*

*our belief regarding component availability;*

*expectations regarding the outcome of legal proceedings in which we are involved;*

*our beliefs regarding tax benefits and the timing of future payments, if any, relating to the unrecognized tax benefits, and the adequacy of our tax provisions;*

## Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

*contributions to our pension plans in fiscal 2013; and*

*our beliefs regarding the sufficiency of our cash and cash equivalents to meet our working capital, capital expenditure and other cash needs.*

*Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. You are urged to carefully review the disclosures we make concerning risks and other factors that may affect our business and operating results, including those made in Part II, Item 1A of this Quarterly Report on Form 10-Q, and any of those made in our other reports filed with the Securities and Exchange Commission (the "SEC"). You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this document. We do not intend, and undertake no obligation, to publish revised forward-looking statements to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events.*



## **Table of Contents**

### **Our Company**

We are an industry-leading developer and manufacturer of storage products that enable people to create, manage, experience and preserve digital content. We design and make storage devices, networking equipment and home entertainment products under the WD, HGST and G-Technology brands. We serve each of the primary markets addressing storage opportunities—enterprise and cloud data centers, client, consumer electronics, backup, the Internet and other emerging markets such as automotive and home and small office networking.

We operate our global business through two independent subsidiaries due to regulatory requirements—WD and HGST, both long-time innovators in the storage industry.

Our principal products today are hard drives, which use one or more rotating magnetic disks (magnetic media) to store and allow fast access to data. Hard drives are today's primary storage medium for digital content. Our hard drives are used in desktop and notebook computers, multiple types of data centers including corporate and cloud data centers, home entertainment equipment and stand-alone consumer storage devices. Our other products include solid-state drives, home entertainment and networking products and applications for smart phones and tablets.

### **Acquisition**

#### *Hitachi Global Storage Technologies Holdings Pte. Ltd. (HGST) Acquisition*

On March 8, 2012 (the Closing Date), we, through Western Digital Ireland (WDI), our indirect wholly owned subsidiary, completed the acquisition (the Acquisition) of all the issued and outstanding paid-up share capital of Viviti Technologies Ltd., until recently known as HGST, from Hitachi, Ltd. (Hitachi), pursuant to a Stock Purchase Agreement, dated March 7, 2011, among us, WDI, Hitachi and HGST. The Acquisition is intended over time, and subject to compliance with applicable regulatory conditions imposed on the Acquisition, to result in a more efficient and innovative customer-focused storage company. We do not expect to achieve significant operating expense synergies while the regulatory conditions are in effect.

The preliminary, aggregate purchase price of the Acquisition amounted to approximately \$4.7 billion and was subject to a post-closing adjustment for changes in the working capital of HGST and certain other payments and expenses. In the three months ended December 28, 2012, we finalized the post-closing adjustment for changes in the working capital of HGST and recorded a \$37 million decrease in the purchase price and goodwill. The purchase price consideration remains subject to adjustment based on resolution of a post-closing assumed pension adjustment.

#### *Toshiba Transactions*

In connection with the regulatory approval process of the Acquisition, we announced on May 15, 2012 that we had closed a transaction with Toshiba Corporation (Toshiba) to divest certain 3.5-inch hard drive assets and to purchase Toshiba Storage Device (Thailand) Company Limited, a wholly-owned subsidiary of Toshiba that manufactured hard drives prior to the recent Thailand flooding. The net impact of these two transactions was immaterial to our condensed consolidated financial statements.

#### *Maintenance of Competitive Requirement*

In connection with the regulatory approval process of the Acquisition, we agreed to certain conditions required by the Ministry of Commerce of the People's Republic of China (MOFCOM), including adopting measures to maintain HGST as an independent competitor until MOFCOM agrees otherwise (with the minimum period being two years). We have worked closely with MOFCOM to finalize an operations plan that outlines in more detail the conditions of the competitive requirement.

**Table of Contents****Second Quarter Overview**

In accordance with U.S. generally accepted accounting principles ( U.S. GAAP ), operating results for HGST prior to the date of the Acquisition are not included in our operating results, affecting our discussion of changes in our revenues and expenses for the periods prior to the Acquisition as compared to the periods after the Acquisition.

For the quarter ended December 28, 2012, we believe that overall hard drive industry shipments totaled approximately 136 million units, up 14% from the prior-year period as the prior-year period reflected the supply constraints across the hard drive industry brought about by the Thailand floods, and down 2% sequentially from the September quarter as a result of a continued soft industry demand driven by macroeconomic uncertainty, weak PC demand and inventory rebalancing by our customers.

The following table sets forth, for the periods presented, selected summary information from our condensed consolidated statements of income by dollars and percentage of net revenue (in millions, except percentages):

	Three Months Ended				Six Months Ended			
	Dec. 28, 2012		Dec. 30, 2011		Dec. 28, 2012		Dec. 30, 2011	
Net revenue	\$ 3,824	100.0%	\$ 1,995	100.0%	\$7,859	100.0%	\$ 4,689	100.0%
Gross margin	1,059	27.7	648	32.5	2,252	28.7	1,189	25.4
Total operating expenses	581	15.2	486	24.4	1,182	15.0	768	16.4
Operating income	478	12.5	162	8.1	1,070	13.6	421	9.0
Net income	335	8.8	145	7.3	854	10.9	384	8.2

The following is a summary of our financial performance for the second quarter of 2013:

Consolidated net revenue totaled \$3.8 billion.

49% of our hard drive revenue was derived from non-compute and enterprise markets, which include CE products, enterprise applications, and branded products, as compared to 33% in the prior-year period.

Hard drive unit shipments increased by 108% from the prior-year period to 59.2 million units.

Gross margin decreased to 27.7%, compared to 32.5% for the prior-year period.

Operating income, including \$41 million of employee termination benefits and other charges, was \$478 million, an increase of \$316 million from the prior-year period.

We generated \$772 million in cash flow from operations in the second quarter of fiscal 2013, and we ended the quarter with \$3.8 billion in cash and cash equivalents.

For the quarter ending March 29, 2013, we expect overall hard drive industry shipments to remain flat to slightly down when compared with the December quarter. In addition, we expect our revenue in the March quarter to decrease slightly from the December quarter reflecting the current demand environment, the seasonal change in business mix and the conclusion of our 3.5-inch contract manufacturing arrangement with Toshiba.

**Table of Contents****Results of Operations****Net Revenue**

(in millions, except percentages and average selling price)	Three Months Ended			Six Months Ended		
	Dec. 28, 2012	Dec. 30, 2011	Percentage Change	Dec. 28, 2012	Dec. 30, 2011	Percentage Change
Net revenue	\$ 3,824	\$ 1,995	92%	\$ 7,859	\$ 4,689	68%
Average selling price (per unit)*	\$ 62	\$ 69	(10)%	\$ 62	\$ 54	15%
<b>Revenues by Geography (%)</b>						
Americas	27%	22%		25%	20%	
Europe, Middle East and Africa	23	21		20	22	
Asia	50	57		55	58	
<b>Revenues by Channel (%)</b>						
OEM	61%	59%		62%	56%	
Distributors	24	25		24	27	
Retailers	15	16		14	17	
<b>Unit Shipments*</b>						
Compute	39.0	21.2		81.7	62.4	
Non-compute	13.6	5.6		27.4	19.8	
Enterprise	6.6	1.7		12.6	4.1	
Total units shipped	59.2	28.5	108%	121.7	86.3	41%

\* Based on sales of hard drive units only.

For the quarter ended December 28, 2012, net revenue was \$3.8 billion, an increase of 92% from the prior-year period. Total hard drive shipments increased to 59.2 million units for the quarter ended December 28, 2012 as compared to 28.5 million units in the prior-year period. For the six months ended December 28, 2012, net revenue was \$7.9 billion, an increase of 68% from the prior-year period. Total hard drive shipments increased to 121.7 million units for the six months ended December 28, 2012, as compared to 86.3 million units for the prior-year period. These increases resulted primarily from the contribution of the acquired operations of HGST. For the quarter ended December 28, 2012, average selling price ( ASP ) decreased by \$7 from the prior-year period, from \$69 to \$62. This decrease in ASP was a result of a higher ASP in the prior-year period due to the supply constraints across the hard drive industry brought about by the Thailand floods. For the six months ended December 28, 2012, ASP increased by \$8, from \$54 to \$62. This increase in ASP reflects a lower ASP in the prior-year period preceding the supply constraints across the hard drive industry brought about by the Thailand floods which subsequently increased ASP.

Changes in revenue by geography and channel generally reflect normal fluctuations in market demand and competitive dynamics. However, in the three and six months ended December 28, 2012, our revenue by channel mix reflects a slightly heavier weighting toward OEM as result of the Acquisition. In addition, for both the three and six months ended December 28, 2012, no customer accounted for 10% or more of our net revenue.

In accordance with standard industry practice, we have sales incentive and marketing programs that provide customers with price protection and other incentives or reimbursements that are recorded as a reduction to gross revenue. For the three and six months ended December 28, 2012, these programs represented 9% and 8% of gross revenues, respectively, compared to 1% and 5% in the respective prior-year period. These amounts generally vary according to several factors, including industry conditions, seasonal demand, competitor actions, channel mix and overall availability of product. However, in the respective prior-year periods, sales incentive and marketing programs were significantly reduced due to the supply constraints across the hard drive industry brought about by the Thailand floods.



**Table of Contents****Gross Margin**

(in millions, except percentages)	Three Months Ended			Six Months Ended		
	Dec. 28, 2012	Dec. 30, 2011	Percentage Change	Dec. 28, 2012	Dec. 30, 2011	Percentage Change
Net revenue	\$ 3,824	\$ 1,995	92%	\$ 7,859	\$ 4,689	68%
Gross margin	1,059	648	63%	2,252	1,189	89%
Gross margin %	27.7%	32.5%		28.7%	25.4%	

For the three months ended December 28, 2012, gross margin as a percentage of revenue decreased to 27.7% as compared to 32.5% for the prior-year period. This decrease was a result of a higher gross margin in the prior-year period as a result of increased ASPs due to the supply constraints across the hard drive industry brought about by the Thailand floods. For the six months ended December 28, 2012, gross margin as a percentage of revenue increased to 28.7% as compared to 25.4% for the prior-year period. This increase was primarily a result of product mix, offset by \$38 million for amortization of intangibles related to the Acquisition.

**Operating Expenses**

(in millions, except percentages)	Three Months Ended			Six Months Ended		
	Dec. 28, 2012	Dec. 30, 2011	Percentage Change	Dec. 28, 2012	Dec. 30, 2011	Percentage Change
R&D expense	\$ 378	\$ 191	98%	\$ 774	\$ 384	102%
SG&A expense	162	96	69%	341	185	84%
Employee termination benefits and other charges	41			67		
Charges related to flooding		199			199	
Total operating expenses	\$ 581	\$ 486		\$ 1,182	\$ 768	

Research and development ( R&D ) expense was \$378 million for the three months ended December 28, 2012, an increase of \$187 million from the prior-year period. For the six months ended December 28, 2012, R&D expense was \$774 million, an increase of \$390 million from the prior-year period. These increases were primarily due to the inclusion of HGST's R&D expense as result of the Acquisition, as well as the continued investment in product development to support new programs. As a percentage of net revenue, R&D expense increased to 9.9% and 9.8% in the three and six months ended December 28, 2012, respectively, compared to 9.6% and 8.2% in the respective prior-year periods.

Selling, general and administrative ( SG&A ) expense was \$162 million for the three months ended December 28, 2012, an increase of \$66 million over the prior-year period. For the six months ended December 28, 2012, SG&A expense was \$341 million, an increase of \$156 million over the prior-year period. These increases were primarily due to the inclusion of HGST's SG&A expense and \$11 million for amortization of intangibles as a result of the Acquisition, as well as the expansion of sales and marketing to support new products and growing markets. SG&A expense as a percentage of net revenue decreased to 4.2% and increased to 4.3% in the three and six months ended December 28, 2012, respectively, compared to 4.8% and 3.9% in the respective prior-year periods.

In the second quarter of fiscal 2013, we recorded charges of \$41 million consisting of \$26 million of employee termination benefits, \$12 million of asset impairments and \$3 million of contract and other termination costs in order to realign our operations with anticipated market demand. During the six months ended December 28, 2012, we recorded charges of \$67 million consisting of \$51 million of employee termination benefits, \$12 million of asset impairments and \$4 million of contract and other termination costs in order to realign our operations with anticipated market demand.

During the three months ended December 30, 2011, we recorded \$199 million of charges related to the Thailand flooding, including \$109 million of fixed asset impairments, \$39 million of recovery charges, \$28 million of write-downs of damaged inventory and \$23 million in wage continuation during the shutdown period of our facilities.



---

**Table of Contents***Voluntary Separation Program*

On January 23, 2013, we announced a voluntary separation program (the Program) for the U.S.-based employees of our WD subsidiary. The Program is intended to help realign our cost structure with a softer demand environment. As we do not know the number or job levels of employees that will participate in the Program, at this time, we are unable to estimate the charges we will incur in connection with the Program, although we expect the charges will consist of cash severance and other related termination benefits. We expect to complete the Program by the first quarter of fiscal 2014.

*Other Income (Expense)*

Interest income did not change for the three months ended December 28, 2012 compared to the prior-year period. Interest income for the six months ended December 28, 2012 decreased \$1 million as compared to the prior-year period primarily due to a lower average daily invested cash balance for the period. Interest and other expense for the three and six months ended December 28, 2012 increased \$8 million and \$20 million, respectively, as compared to the prior-year periods primarily due to interest on an increased debt balance.

*Income Tax Provision*

Our income tax provision for the three months ended December 28, 2012 was \$133 million as compared to \$15 million in the prior-year period. Our income tax provision for the six months ended December 28, 2012 was \$192 million as compared to \$34 million in the prior-year period. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia, the Philippines, Singapore and Thailand that expire at various dates from 2013 through 2025, the current year generation of income tax credits and the effect of California Proposition 39 which was passed in November 2012.

On November 6, 2012, California voters approved California Proposition 39, which affects California state income tax apportionment for most multi-state taxpayers for tax years beginning on or after January 1, 2013. This proposition would reduce our future income apportioned to California, making it less likely for us to realize certain California deferred tax assets. As a result, we recorded an \$88 million charge to reduce our previously recognized California deferred tax assets as of December 28, 2012.

In the three months ended December 28, 2012, we did not record a change in our liability for unrecognized tax benefits. In the six months ended December 28, 2012, we recorded a net decrease of \$4 million in our liability for unrecognized tax benefits. As of December 28, 2012, we had a recorded liability for unrecognized tax benefits of approximately \$276 million. Interest and penalties recognized on such amounts were not material.

The Internal Revenue Service (IRS) has completed its field examination of the federal income tax returns for fiscal years 2006 and 2007 for us. We have also received Revenue Agent Reports (RARs) from the IRS that seek adjustments to income before income taxes of approximately \$970 million in connection with unresolved issues related primarily to transfer pricing and certain other intercompany transactions. We disagree with the proposed adjustments. In May 2011, we filed a protest with the IRS Appeals Office regarding the proposed adjustments. Meetings with the Appeals Office began in February 2012. In January 2012, the IRS commenced an examination of our fiscal years 2008 and 2009 and of the 2007 fiscal period ended September 5, 2007 of Komag, Incorporated (Komag), which we acquired on September 5, 2007.

We believe that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in our tax audits are resolved in a manner not consistent with management's expectations, we could be required to adjust our provision for income taxes in the period such resolution occurs. As of December 28, 2012, we believe it is reasonably possible that our liability for unrecognized tax benefits will decrease by \$54 million within the next twelve months. Any significant change in the amount of our liability for unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of our uncertain tax positions.

## Table of Contents

On January 2, 2013, the American Taxpayer Relief Act of 2012 ( the Act ) was signed into law. One of the provisions of the Act provides a retroactive extension of the research and experimentation tax credit ( R&D credit ) through December 31, 2013, which had expired on December 31, 2011. We expect that we will recognize a tax benefit of between \$30 and \$40 million during the third quarter of fiscal 2013 as a result of the retroactive extension of the R&D credit.

### Arbitration Award

As disclosed above in Part I, Item 1, Note 5 in the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q, on November 18, 2011, a sole arbitrator ruled against us in an arbitration in Minnesota. The arbitration involves claims brought by Seagate Technology LLC ( Seagate ) against us and a now former employee, alleging misappropriation of confidential information and trade secrets. The arbitrator issued an interim award against us in the amount of \$525 million plus pre-award interest. On January 23, 2012, the arbitrator issued a final award adding pre-award interest in the amount of \$105.4 million, for a total award of \$630.4 million. On January 23, 2012, we filed a petition in the District Court of Hennepin County, Minnesota to have the final arbitration award vacated, and a hearing on the petition to vacate was held on March 1, 2012. On October 12, 2012, the District Court of Hennepin County, Minnesota vacated, in full, the \$630.4 million final arbitration award and ordered that a rehearing be held concerning certain trade secret claims before a new arbitrator. On October 30, 2012, Seagate initiated an appeal of the Court's decision with the Minnesota Court of Appeals. We strongly believe that the Court's decision was correct and intend to vigorously oppose Seagate's efforts to appeal the decision. Nevertheless, we cannot be certain we will be successful in a new arbitration of the trade secret claims or in Seagate's efforts to appeal the decision. In the event Seagate is successful in its efforts to appeal the Court's decision, the original arbitration award could be reinstated, and payment of the award, including interest (which would apply at the statutory rate of 10% from the date of the original arbitration award), would adversely affect our financial condition, results of operations and cash flows.

### Liquidity and Capital Resources

We ended the second quarter of fiscal 2013 with total cash and cash equivalents of \$3.8 billion. The following table summarizes our statements of cash flows (in millions):

	Six Months Ended	
	Dec. 28, 2012	Dec. 30, 2011
Net cash flow provided by (used in):		
Operating activities	\$ 1,708	\$ 730
Investing activities	(670)	(253)
Financing activities	(430)	(43)
Net increase in cash and cash equivalents	\$ 608	\$ 434

Our investment policy is to manage our investment portfolio to preserve principal and liquidity while maximizing return through the full investment of available funds. In connection with our Acquisition, we entered into a five-year credit agreement (the Credit Facility ), which provides for a \$500 million revolving credit facility. In addition, we may elect to expand the Credit Facility by up to an additional \$500 million if existing or new lenders provide additional term or revolving commitments. We believe our current cash, cash equivalents and cash generated from operations as well as our available credit facilities will be sufficient to meet our working capital, debt, dividend, stock repurchase and capital expenditure needs for at least the next twelve months. Our ability to sustain our working capital position is subject to a number of risks that we discuss in Part II, Item 1A of this Quarterly Report on Form 10-Q.

A total of \$1.4 billion and \$1.7 billion of our cash and cash equivalents was held outside of the United States at December 28, 2012 and June 29, 2012, respectively. Substantially all of the amounts held outside of the United States are intended to be indefinitely reinvested in foreign operations. On September 13, 2012, our Board of Directors approved a capital allocation plan which includes repurchases of our common stock and the adoption of a quarterly cash dividend policy. Our current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations or capital allocation plan for at least the next twelve months. In the event funds from foreign operations are needed in the United States, any repatriation could result in the accrual and payment of additional U.S. income tax.





**Table of Contents****Operating Activities**

Net cash provided by operating activities was \$1.7 billion during the six months ended December 28, 2012. Cash flow from operating activities consists of net income, adjusted for non-cash charges, plus or minus working capital changes. This represents our principal source of cash. Net cash provided by working capital changes was \$78 million for the six months ended December 28, 2012 as compared to net cash used to fund working capital changes of \$120 million in the prior-year period.

Our working capital requirements primarily depend on the effective management of our cash conversion cycle, which measures how quickly we can convert our products into cash through sales. The cash conversion cycles were as follows:

	<b>Three Months Ended</b>	
	<b>Dec. 28, 2012</b>	<b>Dec. 30, 2011</b>
Days sales outstanding	<b>41</b>	<b>34</b>
Days in inventory	<b>40</b>	<b>31</b>
Days payables outstanding	<b>(72)</b>	<b>(60)</b>
Cash conversion cycle	<b>9</b>	<b>5</b>

For the three months ended December 28, 2012, our average days sales outstanding ( DSOs ) increased by 7 days, days in inventory ( DIOs ) increased by 9 days, and days payable outstanding ( DPOs ) increased by 12 days compared to the prior year period. Changes in average DSOs and DIOs are generally related to linearity of shipments and the timing of inventory builds, respectively. In addition, the increase in DIOs was also due to a change in product mix as a result of the Acquisition. Changes in DPOs are generally related to production volume and the timing of purchases during the period. In the prior-year period, DSOs and DPOs were lower as a result of the acceleration of cash payments from our customers and to our vendors in order to increase liquidity in the supply chain during the Thailand flood recovery period. From time to time, we modify the timing of payments to our vendors. We make modifications primarily to manage our vendor relationships and to manage our cash flows, including our cash balances. Generally, we make the payment modifications through negotiations with our vendors or by granting to, or receiving from, our vendors payment term accommodations.

**Investing Activities**

Cash used in investing activities for the six months ended December 28, 2012 was \$670 million as compared to \$253 million for the prior-year period. For the six months ended December 28, 2012, cash used in investing activities consisted of \$628 million of capital expenditures, \$27 million related to acquisitions, net of cash acquired, and \$15 million related to the purchase of an investment, compared to \$253 million of capital expenditures for the prior-year period. The increase in capital expenditures primarily relates to the inclusion of HGST's activities and flood-related recovery capital spending.

Our cash equivalents are invested in highly liquid money market funds that are invested in U.S. Treasury securities. We also have \$14 million of auction-rate securities, which are classified as available-for-sale securities.

**Financing Activities**

Net cash used in financing activities for the six months ended December 28, 2012 was \$430 million as compared to \$43 million in the prior-year period. Net cash used in financing activities for the six months ended December 28, 2012 consisted of \$364 million used to repurchase shares of our common stock, \$121 million used to pay dividends and \$58 million used to repay long-term debt, offset by a net \$113 million provided by employee stock plans. Net cash used in financing activities for the six months ended December 30, 2011 consisted of \$63 million used to repay long-term debt offset by a net \$20 million provided by employee stock plans.

---

**Table of Contents*****Off-Balance Sheet Arrangements***

Other than facility lease commitments incurred in the normal course of business and certain indemnification provisions (see *Contractual Obligations and Commitments* below), we do not have any off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not included in our unaudited condensed consolidated financial statements. Additionally, we do not have an interest in, or relationships with, any special-purpose entities.

***Contractual Obligations and Commitments***

*Long-Term Debt* On March 8, 2012, in connection with the Acquisition, WDI and WDT (collectively, the *Borrowers*) entered into the Credit Facility that provides for \$2.8 billion of unsecured loan facilities, consisting of a \$2.3 billion term loan facility and a \$500 million revolving credit facility. In addition, the Borrowers may elect to expand the Credit Facility by up to an additional \$500 million if existing or new lenders provide additional term or revolving commitments. As of December 28, 2012, the outstanding balance of the term loan facility was \$2.1 billion. We are required to make principal payments on the term loan facility totaling \$230 million a year for fiscal 2013 through fiscal 2016, and the remaining \$1.3 billion balance (subject to adjustment to reflect prepayments or an increase to its term loan facility) due and payable in full in fiscal 2017 on March 8, 2017. As of December 28, 2012, \$500 million was available for future borrowings on the revolving credit facility. See Part I, Item 1, Note 4 in the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

The Credit Facility requires us to comply with a leverage ratio and an interest coverage ratio calculated on a consolidated basis for us and our subsidiaries. In addition, the Credit Facility contains customary covenants, including covenants that limit or restrict, subject to certain exceptions, our ability to incur liens, incur indebtedness, make certain restricted payments, merge, consolidate or dispose of substantially all of our assets, enter into certain speculative hedging arrangements and make any material change in the nature of our business. Upon the occurrence of an event of default under the Credit Facility, the administrative agent at the request, or with the consent, of the Required Lenders (as defined in the Credit Facility) may cease making loans, terminate the Credit Facility and declare all amounts outstanding to be immediately due and payable, require the cash collateralization of letters of credit and/or exercise all other rights and remedies available to it, the lenders and the letter of credit issuer. The Credit Facility specifies a number of events of default (some of which are subject to applicable grace or cure periods), including, among other things, non-payment defaults, covenant defaults, cross-defaults to other material indebtedness, bankruptcy and insolvency defaults, material judgment defaults and a change of control default. As of December 28, 2012, we were in compliance with all covenants under the Credit Facility.

*Purchase Orders* In the normal course of business, we enter into purchase orders with suppliers for the purchase of hard drive components used to manufacture our products. These purchase orders generally cover forecasted component supplies needed for production during the next quarter, are recorded as a liability upon receipt of the components, and generally may be changed or canceled at any time prior to shipment of the components. We also enter into purchase orders with suppliers for capital equipment that are recorded as a liability upon receipt of the equipment. Our ability to change or cancel a capital equipment purchase order without penalty depends on the nature of the equipment being ordered. In some cases, we may be obligated to pay for certain costs related to changes to, or cancellation of, a purchase order, such as costs incurred for raw materials or work in process of components or capital equipment.

We have entered into long-term purchase agreements with various component suppliers, containing minimum quantity requirements. However, the dollar amount of the purchases may depend on the specific products ordered, achievement of pre-defined quantity or quality specifications or future price negotiations. We have also entered into long-term purchase agreements with various component suppliers that carry fixed volumes and pricing which obligate us to make certain future purchases, contingent on certain conditions of performance, quality and technology of the vendor's components.

We enter into, from time to time, other long-term purchase agreements for components with certain vendors. Generally, future purchases under these agreements are not fixed and determinable as they depend on our overall unit volume requirements and are contingent upon the prices, technology and quality of the supplier's products remaining competitive.

**Table of Contents**

See Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Contractual Obligations and Commitments in our Annual Report on Form 10-K for the year ended June 29, 2012, for further discussion of our purchase orders and purchase agreements and the associated dollar amounts. See Part II, Item 1A of this Quarterly Report on Form 10-Q for a discussion of the risks associated with these commitments.

*Foreign Exchange Contracts* We purchase short-term, foreign exchange contracts to hedge the impact of foreign currency fluctuations on certain underlying assets, revenue, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. See Part I, Item 3, of this Quarterly Report on Form 10-Q under the heading Disclosure About Foreign Currency Risk, for a description of our current foreign exchange contract commitments and Part I, Item 1, Note 8 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

*Indemnifications* In the ordinary course of business, we may provide indemnifications of varying scope and terms to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of our breach of agreements, products or services to be provided by us, or from intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with our directors and certain of our officers that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. We maintain director and officer insurance, which may cover certain liabilities arising from our obligation to indemnify our directors and officers in certain circumstances.

It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, we have not incurred material costs as a result of obligations under these agreements.

*Unrecognized Tax Benefits* As of December 28, 2012, the cash portion of our total recorded liability for unrecognized tax benefits was \$276 million. We estimate the timing of the future payments of these liabilities to be within the next one to five years. See Part I, Item 1, Note 6 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q for information regarding our total tax liability for unrecognized tax benefits.

*Stock Repurchase Program* On May 21, 2012, we announced that our Board of Directors authorized \$1.5 billion for the repurchase of our common stock through May 18, 2017. On September 13, 2012, we announced that the Board of Directors authorized an additional \$1.5 billion for the repurchase of our common stock and the extension of our stock repurchase program until September 13, 2017. We repurchased 4.2 million and 9.4 million shares for a total cost of \$146 million and \$364 million during the three and six months ended December 28, 2012, respectively. The remaining amount available to be purchased under our stock repurchase program as of December 28, 2012 was \$2.4 billion. Subsequent to December 28, 2012 through January 31, 2013, we repurchased an additional 3.6 million shares for a total cost of \$166 million. We may continue to repurchase our stock as we deem appropriate and market conditions allow. Repurchases under our stock repurchase program may be made in the open market or in privately negotiated transactions and may be made under a Rule 10b5-1 plan.

*Cash Dividend Policy* On September 13, 2012, we announced that our Board of Directors had authorized the adoption of a quarterly cash dividend policy. Under the cash dividend policy, holders of our common stock receive dividends when and as declared by our Board of Directors. On December 3, 2012 and September 13, 2012, our Board of Directors declared a cash dividend of \$0.25 per share of our common stock, which was paid on December 26, 2012 and October 15, 2012, respectively, to our shareholders of record as of the close of business on December 14, 2012 and September 28, 2012, respectively. We may modify, suspend or cancel our cash dividend policy in any manner and at any time.

---

**Table of Contents****Critical Accounting Policies and Estimates**

We have prepared the unaudited condensed consolidated financial statements in accordance with U.S. GAAP. The preparation of the financial statements requires the use of judgments and estimates that affect the reported amounts of revenues, expenses, assets, liabilities and shareholders equity. We have adopted accounting policies and practices that are generally accepted in the industry in which we operate. We believe the following are our most critical accounting policies that affect significant areas and involve judgment and estimates made by us. If these estimates differ significantly from actual results, the impact to the consolidated financial statements may be material.

***Revenue and Accounts Receivable***

In accordance with standard industry practice, we provide distributors and retailers (collectively referred to as resellers ) with limited price protection for inventories held by resellers at the time of published list price reductions, and we provide resellers and OEMs with other sales incentive programs. At the time we recognize revenue to resellers and OEMs, we record a reduction of revenue for estimated price protection until the resellers sell such inventory to their customers and we also record a reduction of revenue for the other programs in effect. We base these adjustments on several factors including anticipated price decreases during the reseller holding period, resellers' sell-through and inventory levels, estimated amounts to be reimbursed to qualifying customers, historical pricing information and customer claim processing. If customer demand for hard drives or market conditions differs from our expectations, our operating results could be materially affected. We also have programs under which we reimburse qualified distributors and retailers for certain marketing expenditures, which are recorded as a reduction of revenue. These amounts generally vary according to several factors including industry conditions, seasonal demand, competitor actions, channel mix and overall availability of product. Generally, total sales incentive and marketing programs range from 7% to 11% of gross revenues per quarter. For the three months ended December 28, 2012, sales incentive and marketing programs were 9% of gross revenues. Changes in future customer demand and market conditions may require us to adjust our incentive programs as a percentage of gross revenue from the current range. Adjustments to revenues due to changes in accruals for these programs related to revenues reported in prior periods have averaged 0.8% of quarterly gross revenue since the first quarter of fiscal 2012. Customer sales incentive and marketing programs are recorded as a reduction of revenue.

We record an allowance for doubtful accounts by analyzing specific customer accounts and assessing the risk of loss based on insolvency, disputes or other collection issues. In addition, we routinely analyze the different receivable aging categories and establish reserves based on a combination of past due receivables and expected future losses based primarily on our historical levels of bad debt losses. If the financial condition of a significant customer deteriorates resulting in its inability to pay its accounts when due, or if our overall loss history changes significantly, an adjustment in our allowance for doubtful accounts would be required, which could materially affect operating results.

We establish provisions against revenue and cost of revenue for sales returns in the same period that the related revenue is recognized. We base these provisions on existing product return notifications. If actual sales returns exceed expectations, an increase in the sales return accrual would be required, which could materially affect operating results.

***Warranty***

We record an accrual for estimated warranty costs when revenue is recognized. We generally warrant our products for a period of one to five years. Our warranty provision considers estimated product failure rates and trends, estimated replacement costs, estimated repair costs which include scrap costs, and estimated costs for customer compensatory claims related to product quality issues, if any. We use a statistical warranty tracking model to help prepare our estimates and assist us in exercising judgment in determining the underlying estimates. Our statistical tracking model captures specific detail on hard drive reliability, such as factory test data, historical field return rates, and costs to repair by product type. Our judgment is subject to a greater degree of subjectivity with respect to newly introduced products because of limited field experience with those products upon which to base our warranty estimates. We review our warranty accrual quarterly for products shipped in prior periods and which are still under warranty. Any changes in the estimates underlying the accrual may result in adjustments that impact current period gross margin and income. Such changes are generally a result of differences between forecasted and actual return rate experience and costs to repair. If actual product return trends, costs to repair returned products or costs of customer compensatory claims differ significantly from our estimates, our future results of operations could be materially affected. For a summary of historical changes in estimates related to pre-existing warranty provisions, refer to Part I, Item 1, Note 2 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

## **Table of Contents**

### ***Inventory***

We value inventories at the lower of cost (first-in, first-out and weighted average methods) or net realizable value. We use the first-in, first-out ( FIFO ) method to value the cost of the majority of our inventories, while we use the weighted average method to value precious metal inventories. Weighted average cost is calculated based upon the cost of precious metals at the time they are received by us. We have determined that it is not practicable to assign specific costs to individual units of precious metals and, as such, we relieve our precious metals inventory based on the weighted average cost of the inventory at the time the inventory is used in production. The weighted average method of valuing precious metals does not materially differ from a FIFO method. We record inventory write-downs for the valuation of inventory at the lower of cost or net realizable value by analyzing market conditions and estimates of future sales prices as compared to inventory costs and inventory balances.

We evaluate inventory balances for excess quantities and obsolescence on a regular basis by analyzing estimated demand, inventory on hand, sales levels and other information, and reduce inventory balances to net realizable value for excess and obsolete inventory based on this analysis. Unanticipated changes in technology or customer demand could result in a decrease in demand for one or more of our products, which may require a write down of inventory that could materially affect operating results.

### ***Litigation and Other Contingencies***

When we become aware of a claim or potential claim, we assess the likelihood of any loss or exposure. We disclose information regarding each material claim where the likelihood of a loss contingency is probable or reasonably possible. If a loss contingency is probable and the amount of the loss can be reasonably estimated, we record an accrual for the loss. In such cases, there may be an exposure to potential loss in excess of the amount accrued. Where a loss is not probable but is reasonably possible or where a loss in excess of the amount accrued is reasonably possible, we disclose an estimate of the amount of the loss or range of possible losses for the claim if a reasonable estimate can be made, unless the amount of such reasonably possible losses is not material to our financial position, results of operations or cash flows. The ability to predict the ultimate outcome of such matters involves judgments, estimates and inherent uncertainties. The actual outcome of such matters could differ materially from management's estimates. Refer to Part I, Item 1, Note 5 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

### ***Income Taxes***

We account for income taxes under the asset and liability method, which provides that deferred tax assets and liabilities be recognized for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities and expected benefits of utilizing net operating loss and tax credit carryforwards. We record a valuation allowance when it is more likely than not that the deferred tax assets will not be realized. Each quarter, we evaluate the need for a valuation allowance for our deferred tax assets and we adjust the valuation allowance so that we record net deferred tax assets only to the extent that we conclude it is more likely than not that these deferred tax assets will be realized.

We recognize liabilities for uncertain tax positions based on a two-step process. To the extent a tax position does not meet a more-likely-than-not level of certainty, no benefit is recognized in the financial statements. If a position meets the more-likely-than-not level of certainty, it is recognized in the financial statements at the largest amount that has a greater than 50% likelihood of being realized upon ultimate settlement. Interest and penalties related to unrecognized tax benefits are recognized on liabilities recorded for uncertain tax positions and are recorded in our provision for income taxes. The actual liability for unrealized tax benefits in any such contingency may be materially different from our estimates, which could result in the need to record additional liabilities for unrecognized tax benefits or potentially adjust previously-recorded liabilities for unrealized tax benefits and materially affect our operating results.

---

**Table of Contents*****Stock-based Compensation***

We account for all stock-based compensation at fair value. Stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. The fair values of all stock options and stock appreciation rights granted are estimated using a binomial model, and the fair values of all Employee Stock Purchase Plan purchase rights are estimated using the Black-Scholes-Merton option-pricing model. We account for SARs as liability awards based upon our intention to settle such awards in cash. The SARs liability is recognized for that portion of fair value for the service period rendered at the reporting date. The share-based liability is remeasured at each reporting date through the requisite service period. Both the binomial and the Black-Scholes-Merton models require the input of highly subjective assumptions. We are required to use judgment in estimating the amount of stock-based awards that are expected to be forfeited. If actual forfeitures differ significantly from the original estimate, stock-based compensation expense and our results of operations could be materially affected.

***Goodwill and Other Long-Lived Assets***

The fair value of assets acquired and liabilities assumed in a business acquisition are recognized at the acquisition date, with amounts exceeding the fair values being recognized as goodwill. Goodwill is not amortized. Instead, it is tested for impairment on an annual basis or more frequently whenever events or changes in circumstances indicate that goodwill may be impaired. We first use qualitative factors to determine whether goodwill is more likely than not impaired. If we conclude from the qualitative assessment that goodwill is more likely than not impaired, we follow a two-step approach to quantify the impairment.

We are required to use judgment when applying the goodwill impairment test, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. In addition, the estimates used to determine the fair value of each reporting unit may change based on results of operations, macroeconomic conditions or other factors. Changes in these estimates could materially affect our assessment of the fair value and goodwill impairment for each reporting unit.

Other intangible assets consist primarily of technology acquired in business combinations. Acquired intangibles are amortized on a straight-line basis over their respective estimated useful lives. Long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If impairment is indicated, the impairment is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets.

***Recent Accounting Pronouncements***

For a description of recently issued and adopted accounting pronouncements, including the respective dates of adoption and expected effects on our results of operations and financial condition, refer to Part I, Item I, Note 13 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q, which is incorporated herein by reference.

**Item 3. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK*****Disclosure About Foreign Currency Risk**

Although the majority of our transactions are in U.S. dollars, some transactions are based in various foreign currencies. We purchase short-term, foreign exchange contracts to hedge the impact of foreign currency exchange fluctuations on certain underlying assets, revenue, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedge transactions is to minimize the impact of foreign currency fluctuations on our results of operations. The contract maturity dates do not exceed 12 months. We do not purchase foreign exchange contracts for trading purposes. Currently, we focus on hedging our foreign currency risk related to the British Pound Sterling, Euro, Japanese Yen, Malaysian Ringgit, Philippine Peso, Singapore Dollar and Thai Baht. See Part I, Item 1, Note 8 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

**Table of Contents**

As of December 28, 2012, we had outstanding the following purchased foreign exchange contracts (in millions, except weighted average contract rate):

	Contract Amount	Weighted Average Contract Rate*	Unrealized Gains
<b>Foreign exchange contracts:</b>			
<b>Cash flow hedges:</b>			
Malaysian Ringgit	\$ 200	3.14	\$ 2
Singapore Dollar	\$ 15	1.23	
Thai Baht	\$ 478	31.46	\$ 8
<b>Fair value hedges:</b>			
British Pound Sterling	\$ 1	0.62	
Euro	\$ 7	0.76	
Japanese Yen	\$ 55	81.03	
Philippine Peso	\$ 3	40.95	
Singapore Dollar	\$ 4	1.22	
Thai Baht	\$ 140	30.91	

\* Expressed in units of foreign currency per U.S. dollar.

During the three and six months ended December 28, 2012, total net realized transaction and foreign exchange contract currency gains and losses were not material to the condensed consolidated financial statements.

**Disclosure About Other Market Risks***Variable Interest Rate Risk*

Borrowings under the Credit Facility bear interest at a rate equal to, at the option of the applicable Borrower, either (a) a LIBOR rate determined by reference to the British Bankers Association LIBOR Rate for the interest period relevant to such borrowing, subject to certain exceptions (the Eurodollar Rate ) or (b) a base rate determined by reference to the higher of (i) the federal funds rate plus 0.50%, (ii) the prime rate as announced by Bank of America, N.A. and (iii) the Eurodollar Rate plus 1.00% (the Base Rate ), in each case plus an applicable margin. The applicable margin for borrowings under the Credit Facility ranges from 1.50% to 2.50% with respect to borrowings at the Eurodollar Rate and 0.50% to 1.50% with respect to borrowings at the Base Rate. The applicable margins for borrowings under the Credit Facility are determined based upon a leverage ratio of the Company and its subsidiaries calculated on a consolidated basis. If the federal funds rate, prime rate or LIBOR rate increase, our interest payments could also increase. A one percent increase in the variable rate of interest on the term loan facility would increase interest expense by approximately \$21 million annually.



## **Table of Contents**

### **Item 4. CONTROLS AND PROCEDURES**

As required by SEC Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective.

There has been no change in our internal control over financial reporting during the second fiscal quarter ended December 28, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. LEGAL PROCEEDINGS**

For a description of our legal proceedings, refer to Part I, Item 1, Note 5 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q, which is incorporated by reference in response to this item.

### **Item 1A. RISK FACTORS**

We have updated a number of the risk factors affecting our business since those presented in our Annual Report on Form 10-K, Part I, Item 1A, for the fiscal year ended June 29, 2012. Except for the addition of the first two risk factors below, revisions to the third, fourth and fifth risk factors below and the deletion of a risk factor regarding restructuring charges as a result of the HGST acquisition, there have been no material changes in our assessment of our risk factors from those set forth in our Annual Report on Form 10-K for the fiscal year June 29, 2012, as updated in our Quarterly Report on Form 10-Q for the quarter ended September 28, 2012. For convenience, all of our risk factors are included below.

*If we do not properly manage new product development, our competitiveness and operating results may be negatively affected.*

As advances in computer hardware and software are made, our customers have demanded a more diversified portfolio of disk drive products with new and additional features. In some cases, this demand results in investments in new products for a particular market that do not necessarily expand overall market opportunity, which may negatively affect our operating results.

In addition, the success of our new product introductions depends on a number of other factors, including

difficulties faced in manufacturing ramp;

implementing at an acceptable cost product features expected by our customers;

market acceptance/qualification;

effective management of inventory levels in line with anticipated product demand; and

quality problems or other defects in the early stages of new product introduction that were not anticipated in the design of those products.

Our business may suffer if we fail to successfully anticipate and manage issues associated with our product development.



---

**Table of Contents**

*Failure to continue to pay quarterly cash dividends to our shareholders could cause the market price for our common stock to decline.*

Our ability to pay quarterly cash dividends will be subject to, among other things, our financial position and results of operations, available cash and cash flow, capital requirements, and other factors. Any reduction or discontinuance by us of the payment of quarterly cash dividends could cause the market price of our common stock to decline. Moreover, in the event our payment of quarterly cash dividends is reduced or discontinued, our failure or inability to resume paying cash dividends at historical levels could result in a lower market valuation of our common stock.

*Our customers' demand for hard drives may not continue to grow at current industry estimates, which may lower the prices our customers are willing to pay for our products or put us at a disadvantage to competing technologies.*

Our customers' demand for hard drives may not continue to grow at current industry estimates as a result of:

*Mobile Devices.* There has been and continues to be a rapid growth in devices that do not contain a hard drive such as tablet computers and smart phones. As tablet computers and smart phones provide many of the same capabilities as PCs, they have displaced or materially affected, and may continue to displace or materially affect, the demand for PCs. If we are not successful in adapting our product offerings to include disk drives or alternative storage solutions that address these devices, demand for our products may decrease.

*Cloud Computing.* Consumers traditionally have stored their data on their PC, often supplemented with personal external storage devices. Most businesses also include similar local storage as a primary or secondary storage location. This storage is typically provided by hard disk drives. Recently, cloud computing has emerged whereby applications and data are hosted, accessed and processed through a third-party provider over a broadband Internet connection, potentially reducing or eliminating the need for, among other things, significant storage inside the accessing computer. This trend could cause the market for disk drives in computers to decline over time, which could harm our business to the extent this decline is not offset by the sale of our products to customers who provide cloud computing services.

Demand for our products also could be negatively impacted by developments in the regulation and enforcement of digital rights management, the emergence of processes such as data deduplication and storage virtualization, economic conditions, and the rate of increase in areal density exceeding the increase in our customers' demand for storage. These factors could lead to our customers' storage needs being satisfied at lower prices with lower capacity hard drives or solid-state storage products that we do not offer, thereby decreasing our revenue or putting us at a disadvantage to competing storage technologies. As a result, even with increasing aggregate demand for storage, if we fail to anticipate or timely respond to these developments in the demand for storage, our ASPs could decline, which could adversely affect our operating results.

*The nature of our industry and its reliance on intellectual property and other proprietary information subjects us and our suppliers and customers to the risk of significant litigation.*

The data storage industry has been characterized by significant litigation. This includes litigation relating to patent and other intellectual property rights, product liability claims and other types of litigation. Litigation can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of litigation are inherently uncertain and may result in adverse rulings or decisions. We may enter into settlements or be subject to judgments that may, individually or in the aggregate, have a material adverse effect on our business, financial condition or operating results. As disclosed in Part I, Item 1, Note 5 in the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q, on November 18, 2011, a sole arbitrator ruled against us in an arbitration in Minnesota. The arbitration involves claims brought by Seagate Technology LLC against us and a now former employee, alleging misappropriation of confidential information and trade secrets. The arbitrator issued an interim award against us in the amount of \$525 million plus pre-award interest. On January 23, 2012, the arbitrator issued a final award adding pre-award interest in the amount of \$105.4 million, for a total award of \$630.4 million. On January 23, 2012, we filed a petition in the District Court of Hennepin County, Minnesota to have the final arbitration award vacated, and a hearing on the petition was held on March 1, 2012. On October 12, 2012, the District Court of Hennepin County, Minnesota vacated, in full, the \$630.4 million final arbitration award and ordered that a rehearing be held concerning certain trade secret claims before a new arbitrator. On October 30, 2012, Seagate initiated an appeal of the Court's decision with the Minnesota Court of Appeals. We strongly believe that the Court's decision was correct and intend to vigorously oppose Seagate's efforts to appeal the decision. Nevertheless, we cannot be certain we will be successful in a new arbitration of the trade secret claims or in Seagate's efforts to appeal the decision. In the event Seagate is successful in its efforts to appeal the Court's decision, the original arbitration award could be reinstated, and payment of the award, including interest (which would apply at the statutory rate of 10% from the date of the original arbitration award), would adversely affect our financial condition, results of operations and cash flows.



## Table of Contents

We evaluate notices of alleged patent infringement and notices of patents from patent holders that we receive from time to time. If claims or actions are asserted against us, we may be required to obtain a license or cross-license, modify our existing technology or design a new non-infringing technology. Such licenses or design modifications can be extremely costly. In addition, we may decide to settle a claim or action against us, which settlement could be costly. We may also be liable for any past infringement. If there is an adverse ruling against us in an infringement lawsuit, an injunction could be issued barring production or sale of any infringing product. It could also result in a damage award equal to a reasonable royalty or lost profits or, if there is a finding of willful infringement, treble damages. Any of these results would increase our costs and harm our operating results. In addition, our suppliers and customers are subject to similar risks of litigation, and a material, adverse ruling against a supplier or customer could negatively impact our business.

*Failure by certain suppliers to effectively and efficiently develop and manufacture components, technology or production equipment for our products may adversely affect our operations.*

We rely on suppliers for various component parts that we integrate into our hard drives but do not manufacture ourselves, such as semiconductors, motors, flex circuits and suspensions. Likewise, we rely on suppliers for certain technology and equipment necessary for advanced development technology for future products. Some of these components, and most of this technology and production equipment, must be specifically designed to be compatible for use in our products or for developing and manufacturing our future products, and are only available from a limited number of suppliers, some of whom are our sole-source suppliers. We are therefore dependent on these suppliers to be able and willing to dedicate adequate engineering resources to develop components that can be successfully integrated with our products, and technology and production equipment that can be used to develop and manufacture our next-generation products efficiently. As consolidation in the hard drive supply chain increases, these suppliers may reevaluate their business models. The failure of these suppliers to effectively and efficiently develop and manufacture components, technology and production equipment for our products, or a decision by these suppliers to exit this industry, may cause us to experience inability or delay in our manufacturing and shipment of hard drive products, our expansion into new technology and markets, or our ability to remain competitive with alternative storage technologies, therefore adversely affecting our business and financial results. In addition, these suppliers may seek to impose volume guarantees on us or to shift the burden of certain fixed costs to us in order to continue developing and manufacturing components, technology or production equipment for our products, each of which may adversely affect our business and financial results.

*The 2011 severe flooding in Thailand, which inundated our Thailand manufacturing facilities and resulted in the temporary suspension of all production in those facilities, has affected, and will continue to affect, our near-term business, results of operations and financial condition.*

As previously disclosed, the 2011 severe flooding in Thailand resulted in the temporary suspension of production in all of our Thailand manufacturing facilities. While production has resumed in our Thailand facilities, material risks and uncertainties as a result of flooding remain, including the following:

*Under-Absorption of Assets.* Our hard disk drive production capacity has reached a point where we can adequately meet anticipated customer demand; however, industry demand has not returned to pre-flood levels. In addition, we lost market share as a result of the flooding due to the impact on our manufacturing capabilities relative to that of our competitors and due to certain of our competitors entering into long-term purchase agreements with customers. If industry demand does not return to pre-flood levels, or if we are not able to regain market share, our costs will be impacted negatively by significant under-absorption of our assets and infrastructure and our business and results of operations will be adversely affected.

---

**Table of Contents**

*Component Costs.* Due to component supply constraints as a result of the flooding, the cost of certain component materials increased and continues to remain above pre-flood levels. During the flooding we entered into certain volume commitment agreements with certain of our component suppliers, and since the flooding we and our suppliers have taken certain steps to diversify the geographical footprint of our supplier manufacturing base, each of which has resulted and may continue to result in the cost of certain components remaining above pre-flood levels. An increase in the cost of component materials that cannot be recovered through increased pricing could adversely affect our operating results.

*Restored Equipment.* The equipment we use is highly sophisticated and complex. We have repaired or refurbished certain equipment damaged in the flooding; however, the remaining useful life of, and costs associated with maintaining, such equipment is uncertain. If repaired or refurbished equipment does not last as long as planned, we may be required to increase capital expenditures to replace such equipment, which could adversely affect our financial condition and results of operations.

*Insurance.* We maintain insurance coverage that provides property and business interruption coverage in the event of losses arising from flooding. The claim process is underway, but we are unable to predict how much of our losses will be covered by insurance. It is reasonably possible that the final losses that we incur in connection with the flood damage and our business interruption will exceed the limits of our insurance policies. We also cannot estimate the timing of the proceeds we will ultimately receive under our insurance policies, and there may be a substantial delay between our incurrence of losses and our recovery under our insurance policies.

*New Product Development.* The flooding of our Thailand facilities and suspension of operations delayed or adversely impacted our development and introduction of new products and technologies, which may put us at a competitive disadvantage to our competitors who were not as adversely affected by the flooding.

*In connection with obtaining the regulatory approvals required to complete our acquisition of HGST, we agreed to divest certain assets to Toshiba, and the completion of the divestiture is subject to risks and uncertainties, and our business will be adversely affected in the event we fail to successfully execute the divestiture on a timely basis or at all.*

In connection with obtaining the regulatory approvals required to complete our acquisition of HGST, we agreed, subject to review by regulatory agencies in certain jurisdictions, to divest certain assets to Toshiba that will expand Toshiba's capacity to manufacture 3.5-inch hard drives for the desktop, consumer electronics and near-line (business critical) applications. While this divestiture transaction closed in May 2012, certain steps remain before we will have successfully completed the transfer of the divested assets to Toshiba as provided in the purchase agreement. There is no guarantee that we will complete the divestiture to Toshiba on a timely basis or at all. If we are not able to complete the divestiture on a timely basis or at all, the jurisdictions that conditioned their approval of the HGST acquisition on the divestiture could impose certain obligations on us, including a requirement that we divest the assets subject to the Toshiba divestiture (or other assets) to another purchaser, which could adversely affect our business, financial condition and results of operations.

*If we fail to realize the anticipated benefits from our acquisition of HGST on a timely basis, or at all, our business and financial condition may be adversely affected.*

In connection with obtaining the regulatory approvals required to complete the acquisition of HGST, we agreed to certain conditions required by MOFCOM, including adopting measures to keep HGST as an independent competitor until MOFCOM agrees otherwise (with the minimum period being two years). We have worked closely with MOFCOM to finalize an operations plan that outlines in more detail the conditions of the competitive requirement. Compliance with these measures limits our ability to integrate HGST's business with our business (and we do not expect to achieve significant operating expense synergies while the conditions remain in place), could cause delays or uncertainties in making decisions about the combined business, could result in significant costs (including additional capital expenditures relative to our competitors as a result of maintaining separate research and development functions) or could require changes in business practices, each of which could negatively impact our business, financial condition and results of operations. In the event we fail to comply with these measures, the time during which we are required to comply with the condition could be extended and we could be subject to other conditions or penalties that could adversely affect the business.

## **Table of Contents**

In addition to the requirement to maintain HGST as an independent competitor, we may also fail to realize the anticipated benefits from our acquisition of HGST on a timely basis, or at all, for a variety of other reasons, including the following:

difficulties entering new markets or manufacturing in new geographies where we have no or limited direct prior experience;

failure to identify or assess the magnitude of certain liabilities we are assuming in the acquisition, which could result in unexpected litigation or regulatory exposure, unfavorable accounting treatment, unexpected increases in taxes due, a loss of anticipated tax benefits or other adverse effects on our business, operating results or financial condition;

failure to realize the anticipated increase in our revenues due to the acquisition if customers adjust their purchasing decisions and allocate more market share to our competitors;

failure to successfully manage relationships with our supplier and customer base;

difficulties, when allowed, integrating and harmonizing business systems; and

the loss of key employees.

If we are not able to successfully manage these issues, the anticipated benefits and efficiencies of the HGST acquisition may not be realized fully or at all, or may take longer to realize than expected, and our ability to compete, our revenue and gross margins and our results of operations may be adversely affected.

*The financing of the HGST acquisition may have an adverse impact on our liquidity, limit our flexibility in responding to other business opportunities and increase our vulnerability to adverse economic and industry conditions.*

Our acquisition of HGST was financed by a combination of the issuance of additional shares of our common stock, the use of a significant amount of our cash on hand and the incurrence of a significant amount of indebtedness. The use of cash on hand and indebtedness to finance the acquisition reduced our liquidity and could cause us to place more reliance on cash flow from operations to pay principal and interest on our debt, thereby reducing the availability of our cash flow for operations and development activities. The credit agreement we entered into with respect to the indebtedness we incurred to finance the acquisition contains restrictive covenants, including financial covenants requiring us to maintain specified financial ratios. Our ability to meet these restrictive covenants can be affected by events beyond our control. The indebtedness and these restrictive covenants will also have the effect, among other things, of impairing our ability to obtain additional financing, if needed, limiting our flexibility in the conduct of our business and making us more vulnerable to economic downturns and adverse competitive and industry conditions. In addition, a breach of the restrictive covenants could result in an event of default under the credit agreement, which, if not cured or waived, could result in the indebtedness becoming immediately due and payable and could have a material adverse effect on our business, financial condition or operating results.

*Adverse global economic conditions and credit market uncertainty could harm our business, results of operations and financial condition.*

Adverse global economic conditions and uncertain conditions in the credit market have had, and in the future could have, a significant adverse effect on our company and on the storage industry as a whole. Some of the risks and uncertainties we face as a result of these global economic and credit market conditions include the following:

*Volatile Demand.* Negative or uncertain global economic conditions could cause many of our direct and indirect customers to delay or reduce their purchases of our products and systems containing our products. In addition, many of our customers rely on credit financing to purchase our products. If negative conditions in the global credit markets prevent our customers' access to credit, product

## Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

orders may decrease, which could result in lower revenue. Likewise, if our suppliers, sub-suppliers and sub-contractors (collectively referred to as suppliers ) face challenges in obtaining credit, in selling their products or otherwise in operating their businesses, they may be unable to offer the materials we use to manufacture our products. These actions could result in reductions in our revenue and increased operating costs, which could adversely affect our business, results of operations and financial condition.



---

**Table of Contents**

*Restructuring Activities.* Demand for our products has slowed as a result of a deterioration in economic conditions. As a result, we have taken, and may in the future take additional, restructuring activities to realign our cost structure with softening demand. The occurrence of restructuring activities could result in impairment charges and other expenses, which could adversely impact our results of operations or financial condition.

*Credit Volatility and Loss of Receivables.* We extend credit and payment terms to some of our customers. In addition to ongoing credit evaluations of our customers' financial condition, we traditionally seek to mitigate our credit risk by purchasing credit insurance on certain of our accounts receivable balances. As a result of the continued uncertainty and volatility in global economic conditions, however, we may find it increasingly difficult to be able to insure these accounts receivable. We could suffer significant losses if a customer whose accounts receivable we have not insured, or have underinsured, fails and is unable to pay us. Additionally, negative or uncertain global economic conditions increase the risk that if a customer whose accounts receivable we have insured fails, the financial condition of the insurance carrier for such customer account may have also deteriorated such that it cannot cover our loss. A significant loss of an accounts receivable that we cannot recover through credit insurance would have a negative impact on our financial results.

*Impairment Charges.* Negative or uncertain global economic conditions could result in circumstances, such as a sustained decline in our stock price and market capitalization or a decrease in our forecasted cash flows such that they are insufficient, indicating that the carrying value of our long-lived assets or goodwill may be impaired. If we are required to record a significant charge to earnings in our consolidated financial statements because an impairment of our long-lived assets or goodwill is determined, our results of operations will be adversely affected.

*We participate in a highly competitive industry that is subject to the risk of declining average selling prices ( ASPs ), volatile gross margins and significant shifts in market share, all of which could adversely affect our operating results.*

Demand for our hard drives depends in large part on the demand for systems manufactured by our customers and on storage upgrades to existing systems. The demand for systems has been volatile in the past and often has had an exaggerated effect on the demand for hard drives in any given period. As a result, the hard drive market has experienced periods of excess capacity, which can lead to liquidation of excess inventories and more intense price competition. If more intense price competition occurs, we may be forced to lower prices sooner and more than expected, which could adversely impact revenue and gross margins. Our ASPs and gross margins also tend to decline when there is a shift in the mix of product sales, and sales of lower priced products increase relative to those of higher priced products. In addition, rapid technological changes often reduce the volume and profitability of sales of existing products and increase the risk of inventory obsolescence. These factors, along with others, may result in significant shifts in market share among the industry's major participants.

*Our failure to accurately forecast market and customer demand for our products, or to quickly adjust to forecast changes, could adversely affect our business and financial results or operating efficiencies.*

The data storage industry faces difficulties in accurately forecasting market and customer demand for its products. The variety and volume of products we manufacture is based in part on these forecasts. Accurately forecasting demand has become increasingly difficult for us, our customers and our suppliers in light of the volatility in global economic conditions and industry consolidation, which has resulted in less availability of historical market data for certain product segments. In addition, because hard drives are designed to be largely interchangeable with competitors' products, our demand forecasts may be impacted significantly by the strategic actions of our competitors. As forecasting demand becomes more difficult, the risk that our forecasts are not in line with demand increases. If our forecasts exceed actual market demand, then we could experience periods of product oversupply and price decreases, which could impact our financial performance. If market demand increases significantly beyond our forecasts or beyond our ability to add manufacturing capacity, then we may not be able to satisfy customer product needs, which could result in a loss of market share if our competitors are able to meet customer demands.

## **Table of Contents**

*We experience significant sales seasonality and cyclical, which could cause our operating results to fluctuate.*

Sales of computer systems, storage subsystems and consumer electronics tend to be seasonal and cyclical, and therefore we expect to continue to experience seasonality and cyclical in our business as we respond to variations in our customers' demand for hard drives. In the desktop, mobile, CE and retail markets, seasonality historically has been partially attributable to the increase in sales of PCs and CE devices during the back-to-school and winter holiday seasons. In the enterprise market our sales are typically seasonal because of the capital budgeting and purchasing cycles of our end users. However, changes in seasonal and cyclical patterns have made it, and could continue to make it, more difficult for us to forecast demand, especially as a result of the Thailand flooding and the current macroeconomic environment. Changes in the product or channel mix of our business can also impact seasonal and cyclical patterns, adding complexity in forecasting demand. Seasonality and cyclical also may lead to higher volatility in our stock price. It is difficult for us to evaluate the degree to which seasonality and cyclical may affect our stock price or business in future periods because of the rate and unpredictability of product transitions and new product introductions and macroeconomic conditions.

*Selling to the retail market is an important part of our business, and if we fail to maintain and grow our market share or gain market acceptance of our branded products, our operating results could suffer.*

Selling branded products is an important part of our business, and as our branded products revenue increases as a portion of our overall revenue, our success in the retail market becomes increasingly important to our operating results. Our success in the retail market depends in large part on our ability to maintain our brand image and corporate reputation and to expand into and gain market acceptance of our products in multiple channels, including the e-tail channel. Adverse publicity, whether or not justified, or allegations of product or service quality issues, even if false or unfounded, could tarnish our reputation and cause our customers to choose products offered by our competitors. In addition, the proliferation of new methods of mass communication facilitated by the Internet makes it easier for false or unfounded allegations to adversely affect our brand image and reputation. If customers no longer maintain a preference for WD®, HGST - or G-Technology -brand products, our operating results may be adversely affected.

*Sales in the distribution channel are important to our business, and if we fail to respond to demand changes in distribution markets or if distribution markets for hard drives weaken, our operating results could suffer.*

Our distribution customers typically sell to small computer manufacturers, dealers, systems integrators and other resellers. We face significant competition in this channel as a result of limited product qualification programs and a significant focus on price and availability of product. In addition, the PC market is experiencing a shift to notebook and other mobile devices and, as a result, more computing devices are being delivered to the market as complete systems, which could weaken the distribution market. If we fail to respond to changes in demand in the distribution market, our operating results could suffer. Additionally, if the distribution market weakens as a result of a slowing PC growth rate, technology transitions or a significant change in consumer buying preference, or if we experience significant price declines due to demand changes in the distribution channel, then our operating results would be adversely affected.

*Loss of market share with or by a key customer, or consolidation among our customer base, could harm our operating results.*

During the quarter ended December 28, 2012, 45% of our revenue came from sales to our top 10 customers. These customers have a variety of suppliers to choose from and therefore can make substantial demands on us, including demands on product pricing and on contractual terms, which often results in the allocation of risk to us as the supplier. Our ability to maintain strong relationships with our principal customers is essential to our future performance. If we lose a key customer, if any of our key customers reduce their orders of our products or require us to reduce our prices before we are able to reduce costs, if a customer is acquired by one of our competitors or if a key customer suffers financial hardship, our operating results would likely be harmed.

## **Table of Contents**

Additionally, if there is consolidation among our customer base, our customers may be able to command increased leverage in negotiating prices and other terms of sale, which could adversely affect our profitability. In addition, if, as a result of increased leverage, customer pressures require us to reduce our pricing such that our gross margins are diminished, we could decide not to sell our products to a particular customer, which could result in a decrease in our revenue. Consolidation among our customer base may also lead to reduced demand for our products, replacement of our products by the combined entity with those of our competitors and cancellations of orders, each of which could harm our operating results.

*Our entry into additional markets increases the complexity of our business, and if we are unable to successfully adapt our business processes and product offerings as required by these new markets, we will be at a competitive disadvantage and our ability to grow will be adversely affected.*

As we expand our product line to sell into additional markets, the overall complexity of our business increases at an accelerated rate and we become subject to different market dynamics. The new markets into which we are expanding, or may expand, may have different characteristics from the markets in which we currently exist. These different characteristics may include, among other things, demand volume requirements, demand seasonality, product generation development rates, customer concentrations, warranty and product return policies and performance and compatibility requirements. Our failure to make the necessary adaptations to our business model and product offerings to address these different characteristics, complexities and new market dynamics could adversely affect our operating results.

*Expansion into new hard drive markets may cause our capital expenditures to increase, and if we do not successfully expand into new markets, our business may suffer.*

To remain a significant supplier of hard drives, we will need to offer a broad range of hard drive products to our customers. We currently offer a variety of 3.5-inch or 2.5-inch hard drives for the desktop, mobile, enterprise, CE and external storage markets. However, demand for hard drives may shift to products in form factors or with interfaces that our competitors offer but which we do not. Expansion into other hard drive markets and resulting increases in manufacturing capacity requirements may require us to make substantial additional investments in part because our operations are largely vertically integrated now that we manufacture heads and magnetic media for use in many of the hard drives we manufacture. If we fail to successfully expand into new hard drive markets with products that we do not currently offer, we may lose business to our competitors who offer these products.

*Our vertical integration of head and magnetic media manufacturing makes us dependent on our ability to timely and cost-effectively develop heads and magnetic media with leading technology and overall quality, and creates additional capital expenditure costs and asset utilization risks to our business.*

Under our business plan, we are developing and manufacturing a substantial portion of the heads and magnetic media used in the hard drive products we manufacture. Consequently, we are more dependent upon our own development and execution efforts and less able to take advantage of head and magnetic media technologies developed by other manufacturers. Technology transition for head and magnetic media designs is critical to increasing our volume production of heads and magnetic media. There can be no assurance, however, that we will be successful in timely and cost-effectively developing and manufacturing heads or magnetic media for products using future technologies. We also may not effectively transition our head or magnetic media design and technology to achieve acceptable manufacturing yields using the technologies necessary to satisfy our customers' product needs, or we may encounter quality problems with the heads or magnetic media we manufacture. If we are unable to timely and cost-effectively develop heads and magnetic media with leading technology and overall quality, our ability to sell our products may be significantly diminished, which could materially and adversely affect our business and financial results.

In addition, as a result of our vertical integration of head and magnetic media manufacturing, we make more capital investments and carry a higher percentage of fixed costs than we would if we were not vertically integrated. If our overall level of production decreases for any reason, and we are unable to reduce our fixed costs to match sales, our head or magnetic media manufacturing assets may face under-utilization that may impact our operating results. We are therefore subject to additional risks related to overall asset utilization, including the need to operate at high levels of utilization to drive competitive costs and the need for assured supply of components that we do not manufacture ourselves. If we do not adequately address the challenges related to our head or magnetic media manufacturing operations, our ongoing operations could be disrupted, resulting in a decrease in our revenue or profit margins and negatively impacting our operating results.

## **Table of Contents**

*We make significant investments in research and development to improve our technology and develop new technologies, and unsuccessful investments could materially adversely affect our business, financial condition and results of operations.*

Over the past several years, our business strategy has been to derive a competitive advantage by moving from being a follower of new technologies to being a leader in the innovation and development of new technologies. This strategy requires us to make significant investments in research and development and, in attempting to remain competitive, we may increase our capital expenditures and expenses above our historical run-rate model. There can be no assurance that these investments will result in viable technologies or products, or if these investments do result in viable technologies or products, that they will be profitable or accepted by the market. Significant investments in unsuccessful research and development efforts could materially adversely affect our business, financial condition and results of operations. In addition, increased investments in technology could cause our cost structure to fall out of alignment with demand for our products, which would have a negative impact on our financial results.

*Current or future competitors may gain a technology advantage or develop an advantageous cost structure that we cannot match.*

It may be possible for our current or future competitors to gain an advantage in product technology, manufacturing technology, or process technology, which may allow them to offer products or services that have a significant advantage over the products and services that we offer. Advantages could be in capacity, performance, reliability, serviceability, or other attributes. A competitive cost structure for our products, including critical components, labor and overhead, is also critical to the success of our business. We may be at a competitive disadvantage to any companies that are able to gain a technological or cost structure advantage.

*Industry consolidation could provide competitive advantages to our competitors.*

The storage industry has experienced consolidation over the past several years, including the acquisition of the hard disk drive business of Samsung Electronics Co., Ltd. by Seagate Technology plc in December 2011. Consolidation by our competitors may enhance their capacity, abilities and resources and lower their cost structure, causing us to be at a competitive disadvantage.

*Some of our competitors with diversified business units outside of storage products may over extended periods of time sell storage products at prices that we cannot profitably match.*

Some of our competitors earn a significant portion of their revenue from business units outside of storage products. Because they do not depend solely on sales of storage products to achieve profitability, they may sell storage products at lower prices and operate their storage business unit at a loss over an extended period of time while still remaining profitable overall. In addition, if these competitors can increase sales of non-storage products to the same customers, they may benefit from selling their storage products at lower prices. Our operating results may be adversely affected if we cannot successfully compete with the pricing by these companies.

*If we fail to qualify our products with our customers or if product life cycles lengthen, it may have a significant adverse impact on our sales and margins.*

We regularly engage in new product qualification with our customers. Once a product is accepted for qualification testing, failures or delays in the qualification process can result in delayed or reduced product sales, reduced product margins caused by having to continue to offer a more costly current generation product, or lost sales to that customer until the next generation of products is introduced. The effect of missing a product qualification opportunity is magnified by the limited number of high volume OEMs, which continue to consolidate their share of the storage markets. Likewise, if product life cycles lengthen, we may have a significantly longer period to wait before we have an opportunity to qualify a new product with a customer, which could reduce our profits because we expect declining gross margins on our current generation products as a result of competitive pressures.

---

**Table of Contents**

*We are subject to risks related to product defects, which could result in product recalls or epidemic failures and could subject us to warranty claims in excess of our warranty provisions or which are greater than anticipated.*

We warrant the majority of our products for periods of one to five years. We test our hard drives in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal defects in our products, which may not become apparent until after the products have been sold into the market. Accordingly, there is a risk that product defects will occur, which could require a product recall. Product recalls can be expensive to implement and, if a product recall occurs during the product's warranty period, we may be required to replace the defective product. Moreover, there is a risk that product defects may trigger an epidemic failure clause in a customer agreement. If an epidemic failure occurs, we may be required to replace or refund the value of the defective product and to cover certain other costs associated with the consequences of the epidemic failure. In addition, a product recall or epidemic failure may damage our reputation or customer relationships, and may cause us to lose market share with our customers, including our OEM and ODM customers.

Our standard warranties contain limits on damages and exclusions of liability for consequential damages and for misuse, improper installation, alteration, accident or mishandling while in the possession of someone other than us. We record an accrual for estimated warranty costs at the time revenue is recognized. We may incur additional operating expenses if our warranty provision does not reflect the actual cost of resolving issues related to defects in our products, whether as a result of a product recall, epidemic failure or otherwise. If these additional expenses are significant, it could adversely affect our business, financial condition and operating results.

*Dependence on a limited number of qualified suppliers of components and manufacturing equipment could lead to delays, lost revenue or increased costs.*

Our future operating results may depend substantially on our suppliers' ability to timely qualify their components in our programs, and their ability to supply us with these components in sufficient volumes to meet our production requirements. A number of the components that we use are available from only a single or limited number of qualified suppliers, and may be used across multiple product lines. As such, the success of our products depends on our ability to gain access to and integrate parts from reliable component suppliers. To do so, we must maintain effective relationships with our supply base to source our component needs, develop compatible technology, and maintain continuity of supply at reasonable costs. If we fail to maintain effective relationships with our supply base, or if we fail to integrate components from our suppliers effectively, this may adversely affect our ability to develop and deliver the best products to our customers and our profitability could suffer.

Certain equipment and consumables we use in our manufacturing or testing processes are available only from a limited number of suppliers. Some of this equipment and consumables use materials that at times could be in short supply. If these materials are not available, or are not available in the quantities we require for our manufacturing and testing processes, our ability to manufacture our products could be impacted, and we could suffer significant loss of revenue.

Each of the following could also significantly harm our operating results:

an unwillingness of a supplier to supply such components or equipment to us;

consolidation of key suppliers;

failure of a key supplier's business process;

a key supplier's or sub-supplier's inability to access credit necessary to operate its business; or

failure of a key supplier to remain in business, to remain an independent merchant supplier, or to adjust to market conditions.

*Shortages of commodity materials or commodity components, price volatility, or use by other industries of materials and components used in the storage industry, may negatively impact our operating results.*

## Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

Increases in the cost for certain commodity materials or commodity components may increase our costs of manufacturing and transporting hard drives and key components. Shortages of commodity components such as DRAM and NAND flash, or commodity materials such as glass substrates, stainless steel, aluminum, nickel, neodymium, ruthenium, platinum or cerium, may increase our costs and may result in lower operating margins if we are unable to find ways to mitigate these increased costs. We or our suppliers acquire certain precious metals and rare earth metals like ruthenium, platinum, neodymium and cerium, which are critical to the manufacture of components in our products from a number of countries, including the People's Republic of China. The government of China or any other nation may impose regulations, quotas or embargoes upon these metals that would restrict the worldwide supply of such metals and/or increase their cost, both of which could negatively impact our operating results until alternative suppliers are sourced. Furthermore, if other high volume industries increase their demand for materials or components used in our products, our costs may further increase, which could have an adverse effect on our operating margins. In addition, shortages in other commodity components and materials used in our customers' products could result in a decrease in demand for our products, which would negatively impact our operating results. The volatility in the cost of oil also affects our costs and may result in lower operating margins if we are unable to pass these increased costs on to our customers.

## **Table of Contents**

*Contractual commitments with component suppliers may result in us paying increased charges and cash advances for such components or may cause us to have inadequate or excess component inventory.*

To reduce the risk of component shortages, we attempt to provide significant lead times when buying components, which may subject us to cancellation charges if we cancel orders as a result of technology transitions or changes in our component needs. In addition, we may from time to time enter into contractual commitments with component suppliers in an effort to increase and stabilize the supply of those components and enable us to purchase such components at favorable prices. Some of these commitments may require us to buy a substantial number of components from the supplier or make significant cash advances to the supplier; however, these commitments may not result in a satisfactory increase or stabilization of the supply of such components. Furthermore, as a result of uncertain global economic conditions, our ability to forecast our requirements for these components has become increasingly difficult, therefore increasing the risk that our contractual commitments may not meet our actual supply requirements, which could cause us to have inadequate or excess component inventory and adversely affect our operating results and increase our operating costs.

*Changes in product life cycles could adversely affect our financial results.*

If product life cycles lengthen, we may need to develop new technologies or programs to reduce our costs on any particular product to maintain competitive pricing for that product. If product life cycles shorten, it may result in an increase in our overall expenses and a decrease in our gross margins, both of which could adversely affect our operating results. In addition, shortening of product life cycles also makes it more difficult to recover the cost of product development before the product becomes obsolete. Our failure to recover the cost of product development in the future could adversely affect our operating results.

*A fundamental change in recording technology could result in significant increases in our costs and could put us at a competitive disadvantage.*

Historically, when the industry experiences a fundamental change in technology, any manufacturer that fails to successfully and timely adjust its designs and processes to accommodate the new technology fails to remain competitive. There are some revolutionary technologies, such as current-perpendicular-to-plane giant magnetoresistance, shingle magnetic recording, energy assisted magnetic recording, patterned magnetic media and advanced signal processing, that if implemented by a competitor on a commercially viable basis ahead of the industry, could put us at a competitive disadvantage. As a result of these technology shifts, we could incur substantial costs in developing new technologies, such as heads, magnetic media, and tools to remain competitive. If we fail to successfully implement these new technologies, or if we are significantly slower than our competitors at implementing new technologies, we may not be able to offer products with capacities that our customers desire.

*The difficulty of introducing hard drives with higher levels of areal density and the challenges of reducing other costs may impact our ability to achieve historical levels of cost reduction.*

Storage capacity of the hard drive, as manufactured by us, is determined by the number of disks and each disk's areal density. Areal density is a measure of the amount of magnetic bits that can be stored on the recording surface of the disk. Generally, the higher the areal density, the more information can be stored on a single platter. Higher areal densities require existing head and magnetic media technology to be improved or new technologies developed to accommodate more data on a single disk. Historically, we have been able to achieve a large percentage of cost reduction through increases in areal density. Increases in areal density mean that the average drive we sell has fewer heads and disks for the same capacity and, therefore, may result in a lower component cost. However, increasing areal density has become more difficult in the storage industry. If we are not able to increase areal density at the same rate as our competitors or at a rate that is expected by our customers, we may be required to include more components in our drives to meet demand without corresponding incremental revenue, which could negatively impact our operating margins and make achieving historical levels of cost reduction difficult or unlikely. Additionally, increases in areal density may require us to make further capital expenditures on items such as new testing equipment needed as a result of an increased number of gigabytes per platter. Our inability to achieve cost reductions could adversely affect our operating results.

---

**Table of Contents**

*If we do not properly manage technology transitions, our competitiveness and operating results may be negatively affected.*

The storage markets in which we offer our products continuously undergo technology transitions which we must anticipate and adapt our products to address in a timely manner. If we fail to implement these new technologies successfully, or if we are slower than our competitors at implementing new technologies, we may not be able to competitively offer products that our customers desire, which could harm our operating results.

*If we fail to develop and introduce new hard drives that are competitive against alternative storage technologies, our business may suffer.*

Our success depends in part on our ability to develop and introduce new products in a timely manner in order to keep pace with competing technologies. Alternative storage technologies like solid-state storage technology have successfully served digital entertainment markets for products such as digital cameras, MP3 players, USB flash drives, mobile phones and tablet devices that cannot be economically serviced using hard drive technology. Advances in semiconductor technology have resulted in solid-state storage emerging as a technology that is competitive with hard drives for high performance needs in advanced digital computing markets such as enterprise servers and storage. There can be no assurance that we will be successful in anticipating and developing new products for the desktop, mobile, enterprise, CE and external storage markets in response to solid-state storage, as well as other competing technologies. If our hard drive technology fails to offer higher capacity, performance and reliability with lower cost-per-gigabyte than solid-state storage for the desktop, mobile, enterprise, CE and external storage markets, we will be at a competitive disadvantage to companies using semiconductor technology to serve these markets and our business will suffer.

*Our manufacturing operations, and those of certain of our suppliers and customers, are concentrated in large, purpose-built facilities, which subjects us to substantial risk of damage or loss if operations at any of these facilities are disrupted.*

As a result of our cost structure and strategy of vertical integration, we conduct our manufacturing operations at large, high volume, purpose-built facilities in California and in Asia. The manufacturing facilities of many of our customers, our suppliers and our customers suppliers are also concentrated in certain geographic locations in Asia and elsewhere. A localized health risk affecting our employees at these facilities or the staff of our or our customers other suppliers, such as the spread of a pandemic influenza, could impair the total volume of hard drives that we are able to manufacture and/or sell, which would result in substantial harm to our operating results. Similarly, a fire, flood, earthquake, tsunami or other disaster, condition or event such as political instability, civil unrest or a power outage that adversely affects any of these facilities, including access to or from these facilities by employees or logistics operations, would significantly affect our ability to manufacture and/or sell hard drives, which would result in a substantial loss of sales and revenue and a substantial harm to our operating results. For example, prior to the 2011 flooding in Thailand, all of our internal slider capacity and 60% of our hard drive manufacturing capacity was in Thailand. As a result of the flooding in Thailand, our facilities were inundated and temporarily shut down. During that period, our ability to manufacture hard drives was significantly constrained, which adversely affected our business, financial condition and results of operations. While we have taken certain steps to diversify our manufacturing footprint, a significant event that impacts any of our manufacturing sites, or the sites of our customers or suppliers, could adversely affect our ability to manufacture hard drives, and our business, financial condition and results of operations could suffer.

*Manufacturing and marketing our products globally subjects us to numerous risks.*

We are subject to risks associated with our global manufacturing operations and global marketing efforts, including:

obtaining requisite governmental permits and approvals;

currency exchange rate fluctuations or restrictions;



**Table of Contents**

political instability and civil unrest;

limited transportation availability, delays, and extended time required for shipping, which risks may be compounded in periods of price declines;

higher freight rates;

labor challenges, including difficulties finding and retaining talent or responding to labor disputes or disruptions;

trade restrictions or higher tariffs;

copyright levies or similar fees or taxes imposed in European and other countries;

exchange, currency and tax controls and reallocations;

increasing labor and overhead costs; and

loss or non-renewal of favorable tax treatment under agreements or treaties with foreign tax authorities.

*Terrorist attacks may adversely affect our business and operating results.*

The continued threat of terrorist activity and other acts of war or hostility have created uncertainty in the financial and insurance markets and have significantly increased the political, economic and social instability in some of the geographic areas in which we operate. Additionally, it is uncertain what impact the reactions to such acts by various governmental agencies and security regulators worldwide will have on shipping costs. Acts of terrorism, either domestically or abroad, could create further uncertainties and instability. To the extent this results in disruption or delays of our manufacturing capabilities or shipments of our products, our business, operating results and financial condition could be adversely affected.

*Sudden disruptions to the availability of freight lanes could have an impact on our operations.*

We generally ship our products to our customers, and receive shipments from our suppliers, via air, ocean or land freight. The sudden unavailability or disruption of cargo operations or freight lanes, such as due to labor difficulties or disputes, severe weather patterns or other natural disasters, or political instability or civil unrest, could impact our operating results by impairing our ability to timely and efficiently deliver our products.

*We are vulnerable to system failures or attacks, which could harm our business.*

We are heavily dependent on our technology infrastructure, among other functions, to operate our factories, sell our products, fulfill orders, manage inventory and bill, collect and make payments. Our systems are vulnerable to damage or interruption from natural disasters, power loss, telecommunication failures, cyber-attacks such as computer viruses, computer denial-of-service attacks and other events. Our business is also subject to break-ins, sabotage and intentional acts of vandalism by third parties as well as employees. Despite any precautions we may take, such problems could result in, among other consequences, loss or theft of our, our customers or our business partners intellectual property, proprietary business information or personally identifiable information; damage to our reputation; interruptions in our business; and remediation costs, each of which could harm our business, operating results and financial condition.

*If we fail to identify, manage, complete and integrate acquisitions, investment opportunities or other significant transactions, it may adversely affect our future results.*

As part of our growth strategy, we may pursue acquisitions of, investment opportunities in or other significant transactions with companies that are complementary to our business. In order to pursue this strategy successfully, we must identify attractive acquisition or investment opportunities, successfully complete the transaction, some of which may be large and complex, and manage post-closing issues such as integration of the acquired company or employees. We may not be able to identify or complete appealing acquisition or investment opportunities given the intense competition for these transactions. Even if we identify and complete suitable corporate transactions, we may not be able to successfully address any integration challenges in a timely manner, or at all. If we fail to successfully integrate an acquisition, we may not realize all or any of the anticipated benefits of the acquisition, and our future results of operations could be adversely affected. Please see the risk factors above for specific risks and uncertainties regarding our acquisition of HGST.

---

**Table of Contents**

*If we are unable to retain or hire key staff and skilled employees our business results may suffer.*

Our success depends upon the continued contributions of our key staff and skilled employees, many of whom would be extremely difficult to replace. Global competition for skilled employees in the data storage industry is intense and, as we attempt to move to a position of technology leadership in the storage industry, our business success becomes increasingly dependent on our ability to retain our key staff and skilled employees as well as attract, integrate and retain new skilled employees. Volatility or lack of positive performance in our stock price and the overall markets may adversely affect our ability to retain key staff or skilled employees who have received equity compensation. Additionally, because a substantial portion of our key employees' compensation is placed at risk and linked to the performance of our business, when our operating results are negatively impacted by global economic conditions, we are at a competitive disadvantage for retaining and hiring key staff and skilled employees versus other companies that pay a relatively higher fixed salary. If we are unable to retain our existing key staff or skilled employees, or hire and integrate new key staff or skilled employees, or if we fail to implement succession plans for our key staff, our operating results would likely be harmed.

*Our reliance on intellectual property and other proprietary information subjects us to the risk that these key ingredients of our business could be copied by competitors.*

Our success depends, in significant part, on the proprietary nature of our technology, including non-patentable intellectual property such as our process technology. If a competitor is able to reproduce or otherwise capitalize on our technology despite the safeguards we have in place, it may be difficult, expensive or impossible for us to obtain necessary legal protection. Also, the laws of some foreign countries may not protect our intellectual property to the same extent as do U.S. laws. In addition to patent protection of intellectual property rights, we consider elements of our product designs and processes to be proprietary and confidential. We rely upon employee, consultant and vendor non-disclosure agreements and contractual provisions and a system of internal safeguards to protect our proprietary information. However, any of our registered or unregistered intellectual property rights may be challenged or exploited by others in the industry, which might harm our operating results.

*The costs of compliance with state, federal and international legal and regulatory requirements, such as environmental, labor, trade and tax regulations, and customers' standards of corporate citizenship could cause an increase in our operating costs.*

We may be or become subject to various state, federal and international laws and regulations governing our environmental, labor, trade and tax practices. These laws and regulations, particularly those applicable to our international operations, are or may be complex, extensive and subject to change. We will need to ensure that we and our component suppliers timely comply with such laws and regulations, which may result in an increase in our operating costs. For example, the European Union ( EU ) has enacted the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment ( RoHS ) directive, which prohibits the use of certain substances in electronic equipment, and the Waste Electrical and Electronic Equipment ( WEEE ) directive, which obligates parties that place electrical and electronic equipment onto the market in the EU to put a clearly identifiable mark on the equipment, register with and report to EU member countries regarding distribution of the equipment, and provide a mechanism to take back and properly dispose of the equipment. Similar legislation may be enacted in other locations where we manufacture or sell our products. In addition, conflict minerals, climate change and financial reform legislation in the United States is a significant topic of discussion and has generated and may continue to generate federal or other regulatory responses in the near future. If we or our component suppliers fail to timely comply with applicable legislation, our customers may refuse to purchase our products or we may face increased operating costs as a result of taxes, fines or penalties, which would have a materially adverse effect on our business, financial condition and operating results.

In connection with our compliance with such environmental laws and regulations, as well as our compliance with industry environmental initiatives, the standards of business conduct required by some of our customers, and our commitment to sound corporate citizenship in all aspects of our business, we could incur substantial compliance and operating costs and be subject to disruptions to our operations and logistics. In addition, if we were found to be in violation of these laws or noncompliant with these initiatives or standards of conduct, we could be subject to governmental fines, liability to our customers and damage to our reputation and corporate brand which could cause our financial condition or operating results to suffer.

---

**Table of Contents**

*Violation of applicable laws, including labor or environmental laws, and certain other practices by our suppliers or customers could harm our business.*

We expect our suppliers and customers to operate in compliance with applicable laws and regulations, including labor and environmental laws, and to otherwise meet our required standards of conduct. While our internal operating guidelines promote ethical business practices, we do not control our suppliers or customers or their labor or environmental practices. The violation of labor, environmental or other laws by any of our suppliers or customers, or divergence of a supplier's or customer's business practices from those generally accepted as ethical, could harm our business by:

interrupting or otherwise disrupting the shipment of our product components;

damaging our reputation;

forcing us to find alternate component sources;

reducing demand for our products (for example, through a consumer boycott); or

exposing us to potential liability for our suppliers' or customers' wrongdoings.

*Fluctuations in currency exchange rates as a result of our international operations may negatively affect our operating results.*

Because we manufacture and sell our products abroad, our revenue, margins, operating costs and cash flows are impacted by fluctuations in foreign currency exchange rates. If the U.S. dollar exhibits sustained weakness against most foreign currencies, the U.S. dollar equivalents of unhedged manufacturing costs could increase because a significant portion of our production costs are foreign-currency denominated. Conversely, there would not be an offsetting impact to revenues since revenues are substantially U.S. dollar denominated. Additionally, we negotiate and procure some of our component requirements in U.S. dollars from non-U.S. based vendors. If the U.S. dollar continues to weaken against other foreign currencies, some of our component suppliers may increase the price they charge for their components in order to maintain an equivalent profit margin. If this occurs, it would have a negative impact on our operating results.

Prices for our products are substantially U.S. dollar denominated, even when sold to customers that are located outside the United States. Therefore, as a substantial portion of our sales are from countries outside the United States, fluctuations in currency exchange rates, most notably the strengthening of the U.S. dollar against other foreign currencies, contribute to variations in sales of products in impacted jurisdictions and could adversely impact demand and revenue growth. In addition, currency variations can adversely affect margins on sales of our products in countries outside the United States.

We have attempted to manage the impact of foreign currency exchange rate changes by, among other things, entering into short-term, foreign exchange contracts. However, these contracts do not cover our full exposure and can be canceled by the counterparty if currency controls are put in place.

*Increases in our customers' credit risk could result in credit losses and an increase in our operating costs.*

Some of our OEM customers have adopted a subcontractor model that requires us to contract directly with companies, such as ODMs, that provide manufacturing and fulfillment services to our OEM customers. Because these subcontractors are generally not as well capitalized as our direct OEM customers, this subcontractor model exposes us to increased credit risks. Our agreements with our OEM customers may not permit us to increase our product prices to alleviate this increased credit risk. Additionally, as we attempt to expand our OEM and distribution channel sales into emerging economies such as Brazil, Russia, India and China, the customers with the most success in these regions may have relatively short operating histories, making it more difficult for us to accurately assess the associated credit risks. Our acquisition of HGST has also resulted in an increase to our customer credit risk given that we service many of the same customers. Any credit losses we may suffer as a result of these increased risks, or as a result of credit losses from any significant customer, would increase our operating costs, which may negatively impact our operating results.



**Table of Contents**

*Our operating results fluctuate, sometimes significantly, from period to period due to many factors, which may result in a significant decline in our stock price.*

Our quarterly operating results may be subject to significant fluctuations as a result of a number of other factors including:

the timing of orders from and shipment of products to major customers;

our product mix;

changes in the prices of our products;

manufacturing delays or interruptions;

acceptance by customers of competing products in lieu of our products;

variations in the cost of and lead times for components for our products;

limited availability of components that we obtain from a single or a limited number of suppliers;

seasonal and other fluctuations in demand for PCs often due to technological advances; and

availability and rates of transportation.

We often ship a high percentage of our total quarterly sales in the third month of the quarter, which makes it difficult for us to forecast our financial results before the end of the quarter. As a result of the above or other factors, our forecast of operating results for the quarter may differ materially from our actual financial results. If our results of operations fail to meet the expectations of analysts or investors, it could cause an immediate and significant decline in our stock price.

*We have made and continue to make a number of estimates and assumptions relating to our consolidated financial reporting, and actual results may differ significantly from our estimates and assumptions.*

We have made and continue to make a number of estimates and assumptions relating to our consolidated financial reporting. The highly technical nature of our products and the rapidly changing market conditions with which we deal means that actual results may differ significantly from our estimates and assumptions. These changes have impacted our financial results in the past and may continue to do so in the future. Key estimates and assumptions for us include:

price protection adjustments and other sales promotions and allowances on products sold to retailers, resellers and distributors;

inventory adjustments for write-down of inventories to lower of cost or market value (net realizable value);

## Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

testing of goodwill and other long-lived assets for impairment;

reserves for doubtful accounts;

accruals for product returns;

accruals for warranty costs related to product defects;

accruals for litigation and other contingencies;

liabilities for unrecognized tax benefits; and

expensing of stock-based compensation.

*The market price of our common stock is volatile.*

The market price of our common stock has been, and may continue to be, extremely volatile. Factors that may significantly affect the market price of our common stock include the following:

actual or anticipated fluctuations in our operating results, including those resulting from the seasonality of our business;

announcements of technological innovations by us or our competitors, which may decrease the volume and profitability of sales of our existing products and increase the risk of inventory obsolescence;

**Table of Contents**

new products introduced by us or our competitors;

periods of severe pricing pressures due to oversupply or price erosion resulting from competitive pressures or industry consolidation;

developments with respect to patents or proprietary rights;

conditions and trends in the hard drive, computer, data and content management, storage and communication industries;

contraction in our operating results or growth rates that are lower than our previous high growth-rate periods;

changes in financial estimates by securities analysts relating specifically to us or the storage industry in general; and

macroeconomic conditions that affect the market generally.

In addition, general economic conditions may cause the stock market to experience extreme price and volume fluctuations from time to time that particularly affect the stock prices of many high technology companies. These fluctuations often appear to be unrelated to the operating performance of the companies.

Securities class action lawsuits are often brought against companies after periods of volatility in the market price of their securities. A number of such suits have been filed against us in the past, and should any new lawsuits be filed, such matters could result in substantial costs and a diversion of resources and management's attention.

*Current economic conditions have caused us difficulty in adequately protecting our increased cash and cash equivalents from financial institution failures.*

The uncertain global economic conditions and volatile investment markets have caused us to hold more cash and cash equivalents than we would hold under normal circumstances. Since there has been an overall increase in demand for low-risk, U.S. government-backed securities with a limited supply in the financial marketplace, we face increased difficulty in adequately protecting our increased cash and cash equivalents from possible sudden and unforeseeable failures by banks and other financial institutions. A failure of any of these financial institutions in which deposits exceed FDIC limits could have an adverse impact on our financial position.

*If our internal controls are found to be ineffective, our financial results or our stock price may be adversely affected.*

Our most recent evaluation resulted in our conclusion that as of June 29, 2012, in compliance with Section 404 of the Sarbanes-Oxley Act of 2002, our internal control over financial reporting was effective. As a result of our acquisition of HGST on March 8, 2012, our internal control over financial reporting, subsequent to the date of acquisition, includes certain existing controls adopted from HGST. If our internal control over financial reporting is found to be ineffective or if we identify a material weakness in our financial reporting in future periods, investors may lose confidence in the reliability of our financial statements, which may adversely affect our financial results or our stock price.

*From time to time we may become subject to income tax audits or similar proceedings, and as a result we may incur additional costs and expenses or owe additional taxes, interest and penalties that may negatively impact our operating results.*

We are subject to income taxes in the United States and certain foreign jurisdictions, and our determination of our tax liability is subject to review by applicable domestic and foreign tax authorities. For example, as we have previously disclosed, we are under examination by the Internal Revenue Service for certain fiscal years and in connection with that examination, we received Revenue Agent Reports seeking certain adjustments to income as disclosed in Part II, Item 8, Note 9 in the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K. Although we believe our tax positions are properly supported, the final timing and resolution of the notice of proposed adjustment and the audits are subject to significant uncertainty and could result in our having to pay amounts to the applicable tax authority in order to resolve examination of our tax positions, which could result in an increase or decrease of our current estimate of unrecognized tax benefits and



may negatively impact our financial position, results of operations, net income or cash flows.

**Table of Contents****Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table provides information about repurchases by us of shares of our common stock during the quarter ended December 28, 2012:

(in millions, except average price paid per share)	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased As Part of Publicly Announced Program (1)	Maximum Value of Shares that May Yet be Purchased Under the Program(1)
Sept. 29, 2012 - Oct. 26, 2012	1.5	\$ 34.09	1.5	\$ 2,543
Oct. 27, 2012 - Nov. 23, 2012	2.4	\$ 34.75	2.4	\$ 2,460
Nov. 24, 2012 - Dec. 28, 2012	0.3	\$ 34.45	0.3	\$ 2,448
Total	4.2	\$ 34.49	4.2	\$ 2,448

- (1) On May 21, 2012, the Company announced that the Board of Directors authorized \$1.5 billion for the repurchase of our common stock through May 18, 2017. On September 13, 2012, the Company announced that the Board of Directors authorized an additional \$1.5 billion for the repurchase of our common stock and the extension of our stock repurchase program until September 13, 2017. Repurchases under our stock repurchase program may be made in the open market or in privately negotiated transactions and may be made under a Rule 10b5-1 plan.

**Table of Contents****Item 6. EXHIBITS**

Pursuant to the rules and regulations of the SEC, we have filed or incorporated by reference certain agreements as exhibits to this Quarterly Report on Form 10-Q. These agreements may contain representations and warranties by us or our subsidiaries. These representations and warranties have been made solely for the benefit of the other party or parties to such agreements and (i) may have been qualified by disclosures made to such other party or parties, (ii) were made only as of the date of such agreements or such other date(s) as may be specified in such agreements and are subject to more recent developments, which may not be fully reflected in our public disclosures, (iii) may reflect the allocation of risk among the parties to such agreements and (iv) may apply materiality standards different from what may be viewed as material to investors. Accordingly, these representations and warranties may not describe the actual state of affairs at the date hereof and should not be relied upon.

**Exhibit**

<b>Number</b>	<b>Description</b>
2.1	Stock Purchase Agreement, dated March 7, 2011, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 2, 2011)
2.2	First Amendment to Stock Purchase Agreement, dated May 27, 2011, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Annual Report on Form 10-K (File No. 1-08703), as filed with the Securities and Exchange Commission on August 12, 2011)
2.3	Second Amendment to Stock Purchase Agreement, dated November 23, 2011, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on January 27, 2012)
2.4	Third Amendment to Stock Purchase Agreement, dated January 30, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 9, 2012)
2.5	Fourth Amendment to Stock Purchase Agreement, dated February 15, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 9, 2012)
2.6	Fifth Amendment to Stock Purchase Agreement, dated March 6, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 9, 2012)
2.7	Sixth Amendment to Stock Purchase Agreement, dated March 6, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 9, 2012)
2.8	Amendment to Stock Purchase Agreement, dated July 27, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on November 2, 2012)
2.9	Amendment to Stock Purchase Agreement, dated August 29, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on November 2, 2012)

**Table of Contents**

**Exhibit**

<b>Number</b>	<b>Description</b>
3.1	Amended and Restated Certificate of Incorporation of Western Digital Corporation, as amended to date (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on February 8, 2006)
3.2	Amended and Restated Bylaws of Western Digital Corporation, as amended effective as of November 5, 2007 (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 8, 2007)
10.1	Western Digital Corporation Amended and Restated 2004 Performance Incentive Plan (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 13, 2012)*
10.2	Western Digital Corporation Summary of Compensation Arrangements for Named Executive Officers and Directors *

**Table of Contents**

**Exhibit**

<b>Number</b>	<b>Description</b>
31.1	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document**
101.SCH	XBRL Taxonomy Extension Schema Document**
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document**
101.LAB	XBRL Taxonomy Extension Label Linkbase Document**
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document**
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document**

Filed with this report.

\* Management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to applicable rules of the Securities and Exchange Commission.

\*\* Furnished herewith.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned thereunto duly authorized.

WESTERN DIGITAL CORPORATION  
Registrant

/s/ WOLFGANG U. NICKL  
Wolfgang U. Nickl  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer and Principal Accounting Officer)

Date: February 1, 2013

**Table of Contents****Item 6. EXHIBITS**

Pursuant to the rules and regulations of the SEC, we have filed or incorporated by reference certain agreements as exhibits to this Quarterly Report on Form 10-Q. These agreements may contain representations and warranties by us or our subsidiaries. These representations and warranties have been made solely for the benefit of the other party or parties to such agreements and (i) may have been qualified by disclosures made to such other party or parties, (ii) were made only as of the date of such agreements or such other date(s) as may be specified in such agreements and are subject to more recent developments, which may not be fully reflected in our public disclosures, (iii) may reflect the allocation of risk among the parties to such agreements and (iv) may apply materiality standards different from what may be viewed as material to investors. Accordingly, these representations and warranties may not describe the actual state of affairs at the date hereof and should not be relied upon.

**Exhibit**

<b>Number</b>	<b>Description</b>
2.1	Stock Purchase Agreement, dated March 7, 2011, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 2, 2011)
2.2	First Amendment to Stock Purchase Agreement, dated May 27, 2011, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Annual Report on Form 10-K (File No. 1-08703), as filed with the Securities and Exchange Commission on August 12, 2011)
2.3	Second Amendment to Stock Purchase Agreement, dated November 23, 2011, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on January 27, 2012)
2.4	Third Amendment to Stock Purchase Agreement, dated January 30, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 9, 2012)
2.5	Fourth Amendment to Stock Purchase Agreement, dated February 15, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 9, 2012)
2.6	Fifth Amendment to Stock Purchase Agreement, dated March 6, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 9, 2012)
2.7	Sixth Amendment to Stock Purchase Agreement, dated March 6, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on May 9, 2012)
2.8	Amendment to Stock Purchase Agreement, dated July 27, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on November 2, 2012)
2.9	Amendment to Stock Purchase Agreement, dated August 29, 2012, among Western Digital Corporation, Western Digital Ireland, Ltd., Hitachi, Ltd., and Viviti Technologies Ltd. (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on November 2, 2012)

**Table of Contents**

**Exhibit**

<b>Number</b>	<b>Description</b>
3.1	Amended and Restated Certificate of Incorporation of Western Digital Corporation, as amended to date (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on February 8, 2006)
3.2	Amended and Restated Bylaws of Western Digital Corporation, as amended effective as of November 5, 2007 (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 8, 2007)
10.1	Western Digital Corporation Amended and Restated 2004 Performance Incentive Plan (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 13, 2012)*
10.2	Western Digital Corporation Summary of Compensation Arrangements for Named Executive Officers and Directors *



**Table of Contents**

**Exhibit**

<b>Number</b>	<b>Description</b>
31.1	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document**
101.SCH	XBRL Taxonomy Extension Schema Document**
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document**
101.LAB	XBRL Taxonomy Extension Label Linkbase Document**
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document**
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document**

Filed with this report.

\* Management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to applicable rules of the Securities and Exchange Commission.

\*\* Furnished herewith.