

WESTERN DIGITAL CORP

Form 10-Q

November 24, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 29, 2006

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
(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.)

20511 Lake Forest Drive
Lake Forest, California
(Address of principal executive offices)

92630
(Zip Code)

Registrant's telephone number, including area code: (949) 672-7000
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, \$.01 Par Value Per Share	New York Stock Exchange
Rights to Purchase Series A Junior Participating Preferred Stock	New York Stock Exchange

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

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 November 10, 2006, 221.7 million shares of common stock, par value \$.01 per share, were outstanding.

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We have a 52- or 53-week fiscal year, which typically ends on the Friday nearest to June 30. However, approximately every six years, we report a 53-week fiscal year to align our fiscal quarters with calendar quarters by adding a week to our fourth fiscal quarter. The quarters ended September 29, 2006 and September 30, 2005, were 13 weeks. Fiscal year 2006 was comprised of 52 weeks and ended on June 30, 2006. 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 and our refer to Western Digital Corporation and its subsidiaries.

We are a Delaware corporation that operates as the parent company of our hard drive business, Western Digital Technologies, Inc., which was formed in 1970.

Our principal executive offices are located at 20511 Lake Forest Drive, Lake Forest, California 92630. Our telephone number is (949) 672-7000 and our web site is <http://www.westerndigital.com>. The information on our web site is not incorporated in this Quarterly Report on Form 10-Q.

Western Digital®, WD®, the WD logo, WD Caviar®, WD Raptor®, WD Scorpio™, WD Passport™ and My Book™ 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)

	Sept. 29, 2006	June 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 603	\$ 551
Short-term investments	148	148
Accounts receivable, net	614	481
Inventories	216	205
Advances to suppliers	86	80
Prepaid expenses and other	30	27
 Total current assets	 1,697	 1,492
Property and equipment, net	598	549
Intangible and other assets	30	32
 Total assets	 \$ 2,325	 \$ 2,073
 LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 750	\$ 632
Accrued expenses	128	131
Accrued warranty	74	71
Current portion of long-term debt	30	25
 Total current liabilities	 982	 859
Long-term debt	29	19
Other liabilities	42	38
 Total liabilities	 1,053	 916
Commitments and contingent liabilities (Note 5)		
Shareholders' equity:		
Preferred stock, \$.01 par value; authorized 5.0 shares; Outstanding None		
Common stock, \$.01 par value; authorized 450.0 shares; Outstanding 221.7 and 221.7 shares, respectively	2	2
Additional paid-in capital	782	775
Accumulated comprehensive income	1	1
Retained earnings	494	391
Treasury stock - common shares at cost; 0.4 and 1.2 shares, respectively	(7)	(12)
 Total shareholders' equity	 1,272	 1,157
 Total liabilities and shareholders' equity	 \$ 2,325	 \$ 2,073

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

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WESTERN DIGITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in millions, except per share amounts; unaudited)

	THREE MONTHS ENDED	
	Sept. 29, 2006	Sept. 30, 2005
Revenue, net	\$ 1,264	\$ 1,010
Cost of revenue	1,046	832
Gross margin	218	178
Operating expenses:		
Research and development	75	70
Selling, general and administrative	44	40
Total operating expenses	119	110
Operating income	99	68
Non-operating income:		
Interest income	7	3
Interest and other expense		1
Total non-operating income	7	2
Income before income taxes	106	70
Income tax provision	3	1
Net income	\$ 103	\$ 69
Income per common share:		
Basic	\$.47	\$.32
Diluted	\$.46	\$.31
Weighted average shares outstanding:		
Basic	219	213
Diluted	225	221

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

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WESTERN DIGITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions; unaudited)

	THREE MONTHS	
	ENDED	
	Sept. 29,	Sept. 30,
	2006	2005
Cash flows from operating activities		
Net income	\$ 103	\$ 69
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	45	36
Stock-based compensation	9	7
Changes in:		
Accounts receivable	(132)	(67)
Inventories	(11)	(20)
Accounts payable	118	79
Accrued expenses	(1)	(40)
Advances to suppliers	(3)	(21)
Prepaid expenses and other		(3)
Net cash provided by operating activities	128	40
Cash flows from investing activities		
Capital expenditures, net	(72)	(50)
Purchases of short-term investments	(1)	(19)
Redemption of short-term investments	1	57
Net cash used in investing activities	(72)	(12)
Cash flows from financing activities		
Issuance of common stock under employee plans	2	12
Repurchase of common stock		(14)
Repayment of long-term debt	(6)	(5)
Net cash used in financing activities	(4)	(7)
Net increase in cash and cash equivalents	52	21
Cash and cash equivalents, beginning of period	551	485
Cash and cash equivalents, end of period	\$ 603	\$ 506
Supplemental disclosure of cash flow information:		
Cash paid during the period for income taxes	\$ 2	\$ 2
Cash paid during the period for interest	\$ 1	\$ 1

Supplemental disclosure of non-cash investing and financing activities:

Equipment acquired under capital lease	\$	21	\$	6
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The accompanying notes are an integral part of these condensed consolidated financial statements.

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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 Note 1 of the Notes to Consolidated Financial Statements included in the Company s Annual Report on Form 10-K as of and for the year ended June 30, 2006. 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 of America (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 as of and for the year ended June 30, 2006. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year.

Company management makes estimates and assumptions relating to the reporting of certain assets and liabilities in conformity with U.S. GAAP. These estimates and assumptions are applied using methodologies that are consistent throughout the periods presented. However, actual results can differ from these estimates. The Company makes adjustments to these estimates and assumptions in subsequent reporting periods as more current information becomes available. Given the time involved in completing the independent investigation into its stock option accounting, the Company did not file its Annual Report on Form 10-K for its fiscal year ended June 30, 2006 until November 2006. Accordingly, information not normally available regarding these estimates and assumptions as of June 30, 2006 became available during the process of preparing the financial statements for the quarter ended September 29, 2006. The Company evaluated this additional information and its resultant impact on the estimates and assumptions as of June 30, 2006 and determined that they were not material to its financial statements. As a result, the financial impact of these changes in estimates and assumptions has been reflected in the financial statements as adjustments for the three-months ended September 29, 2006 (see Note 2).

2. Supplemental Financial Statement Data*Inventories*

	Sept. 29, 2006	June 30, 2006
	(in millions)	
Inventories:		
Raw materials and component parts	\$ 33	\$ 23
Work in process	81	62
Finished goods	102	120
Total inventories	\$ 216	\$ 205

Warranty

The Company records an accrual for estimated warranty costs when revenue is recognized. Warranty covers costs of repair or replacement of the hard drive over the warranty period, which generally ranges from one to five years. This accrual is based on estimated future returns within the warranty period and costs to repair, using factory test data, historical field returns and current repair costs by product type. Return rate and repair cost estimates are reviewed quarterly and updated to reflect the impact of current results on prior expectations. If actual product return trends or costs to repair returned products demonstrate significant differences from expectations, a change in the warranty accrual is made. Changes in the warranty accrual for the three months ended September 29, 2006 and September 30,

2005 were as follows (in millions):

	THREE MONTHS ENDED	
	Sept. 29, 2006	Sept. 30, 2005
Warranty accrual, beginning of period	\$ 89	\$ 92
Charges to operations	19	21
Utilization	(12)	(10)
Change to prior period accruals	(5)	(7)
Warranty accrual, end of period	\$ 91	\$ 96

Accrued warranty also includes amounts classified in non-current liabilities of \$17 million at September 29, 2006, \$18 million at June 30, 2006, and \$17 million at September 30, 2005.

The \$5.5 million favorable adjustment to the prior period warranty accrual noted in the table above in the quarter ended September 29, 2006 represents a change in estimate and assumptions relating to the warranty accrual as of June 30, 2006. Similar adjustments in estimates and assumptions relating to other assets and liabilities as of June 30, 2006 were made for approximately \$4.3 million, favorably impacting the Company's operating results for the three months ended September 29, 2006. For additional information, see Note 1.

Table of Contents**3. Income per Share**

The Company computes basic income per share using the net income and the weighted average number of common shares outstanding during the period. Diluted income per share is computed using the net income and the weighted average number of common shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include outstanding employee stock options, employee stock purchase plan shares and restricted stock awards.

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

	THREE MONTHS ENDED	
	Sept. 29, 2006	Sept. 30, 2005
Net income	\$ 103	\$ 69
Weighted average shares outstanding:		
Basic	219	213
Employee stock options and other	6	8
Diluted	225	221
Income per share:		
Basic	\$.47	\$.32
Diluted	\$.46	\$.31
Antidilutive common share equivalents excluded	2	6

For purposes of computing diluted income per share, common share equivalents with an exercise price that exceeded the average fair market value of common stock for the period are considered antidilutive and have been excluded from the calculation of diluted shares outstanding.

4. Stock-Based Compensation*Stock Incentive Plans*

As of September 29, 2006, options to purchase 12 million shares of the Company's common stock remain outstanding, of which 8.2 million shares were exercisable, and 3 million shares of restricted stock remain unvested. The maximum number of shares of the Company's common stock that are authorized for award grants under the 2004 Performance Incentive Plan is 23 million shares. For further discussion and description of the Company's Stock Incentive Plans and Employee Stock Purchase Plan (ESPP), see Part II, Item 8, Note 7 in the Company's Annual Report on Form 10-K as of and for the year ended June 30, 2006.

Stock-Based Compensation Expense

Effective July 2, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share Based Payment (SFAS 123-R) using the modified prospective method. SFAS 123-R establishes the financial accounting and reporting standards for stock-based compensation plans. As required by SFAS 123-R, the Company recognized the cost resulting from all share-based payment transactions including shares issued under the Company's stock option plans and ESPP in the financial statements. During the three months ended September 29, 2006, the Company charged to expense \$4 million for stock-based compensation related to options issued under stock option and ESPP plans. At September 29, 2006, total compensation cost related to unvested stock options and ESPP

issued to employees but not yet recognized was \$27 million, which will be amortized on a straight-line basis over a weighted average vesting period of approximately 1.9 years.

Fair Value Disclosures

The fair value of stock options granted during the three months ended September 29, 2006 and September 30, 2005 was estimated using a binomial option pricing model. The binomial model requires the input of highly

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subjective assumptions including the expected stock price volatility, the expected price multiple at which employees are likely to exercise stock options and the expected employee termination rate. The Company uses historical data to estimate the rate at which employee options are exercised, employee terminations, 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 during the three months ended September 29, 2006 and September 30, 2005 was estimated using the following weighted average assumptions:

	THREE MONTHS ENDED	
	Sept. 29, 2006	Sept. 30, 2005
Suboptimal exercise factor	1.64	1.58
Range of risk-free interest rates	4.59% to 4.91%	4.01% to 4.34%
Range of expected stock price volatility	0.42 to 0.77	0.38 to 0.82
Weighted average expected volatility	0.63	0.68
Post-vesting termination rate	5.25%	15.36%
Dividend yield		
Fair value	\$7.65	\$5.82

The fair value of ESPP shares issued are estimated at the date of issue using the Black-Scholes-Merton option-pricing model. The Black-Scholes-Merton option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. 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. Shares granted under the current ESPP provisions are issued on either June 1 or December 1, except for the initial offering period, which began on December 15, 2005. Accordingly, there were no shares issued under the Company's ESPP for the quarters ended September 29, 2006 and September 30, 2005.

Stock Options

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

	Number of Shares	Weighted Average Exercise Price Per Share	Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Options outstanding at June 30, 2006	12.4	\$ 10.65		
Granted	0.1	17.26		
Exercised	(0.2)	9.47		
Canceled or expired	(0.1)	11.62		
Options outstanding at September 29, 2006	12.2	\$ 10.73	5.9	\$ 102
Exercisable at September 29, 2006	8.2	\$ 9.84	4.8	\$ 78

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company's common stock for those awards that have an exercise price currently below the

quoted price. As of September 29, 2006, the Company had options outstanding to purchase an aggregate of 7 million shares with an exercise price below the quoted price of the Company's stock resulting in an aggregate intrinsic value of \$102 million. During the three months ended September 29, 2006 and September 30, 2005, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$2 million and \$5 million, respectively, determined as of the date of exercise.

Deferred Stock Compensation

The Company granted five thousand shares of restricted stock during the three months ended September 29, 2006. The aggregate market value of these awards was \$0.1 million. As of September 29, 2006, the aggregate unamortized fair value of all unvested restricted stock awards was \$22 million and will be amortized on a straight-line basis over a weighted average vesting period of approximately 1.1 years. For the three months ended September 29, 2006, the Company charged to expense \$5 million related to restricted stock awards that were vested during the

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period. Of these amounts, \$2 million represented the incremental cost from modification of pre-existing awards in the beginning of fiscal 2006.

5. Legal Proceedings

In the normal course of business, the Company is subject to legal proceedings, lawsuits and other claims. Although the ultimate aggregate amount of monetary liability or financial impact with respect to these 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 matters or the specified matters below, individually and in the aggregate, beyond that provided at September 29, 2006, would not be material to the Company's financial condition. However, there can be no assurance with respect to such result, and monetary liability or financial impact to the Company from these legal proceedings, lawsuits and other claims could differ materially from those projected.

Since the Company's announcement on July 27, 2006 that it was conducting a company-initiated, voluntary review of its historical stock option grants, several purported derivative actions were filed nominally on behalf of the Company against certain current and former directors and officers of the Company in the United States District Court for the Central District of California and the Superior Court of the State of California for the County of Orange. These complaints assert claims for violations of Sections 14(a) and 20(a) of the Securities Exchange Act, accounting, breach of fiduciary duty and/or aiding and abetting, constructive fraud, waste of corporate assets, unjust enrichment, rescission, breach of contract, violation of the California Corporations Code, abuse of control, gross mismanagement, and constructive trust in connection with the Company's option granting practices. The complaints seek unspecified monetary damages and other relief against the individual defendants and certain governance reforms affecting the Company. The Company is named solely as a nominal defendant in each action. The Company has joined or intends to join the other defendants in filing motions to dismiss each action.

6. New Accounting Standards

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. FIN No. 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation applies to all tax positions related to income taxes subject to SFAS No. 109. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. Differences between the amounts recognized in the statements of financial position prior to the adoption of FIN No. 48 and the amounts reported after adoption should be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. The Company is currently evaluating the impact the adoption of FIN No. 48 could have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in U.S. GAAP, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of SFAS No. 157 could have on its consolidated financial statements.

In September 2006, the SEC staff published Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 addresses quantifying the financial statement effects of misstatements, specifically, how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. This statement is effective for fiscal years ending after November 15, 2006. The Company is currently evaluating the impact the adoption of SAB 108 could have on its consolidated financial statements.

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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 Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K as of and for the year ended June 30, 2006.

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 and our refer to Western Digital Corporation and its subsidiaries.

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, project, believe, anticipate, expect, estimate, continue, potential, plan, forecasts, 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:

growth in demand for hard drives in the desktop, mobile, enterprise and consumer electronics markets and factors contributing to such growth;

our expansion into new hard drive markets, such as consumer electronics, retail, and enterprise, and into emerging geographic markets;

increase in our sales of notebook hard drives and our on-going volume ramp of our Scorpio™ 2.5-inch hard drives;

our planned use of new recording technologies;

expectations regarding traditional seasonal demand trends and price declines for the hard drive industry;

beliefs regarding the sufficiency of our cash, cash equivalents and short-term investments to meet our working capital needs; and

beliefs regarding our operating performance and general industry conditions and their impacts on the realization of our deferred tax assets and the need to reduce all or a portion of our valuation allowance.

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 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.

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Our Company

We design, develop, manufacture and sell hard drives. A hard drive is a device that uses one or more rotating magnetic disks to store and allow fast access to data. Hard drives are key components of computers, data storage subsystems and many consumer electronic devices.

We sell our products worldwide to original equipment manufacturers (OEMs) for use in computer systems, subsystems and consumer electronics (CE) devices, and to distributors, resellers and retailers. Our hard drives are used in desktop computers, notebook computers, and enterprise applications such as servers, workstations, network attached storage and storage area networks. Additionally, our hard drives are used in CE applications such as digital video recorders (DVRs), satellite and cable set-top boxes, MP3 players, and USB thumb drives. We also sell our hard drives as stand-alone storage products and integrate them into our own WD-branded external storage products for purposes such as personal data backup and portable or expanded storage of digital music, photography, video, and other data.

Hard drives provide non-volatile data storage, which means that the data remains present when power is no longer applied to the device. Our hard drives currently include 3.5-inch, 2.5-inch and 1.0-inch form factor drives. The 3.5-inch form factor drives have capacities ranging from 36 gigabytes (GB) to 500 GB, nominal rotation speeds of 7,200 and 10,000 revolutions per minute (RPM), and offer interfaces including both Enhanced Integrated Drive Electronics (EIDE) and Serial Advanced Technology Attachment (SATA). The 2.5-inch form factor drives have capacities ranging from 40 GB to 160 GB, nominal rotation speed of 5,400 RPM, and offer both the EIDE and SATA interfaces. Our 1.0-inch form factor, with 4 GB and 6 GB capacities, have a nominal rotation speed of 3,600 RPM and use the CompactFlash® 130 interface.

We assemble hard drives in Malaysia and Thailand. We also design and manufacture a substantial portion of our required magnetic heads, head gimbal assemblies and head stack assemblies in Fremont, California and Bang Pa-In, Thailand. For geographical financial data, see Part II, Item 8, Note 10 in the Notes to Consolidated Financial Statements, included in our Annual Report on Form 10-K as of and for the year ended June 30, 2006.

Market Overview

For calendar year 2005, we believe that the total market for hard drives was more than 380 million units, or almost \$28 billion in sales. Over half of these unit shipments were to the desktop market. Total hard drive unit growth depends greatly on developments in the personal computer (PC) market. We believe that the demand for hard drives in the PC market has grown in part due to:

the overall growth of PC sales;

the increasing needs of businesses and individuals for increased storage capacity on their PCs;

the continuing development of software applications to manage multimedia content; and

the increasing use of broadband Internet, including content downloaded from the Internet onto PC hard drives.

We believe several other factors affect the rate of PC unit growth, including maturing PC markets in North America and Western Europe, an increase in first-time buyers of PCs in Asia, Eastern Europe and Latin America, and the lengthening of PC replacement cycles.

We entered the mobile computing part of the PC market in the first quarter of 2005, commencing volume production of our WD Scorpio family of 2.5-inch hard drives for notebook computers. We expect the mobile market, which is primarily notebook computers, to continue to grow faster than the desktop or enterprise markets in the next three years. We believe that the demand for mobile drives has grown from approximately 16% of the overall hard drive market in 2003 to 21% of the overall hard drive market in 2005. As the mobile market evolves to a higher volume market, we believe customers are placing increased emphasis on attributes such as quality,

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reliability, execution, flexibility, and competitive cost structures on their hard drive suppliers. These are the same attributes that have mattered for many years to customers in the high-volume desktop market.

The enterprise market for hard drives focuses on customers that make workstations, servers, network attached storage devices, storage area networks, and other computing systems or subsystems. We serve this market with hard drives using the SATA interface, which is similar in performance in some applications to the Small Computer Systems Interface (SCSI), but more cost effective than SCSI. We believe that the enterprise market has two distinct sectors: a marketplace for high-performance enterprise hard drives and a marketplace for high capacity enterprise hard drives. We believe that acceptance of SATA in both of these enterprise market sectors is growing. Additionally, we offer high-capacity, high reliability Parallel Advanced Technology Attachment (PATA) enterprise products to service video surveillance and similar PATA-based systems. Expansion of our involvement in the enterprise market may require us to make additional investments.

The use of hard drives in CE products has been a major growth area in recent years. Today's three largest segments of this market are: (1) digital television content in applications such as DVRs; (2) audio content in applications such as consumer handheld devices, such as MP3 players; and (3) hard drives in game consoles. Since 1999, DVRs have been available for use in home entertainment systems and they offer enhanced capabilities such as pausing live television, simplifying the process of recording, cataloging recorded television programs and quickly forwarding or returning to any section of a recorded television program. The market for DVR products favors large capacity hard drives, such as the 3.5-inch form factor, and continues to grow in Japan, North America, and Europe. We believe growth in this market will continue to build demand for higher capacity hard drives. Hard drives with 1.8-inch or 1.0-inch form factors primarily address the consumer handheld device and portable external storage markets. The majority of hard drives used in portable media players that play both digital audio and video content are 1.8-inch form factors. Game consoles that include hard drives primarily use the 2.5-inch form factors.

The branded products market for hard drives features storage products that we sell directly to end customers through retail store fronts and online stores. Our branded products include external hard drives, which are internal drives embedded into WD branded PC peripheral-style enclosures, which have FireWire , USB 2.0 and Ethernet network connections; and internal hard drives that are packaged as an installation kit with the WD brand for retail store sales. We believe the worldwide demand for external hard drives is growing, spurred by consumers' and businesses' expanding use of digital content in the form of photographs, video and music—all of which consume large amounts of storage.

First Quarter Overview

The following table sets forth, for the periods indicated, selected summary information from our condensed consolidated statements of income (dollars in millions):

	THREE MONTHS ENDED			
	Sept. 29, 2006		Sept. 30, 2005	
Net revenue	\$ 1,264	100.0%	\$ 1,010	100.0%
Gross margin	218	17.3	178	17.7
Total operating expenses	119	9.3	110	10.9
Operating income	99	7.9	68	6.7
Net income	103	8.2	69	6.8

The following is a summary of our financial performance for the first quarter of 2007:

Our net revenue for the first quarter of 2007 totaled \$1.3 billion, an increase of 25% over the prior year's first quarter.

During the September quarter, 35% of our revenue was derived from non-desktop PC sources, including CE products, enterprise applications, notebook computers and branded product sales, as compared to 25% in the prior year and 34% in the fourth quarter of fiscal 2006.

Unit shipments increased by 33% over the prior year to 22.7 million.

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Operating income for the September quarter was \$99 million, an increase of \$31 million over the prior year.

Operating margins improved to 8% as a percentage of net revenue in the first quarter of 2007 compared to 7% in the first quarter of 2006.

We generated \$128 million in cash flow from operations and finished the quarter with \$751 million in cash, cash equivalents and short-term investments.

Results of Operations**Net Revenue**

	THREE MONTHS ENDED		Percentage Change
	Sept. 29, 2006	Sept. 30, 2005	
	(in millions, except percentages & ASP)		
Net revenue	\$1,264	\$1,010	25%
Unit shipments	22.7	17.1	35%
ASP (per unit)	\$ 56	\$ 59	(5)%

Revenue by Geography (%)

Americas	35%	36%
Europe	28	29
Asia	37	35

Revenue by Channel (%)

OEM	52%	55%
Distributors	37	39
Branded products	11	6

Revenue by Product (%)

Desktop computers	65%	75%
Non-desktop sources	35	25

For the quarter ended September 29, 2006, net revenue was \$1.3 billion, an increase of 25%, or \$254 million, over the quarter ended September 30, 2005. Total unit shipments increased to 22.7 million for the first quarter of 2007 as compared to 17.1 million for the first quarter of 2006. This unit increase resulted from increased overall demand for hard drives, an increase in our market share and our increasing focus on non-desktop PC markets. For example, we shipped 2.2 million units to the mobile PC market in the first quarter of 2007 as compared to 1.0 million units in the first quarter of 2006. In addition, we shipped 2.5 million units to the DVR market in the first quarter of 2007 as compared to 1.3 million units in the first quarter of 2006. Average selling prices (ASPs) for the first quarter of 2007 were lower than the prior year due to normal industry price declines. These price declines were partially offset by an increase in sales of higher capacity products, due in part to an increase in sales of branded products. The changes in revenue by geography and by channel generally reflect overall market demand fluctuations for hard drives.

Table of Contents**Gross Margin**

	THREE MONTHS ENDED		Percentage Change
	Sept. 29, 2006	Sept. 30, 2005	
	(in millions)		
Net revenue	\$1,264	\$1,010	25.1%
Gross margin	218	178	22.3
<i>Gross margin %</i>	17.3	17.7	

Gross margin for the three months ended September 29, 2006 was \$218 million, an increase of \$40 million, or 22.3% over the three months ended September 30, 2005. Gross margin was favorably impacted in 2007 by ongoing manufacturing efficiencies, lower customer returns resulting from ongoing quality improvements that favorably impacted warranty obligations, and an increase in the average storage capacity of hard drives sold. During the three months ended September 29, 2006, our warranty accrual was favorably adjusted by approximately \$5.5 million as a result of changes in our repair cost assumptions for prior quarters' shipments. Similar adjustments in estimates and assumptions for other assets and liabilities as of June 30, 2006 were made for approximately \$4.3 million, favorably impacting gross margin in the quarter ended September 29, 2006. For additional information, see Notes 1 and 2 to the Condensed Consolidated Financial Statements. Gross margin as a percentage of revenue was impacted by normal industry price declines, which offset the favorable impact of the aforementioned factors.

Operating Expenses

	THREE MONTHS ENDED		Percentage Change
	Sept. 29, 2006	Sept. 30, 2005	
	(in millions)		
R&D expense	\$ 75	\$ 70	7.1%
SG&A expense	44	40	10.0
Total operating expenses	119	110	8.2

Research and development (R&D) expense was \$75 million for the three months ended September 29, 2006, an increase of \$5 million over the three months ended September 30, 2005. This increase was primarily related to the development of new product platforms in support of our entry into new markets and expenditures for advanced head technologies. Selling, general and administrative (SG&A) expense was \$44 million for the three months ended September 29, 2006, an increase of \$4 million over the prior year's comparable period. This increase includes approximately \$5 million of expense related to our independent stock option investigation that began in July 2006.

Interest Income

Interest income was \$7 million for the September quarter, an increase of \$4 million over the prior year. The increase resulted from higher average daily invested cash balances for the period and an increase in the rates of return on our investments given an increase in interest rates compared to the prior year.

Income Tax Provision

Our income tax provision for the three months ended September 29, 2006 was \$3 million, or 2.5% of income before taxes. Differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia and Thailand that expire at various times ranging from 2008 to 2019 and the partial utilization of net operating loss carryforwards. We currently anticipate the fiscal 2007 effective tax rate to be approximately 3%. However, our quarterly effective tax rate may fluctuate given changes in the valuation of deferred tax assets as we update our estimates of future taxable income. Each period 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. The realization of our deferred tax assets is primarily dependent on our ability to generate sufficient earnings in certain jurisdictions in future periods through the end of the first quarter of fiscal 2009. A two-year period is used due to the difficulty in accurately projecting income for longer periods of time given the cyclical nature of our industry. This assumption may change in the future based on fluctuating industry or company conditions. The amount of deferred tax assets considered realizable may increase or decrease in subsequent quarters when we update our estimates of future income or re-evaluate the two-year assumption. The impact of such updates were not material to the tax provision for the three months ended September 29, 2006.

Liquidity and Capital Resources

Our investment policy is to manage our investment portfolio to preserve principal and liquidity while maximizing return through the full investment of available funds. A portion of our funds is invested in auction rate securities, which are short-term investments in bonds with original maturities greater than 90 days. We ended the first quarter of 2007 with total cash, cash equivalents and short-term investments of \$751 million, an increase of \$52 million from June 30, 2006. Our short-term investments of \$148 million remained unchanged during the quarter (see Investing Activities below). The following table summarizes our statements of cash flows for the three months ended September 29, 2006 and September 30, 2005 (in millions):

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	THREE MONTHS ENDED	
	Sept. 29, 2006	Sept. 30, 2005
Net cash flow provided by (used in):		
Operating activities	\$ 128	\$ 40
Investing activities	(72)	(12)
Financing activities	(4)	(7)
Net increase in cash and cash equivalents	\$ 52	\$ 21

Operating Activities

Net cash provided by operating activities during the three months ended September 29, 2006 was \$128 million as compared to \$40 million during the three months ended September 30, 2005. Cash flow from operations consists of net income, adjusted for non-cash charges, plus or minus working capital changes. This represents our principal source of cash. Net cash used to fund working capital changes was \$29 million for the three months ended September 29, 2006 as compared to net cash used in working capital changes of \$72 million for the prior year.

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 for the three months ended September 29, 2006, June 30, 2006 and September 30, 2005, were as follows:

	THREE MONTHS ENDED		
	Sept. 29, 2006	June 30, 2006	Sept. 30, 2005
Days sales outstanding	44	40	42
Days in inventory	19	21	19
Days payables outstanding	(65)	(65)	(71)
Cash conversion cycle	(2)	(4)	(10)

The decline in the cash conversion cycle compared to the prior year primarily relates to the timing of payments to our vendors. From time to time, we modify the timing of payments to our vendors. We make these 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 or by granting to or receiving from our vendors payment term accommodations.

Investing Activities

Net cash used in investing activities for the three months ended September 29, 2006 was approximately \$72 million as compared to \$12 million for the three months ended September 30, 2005. For the three months ended September 29, 2006, cash used for investing activities consisted primarily of \$72 million for capital expenditures. Net cash used in investing activities for the three months ended September 30, 2005 consisted of \$50 million for capital expenditures, offset by a \$38 million net redemption of short-term investments.

For fiscal 2007, capital expenditures are currently expected to be approximately \$350 million to \$375 million and consist primarily of investments in advanced head technologies, new product platforms and capacity for our broadening and growing product portfolio. Depreciation and amortization expense for fiscal 2007 is estimated to be approximately \$180 million to \$200 million.

Financing Activities

Net cash used in financing activities for the three months ended September 29, 2006 was \$4 million as compared to net cash used in financing activities of \$7 million in the prior year. Net cash used in financing activities for the three months ended September 29, 2006 consisted of \$6 million utilized for debt repayment offset by \$2 million received upon exercise of outstanding employee stock options. Net cash used in financing activities for the three months ended September 30, 2005 consisted primarily of \$5 million for debt repayments and \$14 million used to repurchase our common stock, offset by \$12 million received upon issuance of outstanding employee stock options.

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

Other than facility and equipment lease commitments incurred in the normal course of business and certain indemnification provisions (see *Capital 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.

Capital Commitments

Line of Credit We have a \$125 million credit facility (*Senior Credit Facility*) consisting of a revolving credit line (subject to outstanding letters of credit and a borrowing base calculation) and a term loan of \$22 million as of September 29, 2006. Both the revolving credit facility and the term loan mature on September 20, 2009, and are secured by our accounts receivable, inventory, 65% of our stock in our foreign subsidiaries and other assets. For the three months ended September 29, 2006, we had no borrowings on the revolving credit line and the average variable rate on our term loan was 7.6%. The term loan requires quarterly principal payments of approximately \$3 million. Principal payments made on the term loan increase the amount of revolving credit available. At September 29, 2006, \$101 million was available for borrowing under the revolving credit line and we had \$2 million in outstanding letters of credit. As of September 29, 2006, we were in compliance with all covenants related to the Senior Credit Facility.

The terms of the Senior Credit Facility require that we deliver to the lenders our audited financial statements within 90 days of the end of each fiscal year. As a result of the independent investigation into our stock option accounting that was conducted under the direction of a special committee of our Board of Directors, we were delayed in completing our fiscal year 2006 audited financial statements, our Annual Report on Form 10-K as of and for the year ended June 30, 2006, and this Quarterly Report on Form 10-Q. At our request, the lenders under the Senior Credit Facility agreed that we would not be in default under the Senior Credit Facility as a result of our failure to timely deliver our 2006 audited financial statements, provided that the lenders receive the 2006 audited financial statements and all other documents reasonably requested by the lenders including the Management's Discussion and Analysis of Financial Condition and Results of Operations section from this Quarterly Report on Form 10-Q before the earlier of: (a) 30 days following the filing of our Annual Report on Form 10-K as of and for the year ended June 30, 2006, or (b) January 12, 2007. We filed our 2006 Annual Report on Form 10-K on November 20, 2006 and intend to deliver audited financial statements to the lenders as soon as practicable. We also intend to deliver the Management's Discussion and Analysis of Financial Position and Result of Operations section from this Quarterly Report on Form 10-Q for the three months ended September 29, 2006 on or around the date of filing.

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. 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.

We have entered into long-term purchase agreements with various component suppliers, which contain 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. In conjunction with these agreements, we have advanced approximately \$95 million, net of repayments, related to future purchase commitments, of which \$9 million has been classified as a long-term asset at September 29, 2006.

See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations *Capital Commitments* in our Annual Report on Form 10-K as of and for the year ended June 30, 2006, for further discussion of our purchase orders and purchase agreements and the associated dollar amounts.

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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. See Part II, Item 1A in this Quarterly Report on form 10-Q for a discussion of these commitments.

Forward Exchange Contracts We purchase short-term, forward exchange contracts to hedge the impact of foreign currency fluctuations on certain underlying assets, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. See Part I, Item 3, under the heading "Disclosure About Foreign Currency Risk," for our current forward exchange contract commitments.

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 such agreements, 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.

Stock Repurchase Program Our Board of Directors has authorized us to repurchase \$250 million of our common stock in open market transactions. The term of the program is a five-year period from November 17, 2005 to November 17, 2010. We expect stock repurchases to be funded principally by operating cash flows. Given the independent stock option investigation that was in process, we did not repurchase any shares of common stock under our repurchase program during the first quarter of 2007. Through November 10, 2006, we have repurchased 10.2 million shares for a total cost of \$115 million (including commissions). We may continue to repurchase our stock as we deem appropriate and market conditions allow.

We believe our current cash, cash equivalents and short-term investments will be sufficient to meet our working capital needs through the foreseeable future. Additionally, there can be no assurance that our Senior Credit Facility will continue to remain available. Also, our ability to sustain our working capital position is dependent upon a number of factors that we discuss in Part II, Item 1A of this Quarterly Report on Form 10-Q. We currently anticipate that we will continue to utilize our liquidity and cash flows to improve the efficiency and capability of our existing hard drive and head manufacturing operations.

Critical Accounting Policies

We have prepared the accompanying unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. The preparation of the financial statements requires the use of judgment and estimates that affect the reported amounts of revenues, expenses, assets, liabilities and 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 have agreements with resellers that provide limited price protection for inventories held by resellers at the time of published list price reductions and other incentive programs. In accordance with current accounting standards, we recognize revenue upon delivery to OEMs and

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resellers and record a reduction to revenue for estimated price protection and other programs in effect until the resellers sell such inventory to their customers. We base these adjustments on anticipated price decreases during the reseller holding period, estimated amounts to be reimbursed to qualifying customers, as well as historical pricing information. If end-market demand for hard drives declines significantly, we may have to increase sell-through incentive payments to resellers, resulting in an increase in our allowances, which could adversely impact operating results.

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 affect operating results.

We establish provisions against revenue and cost of revenue for estimated 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 negatively affect operating results.

Warranty

We record an accrual for estimated warranty costs when revenue is recognized. Warranty covers costs of repair or replacement of the hard drive over the warranty period, which generally ranges from one to five years. We have comprehensive processes with which to estimate accruals for warranty, which include specific detail on hard drive reliability, such as factory test data, historical field return rates, and costs to repair by product type. If actual product return trends or costs to repair returned products demonstrate significant differences from expectations, a change in the warranty provision is made. If these estimates differ significantly from actual results, the impact to the consolidated financial statements may be material. 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.

Inventory

We value inventories at the lower of cost (first-in, first-out basis) or net realizable value. 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 backlog, 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 an increase in inventory balance adjustments that could negatively affect operating results.

Litigation and Other Contingencies

We apply SFAS No. 5, Accounting for Contingencies, to determine when and how much to accrue for and disclose related to legal and other contingencies. Accordingly, we disclose contingencies deemed to be reasonably possible and accrue loss contingencies when, in consultation with our legal advisors, we conclude that a loss is probable and reasonably estimable (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). 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.

Table of Contents***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 (NOL) and tax credit carryforwards. We record a valuation allowance where it is more likely than not that the deferred tax assets will not be realized. Each period 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. The realization of our deferred tax assets is primarily dependent on our ability to generate sufficient earnings in certain jurisdictions in future periods through the end of the first quarter of fiscal 2009. A two-year period is used due to the difficulty in accurately projecting income for longer periods of time given the cyclical nature of our industry. This assumption may change in the future based on fluctuating industry or company conditions. The amount of deferred tax assets considered realizable may increase or decrease in subsequent quarters when we update our estimates of future income or re-evaluate the two-year assumption.

We record estimated liabilities for tax uncertainties. To the extent a tax position does not meet a probable level of certainty, a liability is established based on the best estimate of the amount that will not be sustained. However, the actual liability in any such contingency may be materially different from our estimates, which could result in the need to record additional tax liabilities or potentially adjust previously recorded tax liabilities.

Stock-Based Compensation

We account for all stock-based compensation in accordance with the fair value recognition provisions of SFAS No. 123-R, *Share-Based Payment* . Under these provisions, 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. Under SFAS No. 123-R, 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 impacted.

Prior to the adoption of SFAS No. 123-R, we accounted for stock-based employee compensation plans (including shares issued under our stock option plans and ESPP) in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and its related interpretations (APB No. 25), and followed the pro forma net income, pro forma income per share, and stock-based compensation plan disclosure requirements set forth in SFAS No. 123, *Accounting for Stock-Based Compensation*. All other types of equity awards were previously accounted for in accordance with SFAS No. 123.

The fair values of all stock options granted subsequent to April 1, 2005 were estimated using a binomial model, and the fair values of all options granted prior to April 1, 2005 and all ESPP shares were estimated using the Black-Scholes-Merton option pricing model. Both the binomial and the Black-Scholes-Merton models require the input of highly subjective assumptions.

New Accounting Standards

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN No. 48), *Accounting for Uncertainty in Income Taxes*, an interpretation of Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. FIN No. 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation applies to all tax positions related to income taxes subject to SFAS No. 109. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. Differences between the amounts recognized in the statements of financial position prior to the adoption of FIN No. 48 and the amounts reported after adoption should be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. We are currently evaluating the impact the adoption of FIN No. 48 could have on our consolidated financial statements.

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In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently evaluating the impact the adoption of SFAS No. 157 could have on our consolidated financial statements.

In September 2006, the SEC staff published Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 addresses quantifying the financial statement effects of misstatements, specifically, how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. This statement is effective for fiscal years ending after November 15, 2006. We are currently evaluating the impact the adoption of SAB 108 could have on our consolidated financial statements.

Table of Contents**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, forward exchange contracts to hedge the impact of foreign currency fluctuations on certain underlying assets, 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 six months. We do not purchase short-term forward exchange contracts for trading purposes. Currently, we focus on hedging our foreign currency risk related to the Thai Baht, the Euro and the British Pound Sterling. Thai Baht contracts are designated as cash flow hedges. All other contracts are designated as fair value hedges. See Part II, Item 8, Note 1 in the Notes to Consolidated Financial Statements, included in our Annual Report on Form 10-K as of and for the year ended June 30, 2006.

As of September 29, 2006, we had the following purchased foreign currency forward exchange contracts outstanding (in millions, except weighted average contract rate):

		September 29, 2006	
	Contract	Weighted	Unrealized
	Amount	Average	Gain
		Contract Rate *	
Foreign currency forward contracts:			
Thai Baht	\$237.2	38.00	\$ 0.3
Euro	1.4	0.79	
British Pound Sterling	1.2	0.53	

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

During the three month periods ended September 29, 2006 and September 30, 2005, total net realized transaction and forward exchange contract currency gains and losses were not material to the condensed consolidated financial statements.

Disclosure About Other Market Risks*Variable Interest Rate Risk*

At our option, borrowings under the Senior Credit Facility would bear interest at either LIBOR (with option periods of one to three months) or a base rate, plus a margin. If LIBOR or the base rate increases, our interest payments would also increase. At September 29, 2006, we had a \$22 million term loan outstanding under the Senior Credit Facility. A one percent increase in the variable rate of interest on the Senior Credit Facility would increase interest expense by approximately \$0.2 million annually.

Item 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures were effective. There were no changes in our internal control over financial reporting during the quarter ended September 29, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

In the normal course of business, we are subject to legal proceedings, lawsuits and other claims. We believe that any monetary liability or financial impact to us from these matters, individually and in the aggregate, beyond what we have provided for at September 29, 2006, would not be material to our financial condition. However, the ultimate amount of monetary liability or financial impact with respect to these matters is very uncertain and difficult to predict, and could therefore differ materially from our expectations.

The following purported shareholder derivative actions have been filed challenging conduct by certain of our current and former board members and officers in connection with various stock option grants:

Dreyfuss v. Massengill, et al., Case No. SACV 06-729 AG (RNGx), United States District Court for the Central District of California, filed August 9, 2006 and *Kastella and Sakamoto v. Mercer, et al., Case No. SACV 06-868 CJC (MLGx)*, United States District Court for the Central District of California, filed September 14, 2006. The plaintiffs in the *Dreyfuss* and *Kastella and Sakamoto* actions jointly filed an amended complaint on September 29, 2006 asserting claims for violations of Sections 14(a) and 20(a) of the Securities Exchange Act, accounting, breach of fiduciary duty and/or aiding and abetting, constructive fraud, waste of corporate assets, unjust enrichment, rescission, breach of contract, and violation of the California Corporations Code in connection with our option granting practices. We have been advised by plaintiffs' counsel that the parties intend to consolidate the *Dreyfuss* action with the *Kastella and Sakamoto* action.

Mason v. Massengill, et al., Case No. CV06-6845 PA (RZx), United States District Court for the Central District of California, filed October 27, 2006. The complaint asserts claims for violations of Section 14(a) of the Securities Exchange Act, accounting, breach of fiduciary duty and/or aiding and abetting, abuse of control, gross mismanagement, constructive fraud, waste of corporate assets, unjust enrichment, rescission, and violation of the California Corporations Code in connection with our option granting practices.

Lasker v. Massengill, et al., Case No. 06-CC-00159, Superior Court of the State of California for the County of Orange, filed August 14, 2006. The complaint asserts causes of action for breach of fiduciary duty, accounting, abuse of control, gross mismanagement, constructive fraud, corporate waste, unjust enrichment, and rescission in connection with our option granting practices.

Rosen v. Shakeel, et al., Case No. 06CC00234, Superior Court of the State of California for the County of Orange, filed November 6, 2006. The complaint asserts causes of action for unjust enrichment, breach of fiduciary duty, violations of the California Corporations Code, abuse of control, gross mismanagement, waste of corporate assets, accounting, rescission, and constructive trust in connection with our option granting practices.

We have joined the other defendants in filing a motion to dismiss the *Dreyfuss* and *Kastella and Sakamoto* actions.

Item 1A. RISK FACTORS

We have updated the risk factors discussed in Item 1A of our Annual Report on Form 10-K as of and for the year ended June 30, 2006. We do not believe any of the updates constitute material changes from the risk factors previously disclosed in our Annual Report on Form 10-K as of and for the year ended June 30, 2006.

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Declines in average selling prices (ASPs) in the hard drive industry adversely affect our operating results.

The hard drive industry historically has experienced declining ASPs. Our ASPs tend to decline when competitors lower prices as a result of decreased costs or to absorb excess capacity, liquidate excess inventories, restructure or attempt to gain market share. Our ASPs also 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. If ASPs in the hard drive industry continue to decline, then our ASPs will also likely decline, which would adversely affect our operating results.

If we fail to anticipate or timely respond to changes in the markets for hard drives, our operating results could be adversely affected.

Over the past few years the consumer market for computers has shifted significantly towards lower priced systems. If we are not able to continue to offer a competitively priced hard drive for the low-cost PC market, our share of that market will likely fall, which could harm our operating results.

The market for hard drives is also fragmenting into a variety of devices and products. Many industry analysts expect, as do we, that as content increasingly convert to digital technology from the older, analog technology, the technology of computers and consumer electronics will continue to converge, and hard drives will be found in many CE products other than computers.

In addition, we expect that the consumer market for multi-media applications, including audio-video products, incorporating high capacity, and handheld consumer storage will continue to grow. However, because this market remains relatively new, accurate forecasts for future growth remain challenging. Moreover, some of the devices, such as personal video recorders and digital video recorders, or other products outside of the CE market, may require attributes not currently offered in our products, resulting in a need to expend capital to develop new interfaces, form factors, technical specifications or hard drive features, increasing our overall operational expense without corresponding incremental revenue at this stage. If we are not successful in continuing to deploy our hard drive technology and expertise to develop new products for the emerging CE market, or if we are required to incur significant costs in developing such products, it may harm our operating results.

Our prices and margins are subject to declines due to unpredictable end-user demand and oversupply of hard drives.

Demand for our hard drives depends 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 intense price competition. If intense price competition occurs, we may be forced to lower prices sooner and more than expected, which could result in lower revenue and gross margins.

Our failure to accurately forecast market and customer demand for our products could adversely affect our business and financial results.

The hard drive 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. If our forecasts exceed actual market demand, or if market demand decreases significantly from our forecasts, then we could experience periods of product oversupply and price decreases, which could impact our financial performance. If our forecasts do not meet actual market demand, or if market demand increases significantly beyond our forecasts, 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.

We also use forecasts in making decisions regarding investment of our resources. For example, as the hard drive industry transitions from the Parallel Advanced Technology Attachment (PATA) interface to the SATA interface, we may invest more resources in the development of products using the SATA interface. If our forecasts regarding

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the replacement of the PATA interface with the SATA interface are inaccurate, we may not have products available to meet our customers' needs.

In addition, although we receive forecasts from our customers, they are not obligated to purchase the forecasted amounts. In particular, sales volumes in the distribution channel are volatile and harder to predict than sales to our OEM customers. We consider these forecasts in determining our component needs and our inventory requirements. If we fail to accurately forecast our customers' product demands, we may have inadequate or excess inventory of our products or components, which could adversely affect our operating results.

Increases in areal density may outpace customers' demand for storage capacity, which may lower the prices our customers are willing to pay for new products.

Historically, the industry has experienced periods of increased areal density growth rates. Although in recent years there has been a decrease in the rate of areal density growth, if industry conditions return to periods of increased growth rates, the rate of increase in areal density may exceed the increase in our customers' demand for aggregate storage capacity. Furthermore, our customers' demand for storage capacity may not continue to grow at current industry estimates as a result of developments in the regulation and enforcement of digital rights management or otherwise. These factors could lead to our customers' storage capacity needs being satisfied with lower capacity hard drives at lower prices, thereby decreasing our revenue. As a result, even with increasing aggregate demand for storage capacity, our ASPs could decline, which could adversely affect our results of operations.

A low cost structure is critical to our operating results and increased costs may adversely affect our operating margins.

A low cost structure for our products, including critical components, labor and overhead, is critical to the success of our business and our operating results depend on our ability to maintain competitive cost structures on new and established products. If our competitors are able to achieve a lower cost structure for manufacturing hard drives, and we are unable to match their cost structure, we could be at a competitive disadvantage to those competitors.

Additionally, there are costs for certain commodity materials, an increase in which increases our costs of manufacturing and transporting hard drives and key components. For example, shortages of materials such as steel and aluminum increase our costs and may result in lower operating margins if we are unable to find ways to mitigate these increased costs. The rising cost of oil also increases our costs and may result in lower operating margins if we are unable to pass such increased costs through to our customers.

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

Product life cycles have been extending since the middle of calendar year 2002 due in large part to a decrease in the rate of hard drive areal density growth. However, there can be no assurance that this trend will continue. If longer product life cycles continue, we may need to develop new technologies or programs to reduce our costs on any particular product to maintain competitive pricing for that product. This 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. If product life cycles shorten, it may be 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.

If we fail to make the technical innovations necessary to continue to increase areal density, we may fail to remain competitive.

New products in the hard drive market typically require higher areal densities than previous product generations, posing formidable technical and manufacturing challenges. Higher areal densities require existing head and media technology to be improved or new technology developed to accommodate more data on a single disk. In addition, our introduction of new products during a technology transition increases the likelihood of unexpected quality

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concerns. Our failure to bring high quality new products to market on time and at acceptable costs may put us at a competitive disadvantage to companies that achieve these results.

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

Currently the majority of the hard drive industry uses giant magnetoresistive head technology, which allows significantly higher storage capacities than the previously utilized thin-film head technology. However, the industry is developing and now implementing new recording technologies that may enable greater recording densities than currently available using magnetoresistive head technology, including perpendicular, current perpendicular-to-plane, and tunneling junction technology, each of which represent a significant change in fundamental recording technology. The industry is experiencing a fundamental shift in recording technology, this shift in technology is difficult to implement and historically, when the industry experiences a fundamental change in technology, any manufacturer that fails to successfully and timely adjust their designs and processes to accommodate the new technology, fails to remain competitive. There are some technologies, such as heat assisted magnetic recording, that, if they can be implemented by a competitor on a commercially viable basis, will represent a revolutionary recording technology that could put us at a competitive disadvantage.

As a result, we could incur substantial costs in developing new technologies, such as, heads, 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. Furthermore, as we attempt to develop and implement new technologies, we may become more dependent on suppliers to ensure our access to components that accommodate the new technology. For example, new recording technology requires changes in the manufacturing process of media, which may cause longer production times and reduce the overall availability of media in the industry. Additionally, the new technology requires a greater degree of integration between heads and media which may lengthen our time of development of hard drives using this technology. These results would increase our operating costs, which may negatively impact our operating results. *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. 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, because increases in areal density have become more difficult in the hard drive industry, such increases may require increases in component costs. In addition, other opportunities to reduce costs may not continue at historical rates. Our inability to achieve cost reductions could adversely affect our operating results.

If we fail to maintain effective relationships with our major component suppliers, our supply of critical components may be at risk and our profitability could suffer.

Under our business model, we do not manufacture many of the component parts used in our hard drives, however, for some of our product families, we do make most of our own heads. As a result, the success of our products depends on our ability to gain access to and integrate parts that are best in class from reliable component suppliers. To do so, we must effectively manage our relationships with our major component suppliers. We must also effectively integrate different products from a variety of suppliers, each of which employs variations on technology, which can impact, for example, feasible combinations of heads and media components. In August 2003, we settled litigation with a supplier who previously was the sole source of read channel devices for our hard drives. As a result of the disputes that gave rise to the litigation, our profitability was at risk until another supplier's read

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channel devices could be designed into our products. Similar disputes with other strategic component suppliers could adversely affect our operating results.

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

Certain components are available from a limited number of suppliers. Because we depend on a limited number of suppliers for certain hard drive components and manufacturing equipment, each of the following could significantly harm our operating results:

an increase in the cost of such components or equipment;

an extended shortage of required components or equipment;

consolidation of key suppliers;

failure of a key supplier's business process; or

the failure of key suppliers to remain in business, adjust to market conditions, or to meet our quality, yield or production requirements.

Our future operating results may also 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 outside suppliers, and may be used across multiple product lines. In addition, some of the components (or component types) used in our products are used in other devices, such as mobile telephones and digital cameras. If there is a significant simultaneous upswing in demand for such a component (or component type) from several high volume industries, resulting in a supply reduction, or a component is otherwise in short supply, or if a supplier fails to qualify or has a quality issue with a component, we may experience delays or increased costs in obtaining that component. For example, the hard drive industry is currently facing a tightness in the availability of media (rotating magnetic disks) components, and there are currently only three independent suppliers of aluminum media and three independent suppliers of glass media in the market. Several of our competitors have an internal supply of media therefore allowing them to better withstand a shortage of media while, if we are unable to obtain sufficient quantities of media, or other necessary components, we may experience production delays which could cause us loss of revenue. If a component becomes unavailable, we could suffer significant loss of revenue.

In addition, certain equipment we use in our manufacturing or testing processes is available only from a limited number of suppliers. Some of this equipment uses 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.

Contractual commitments with component suppliers may result in us paying increased charges and cash advances for such components.

To reduce the risk of component shortages, we attempt to provide significant lead times when buying these components. As a result, we may be subject to cancellation charges if we cancel orders, which may occur when we make technology transitions or when our component needs change. In addition, we have entered into contractual commitments with component suppliers, such as suppliers of media, and may enter into contractual commitments with other 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 require or 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.

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We have high-volume hard drive manufacturing facilities in Malaysia and Thailand, which subjects us to the risk of damage or loss of any of these facilities and localized risks to personnel in these locations.

Our hard drives are manufactured in facilities in Malaysia and Thailand. A fire, flood, earthquake or other disaster, condition or event such as a power outage that adversely affects any of these facilities or our ability to manufacture could limit the total volume of hard drives we are able to manufacture and result in a loss of sales and revenue and harm our operating results. Similarly, a localized health risk affecting our personnel in Malaysia and Thailand, such as a new pandemic influenza in Asia Pacific, could impair the total volume of hard drives that we are able to manufacture.

Our head manufacturing operations include a single wafer fabrication facility in Fremont, California and a single head gimbal/head stack assembly facility in Bang Pa-In, Thailand, which subjects us to substantial risk of damage or loss if operations at either of these facilities are disrupted.

As we have previously discussed in public statements, our business plan presently contemplates that we plan to design and manufacture approximately 70% of the heads required for the hard drives we manufacture. We fabricate wafers in our Fremont, California facility, and the wafers are then sent to our Thailand facility for slider fabrication/wafer slicing, HGA assembly and testing, and HSA assembly and testing. A fire, flood, earthquake or other disaster, condition or event such as a power outage that adversely affects our facilities in Fremont, California or Bang Pa-In, Thailand would significantly affect our supply of heads and limit our ability to manufacture hard drives which would result in a substantial loss of sales and revenue and a substantial harm to our operating results.

Our head manufacturing operations may result in additional costs and risks to our business.

Our vertical integration of head manufacturing resulted in a fundamental change in our operating structure, as we now manufacture heads for use in many of the hard drives we manufacture. Consequently, we make more capital investments than we would if we were not vertically integrated and carry a higher percentage of fixed costs than assumed in our prior financial business model. If the overall level of production decreases for any reason, and we are unable to reduce our fixed costs to match sales, our head manufacturing assets may face under-utilization that may impact our results of operations. 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, especially hard drive media, that is optimized to work with our heads.

In addition, we may incur additional risks, including:

insufficient head sources if we are unable to manufacture a sufficient supply of heads to satisfy our needs;

third party head suppliers may not continue to do business with us or may not do business with us on the same terms and conditions we have previously enjoyed;

claims that our manufacturing of heads may infringe certain intellectual property rights of other companies; and

difficulties locating suitable manufacturing equipment for our head manufacturing processes and replacement parts for such equipment.

If we do not adequately address the challenges related to our head manufacturing operations, our ongoing operations could be disrupted, resulting in a decrease in our revenue or profit margins and negatively impacting our operating results.

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Our operating results may be adversely affected if we fail to optimize the overall quality, time-to-market and time-to-volume of new and established products.

To achieve consistent success with our customers who manufacture computers, systems and CE products, we must balance several key attributes such as time-to-market, time-to-volume, quality, cost, service, price and a broad product portfolio. If we fail to:

maintain overall quality of products on new and established programs;

produce sufficient quantities of products at the capacities our customers demand while managing the integration of new and established technologies;

develop and qualify new products that have changes in overall specifications or features that our customers may require for their business needs;

obtain commitments from our customers to qualify new products, redesigns of current products, or new components in our existing products;

qualify these products with key customers on a timely basis by meeting all of our customers' needs for performance, quality and features;

maintain an adequate supply of components required to manufacture our products;

maintain the manufacturing capability to quickly change our product mix between different capacities, form factors and spin speeds in response to changes in customers' product demands; or

consistently meet stated quality requirements on delivered products, our operating results could be adversely affected.

If we are unable to timely and cost-effectively develop heads 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.

Under our business plan, we are developing and manufacturing a substantial portion of the heads used in some of the product families of hard drives we manufacture. Consequently, we are more dependent upon our own development and execution efforts and less able to take advantage of head technologies developed by other head manufacturers. Technology transition for head designs is critical to increasing our volume production of heads. There can be no assurance, however, that we will be successful in timely and cost-effectively developing and manufacturing heads for products using future technologies. We also may not effectively transition our head design and head 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 we manufacture. In addition, we may not have access to external sources of supply without incurring substantial costs. For example, we recently began using perpendicular recording heads in certain of our products. We face various challenges in ramping the manufacturing volume of these products and if we do not adequately address these challenges, or if we encounter quality problems with the heads we manufacture for these products, our continued shipment of these products may be delayed, impairing our ability to realize revenue from these products.

If we fail to qualify our products with our customers, they may not purchase any units of a particular product line, which would have a significant adverse impact on our sales.

We regularly engage in new product qualification with our customers. To be considered for qualification, we must be among the leaders in time-to-market with our new products. Once a product is accepted for qualification testing, failures or delays in the qualification process can result in our losing sales to that customer until the next generation of products is introduced. The effect of missing a product qualification opportunity is magnified by the

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limited number of high volume OEMs, which continue to consolidate their share of the desktop, mobile and CE markets. If product life cycles continue to be extended due to a decrease in the rate of areal density growth, we may have a significantly longer period to wait before we have an opportunity to qualify a new product with a customer, which could harm our competitive position. These risks are increased because we expect cost improvements and competitive pressures to result in declining gross margins on our current generation products.

We are subject to risks related to product defects, which could result in product recalls and could subject us to warranty claims in excess of our warranty provisions or which are greater than anticipated due to the unenforceability of liability limitations.

We warrant our products for up 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 latent 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. In addition, a product recall may damage our relationship with our customers, and we may lose market share with our customers, including our OEM 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. If these additional expenses are significant, it could adversely affect our business, financial condition and results of operations.

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.

Higher capacity storage needs have typically been better served by magnetic hard drives than flash memory as hard drive manufacturers can offer better value at high capacities, while lower capacity needs have been successfully served by solid state storage such as flash memory technology. Advances in magnetic, optical, semiconductor or other data storage technologies could result in competitive products that have better performance or lower cost per unit of capacity than our products. If we fail to be cost competitive against flash memory, we could be at a competitive disadvantage to competitors using semiconductor technology. For example, flash memory recently achieved improvements in their cost structure and we believe reduced their pricing, thus more effectively competing with our 1.0-inch hard drive product. If we are unable to lower the cost structure of future generations of sub-2.5-inch form factor hard drive products through technology advances such as increased storage capacity, this product category could be at a competitive disadvantage to flash technology.

Further industry consolidation could provide competitive advantages to our competitors.

The hard drive industry has experienced consolidation over the past several years, including the recent acquisition of Maxtor Corporation by Seagate Technology. Consolidation by our competitors may enhance their capacity, abilities and resources and lower their cost structure, causing us to be at a competitive disadvantage. Additionally, continued industry consolidation may lead to uncertainty in areas such as component availability, which could negatively impact our cost structure.

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Sales in the distribution channel are important to our business, and if we fail to maintain brand preference with our distributors 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. If we fail to remain competitive in terms of our technology, quality, service and support, our distribution customers may favor our competitors, and our operating results could suffer. We also face significant risk in the distribution market for hard drives. If the distribution market weakens as a result of a slowing PC growth rate, technology transitions or a significant change in consumer buying preference from white box to branded PCs, or we experience significant price declines due to oversupply in the distribution channel, then our operating results would be adversely affected.

The hard drive industry is highly competitive and can be characterized by significant shifts in market share among the major competitors.

The price of hard drives has fallen over time due to increases in supply, cost reductions, technological advances and price reductions by competitors seeking to liquidate excess inventories or attempting to gain market share. In addition, rapid technological changes often reduce the volume and profitability of sales of existing products and increase the risk of inventory obsolescence. We also face competition from other companies that produce alternative storage technologies like flash memory. These factors, taken together, may result in significant shifts in market share among the industry's major participants. In addition, product recalls can lead to a loss of market share, which could adversely affect our operating results.

Some of our competitors with diversified business units outside the hard drive industry may be able to sell disk drives at lower margins that we cannot match.

Some of our competitors earn a significant portion of their revenue from business units outside the hard drive industry. Because they do not depend solely on sales of hard drives to achieve profitability, they may be able to sell hard drives at lower margins and operate their hard drive business unit at a loss while still remaining profitable overall. In addition, if these competitors can increase sales of non-hard drive products to the same customers, they may benefit from selling their hard drives at low margins. Our results of operations may be adversely affected if we can not successfully compete with these companies.

If we do not successfully expand into new hard drive 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 hard drives for the desktop, enterprise, CE and external storage markets, and we also offer 2.5-inch form factor hard drives for the mobile, CE and external storage markets. However, demand for hard drives may shift to products in smaller other form factors, which our competitors may already offer. We recently entered into the sub-2.5-inch hard drive market with a 1.0-inch hard drive product, however the demand for the 1.0-inch form factor drive is significantly less than our initial estimates of this market, thus impairing our ability to realize revenue from this product.

In addition, the desktop and enterprise markets are transitioning from parallel interfaces, such as PATA and SCSI, to serial interfaces, such as SATA and SAS, to handle higher data transfer rates. We currently offer SATA products; however, the transition of technology and the introduction of new products are challenging and create risks. For example, acceptance of the SATA interface may not continue to grow, or customers may choose to purchase alternative interfaces that may not be compatible with future generations of SATA hard drives. Moreover, our customers may require new SATA features that we may not be able to deliver in a timely and cost effective manner.

While we continue to develop new products and look to expand into other hard drive markets, the success of our new product introductions is dependent on a number of factors, including difficulties faced in manufacturing ramp, market acceptance, effective management of inventory levels in line with anticipated product demand, and the risk

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that our new products may have quality problems or other defects in the early stages of introduction that were not anticipated in the design of those products. Further, we need to identify how any of the hard drive markets that we are expanding into may have different characteristics from the desktop market, such as, demand volume growth rates, demand seasonality, product generations development rates, customer concentrations, and cost and performance requirements, and we must properly address these differences. If we fail to successfully develop and manufacture new products and expand into new hard drive markets, customers may decrease the amount of our products that they purchase, and we may lose business to our competitors who offer these products.

Expanding into new hard drive markets exposes our business to different seasonal demand cycles, which in turn could adversely affect our operating results.

The CE markets that we are attempting to expand into have different seasonal pricing and volume demand cycles as compared to the PC market. By expanding into these markets, we become exposed to seasonal fluctuations that are different than, and in addition to, those of the PC market. For example, because the primary customer for products such as consumer handheld devices and game consoles are individual consumers, these markets experience a dramatic increase in demand during the winter holiday season. If we do not properly adjust our supply to new demand cycles such as this, we risk having excess inventory during periods of low demand and insufficient inventory during periods of high demand, therefore harming our operating results.

If we do not successfully continue to expand into the mobile market, our business may suffer.

We began shipping 2.5-inch form factor hard drives for the mobile market during calendar year 2004. Although many of our customers who purchase 3.5-inch form factor hard drives also purchase the 2.5-inch form factor drives, the markets are characterized by some different competitors and different overall requirements. If we are unable to adapt to these differences and meet the new requirements, we would have a competitive disadvantage to companies that are successful in this regard, and our business and financial results could suffer. In addition, if we continue to incur significant costs in manufacturing and selling the 2.5-inch hard drives, and if we are unable to recover those costs from sales of the products, then we may not be able to compete successfully in this market and our operating results may suffer.

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.

We sell our branded products directly to a select group of major retailers, for example, computer superstores and CE stores, and authorize sales through distributors to other retailers and online resellers. Our current retail customer base is primarily in the United States, Canada and Europe. We are facing increased competition from other companies for shelf space at major retailers, which could result in lower revenues. If we fail to successfully maintain a customer preference for Western Digital brand products or fail to successfully expand into multiple channels, our operating results may be adversely affected. In certain markets, we are trying to grow market share, and in the process may face strong competition, which could result in lower gross margins. We will continue to introduce new products in the retail market that incorporate our disk drives. There can be no assurance that these products gain market acceptance, and if they do not, our operating results could suffer.

Loss of market share with or by a key customer could harm our operating results.

A majority of our revenue comes from about a dozen customers. For example, during 2006, one customer, Dell, accounted for more than 12% of our revenue, and sales to our top 10 customers, including Dell, accounted for 47% of revenue. 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. Even if we successfully qualify a product with a customer, the customer generally is not obligated to purchase any minimum volume of products from us and may be able to cancel an order or terminate its relationship with us at any time. 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

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competitors or if a key customer suffers financial hardship then our operating results would likely be harmed. In addition, if 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.

We may be unable to retain our key personnel and skilled employees.

Our success depends upon the continued contributions of our key personnel and skilled employees, many of whom would be extremely difficult to replace. Worldwide competition for skilled employees in the hard drive industry is intense. Volatility or lack of positive performance in our stock price may adversely affect our ability to retain key personnel or skilled employees who have received equity compensation. If we are unable to retain our existing key personnel or skilled employees, or hire and integrate new key personnel or skilled employees, or if we fail to implement a succession plan to prepare qualified individuals to join us upon the departure of a member of our key personnel, our operating results would likely be harmed.

Manufacturing and marketing our products abroad subjects us to numerous risks.

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

obtaining requisite United States of America and foreign governmental permits and approvals;

currency exchange rate fluctuations or restrictions;

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 problems;

trade restrictions or higher tariffs;

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. 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.

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We face litigation risks relating to our historical stock option grants that could have a material adverse effect on the operation of our business.

Several purported derivative actions were filed nominally on our behalf against certain of our current and former directors and officers in connection with our historical stock option granting practices. See Part I, Item 3, *Legal Proceedings* for a more detailed description of these proceedings. We are and may in the future be subject to other litigation or government investigations arising in connection with such option practices. These proceedings may be time-consuming, expensive and disruptive to normal business operations, and the outcome of any such proceeding is difficult to predict. The defense of such lawsuits or investigations could result in significant expense and the diversion of our management's time and attention from the operation of our business, which could impede our ability to achieve our business objectives. Some or all of the amount we may be required to pay to defend or to satisfy a judgment or settlement of any or all of these proceedings may not be covered by insurance.

Under indemnification agreements we have entered into with our current and former officers and directors, we are required to indemnify them, and advance expenses to them, in connection with their participation in proceedings arising out of their service to us. These payments may be material.

The nature of our business and our reliance on intellectual property and other proprietary information subjects us to the risk of significant litigation.

The hard drive 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 results of operations.

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 likely increase our costs and harm our operating results.

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. Despite safeguards, to the extent that a competitor is able to reproduce or otherwise capitalize on our technology, 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 the laws of the United States. 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.

Environmental regulation costs could harm our operating results.

We may be subject to various state, federal and international laws and regulations governing the environment, including those restricting the presence of certain substances in electronic products and making producers of those products financially responsible for the collection, treatment, recycling and disposal of certain products. Such laws

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and regulations have been passed in several jurisdictions in which we operate, including various European Union member countries. For example, the European Union has enacted the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) and the Waste Electrical and Electronic Equipment (WEEE) directives. RoHS prohibits the use of certain substances, including lead, in certain products, including hard drives, put on the market after July 1, 2006. The WEEE directive 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. Each EU member country has enacted, or is expected to soon enact, legislation clarifying what is and what is not covered by the WEEE directive in that country. However, there is still some uncertainty in certain EU countries as to which party involved in the manufacture, distribution and sale of electronic equipment will be ultimately responsible for registration, reporting and disposal. Similar legislation may be enacted in other locations where we manufacture or sell our products, such as Asia. We will need to ensure that we comply with such laws and regulations as they are enacted, and that our component suppliers also timely comply with such laws and regulations. If we fail to timely comply with the legislation, our customers may refuse to purchase our products, which would have a materially adverse effect on our business, financial condition and results of operations.

In connection with our compliance with such environmental laws and regulations, we could incur substantial costs and be subject to disruptions to our operations and logistics. In addition, if we were found to be in violation of these laws, we could be subject to governmental fines and liability to our customers. If we have to make significant capital expenditures to comply with environmental laws, or if we are subject to significant expenses in connection with a violation of these laws, our financial condition or operating results could suffer.

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

Because we manufacture our products abroad, our operating costs are subject to fluctuations in foreign currency exchange rates. Further fluctuations in the exchange rate of the Thai Baht and of the Malaysian Ringgit may negatively impact our operating results.

The Thai Baht is a free floating currency while the Malaysian Ringgit exchange rate policy recently defined by the Malaysian government is one of a managed float. We have attempted to manage the impact of foreign currency exchange rate changes by, among other things, entering into short-term, forward contracts. However, these contracts do not cover our full exposure and can be canceled by the issuer if currency controls are put in place. Currently, we hedge the Thai Baht, Euro and British Pound Sterling with forward contracts.

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.

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 that provide manufacturing 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 in these regions may have a relatively short operating history, making it more difficult for us to accurately assess the associated credit risks. 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.

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Inaccurate projections of demand for our product can cause large fluctuations in our quarterly results.

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. In addition, our quarterly projections and 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 components for our products;

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

competition and consolidation in the data storage industry;

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

availability and rates of transportation.

Rapidly changing conditions in the hard drive industry make it difficult to predict actual results.

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:

accruals for warranty costs related to product defects;

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);

reserves for doubtful accounts;

accruals for product returns;

accruals for litigation and other contingencies; and

reserves for deferred tax assets.

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 such as the following may significantly affect the market price of our common stock:

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actual or anticipated fluctuations in our operating results;

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;

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; and

changes in financial estimates by securities analysts relating specifically to us or the hard drive industry in general.

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.

We may be unable to raise future capital through debt or equity financing.

Due to the risks described herein, in the future we may be unable to maintain adequate financial resources for capital expenditures, expansion or acquisition activity, working capital and research and development. We have a credit facility which matures on September 20, 2009. If we decide to increase or accelerate our capital expenditures or research and development efforts, or if results of operations do not meet our expectations, we could require additional debt or equity financing. However, we cannot ensure that additional financing will be available to us or available on acceptable terms. An equity financing could also be dilutive to our existing stockholders.

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

Our evaluation resulted in our conclusion that as of September 29, 2006, in compliance with Section 302 of the Sarbanes-Oxley Act of 2002, our disclosure controls and procedures were effective. We believe that we currently have adequate internal control procedures in place for future periods; however, if our internal controls are found to be ineffective, our financial results or our stock price may be adversely affected.

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

(c) The following table provides information about repurchases by us of our common stock during the quarter ended September 29, 2006:

	Total Number of Shares Purchased	Average Price Paid per Share(1)	Total Number of Shares Purchased As Part of Publicly Announced Program	Maximum Value of Shares that May Yet be Purchased Under the Program(2)
Jul. 1, 2006 Jul. 28, 2006		\$		\$ 135,922,313
Jul. 29, 2006 Aug. 25, 2006		\$		\$ 135,922,313
Aug. 26, 2006 Sept. 29, 2006	3,704(3)	\$ 17.56		\$ 135,922,313
Total	3,704	\$ 17.56		\$ 135,922,313

(1) Average price paid per share excludes commission.

(2) Our Board of Directors has authorized us to repurchase \$250 million of our common stock in open market transactions. The term of the program is a five-year period from November 17, 2005 to November 17, 2010.

(3) Represents shares delivered by our employees to us to satisfy

tax-withholding
obligations upon
the vesting of
restricted stock.

Our Senior Credit Facility prohibits us from paying cash dividends on our common stock.

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Item 6. EXHIBITS

Exhibit No.	Description
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)
3.3	Amended and Restated Bylaws of Western Digital Corporation, as amended effective as of May 10, 2006 (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 May 16, 2006)
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

Exhibit filed
with this Report.

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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/ Stephen D. Milligan
Stephen D. Milligan
Senior Vice President and Chief Financial
Officer
(Principal Financial Officer)

/s/ Joseph R. Carrillo
Joseph R. Carrillo
Vice President and Corporate Controller
(Principal Accounting Officer)

Date: November 22, 2006

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