WESTERN DIGITAL CORP
Form 10-Q
October 28, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

Or

o **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	**33-0956711**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3355 Michelson Drive, Suite 100 **Irvine, California**	**92612**
(Address of principal executive offices)	(Zip Code)

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

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

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

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

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

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

As of the close of business on October 20, 2011, 233,790,441 shares of common stock, par value $.01 per share, were outstanding.

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Our fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every five years, we report a 53-week fiscal year to align our fiscal year with the foregoing policy. Our fiscal first quarters ended

September 30, 2011 and October 1, 2010 both consisted of 13 weeks. Fiscal year 2011 was comprised of 52 weeks and ended on July 1, 2011. Fiscal year 2012 will be comprised of 52 weeks and will end on June 29, 2012. Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters, and references to financial information are on a consolidated basis. As used herein, the terms we, us, our, the Compan and WD 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 3355 Michelson Drive, Suite 100, Irvine, California 92612. Our telephone number is (949) 672-7000 and our Web site is www.westerndigital.com. The information on our Web site is not incorporated in this Quarterly Report on Form 10-Q.

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

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PART I. FINANCIAL INFORMATION
Item 1. ***FINANCIAL STATEMENTS***

WESTERN DIGITAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions, except par values; unaudited)

	Sept. 30, 2011	Jul. 1, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,675	$ 3,490
Accounts receivable, net	1,356	1,206
Inventories	645	577
Other current assets	250	214
Total current assets	5,926	5,487
Property, plant and equipment, net	2,209	2,224
Goodwill	151	151
Other intangible assets, net	67	71
Other non-current assets	114	185
Total assets	$ 8,467	$ 8,118
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,708	$ 1,545
Accrued expenses	348	349
Accrued warranty	135	132
Current portion of long-term debt	163	144
Total current liabilities	2,354	2,170
Long-term debt	100	150
Other liabilities	290	310
Total liabilities	2,744	2,630
Commitments and contingencies (Note 4 and 5)		
Shareholders equity:		
Preferred stock, $.01 par value; authorized 5 shares; issued and outstanding none		
Common stock, $.01 par value; authorized 450 shares; issued and outstanding 234 and 233 shares, respectively	2	2
Additional paid-in capital	1,106	1,091
Accumulated other comprehensive loss	(24)	(5)
Retained earnings	4,639	4,400
Total shareholders equity	5,723	5,488
Total liabilities and shareholders equity	$ 8,467	$ 8,118

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. 30, 2011	Oct. 1, 2010
Revenue, net	$ 2,694	$ 2,396
Cost of revenue	2,153	1,959
Gross margin	541	437
Operating expenses:		
Research and development	193	167
Selling, general and administrative	89	59
Total operating expenses	282	226
Operating income	259	211
Other income (expense):		
Interest income	3	2
Interest and other expense	(4)	(2)
Total other expense, net	(1)	
Income before income taxes	258	211
Income tax provision	19	14
Net income	$ 239	$ 197
Income per common share:		
Basic	$ 1.03	$ 0.86
Diluted	$ 1.01	$ 0.84
Weighted average shares outstanding:		
Basic	233	230
Diluted	237	234

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

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

	Three Months Ended	
	Sept. 30, 2011	Oct. 1, 2010
Cash flows from operating activities		
Net income	$ 239	$ 197
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	158	150
Stock-based compensation	17	19
Deferred income taxes	9	
Changes in:		
Accounts receivable, net	(150)	(68)
Inventories	(68)	(1)
Accounts payable	157	162
Accrued expenses	(17)	(52)
Other assets and liabilities	7	(17)
Net cash provided by operating activities	352	390
Cash flows from investing activities		
Purchases of property, plant and equipment	(134)	(200)
Cash used in investing activities	(134)	(200)
Cash flows from financing activities		
Issuance of stock under employee stock plans	2	2
Taxes paid on vested stock awards under employee stock plans	(5)	(4)
Excess tax benefits from employee stock plans	1	11
Repurchases of common stock		(50)
Repayment of debt	(31)	(25)
Net cash used in financing activities	(33)	(66)
Net increase in cash and cash equivalents	185	124
Cash and cash equivalents, beginning of period	3,490	2,734
Cash and cash equivalents, end of period	$ 3,675	$ 2,858
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 2	$ 2
Cash paid for interest	$ 1	$ 1

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 Part II, Item 8, Note 1 of the Notes to Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended July 1, 2011. In the opinion of management, all adjustments necessary to fairly state the unaudited condensed consolidated financial statements have been made. All such adjustments are of a normal, recurring nature. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended July 1, 2011. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year (see note 12).

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

2. Supplemental Financial Statement Data

Inventories

	Sept. 30, 2011	Jul. 1, 2011
	(in millions)	
Raw materials and component parts	**$ 170**	$ 172
Work-in-process	**275**	263
Finished goods	**200**	142
Total inventories	**$ 645**	$ 577

Warranty

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

	Three Months Ended	
	Sept. 30,	Oct. 1,

	2011	2010
Warranty accrual, beginning of period	**$ 170**	$ 170
Charges to operations	**45**	44
Utilization	**(42)**	(38)
Changes in estimate related to pre-existing warranties		(3)
Warranty accrual, end of period	**$ 173**	$ 173

Accrued warranty also includes amounts classified in other liabilities of $38 million at September 30, 2011 and July 1, 2011.

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3. Income per Common Share

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

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

	Three Months Ended	
	Sept. 30, 2011	**Oct. 1, 2010**
Net income	**$ 239**	$ 197
Weighted average shares outstanding:		
Basic	**233**	230
Employee stock options and other	**4**	4
Diluted	**237**	234
Income per common share:		
Basic	**$ 1.03**	$ 0.86
Diluted	**$ 1.01**	$ 0.84
Anti-dilutive potential common shares excluded*	**4**	4

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

4. Debt

In February 2008, Western Digital Technologies, Inc. (WDTI), a wholly-owned subsidiary of the Company, entered into a five-year credit agreement that provided for a $500 million term loan facility. As of September 30, 2011, the term loan facility had a variable interest rate of 1.50% and a remaining balance of $263 million, which requires principal payments totaling $113 million through the remainder of fiscal 2012 and $150 million in fiscal 2013. The term loan facility has a maturity date of February 11, 2013. As of September 30, 2011, WDTI was in compliance with all covenants.

See Note 10 for additional disclosures related to the Company s new credit facility to be entered into in connection with the closing of the planned acquisition of Viviti Technologies Ltd., until recently known as Hitachi Global Storage Technologies Holdings Pte. Ltd (HGST).

5. Legal Proceedings

When the Company becomes aware of a claim or potential claim, the Company assesses the likelihood of any loss or exposure. The Company discloses information regarding each material claim where the likelihood of a loss contingency is probable or reasonably possible. If a loss contingency is probable and the amount of the loss can be reasonably estimated, the Company records an accrual for the loss. In such cases, there may be an exposure to potential loss in excess of the amount accrued. Where a loss is not probable but is reasonably possible or where a loss

in excess of the amount accrued is reasonably possible, the Company discloses an estimate of the amount of the loss or range of possible losses for the claim if a reasonable estimate can be made, unless the amount of such reasonably possible losses is not material to the Company s financial position, results of operations or cash flows. For each of the matters described below, the Company has either recorded an accrual for losses that are probable and reasonably estimable or has determined that, while a loss is reasonably possible (including potential losses in excess of the amounts accrued by the Company), a reasonable estimate of the amount of loss or range of possible losses with respect to the claim or in excess of amounts already accrued by the Company cannot be made. The ability to predict the ultimate outcome of such matters involves judgments, estimates and inherent uncertainties. The actual outcome of such matters could differ materially from management s estimates.

Intellectual Property Litigation

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

On July 15, 2009, plaintiffs Carl B. Collins and Farzin Davanloo filed a complaint in the Eastern District of Texas against the Company and ten other companies alleging infringement of U.S. Patent Nos. 5,411,797 and 5,478,650. Plaintiffs are seeking injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to nanophase diamond films. On October 11, 2011, plaintiffs and the Company filed a joint motion to stay all deadlines applicable to claims involving the Company, indicating that the parties have reached an agreement in principle that would resolve the case for an immaterial amount that was accrued by the Company in the first quarter of fiscal 2012. The Court approved the motion on October 13, 2011. The parties are in the process of finalizing a formal written settlement agreement.

On December 7, 2009, plaintiff Nazomi Communications filed a complaint in the Eastern District of Texas against the Company and seven other companies alleging infringement of U.S. Patent Nos. 7,080,362 and 7,225,436. Plaintiffs dismissed the Eastern District of Texas suit after filing a similar complaint in the Central District of California on February 8, 2010. The case was subsequently transferred to the Northern District of California on October 14, 2010. Plaintiffs are seeking injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to processor cores capable of Java hardware acceleration. The Company intends to defend itself vigorously in this matter.

On January 5, 2010, plaintiff Enova Technology Corporation filed a complaint in the District of Delaware against the Company and Initio Corporation alleging infringement of U.S. Patent Nos. 7,136,995 and 7,386,734. Plaintiff is seeking injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to real time full disk encryption application specific integrated circuits, or ASICs. The Company intends to defend itself vigorously in this matter.

On November 10, 2010, plaintiff Rembrandt Data Storage filed a complaint in the Western District of Wisconsin against the Company alleging infringement of U.S. Patent Nos. 5,995,342 and 6,195,232. Plaintiff is seeking injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to specific thin film heads having solenoid coils. The Company intends to defend itself vigorously in this matter.

On August 1, 2011, plaintiff Guzik Technical Enterprises filed a complaint in the Northern District of California against the Company and various of its subsidiaries alleging infringement of U.S. Patent Nos. 6,023,145 and 6,785,085, breach of contract and misappropriation of trade secrets. Plaintiff is seeking injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to devices used to test hard disk drive heads and media. The Company intends to defend itself vigorously in this matter.

On September 6, 2011, plaintiff Powerline Innovations filed a complaint in the Eastern District of Texas against the Company alleging infringement of U.S. Patent No. 5,471,190. Plaintiff is seeking unspecified monetary damages, fees and costs. The asserted patent allegedly relates to power line Ethernet communications. The Company intends to defend itself vigorously in this matter.

On October 4, 2006, plaintiff Seagate Technology LLC (Seagate) filed a complaint against the Company and one of its employees formerly employed by Seagate in the Minnesota Fourth Judicial District Court. The complaint alleges claims based on supposed misappropriation of trade secrets and seeks injunctive relief and unspecified monetary damages, fees and costs. On June 19, 2007, the Company s employee filed a demand for arbitration with the American Arbitration Association. A motion to stay the litigation as against all defendants and to compel arbitration of all Seagate s claims was granted on September 19, 2007. On September 23, 2010, Seagate filed a motion to amend its claims and add allegations based on the supposed misappropriation of additional confidential information, and the

arbitrator granted Seagate s motion. The arbitration hearing commenced on May 23, 2011 and concluded on July 11, 2011. The parties filed post-arbitration briefs in August 2011. The arbitrator is expected to render a decision by November 30, 2011. The Company continues to defend itself vigorously in this matter.

Employment Litigation

On March 20, 2009, plaintiff Ghazala H. Durrani, a former employee of the Company, filed a putative class action complaint in the Alameda County (California) Superior Court. The complaint alleged that certain of the Company s engineers had been misclassified as exempt employees under California state law and were, therefore, due unspecified amounts for unpaid hourly overtime wages and other amounts, as well as penalties for allegedly missed meal and rest periods. By court order dated April 24, 2009, the case was transferred to the Orange County (California) Superior Court. On or about June 16, 2009, the Company was dismissed from the case without prejudice by stipulation, leaving WDTI as the sole remaining defendant. On or about June 4, 2009, WDTI filed its answer to the complaint, denying the substantive allegations thereof and raising several affirmative defenses. The parties participated in a mediation of the case on June 3, 2010, which led to a proposed settlement of the case. The proposed settlement, which was ultimately approved by the court, resolved the case on a class-wide basis for an immaterial amount that was accrued by the Company in the fourth quarter of fiscal 2010. The court granted final approval of the settlement and entered judgment on February 7, 2011. A final accounting hearing took place on July 11, 2011, at which the court confirmed that the settlement amount was fully paid in accordance with the settlement agreement.

On February 26, 2010, and as thereafter amended on August 23, 2010 and December 22, 2010, plaintiff Tariq Sadaat, a former employee of the Company, filed a putative class action complaint in the Orange County (California) Superior Court against the Company, WDTI, Kelly Services, Inc., a Delaware corporation (Kelly Services), and certain other unnamed individuals. Plaintiff sought to represent certain hourly employees who were assigned to work at certain of the Company s facilities by Kelly Services, a temporary staffing agency. In this regard, the complaint alleged that the hourly employees were due unspecified sums for unpaid overtime wages and other amounts, as well as penalties for allegedly missed meal and rest periods. The complaint sought unspecified damages including lost wages, penalties under the California Labor Code and other statutes, compensatory and punitive damages, declaratory relief, injunctive relief, interest, attorneys fees and costs. The Company s response to the complaint was filed and served in January 2011. The parties participated in a mediation of the case, which led to a proposed settlement of Sadaat s individual claims for an immaterial amount. The Court approved the proposed settlement on July 26, 2011, and dismissed the complaint in its entirety, with prejudice as to Sadaat s individual claims and without prejudice as to the alleged class claims.

Other Matters

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

6. Income Taxes

The Company s income tax provision for the three months ended September 30, 2011 was $19 million as compared to $14 million in the prior-year period. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia, Singapore and Thailand that expire at various dates through 2023 and the current year generation of income tax credits.

In the three months ended September 30, 2011, the Company recorded a net decrease of $14 million in its liability for unrecognized tax benefits. The decrease is due primarily to the resolution of the United States Internal Revenue Service (IRS) audit of Komag, Incorporated (Komag), which was acquired by the Company on September 5, 2007. As of September 30, 2011, the Company had a recorded liability for unrecognized tax benefits of approximately $231 million. Interest and penalties recognized on such amounts were not material.

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The IRS has completed its field examination of the federal income tax returns for fiscal years 2006 and 2007 for the Company and calendar years 2005 and 2006 for Komag. In September 2011, the Company received a final Revenue Agent Report (RAR) and Closing Agreement with respect to the years under examination for Komag. This agreement resulted in an immaterial benefit to the Company s income tax provision. The Company has also received RARs from the IRS that seek adjustments to income before income taxes of approximately $970 million in connection with unresolved issues related primarily to transfer pricing and certain other intercompany transactions. The Company disagrees with the proposed adjustments. In May 2011, the Company filed a protest with the IRS Appeals Office regarding the proposed adjustments.

The Company believes that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company s tax audits are resolved in a manner not consistent with management s expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs. As of September 30, 2011, it is not possible to estimate the amount of change, if any, in the unrecognized tax benefits that is reasonably possible within the next twelve months. Any significant change in the amount of the Company s unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of the Company s uncertain tax positions.

7. Fair Value Measurements

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

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

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

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

The following table presents information about the Company s financial assets that are measured at fair value on a recurring basis as of September 30, 2011, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

	Fair Value Measurements at Reporting Date Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total**
Assets:				
Cash equivalents				
Money market funds	$ 807	$	$	$ 807
U.S. Treasury securities		53		53
U.S. Government agency securities		53		53
Total cash equivalents	807	106		913
Auction-rate securities			15	15
Total assets at fair value	$ 807	$ 106	$ 15	$ 928

Liabilities:							
Foreign exchange contracts				(33)			(33)
Total liabilities at fair value	$		$	(33)	$	$	(33)

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

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

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

Auction-Rate Securities. The Company s auction-rate securities have maturity dates through 2050, are primarily backed by insurance products and are accounted for as available-for-sale securities. These investments are classified as long-term investments and recorded within other non-current assets in the condensed consolidated balance sheets. Auction-rate securities are valued using an income approach that is based on a discounted cash flow model or a credit default model. The inputs to the discounted cash flow model include market interest rates and a discount factor to reflect the illiquidity of the investments. The inputs to the credit default model include market interest rates, yields of similar securities, and probability-weighted assumptions related to the creditworthiness of the underlying assets.

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

In the three months ended September 30, 2011, there were no changes in Level 3 financial assets measured on a recurring basis.

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

8. Foreign Exchange Contracts

Although the majority of the Company s transactions are in U.S. dollars, some transactions are based in various foreign currencies. The Company purchases short-term, foreign exchange contracts to hedge the impact of foreign currency exchange fluctuations on certain underlying assets, revenue, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedging transactions is to minimize the impact of foreign currency fluctuations on the Company s results of operations. These contract maturity dates do not exceed 12 months. All foreign exchange contracts are for risk management purposes only. The Company does not purchase foreign exchange contracts for trading or speculative purposes. As of September 30, 2011, the Company had outstanding foreign exchange contracts with commercial banks for Thai Baht, Malaysian Ringgit, Euro and British Pound Sterling. Thai Baht contracts are designated as either cash flow or fair value hedges. Malaysian Ringgit contracts are designated as cash flow hedges. Euro and British Pound Sterling contracts are designated as fair value hedges.

If the derivative is designated as a cash flow hedge, the effective portion of the change in fair value of the derivative is initially deferred in other comprehensive income (loss), net of tax. These amounts are subsequently recognized into earnings when the underlying cash flow being hedged is recognized into earnings. Recognized gains and losses on foreign exchange contracts entered into for manufacturing-related activities are reported in cost of revenue. Hedge effectiveness is measured by comparing the hedging instrument s cumulative change in fair value from inception to maturity to the underlying exposure s terminal value. As of September 30, 2011, the net amount of existing gains expected to be reclassified into earnings within the next 12 months was $24 million. The Company determined the ineffectiveness associated with its cash flow hedges to be immaterial.

A change in the fair value of fair value hedges is recognized in earnings in the period incurred and is reported as a component of operating expenses. All fair value hedges were determined to be effective. The fair value and the changes in fair value on these contracts were not material to the condensed consolidated financial statements.

As of September 30, 2011, the Company did not have any foreign exchange contracts with credit-risk-related contingent features. The Company opened $902 million and $907 million, and closed $836 million and $727 million, in foreign exchange contracts in the three months ended September 30, 2011 and October 1, 2010, respectively. The fair value and balance sheet location of such contracts were as follows (in millions):

	Asset Derivatives				Liability Derivatives			
	Sept. 30, 2011		Jul. 1, 2011		Sept. 30, 2011		Jul. 1, 2011	
Derivatives Designated as Hedging Instruments	**Balance Sheet Location**	**Fair Value**	**Balance Sheet Location**	**Fair Value**	**Balance Sheet Location**	**Fair Value**	**Balance Sheet Location**	**Fair Value**
Foreign exchange contracts					Accrued Expenses	$ 33	Accrued Expenses	$ 5

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

Derivatives in Cash Flow Hedging Relationships	**Amount of Gain (Loss) Recognized in Accumulated OCI on Derivatives**		**Location of Gain (Loss) Reclassified from Accumulated OCI into Income**	**Amount of Gain (Loss) Reclassified from Accumulated OCI into Income**	
	Sept. 30, 2011	**Oct. 1, 2010**		**Sept. 30, 2011**	**Oct. 1, 2010**
Foreign exchange contracts	$ (8)	$ 55	Cost of revenue	$ 11	$ 27

The total net realized transaction and foreign exchange contract currency gains and losses were not material to the condensed consolidated financial statements during the three months ended September 30, 2011 and October 1, 2010.

9. Stock-Based Compensation

During the three months ended September 30, 2011, the Company recognized in expense $9 million for stock-based compensation related to the vesting of options issued under stock option plans and the ESPP, compared to $11 million in the comparative prior-year period. As of September 30, 2011, total compensation cost related to unvested stock options and ESPP rights issued to employees but not yet recognized was $80 million and will be amortized on a straight-line basis over a weighted average service period of approximately 2.5 years.

During the three months ended September 30, 2011 and the comparative prior-year period, the Company recognized in expense $8 million related to the vesting of awards of restricted stock and restricted stock units (RSUs). As of September 30, 2011, the aggregate unamortized fair value of all unvested RSUs was $60 million, which will be recognized on a straight-line basis over a weighted average vesting period of approximately 1.8 years.

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Stock Option Activity

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

	Number of Shares		Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (in years)		Aggregate Intrinsic Value
Options outstanding at July 1, 2011	10.2	$	22.49			
Granted	2.5		29.64			
Exercised	(0.2)		7.99			
Canceled or expired						
Options outstanding at September 30, 2011	12.5	$	24.20	4.9	$	46
Exercisable at September 30, 2011	6.2	$	20.75	3.9	$	38
Vested and expected to vest after September 30, 2011	12.3	$	24.13	4.9	$	46

If an option has an exercise price that is less than the quoted price of the Company s common stock at the particular time, the aggregate intrinsic value of that option at that time is calculated based on the difference between the exercise price of the underlying options and the quoted price of the Company s common stock at that time. As of September 30, 2011, the Company had options outstanding to purchase an aggregate of 5.8 million shares with an exercise price below the quoted price of the Company s stock on that date resulting in an aggregate intrinsic value of $46 million at that date. During the three months ended September 30, 2011, the aggregate intrinsic value of options exercised under the Company s stock option plans was $5 million, determined as of the date of exercise, compared to $2 million in the comparative prior-year period.

Fair Value Disclosure Binomial Model

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

	Three Months Ended	
	Sept. 30, 2011	**Oct. 1, 2010**
Suboptimal exercise factor	**1.81**	1.81
Range of risk-free interest rates	**0.13% to 1.43%**	0.26% to 1.90%
Range of expected stock price volatility	**0.41 to 0.54**	0.42 to 0.59
Weighted average expected volatility	**0.48**	0.52
Post-vesting termination rate	**2.63%**	2.42%

Dividend yield		
Fair value	**$11.97**	$11.26

The weighted average expected term of the Company s stock options granted during the three months ended September 30, 2011 was 4.9 years, compared to 4.7 years in the comparative prior-year period.

Fair Value Disclosure Black-Scholes-Merton Model

The fair value of ESPP purchase rights issued is estimated at the date of grant of the purchase rights using the Black-Scholes-Merton option-pricing model. The Black-Scholes-Merton option-pricing model 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. Purchase rights under the current ESPP provisions are granted on either June 1 or December 1. ESPP activity was immaterial to the condensed consolidated financial statements for the three months ended September 30, 2011 and October 1, 2010.

RSU Activity

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

	Number of Shares		Weighted Average Grant Date Fair Value
RSUs outstanding at July 1, 2011	3.1	$	28.85
Granted	0.9		29.64
Vested	(0.6)		23.94
Canceled or expired			
RSUs outstanding at September 30, 2011	3.4	$	29.83
Expected to vest after September 30, 2011	3.3	$	29.90

The fair value of each RSU is the market price of our stock at the date of grant. RSUs are generally payable in an equal number of shares of the Company s common stock at the time of vesting of the units. The grant-date fair value of the shares underlying the restricted stock awards at the date of grant was $28 million for the three months ended September 30, 2011. These amounts are being recognized to expense over the corresponding vesting periods. For purposes of valuing these awards, the Company has assumed a forfeiture rate of 2.3%, based on a historical analysis indicating forfeitures for these types of awards.

10. Planned Acquisition

On March 7, 2011, the Company entered into a stock purchase agreement (the Purchase Agreement) with Hitachi, Ltd. (Hitachi), Viviti Technologies Ltd., until recently known as Hitachi Global Storage Technologies Holdings Pte. Ltd., a wholly owned subsidiary of Hitachi (HGST), and Western Digital Ireland, Ltd., an indirect wholly owned subsidiary of the Company (WDI). Pursuant to the Purchase Agreement, WDI agreed to acquire all of the issued and outstanding paid-up share capital of HGST from Hitachi. The planned acquisition is intended to result in a more efficient and innovative customer-focused storage company, with significant operating scale, strong global talent and the industry s broadest product lineup backed by a rich technology portfolio. The aggregate purchase price of the planned acquisition is estimated to be approximately $4.2 billion, due at closing, and is expected to be funded with existing cash, new debt, and 25 million newly issued shares of the Company s common stock. The Purchase Agreement contains certain termination rights for both the Company and Hitachi, including the right to terminate the Purchase Agreement if the planned acquisition has not closed by March 7, 2012. The Purchase Agreement does not contain a termination right for the benefit of the Company in the event it cannot obtain financing for the transaction. If the planned acquisition has not closed by March 7, 2012 due to the failure to receive any required antitrust or competition authority s consent, approval or clearance or any action by certain governmental entities to prevent the planned acquisition for antitrust or competition reasons, the Company will, concurrently with such termination, be required to pay Hitachi a fee of $250 million in cash. During the three months ended September 30, 2011, the Company incurred $11 million of expenses related to the planned acquisition of HGST, which are included within selling, general and administrative expense in the condensed consolidated statement of income.

On March 7, 2011, in connection with the planned acquisition of HGST, the Company, WDTI and WDI entered into a commitment letter with Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated regarding a new credit facility for an amount of $2.5 billion, consisting of a $500 million revolving credit facility and $2.0 billion in term loans, to be entered into in connection with the closing of the planned acquisition (the Senior Facility). Since entering into the commitment letter, Bank of America N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated led the effort to syndicate the Senior Facility for an amount of up to $3.0 billion, consisting of a $500 million revolving credit facility and up to $2.5 billion in term loans. As a result of such effort, the Company, WDTI and WDI

have fully negotiated definitive loan documents for the Senior Facility with the syndicate members. The Company, WDTI and WDI expect all of these syndicate members to be part of the final lender group, subject to customary closing conditions, including completion of the acquisition in accordance with its terms, the receipt of antitrust approvals or the expiration of applicable waiting periods without any action being taken by an authority that would impose any material adverse condition on the Company, HGST or their respective subsidiaries taken as a whole, and there not having occurred for HGST, the Company or WDI a material adverse effect on their respective business, financial condition or operations. We are required to pay a commitment fee at the rate of 0.35%, per annum, of the aggregate unfunded amount committed to be borrowed under the Senior Facility. During the three months ended September 30, 2011, the Company incurred debt commitment fees of $3 million related to the planned acquisition of HGST, which are included within interest and other expense in the condensed consolidated statement of income.

The planned acquisition of HGST is subject to several closing conditions, including the receipt of antitrust approvals or the expiration of applicable waiting periods in the United States, the European Union, the People s Republic of China, Japan, Korea and Mexico. In certain jurisdictions, the Company has received requests for additional information and is engaged in more in-depth reviews of the pending acquisition. The Company has proposed a remedy to the European Commission intended to address the preliminary assessment of competitive effects of the transaction set out by the European Commission. This proposal remains under consideration by the European Union and there is no assurance that the proposal will be accepted or, if accepted, can be successfully implemented. The Company is cooperating fully with each of the regulatory authorities reviewing the proposed transaction. Subject to obtaining the required regulatory approvals or expiration of applicable waiting periods, the Company is targeting the transaction to close in its second quarter of fiscal 2012.

11. Recent Accounting Pronouncements

In June 2011, the FASB issued ASU 2011-05 Presentation of Comprehensive Income (ASU 2011-05). ASU 2011-05 requires that all non-owner changes in shareholders equity be presented either in a single continuous statement of comprehensive income or in two separate but continuous statements. If presented in two separate statements, the first statement should present total net income and its components followed immediately by a second statement of total other comprehensive income, its components and the total comprehensive income. ASU 2011-05 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011, which for the Company is the first quarter of fiscal 2013. The Company is currently evaluating how it will report comprehensive income, but either method permitted will constitute a change in the Company s financial statement presentation.

12. Subsequent Event

The Company suspended production in all of its Thailand manufacturing facilities during the week of October 10, 2011 due to severe flooding in Thailand, and the flood waters have since inundated these facilities and submerged equipment located there. The flooded facilities in Thailand include the Company s magnetic head slider fabrication facilities, which supply a substantial majority of the Company s magnetic head requirements. The flooded facilities in Thailand also include the Company s hard drive, head gimbal assembly (HGA) and head stack assembly (HSA) facilities. Approximately 60% of the hard drives produced by the Company in the quarter ended September 30, 2011 came from its Thailand facilities. In addition to the suspension of the Company s Thailand hard drive assembly operations and the internal slider shortages, the Company is also experiencing other shortages of component parts from vendors located in several Thailand industrial parks that have been flooded or have been affected by protective plant shutdowns.

The Company is evaluating the Thailand situation on an ongoing basis and does not know, at this time, when it will recommence operations in Thailand, including the operation of its Thailand slider fabrication facility that also supports operations outside of Thailand. The Company is also uncertain about the timeline for recovery and recommencement of production by suppliers in Thailand. The Company is pursuing its options so that it can safely begin working to accelerate the water removal and either extract and transfer equipment to clean rooms in another location or prepare the equipment for operation on-site. The Company expects the suspension of its operations in Thailand and that of some of its suppliers will continue into the March quarter and possibly beyond. During this time, the Company s operations outside Thailand will be impacted by a shortage of sliders that would otherwise be produced by the Company in Thailand and other shortages of components produced by some of its suppliers impacted by the floods. The Company is working with its suppliers to better understand the effect of the flooding on the supply chain and to locate alternative sources of supply, and is also pursuing all options to maximize existing capacity in other locations, including its Malaysian hard drive assembly facility and a third-party slider fabrication facility in the Philippines.

The flooding of the Company s Thailand facilities, combined with the flood damage to the supply chain in Thailand, will have a significant impact on the Company s overall operations and its ability to meet customer demand for its products in the December quarter and possibly beyond. While the Company expects industry unit demand in the December quarter will be flat to slightly down from the September quarter, it expects that its hard drive shipments during the December quarter will be between 22 million and 26 million units in contrast to the 58 million units shipped in the September quarter and that the overall hard drive industry unit shipments in the December quarter will also be supply constrained due to the flooding. In addition, while the Company s operations in Thailand remain suspended completely or in part, its costs will be impacted negatively by significant under-absorption of its assets and infrastructure, costs it will incur in restoring supply and increased costs of use of air freight and other charges to expedite the immediate availability of the Company s production for its customers. The Company also expects to incur significant unusual charges and expenses related to the flooding of its operations, including such items as fixed asset impairments, inventory write-downs, purchase order cancellations for excess materials that cannot be used near term, service charges for reclaim and recovery work and foreign exchange losses to settle a portion of its forward exchange contracts that exceed its current requirements. The Company is unable to estimate the amount of these charges and expenses at this time.

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Given the lower expected product shipments, the Company anticipates its net revenue in the December quarter will be substantially lower than the quarter ended September 30, 2011. In addition, while the Company believes that supply constraint, relative to demand, will result in a higher average selling price (ASP) for the December quarter, the Company expects that the higher costs referenced above will result in negative gross margins and that it will incur a significant loss for the quarter before taking into account unusual charges and expenses the Company expects to incur related to the flooding. The Company s revenues, gross margins and operating results will continue to be negatively impacted in subsequent quarters until the Company and its supply sources affected by the Thailand flooding are able to substantially restore operations, the supply chain infrastructure is re-established and the Company is able to regain any lost market share.

The Company maintains insurance coverage that provides for reimbursement from losses resulting from flood damage. The Company anticipates the amount of flood damage incurred will exceed the policy s limit but cannot estimate by how much at this time. The Company also maintains insurance for business interruption losses, and is currently working with its insurance carrier to determine the amounts which may be recoverable under this policy.

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

This information should be read in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included in this Quarterly Report on Form 10-Q, and the audited consolidated financial statements and notes thereto and Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended July 1, 2011.

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

Forward-Looking Statements

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

- *the impact of the flooding in Thailand on the industry and our business in the December quarter and beyond, including our hard drive production capacity, the availability of components from our suppliers, our planned operations recovery efforts and the expected costs and expenses that we will incur in connection with these efforts, and our ability to complete recovery efforts and recommence normal operations in our Thailand facilities;*
- *expectations regarding industry demand and the impact of the flooding in Thailand on industry supply in the December quarter;*
- *expectations regarding the impact of the Thailand flooding on our net revenue, gross margin and expected unit shipments in the December quarter;*
- *the planned acquisition of Viviti Technologies Ltd., until recently known as Hitachi Global Storage Technologies Holdings Pte. Ltd., a wholly owned subsidiary of Hitachi Ltd. (HGST), including the expected timing and anticipated benefits of the acquisition;*

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the terms of and our ability to syndicate the new credit facility to be entered into in connection with the planned acquisition of HGST;
demand for hard drives and solid-state drives in the various markets and factors contributing to such demand;
our plans to continue to develop new products and expand into new storage markets and into emerging economic markets;
our entry into and position in the traditional enterprise market;
emergence of new storage markets for hard drives;
emergence of competing storage technologies;
our share repurchase plans;
our stock price volatility;
expectations regarding the outcome of legal proceedings in which we are involved;
our beliefs regarding the adequacy of our tax provisions and the timing of future payments, if any, relating to the unrecognized tax benefits; and
our beliefs regarding the sufficiency of our cash and cash equivalents to meet our working capital, capital expenditure and other cash needs, and the expected impact of the flooding in Thailand and suspension of our Thailand operations on our liquidity.

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

Our Company

We are a global provider of solutions for the collection, storage, management, protection and use of digital content, including audio and video. Our principal products are hard drives, which are devices that use one or more rotating magnetic disks (magnetic media) to store and allow fast access to data. Hard drives are currently the primary storage medium for digital content. Our hard drives are used in desktop and notebook computers, corporate and cloud computing data centers, home entertainment equipment and stand-alone consumer storage devices. In addition to hard drives, we offer solid-state drives and home entertainment and networking products.

Severe Flooding in Thailand and Suspension of Thailand Operations

We suspended production in all of our Thailand manufacturing facilities during the week of October 10, 2011 due to severe flooding in Thailand, and the flood waters have since inundated these facilities and submerged equipment located there. The flooded facilities in Thailand include our magnetic head slider fabrication facilities, which supply a substantial majority of our magnetic head requirements. The flooded facilities in Thailand also include our hard drive, head gimbal assembly (HGA) and head stack assembly (HSA) facilities. Approximately 60% of the hard drives we produced in the quarter ended September 30, 2011 came from our Thailand facilities. In addition to the suspension of our Thailand hard drive assembly operations and the internal slider shortages, we are also experiencing other shortages of component parts from vendors located in several Thailand industrial parks that have been flooded or have been affected by protective plant shutdowns.

We are evaluating the Thailand situation on an ongoing basis and do not know, at this time, when we will recommence operations in Thailand, including the operation of our Thailand slider fabrication facility that also supports operations outside of Thailand. We are also uncertain about the timeline for recovery and recommencement of production by suppliers in Thailand. We are pursuing our options so that we can safely begin working to accelerate the water removal and either extract and transfer equipment to clean rooms in another location or prepare the equipment for operation on-site. We expect the suspension of our operations in Thailand and that of some of our suppliers will continue into the March quarter and possibly beyond. During this time, our operations outside Thailand will be impacted by a shortage of sliders that would otherwise be produced by us in Thailand and other shortages of components produced by some of our suppliers impacted by the floods. We are working with our suppliers to better understand the effect of the flooding on the supply chain and to locate alternative sources of supply, and we are also pursuing all options to maximize existing capacity in other locations, including our Malaysian hard drive assembly facility and a third-party slider fabrication facility in the Philippines.

The flooding of our Thailand facilities, combined with the flood damage to the supply chain in Thailand, will have a significant impact on our overall operations and our ability to meet customer demand for our products in the December quarter and possibly beyond. While we expect industry unit demand in the December quarter will be flat to slightly down from the September quarter, we expect that our hard drive shipments during the December quarter will be between 22 million and 26 million units in contrast to the 58 million units we shipped in the September quarter and that the overall hard drive industry unit shipments in the December quarter will also be supply constrained due to the flooding. In addition, while our operations in Thailand remain suspended completely or in part, our costs will be impacted negatively by significant under-absorption of our assets and infrastructure, costs we will incur in restoring supply and increased costs of use of air freight and other charges to expedite the immediate availability of our production for our customers. We also expect to incur significant unusual charges and expenses related to the flooding of our operations, including such items as fixed asset impairments, inventory write-downs, purchase order cancellations for excess materials that cannot be used near term, service charges for reclaim and recovery work and foreign exchange losses to settle a portion of our forward exchange contracts that exceed our current requirements. We are unable to estimate the amount of these charges and expenses at this time.

Given the lower expected product shipments, we anticipate our net revenue in the December quarter will be substantially lower than the quarter ended September 30, 2011. In addition, while we believe that supply constraint, relative to demand, will result in a higher average selling price (ASP) for the December quarter, we expect that the higher costs referenced above will result in negative gross margins and that we will incur a significant loss for the quarter before taking into account unusual charges and expenses we expect to incur related to the flooding. Our revenues, gross margins and operating results will continue to be negatively impacted in subsequent quarters until we and our supply sources affected by the Thailand flooding are able to substantially restore operations, the supply chain infrastructure is re-established and we are able to regain any lost market share.

We maintain insurance coverage that provides for reimbursement from losses resulting from flood damage. We anticipate the amount of flood damage incurred will exceed the policy s limit but cannot estimate by how much at this time. We also maintain insurance for business interruption losses, and we are currently working with our insurance carrier to determine the amounts which may be recoverable under this policy.

Planned Acquisition of Hitachi Global Storage Technologies

On March 7, 2011, we entered into a stock purchase agreement (the Purchase Agreement) with Hitachi, Ltd. (Hitachi), Viviti Technologies Ltd., until recently known as Hitachi Global Storage Technologies Holdings Pte. Ltd., a wholly owned subsidiary of Hitachi (HGST), and Western Digital Ireland, Ltd., our indirect wholly owned subsidiary (WDI). Pursuant to the Purchase Agreement, WDI agreed to acquire all of the issued and outstanding paid-up share capital of HGST from Hitachi. The planned acquisition is intended to result in a more efficient and innovative customer-focused storage company, with significant operating scale, strong global talent and the industry s broadest product lineup backed by a rich technology portfolio. The aggregate purchase price of the planned acquisition is estimated to be approximately $4.2 billion, due at closing, and is expected to be funded with existing cash, new debt, and 25 million newly issued shares of our common stock. The Purchase Agreement contains certain termination rights for both us and Hitachi, including the right to terminate the Purchase Agreement if the planned acquisition has not closed by

March 7, 2012. The Purchase Agreement does not contain a termination right for the benefit of WD in the event we cannot obtain financing for the transaction. If the planned acquisition has not closed by March 7, 2012 due to the failure to receive any required antitrust or competition authority s consent, approval or clearance or any action by certain governmental entities to prevent the planned acquisition for antitrust or competition reasons, we will, concurrently with such termination, be required to pay Hitachi a fee of $250 million in cash.

On March 7, 2011, in connection with the planned acquisition of HGST, WD, Western Digital Technologies, Inc. (WDTI), our wholly-owned subsidiary, and WDI entered into a commitment letter with Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated regarding a new credit facility for an amount of $2.5 billion, consisting of a $500 million revolving credit facility and $2.0 billion in term loans, to be entered into in connection with the closing of the planned acquisition (the Senior Facility). Since entering into the commitment letter, Bank of America N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated led the effort to syndicate the Senior Facility for an amount of up to $3.0 billion, consisting of a $500 million revolving credit facility and up to $2.5 billion in term loans. As a result of such effort, WD, WDTI and WDI have fully negotiated definitive loan documents for the Senior Facility with the syndicate members. WD, WDTI and WDI expect all of these syndicate members to be part of the final lender group, subject to customary closing conditions, including completion of the acquisition in accordance with its terms, the receipt of antitrust approvals or the expiration of applicable waiting periods without any action being taken by an authority that would impose any material adverse condition on WD, HGST or their respective subsidiaries taken as a whole, and there not having occurred for HGST, WD or WDI a material adverse effect on their respective business, financial condition or operations. We are required to pay a commitment fee at the rate of 0.35%, per annum, of the aggregate unfunded amount committed to be borrowed under the Senior Facility.

The planned acquisition of HGST is subject to several closing conditions, including the receipt of antitrust approvals or the expiration of applicable waiting periods in the United States, the European Union, the People s Republic of China, Japan, Korea and Mexico. In certain jurisdictions, we have received requests for additional information and are engaged in more in-depth reviews of the pending acquisition. We have proposed a remedy to the European Commission intended to address the preliminary assessment of competitive effects of the transaction set out by the European Commission. This proposal remains under consideration by the European Union and there is no assurance that the proposal will be accepted or, if accepted, can be successfully implemented. We are cooperating fully with each of the regulatory authorities reviewing the proposed transaction. Subject to obtaining the required regulatory approvals or expiration of applicable waiting periods, we are targeting the transaction to close in our second quarter of fiscal 2012.

First Quarter Overview

For the September quarter, we believe that overall hard drive industry shipments totaled approximately 176 million units, up 7% from the prior-year period and up 6% sequentially from the June quarter. We also believe that the industry growth in the September quarter compared to the June quarter was muted by historical standards as a result of global economic uncertainties, the slow growth being experienced in many mature markets and the PC industry s continued shift to a higher rate of sea freight versus more expensive air freight, which has time-shifted typical seasonal linearity.

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

	Three Months Ended			
	Sept. 30, 2011		**Oct. 1, 2010**	
Net revenue	**$ 2,694**	**100.0%**	$ 2,396	100.0%
Gross margin	**541**	**20.1**	437	18.2
Total operating expenses	**282**	**10.5**	226	9.4
Operating income	**259**	**9.6**	211	8.8
Net income	**239**	**8.9**	197	8.2

The following is a summary of our financial performance for the first quarter of 2012:

- Consolidated net revenue totaled $2.7 billion.
- 36% of our hard drive revenue was derived from non-compute and enterprise markets, which include CE products, enterprise applications, and WD®-branded products, as compared to 37% in the prior-year period.
- Hard drive unit shipments increased by 14% over the prior-year period to 57.8 million units.
- Gross margin increased to 20.1%, compared to 18.2% for the prior-year period.
- Operating income, including $11 million of acquisition-related expenses and $7 million of accruals for unrelated litigation contingencies, was $259 million, an increase of $48 million from the prior-year period.
- We generated $352 million in cash flow from operations in the first quarter of 2012, and we finished the quarter with $3.7 billion in cash and cash equivalents.

Results of Operations

Net Revenue

	Three Months Ended		
(in millions, except percentages and average selling price)	**Sept. 30, 2011**	**Oct. 1, 2010**	**Percentage Change**
Net revenue	**$ 2,694**	$ 2,396	12%
Average selling price (per unit)*	**$ 46**	$ 46	
Revenues by Geography (%)			
Americas	**19%**	23%	
Europe, Middle East and Africa	**22**	23	
Asia	**59**	54	
Revenues by Channel (%)			
OEM	**53%**	50%	
Distributors	**29**	32	
Retailers	**18**	18	
Unit Shipments*			
Compute	**41.2**	37.5	
Non-compute	**14.2**	10.9	
Enterprise	**2.4**	2.3	
Total Units Shipped	**57.8**	50.7	14%

* Based on sales of hard drive units only.

For the quarter ended September 30, 2011, net revenue was $2.7 billion, an increase of 12% from the prior-year period. Total hard drive shipments increased to 57.8 million units for the quarter ended September 30, 2011 as

compared to 50.7 million units in the prior-year period. The increase in net revenue resulted primarily from an increase in hard drive shipments. For the three months ended September 30, 2011 and October 1, 2010, our average selling price (ASP) remained at $46.

Changes in revenue by geography and channel generally reflect normal fluctuations in market demand and competitive dynamics. For the three months ended September 30, 2011, no single customer accounted for 10%, or more, of our revenue.

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In accordance with standard industry practice, we have sales incentive and marketing programs that provide customers with price protection and other incentives or reimbursements that are recorded as a reduction to gross revenue. For the three months ended September 30, 2011, these programs represented 9% of gross revenues compared to 11% in the comparative prior-year period. These amounts generally vary according to several factors, including industry conditions, seasonal demand, competitor actions, channel mix and overall availability of product.

Gross Margin

	Three Months Ended		
(in millions, except percentages)	**Sept. 30, 2011**	**Oct. 1, 2010**	**Percentage Change**
Net revenue	**$ 2,694**	$ 2,396	12%
Gross margin	**541**	437	24%
Gross margin %	**20.1%**	18.2%	

For the three months ended September 30, 2011, gross margin as a percentage of revenue increased to 20.1% as compared to 18.2% for the prior-year period. This increase was primarily a result of an improved product mix.

Operating Expenses

	Three Months Ended		
(in millions, except percentages)	**Sept. 30, 2011**	**Oct. 1, 2010**	**Percentage Change**
R&D expense	**$ 193**	$ 167	16%
SG&A expense	**89**	59	51%
Total operating expenses	**$ 282**	$ 226	

Research and development (R&D) expense was $193 million for the three months ended September 30, 2011, an increase of $26 million over the prior-year period. As a percentage of net revenue, R&D expense increased to 7.2% in the three months ended September 30, 2011, compared to 7.0% in the prior-year period. The increase was primarily due to increased investments in new product and technology development.

Selling, general and administrative (SG&A) expense was $89 million for the three months ended September 30, 2011, an increase of $30 million over the prior-year period. SG&A expense as a percentage of net revenue increased to 3.3% in the three months ended September 30, 2011, compared to 2.5% in the prior-year period. The increase was primarily due to $11 million of acquisition-related expenses and $7 million of accruals for unrelated litigation contingencies, with the remainder of the increase related to the expansion of sales and marketing to support new products and growing markets.

Other Income (Expense)

Interest income for the three months ended September 30, 2011 was $3 million, an increase of $1 million compared to the prior-year period. The increase was primarily due to higher average daily invested cash balances for the periods. Interest and other expense for the three months ended September 30, 2011 increased by $2 million as compared to the prior-year period, primarily due to $3 million of debt commitment fees related to the planned acquisition of HGST, offset by a $1 million decrease in our term loan interest expense due to a lower principal balance.

Income Tax Provision

Our income tax provision for the three months ended September 30, 2011 was $19 million as compared to $14 million in the prior-year period. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia, Singapore and Thailand that expire at various dates through 2023 and the current year generation of income tax credits.

In the three months ended September 30, 2011, we recorded a net decrease of $14 million in our liability for unrecognized tax benefits. The decrease is due primarily to the resolution of the United States Internal Revenue Service (IRS) audit of Komag, Incorporated (Komag), which we acquired on September 5, 2007. As of September 30, 2011, we had a recorded liability for unrecognized tax benefits of approximately $231 million. Interest and penalties recognized on such amounts were not material.

The IRS has completed its field examination of the federal income tax returns for fiscal years 2006 and 2007 for the Company and calendar years 2005 and 2006 for Komag. In September 2011, we received a final Revenue Agent Report (RAR) and Closing Agreement with respect to the years under examination for Komag. This agreement resulted in an immaterial benefit to our income tax provision. We have also received RARs from the IRS that seek adjustments to income before income taxes of approximately $970 million in connection with unresolved issues related primarily to transfer pricing and certain other intercompany transactions. We disagree with the proposed adjustments. In May 2011, we filed a protest with the IRS Appeals Office regarding the proposed adjustments.

We believe that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in our tax audits are resolved in a manner not consistent with management s expectations, we could be required to adjust our provision for income taxes in the period such resolution occurs. As of September 30, 2011, it is not possible to estimate the amount of change, if any, in the unrecognized tax benefits that is reasonably possible within the next twelve months. Any significant change in the amount of our unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of our uncertain tax positions.

Liquidity and Capital Resources

We ended the first quarter of fiscal 2012 with total cash and cash equivalents of $3.7 billion. The following table summarizes our statements of cash flows (in millions):

	Three Months Ended	
	Sept. 30, 2011	**Oct. 1, 2010**
Net cash flow provided by (used in):		
Operating activities	**$ 352**	$ 390
Investing activities	**(134)**	(200)
Financing activities	**(33)**	(66)
Net increase in cash and cash equivalents	**$ 185**	$ 124

Our investment policy is to manage our investment portfolio to preserve principal and liquidity while maximizing return through the full investment of available funds. We expect that our cash position will be adversely impacted by the suspension of our operations in Thailand and expenditures related to the recovery from the flooding of our Thailand facilities. Specifically, we expect our cash flow for the quarter ending December 30, 2011, and possibly beyond, to be negative. We expect to incur significant unusual charges and expenses related to the flooding and some of these will be cash charges and expenses. We further anticipate that we will need to repair and replace equipment that has been submerged as a result of the flooding, and our capital expenditures to do so are expected to be significantly in excess of our business model range of between 7 and 8 percent of revenue. Notwithstanding the foregoing, we believe our current cash, cash equivalents and cash generated from operations will be sufficient to meet our working capital and capital expenditure needs for the next 12 months as well as to pay the portion of the purchase price for our planned acquisition of HGST that will be funded with existing cash. Our ability to sustain our working capital position is subject to a number of risks that we discuss in Part II, Item 1A of this Quarterly Report on Form 10-Q.

We had cash and cash equivalents of $3.7 billion at September 30, 2011 and $3.5 billion at July 1, 2011, of which $3.0 billion at September 30, 2011 and July 1, 2011 was held outside of the United States. Substantially all of the amounts held outside of the United States are intended to be indefinitely reinvested in foreign operations. We are

assessing the impact the Thailand floods will have on our U.S. cash flows. In the event funds from foreign operations are needed in the United States, any repatriation could result in the accrual and payment of additional U.S. income tax.

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Operating Activities

Net cash provided by operating activities during the three months ended September 30, 2011 was $352 million as compared to $390 million during the three months ended October 1, 2010. Cash flow from operating activities consists of net income, adjusted for non-cash charges, plus or minus working capital changes. This represents our principal source of cash. Net cash used to fund working capital changes was $71 million for the three months ended September 30, 2011 as compared to $24 million provided by working capital changes for the prior-year period.

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

	Three Months Ended	
	Sept. 30, 2011	**Oct. 1, 2010**
Days sales outstanding	**46**	50
Days in inventory	**27**	26
Days payables outstanding	**(72)**	(79)
Cash conversion cycle	**1**	(3)

For the three months ended September 30, 2011, our days sales outstanding (DSOs) decreased by 4 days, days in inventory (DIOs) increased by 1 day, and days payable outstanding (DPOs) decreased by 7 days as compared to the prior-year period. Changes in average DSOs are generally related to linearity of shipments throughout the quarter. The increase in DIOs was primarily due to an increase in our finished goods inventory as a result of increasing our utilization of ocean shipments which has longer lead times compared to air freight. Changes in DPOs are generally related to production volume and the timing of purchases during the period. From time to time, we modify the timing of payments to our vendors. We make modifications primarily to manage our vendor relationships and to manage our cash flows, including our cash balances. Generally, we make the payment modifications through negotiations with our vendors or by granting to, or receiving from, our vendors payment term accommodations.

Investing Activities

Cash used in investing activities for the three months ended September 30, 2011 was $134 million as compared to $200 million for the prior-year period and consisted of capital expenditures.

Our cash equivalents are invested in highly liquid money market funds that are invested in U.S. Treasury securities, U.S. Treasury bills and U.S. Government agency securities. We also have $15 million of auction-rate securities, which are classified as available-for-sale securities.

Financing Activities

Net cash used in financing activities for the three months ended September 30, 2011 was $33 million as compared to $66 million in the prior-year period. Net cash used in financing activities for the three months ended September 30, 2011 consisted of $31 million used to repay long-term debt and a net $2 million related to employee stock plans. Net cash used in financing activities for the three months ended October 1, 2010 consisted of $50 million used to repurchase shares of our common stock and $25 million used to repay long-term debt, partially offset by a net $9 million related to employee stock plans.

Off-Balance Sheet Arrangements

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

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Contractual Obligations and Commitments

Long-Term Debt In February 2008, WDTI, entered into a five-year credit agreement that provided for a $500 million term loan facility. As of September 30, 2011, the remaining balance of the term loan facility was $263 million, which requires principal payments totaling $113 million through the remainder of 2012 and $150 million in 2013. See Part I, Item 1, Note 4 in the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

On March 7, 2011, in connection with the planned acquisition of HGST, WD, WDTI and WDI entered into a commitment letter for the Senior Facility. Since entering into the commitment letter, Bank of America N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated led the effort to syndicate the Senior Facility for an amount of up to $3.0 billion, consisting of a $500 million revolving credit facility and up to $2.5 billion in term loans. As a result of such effort, WD, WDTI and WDI have fully negotiated definitive loan documents for the Senior Facility with the syndicate members. WD, WDTI and WDI expect all of these syndicate members to be part of the final lender group, subject to customary closing conditions, including completion of the acquisition in accordance with its terms, the receipt of antitrust approvals or the expiration of applicable waiting periods without any action being taken by an authority that would impose any material adverse condition on WD, HGST, or their respective subsidiaries taken as a whole, and there not having occurred for HGST, WD or WDI a material adverse effect on their respective business, financial condition or operations. We are required to pay a commitment fee at the rate of 0.35%, per annum, of the aggregate unfunded amount committed to be borrowed under the Senior Facility.

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

We have entered into long-term purchase agreements with various component suppliers, 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. We have also entered into long-term purchase agreements with various component suppliers that carry fixed volumes and pricing which obligate us to make certain future purchases, contingent on certain conditions of performance, quality and technology of the vendor s components.

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

See Part II, Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Contractual Obligations and Commitments in our Annual Report on Form 10-K for the year ended July 1, 2011, for further discussion of our purchase orders and purchase agreements and the associated dollar amounts. See Part II, Item 1A of this Quarterly Report on Form 10-Q for a discussion of the risks associated with these commitments.

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

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

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

Unrecognized Tax Benefits As of September 30, 2011, the cash portion of our total recorded liability for unrecognized tax benefits was $150 million. We estimate the timing of the future payments of these liabilities to be within the next one to five years. See Part I, Item 1, Note 6 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q for information regarding our total tax liability for unrecognized tax benefits.

Stock Repurchase Program Our Board of Directors previously authorized us to repurchase $750 million of our common stock in open market transactions under a stock repurchase program through March 31, 2013. Since the inception of this program in 2005 through September 30, 2011, we have repurchased 20 million shares of our common stock for a total cost of $334 million. We did not repurchase any shares under this program during the three months ended September 30, 2011. We may continue to repurchase our stock as we deem appropriate and market conditions allow. We expect stock repurchases to be funded principally by operating cash flows.

Planned Acquisition Termination Fee If the planned acquisition of HGST has not closed by March 7, 2012 due to the failure to receive any required antitrust or competition authority s consent, approval or clearance or any action by any certain governmental entities to prevent the planned acquisition for antitrust or competition reasons, we will, concurrently with such termination, be required to pay Hitachi a fee of $250 million in cash.

Critical Accounting Policies and Estimates

We have prepared the accompanying unaudited condensed consolidated financial statements in accordance with U.S. GAAP. The preparation of the financial statements requires the use of judgments and estimates that affect the reported amounts of revenues, expenses, assets, liabilities and shareholders equity. We have adopted accounting policies and practices that are generally accepted in the industry in which we operate. We believe the following are our most critical accounting policies that affect significant areas and involv