

WESTERN DIGITAL CORP

Form 10-Q

January 28, 2011

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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 December 31, 2010**

**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.)

**3355 Michelson Drive, Suite 100**

**Irvine, California**

(Address of principal executive offices)

**92612**

(Zip Code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a  
smaller reporting  
company)

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

As of the close of business on January 19, 2011, 231,667,319 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 second quarters ended December 31, 2010 and January 1, 2010 both consisted of 13 weeks. Fiscal year 2010 was comprised of 52 weeks and ended on July 2, 2010. Fiscal year 2011 will be comprised of 52 weeks and will end on July 1, 2011. Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters,

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and references to financial information are on a consolidated basis. As used herein, the terms we, us, our, the Company 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](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 Green, and WD GreenPower Technology 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)

|   | <b>Dec. 31,<br/>2010</b> | <b>Jul. 2,<br/>2010</b> |
|---|--------------------------|-------------------------|
| <b>ASSETS</b>   |                          |                         |
| Current assets:   |                          |                         |
| Cash and cash equivalents   | \$ 3,110                 | \$ 2,734                |
| Accounts receivable, net  | 1,250                    | 1,256                   |
| Inventories   | 568                      | 560                     |
| Other current assets  | 192                      | 170                     |
| Total current assets  | 5,120                    | 4,720                   |
| Property, plant and equipment, net  | 2,277                    | 2,159                   |
| Goodwill  | 151                      | 146                     |
| Other intangible assets, net  | 79                       | 88                      |
| Other non-current assets  | 216                      | 215                     |
| Total assets  | \$ 7,843                 | \$ 7,328                |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                          |                         |
| Current liabilities:  |                          |                         |
| Accounts payable  | \$ 1,628                 | \$ 1,507                |
| Accrued expenses  | 262                      | 281                     |
| Accrued warranty  | 135                      | 129                     |
| Current portion of long-term debt   | 119                      | 106                     |
| Total current liabilities   | 2,144                    | 2,023                   |
| Long-term debt  | 231                      | 294                     |
| Other liabilities   | 309                      | 302                     |
| Total liabilities   | 2,684                    | 2,619                   |
| Commitments and contingencies (Note 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 232 and 231 shares, respectively | 2                        | 2                       |
| Additional paid-in capital  | 1,040                    | 1,022                   |
| Accumulated other comprehensive income  | 21                       | 11                      |
| Retained earnings   | 4,096                    | 3,674                   |
| Total shareholders' equity  | 5,159                    | 4,709                   |
| Total liabilities and shareholders' equity  | \$ 7,843                 | \$ 7,328                |

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)

|   | <b>Three Months Ended</b> |                         | <b>Six Months Ended</b>  |                         |
|---|---------------------------|-------------------------|--------------------------|-------------------------|
|   | <b>Dec. 31,<br/>2010</b>  | <b>Jan. 1,<br/>2010</b> | <b>Dec. 31,<br/>2010</b> | <b>Jan. 1,<br/>2010</b> |
| Revenue, net                                | \$ 2,475                  | \$ 2,619                | \$ 4,871                 | \$ 4,827                |
| Cost of revenue                             | 2,000                     | 1,932                   | 3,959                    | 3,626                   |
| Gross margin                                | 475                       | 687                     | 912                      | 1,201                   |
| Operating expenses:                         |                           |                         |                          |                         |
| Research and development                    | 169                       | 154                     | 336                      | 296                     |
| Selling, general and administrative         | 66                        | 60                      | 125                      | 113                     |
| Total operating expenses                    | 235                       | 214                     | 461                      | 409                     |
| Operating income                            | 240                       | 473                     | 451                      | 792                     |
| Other income (expense):                     |                           |                         |                          |                         |
| Interest income                             | 2                         | 1                       | 4                        | 2                       |
| Interest and other expense                  | (3)                       | (3)                     | (5)                      | (6)                     |
| Total other expense, net                    | (1)                       | (2)                     | (1)                      | (4)                     |
| Income before income taxes                  | 239                       | 471                     | 450                      | 788                     |
| Income tax provision                        | 14                        | 42                      | 28                       | 71                      |
| Net income                                  | \$ 225                    | \$ 429                  | \$ 422                   | \$ 717                  |
| <b>Income per common share:</b>             |                           |                         |                          |                         |
| Basic                                       | \$ 0.98                   | \$ 1.89                 | \$ 1.83                  | \$ 3.17                 |
| Diluted                                     | \$ 0.96                   | \$ 1.85                 | \$ 1.80                  | \$ 3.10                 |
| <b>Weighted average shares outstanding:</b> |                           |                         |                          |                         |
| Basic                                       | 230                       | 227                     | 230                      | 226                     |
| Diluted                                     | 235                       | 232                     | 235                      | 231                     |

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)

|   | <b>Six Months Ended</b> |                |
|---|-------------------------|----------------|
|   | <b>Dec. 31,</b>         | <b>Jan. 1,</b> |
|   | <b>2010</b>             | <b>2010</b>    |
| <b>Cash flows from operating activities</b>                             |                         |                |
| Net income  | \$ 422                  | \$ 717         |
| Adjustments to reconcile net income to net cash provided by operations: |                         |                |
| Depreciation and amortization   | 301                     | 247            |
| Stock-based compensation  | 37                      | 27             |
| Deferred income taxes   | 1                       | (5)            |
| Changes in:   |                         |                |
| Accounts receivable, net  | 7                       | (439)          |
| Inventories   | (8)                     | (77)           |
| Accounts payable  | 157                     | 428            |
| Accrued expenses  | (13)                    | 57             |
| Other assets and liabilities  | (9)                     | 36             |
| <br>Net cash provided by operating activities                           | <br>895                 | <br>991        |
| <br><b>Cash flows from investing activities</b>                         |                         |                |
| Purchases of property, plant and equipment                              | (450)                   | (375)          |
| Sales and maturities of investments                                     |                         | 3              |
| <br>Net cash used in investing activities                               | <br>(450)               | <br>(372)      |
| <br><b>Cash flows from financing activities</b>                         |                         |                |
| Issuance of stock under employee stock plans                            | 24                      | 47             |
| Taxes paid on vested stock awards under employee stock plans            | (4)                     | (7)            |
| Excess tax benefits from employee stock plans                           | 11                      | 20             |
| Repurchases of common stock   | (50)                    |                |
| Repayment of debt   | (50)                    | (38)           |
| <br>Net cash provided by (used in) financing activities                 | <br>(69)                | <br>22         |
| <br>Net increase in cash and cash equivalents                           | <br>376                 | <br>641        |
| Cash and cash equivalents, beginning of period                          | 2,734                   | 1,794          |
| <br>Cash and cash equivalents, end of period                            | <br>\$ 3,110            | <br>\$ 2,435   |
| <br><b>Supplemental disclosure of cash flow information:</b>            |                         |                |
| Cash paid for income taxes  | \$ 6                    | \$ 2           |
| Cash paid for interest  | \$ 3                    | \$ 2           |

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 2, 2010. 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 2, 2010. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year. Company management has made estimates and assumptions relating to the reporting of certain assets and liabilities in conformity with U.S. GAAP. These estimates and assumptions have been applied using methodologies that are consistent throughout the periods presented. However, actual results could differ materially from these estimates.

**2. Supplemental Financial Statement Data***Inventories*

|                                   | Dec. 31,<br>2010 | Jul. 2,<br>2010 |
|-----------------------------------|------------------|-----------------|
|                                   | (in millions)    |                 |
| Raw materials and component parts | \$ 141           | \$ 159          |
| Work-in-process                   | 274              | 255             |
| Finished goods                    | 153              | 146             |
| Total inventories                 | \$ 568           | \$ 560          |

*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 materially affect operating results. 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<br>Ended |                 | Six Months<br>Ended |                 |
|-----------------------|-----------------|---------------------|-----------------|
| Dec. 31,<br>2010      | Jan. 1,<br>2010 | Dec. 31,<br>2010    | Jan. 1,<br>2010 |
|                       |                 |                     |                 |

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|  |    |             |    |      |    |             |    |      |
|--|----|-------------|----|------|----|-------------|----|------|
| Warranty accrual, beginning of period                  | \$ | <b>173</b>  | \$ | 132  | \$ | <b>170</b>  | \$ | 123  |
| Charges to operations                                  |    | <b>46</b>   |    | 50   |    | <b>90</b>   |    | 89   |
| Utilization  |    | <b>(40)</b> |    | (32) |    | <b>(79)</b> |    | (62) |
| Changes in estimate related to pre-existing warranties |    | <b>(3)</b>  |    | 5    |    | <b>(5)</b>  |    | 5    |
| Warranty accrual, end of period                        | \$ | <b>176</b>  | \$ | 155  | \$ | <b>176</b>  | \$ | 155  |

Accrued warranty also includes amounts classified in non-current other liabilities of \$41 million at December 31, 2010 and \$41 million at July 2, 2010.

**Table of Contents****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):

|   | <b>Three Months Ended</b> |                     | <b>Six Months Ended</b> |                     |
|---|---------------------------|---------------------|-------------------------|---------------------|
|   | <b>Dec. 31, 2010</b>      | <b>Jan. 1, 2010</b> | <b>Dec. 31, 2010</b>    | <b>Jan. 1, 2010</b> |
| Net income                                      | \$ 225                    | \$ 429              | \$ 422                  | \$ 717              |
| Weighted average shares outstanding:            |                           |                     |                         |                     |
| Basic   | 230                       | 227                 | 230                     | 226                 |
| Employee stock options and other                | 5                         | 5                   | 5                       | 5                   |
| Diluted   | 235                       | 232                 | 235                     | 231                 |
| Income per common share:                        |                           |                     |                         |                     |
| Basic   | \$ 0.98                   | \$ 1.89             | \$ 1.83                 | \$ 3.17             |
| Diluted   | \$ 0.96                   | \$ 1.85             | \$ 1.80                 | \$ 3.10             |
| Anti-dilutive potential common shares excluded* | 4                         | 1                   | 4                       | 1                   |

\* 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 December 31, 2010, the term loan facility had a variable interest rate of 1.56% and a remaining balance of \$350 million, which requires principal payments totaling \$56 million through the remainder of 2011, \$144 million in 2012 and \$150 million in 2013. The term loan facility has a maturity date of February 11, 2013. As of December 31, 2010, WDTI was in compliance with all covenants.

**5. Legal Proceedings**

The Company discloses material loss contingencies deemed to be reasonably possible and accrues for loss contingencies when, in consultation with the Company's legal advisors, the Company concludes that a loss is probable and reasonably estimable. Except as otherwise indicated, the possible losses relating to the matters described below are not reasonably estimable. 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. Convolve is seeking 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. The Company intends to defend itself vigorously in this matter.

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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. The Company intends to defend itself vigorously in this matter.

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 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 October 4, 2006, 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. The parties are engaged in arbitration, and discovery in the arbitration proceeding is ongoing. On September 23, 2010, Seagate filed a motion to amend its claims and add allegations based on the supposed misappropriation of addition confidential information. The arbitrator granted Seagate s motion, and the plenary hearing in the arbitration is now set to begin in May 2011. The Company intends to continue 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 alleges that certain of the Company s engineers have been misclassified as exempt employees under California state law and are, 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, where it is now pending. 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. Formal discovery has commenced. 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 would resolve 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 proposed class action settlement must receive preliminary and final approval by the court before the settlement will become final and binding. A hearing for preliminary approval of the settlement was heard on October 18, 2010, and the court preliminarily approved the settlement. The final approval hearing is currently scheduled for February 2011. If the court does not grant final approval of the settlement, and the Company is unsuccessful in its defense of this matter, potential liability could include unpaid wages, interest, penalties, attorneys fees and costs. Absent final approval of the settlement, the Company intends to continue to defend itself vigorously in this matter.





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On February 26, 2010, and as thereafter amended on August 23, 2010 and December 22, 2010, plaintiff Tarrig 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. The named plaintiff seeks 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 alleges that the hourly employees are due unspecified sums for unpaid overtime wages and other amounts, as well as penalties for allegedly missed meal and rest periods. The complaint seeks 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 Company denies the allegations and intends to defend itself vigorously.

*Other Matters*

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

**6. Income Taxes**

The Company's income tax provision for the three months ended December 31, 2010 was \$14 million as compared to \$42 million in the prior-year period. The Company's income tax provision for the six months ended December 31, 2010 was \$28 million as compared to \$71 million in the prior-year period. The tax provision for the three and six months ended December 31, 2010 reflects the retroactive extension of the research and development tax credit that was signed into law in December 2010. The 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 dates through 2023 and the current year generation of income tax credits.

In the three months ended December 31, 2010, the Company recognized a net increase of \$11 million in its liability for unrecognized tax benefits. As of December 31, 2010, the Company had recognized a liability of approximately \$240 million of unrecognized tax benefits, which considers the status of the United States Internal Revenue Service (the IRS) examination as described below. Interest and penalties recognized on such amounts were not material. The IRS is currently examining fiscal years 2006 and 2007 for the Company and calendar years 2005 and 2006 for Komag, Incorporated, which was acquired by the Company on September 5, 2007. The Company anticipates that the IRS fieldwork will be completed in the March quarter ending April 1, 2011. To date, the Company has received one notice of proposed adjustment from the IRS related to the 2006 and 2007 audit of the Company which seeks an adjustment to income of approximately \$300 million. The Company disagrees with the proposed adjustment, believes that its tax position is properly supported and will vigorously contest the position taken by the IRS.

Due to the risk that audit outcomes and the timing of audit settlements are subject to significant uncertainty, the Company's current estimate of the total amounts of unrecognized tax benefits could increase or decrease for all open tax years. As of December 31, 2010, 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.

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The following table presents information about the Company's financial assets that are measured at fair value on a recurring basis as of December 31, 2010, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

|                                   | Fair Value Measurements at Reporting Date Using                |   |   | Total    |
|-----------------------------------|--|---|---|----------|
|                                   | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |          |
| Cash equivalents                  |  |   |   |          |
| Money market funds                | \$ 586   | \$  | \$  | \$ 586   |
| U.S. Treasury securities          |  | 276   |   | 276      |
| U.S. Government agency securities |  | 197   |   | 197      |
| Total cash equivalents            | 586  | 473   |   | 1,059    |
| Auction-rate securities           |  |   | 15  | 15       |
| Foreign exchange contracts        |  | 29  |   | 29       |
| Total assets at fair value        | \$ 586   | \$ 502  | \$ 15                                     | \$ 1,103 |

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

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

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

*Auction-Rate Securities.* The Company's auction-rate securities have maturity dates through 2050, are primarily backed by insurance products and are accounted for as available-for-sale securities. These investments are expected to be held until secondary markets become available and as a result, 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 which 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 which is based on a present value of future cash flows

model. The market-based observable inputs for the model include forward rates and credit default swap rates. In the six months ended December 31, 2010, there were no changes in Level 3 financial assets measured on a recurring basis. The Company had no liabilities that were re-measured and reported at fair value on a recurring basis at December 31, 2010.

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

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

Although the majority of the Company's transactions are in U.S. dollars, some transactions are based in various foreign currencies. The Company purchases short-term, foreign exchange contracts to hedge the impact of foreign currency exchange fluctuations on certain underlying assets, revenue, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedging transactions is to minimize the impact of foreign currency fluctuations on the Company's results of operations. These contract maturity dates do not exceed 12 months. All foreign exchange contracts are for risk management purposes only. The Company does not purchase foreign exchange contracts for trading purposes. As of December 31, 2010, the Company had outstanding foreign exchange contracts with commercial banks for Thai Baht, Malaysian Ringgit, Euro and British Pound Sterling. Malaysian Ringgit contracts are designated as cash flow hedges. Euro and British Pound Sterling contracts are designated as fair value hedges. Thai Baht contracts are designated as either cash flow or fair value hedges.

If the derivative is designated as a cash flow hedge, the effective portion of the change in fair value of the derivative is initially deferred in other comprehensive income (loss), net of tax. These amounts are subsequently recognized into earnings when the underlying cash flow being hedged is recognized into earnings. Recognized gains and losses on foreign exchange contracts entered into for manufacturing-related activities are reported in cost of revenues. 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 December 31, 2010, the net amount of existing gains expected to be reclassified into earnings within the next 12 months was \$21 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 December 31, 2010, the Company did not have any foreign exchange contracts with credit-risk-related contingent features. The Company opened \$1.0 billion and \$1.9 billion, and closed \$869 million and \$1.6 billion, in foreign exchange contracts in the three and six months ended December 31, 2010, respectively. The fair value and balance sheet location of such contracts were as follows (in millions):

| Derivatives Designated as Hedging Instruments | Asset Derivatives      |            |                        |            | Liability Derivatives  |            |                        |            |
|---|------------------------|------------|------------------------|------------|------------------------|------------|------------------------|------------|
|   | Dec. 31, 2010          |            | Jul. 2, 2010           |            | Dec. 31, 2010          |            | Jul. 2, 2010           |            |
|   | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
|   | Other current assets   | \$ 29      | Other current assets   | \$ 17      |                        |            |                        |            |

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

| Derivatives in Cash | Amount of Gain Recognized in Accumulated OCI on Derivatives |                                |                                 |                               | Location of Gain Reclassified from Accumulated OCI into Income | Amount of Gain Reclassified from Accumulated OCI into Income |                                |                                 |                               |
|---------------------|---|--------------------------------|---------------------------------|-------------------------------|--|--|--------------------------------|---------------------------------|-------------------------------|
|                     | Three Months Ended Dec. 31, 2010                            | Six Months Ended Dec. 31, 2010 | Three Months Ended Jan. 1, 2010 | Six Months Ended Jan. 1, 2010 |  | Three Months Ended Dec. 31, 2010                             | Six Months Ended Dec. 31, 2010 | Three Months Ended Jan. 1, 2010 | Six Months Ended Jan. 1, 2010 |
|                     | Flow Hedging Relationships                                  | \$ 19                          | \$ 74                           | \$ 8                          |  | \$ 22  | Cost of revenue                | \$ 37                           | \$ 64                         |

The total net realized transaction and foreign exchange contract currency gains and losses were not material to the condensed consolidated financial statements during the three and six months ended December 31, 2010 and January 1,

2010.

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

The Company granted approximately 0.9 million restricted stock units during the six months ended December 31, 2010, which are payable in an equal number of shares of the Company's common stock at the time of vesting of the units. The aggregate fair value of the shares underlying the restricted stock unit awards was \$25 million at the date of grant. These amounts are being recognized as expense over the corresponding vesting periods. For purposes of valuing these awards, the Company has assumed a forfeiture rate of 1.78% based on a historical analysis indicating forfeitures for these types of awards.

For the three and six months ended December 31, 2010, the Company recognized approximately \$9 million and \$17 million, respectively, in expense related to the vesting of restricted stock unit awards compared to \$4 million and \$10 million in the comparative prior-year periods. During the three and six months ended December 31, 2010, the Company charged to expense \$9 million and \$20 million, respectively, for stock-based compensation related to options issued under stock option plans and the ESPP, compared to \$9 million and \$17 million in the comparative prior-year periods.

As of December 31, 2010, the aggregate unamortized fair value of all unvested restricted stock unit awards was \$58 million, which will be recognized on a straight-line basis over a weighted average vesting period of approximately 1.7 years. At December 31, 2010, total compensation cost related to unvested stock options and ESPP rights issued to employees but not yet recognized was \$77 million and will be amortized on a straight-line basis over a weighted average service period of approximately 2.5 years.

*Stock Option Activity*

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

|  |                     |                             | Weighted<br>Average |  |                                 |
|--|---------------------|-----------------------------|---------------------|--|---------------------------------|
|  | Number<br>of Shares | Exercise Price<br>Per Share | Weighted<br>Average | Remaining<br>Contractual<br>Life<br>(in years) | Aggregate<br>Intrinsic<br>Value |
| <b>Options outstanding at July 2, 2010</b>                     | 9.4                 | \$ 20.61                    |                     |  |                                 |
| Granted  | 2.4                 | 26.14                       |                     |  |                                 |
| Exercised  | (0.1)               | 12.21                       |                     |  |                                 |
| Canceled or expired  | (0.1)               | 27.04                       |                     |  |                                 |
| <b>Options outstanding at October 1, 2010</b>                  | 11.6                | \$ 21.82                    |                     |  |                                 |
| Granted  | 0.1                 | 33.27                       |                     |  |                                 |
| Exercised  | (0.4)               | 14.04                       |                     |  |                                 |
| Canceled or expired  | (0.1)               | 24.42                       |                     |  |                                 |
| <b>Options outstanding at December 31, 2010</b>                | 11.2                | \$ 22.21                    |                     | 4.9  | \$ 134                          |
| <b>Exercisable at December 31, 2010</b>                        | 5.3                 | \$ 18.40                    |                     | 4.0  | \$ 84                           |
| <b>Vested and expected to vest after<br/>December 31, 2010</b> | 11.0                | \$ 22.14                    |                     | 4.9  | \$ 132                          |

The aggregate intrinsic value is calculated based on the difference between the exercise price of the underlying options and the quoted price of the Company's common stock for those awards that have an exercise price below the quoted price on the date the intrinsic value is determined. As of December 31, 2010, the Company had options

outstanding to purchase an aggregate of 9.8 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 \$134 million. During the three and six months ended December 31, 2010, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$8 million and \$10 million, respectively, determined as of the date of exercise, compared to \$33 million and \$50 million in the comparative prior-year periods.



**Table of Contents***Fair Value Disclosure – Stock Options and ESPP*

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:

|  | <b>Three Months Ended</b> |                         | <b>Six Months Ended</b>  |                         |
|--|---------------------------|-------------------------|--------------------------|-------------------------|
|  | <b>Dec. 31,<br/>2010</b>  | <b>Jan. 1,<br/>2010</b> | <b>Dec. 31,<br/>2010</b> | <b>Jan. 1,<br/>2010</b> |
| Suboptimal exercise factor               | <b>1.81</b>               | 1.77                    | <b>1.81</b>              | 1.73                    |
| Range of risk-free interest rates        | <b>0.29% to 2.71%</b>     | 0.47% to 3.39%          | <b>0.26% to 2.71%</b>    | 0.37% to 3.39%          |
| Range of expected stock price volatility | <b>0.42 to 0.57</b>       | 0.51 to 0.63            | <b>0.42 to 0.59</b>      | 0.51 to 0.72            |
| Weighted average expected volatility     | <b>0.50</b>               | 0.54                    | <b>0.52</b>              | 0.57                    |
| Post-vesting termination rate            | <b>2.80%</b>              | 3.81%                   | <b>2.44%</b>             | 3.60%                   |
| Dividend yield                           |                           |                         |                          |                         |
| Fair value                               | <b>\$13.92</b>            | \$17.26                 | <b>\$11.38</b>           | \$17.10                 |

The weighted average expected term of the Company's stock options for the three and six months ended December 31, 2010 was 4.9 years and 4.7 years, respectively, compared to 4.7 years and 4.6 years in the comparative prior-year periods.

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 and six months ended December 31, 2010 and January 1, 2010.

**10. Recent Accounting Pronouncements**

In September 2009, the FASB issued Accounting Standards Update (ASU) 2009-13, Multiple-Deliverable Revenue Arrangements (ASU 2009-13), and ASU 2009-14, Certain Revenue Arrangements That Include Software Elements (ASU 2009-14). ASU 2009-13 amends the revenue guidance under Subtopic 605-25, Multiple Element Arrangements, and addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how arrangement consideration shall be measured and allocated to the separate units of accounting in the arrangement. ASU 2009-14 excludes tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of Subtopic 985-605, Revenue Recognition. ASU 2009-13 and ASU 2009-14 are effective for fiscal periods beginning on or after June 15, 2010, which for the Company was the first quarter of fiscal 2011. The Company's adoption of ASU 2009-13 and ASU 2009-14 had no impact on its condensed consolidated financial statements.

**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 2, 2010.

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 subsidi



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### **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, 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:*

*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;*  
*traditional seasonal demand and pricing trends;*  
*our beliefs regarding the adequacy of our facilities and fabrication capacity;*  
*our share repurchase plans;*  
*our stock price volatility;*  
*expectations regarding the outcome of legal proceedings in which we are involved;*  
*the timing of future payments, if any, relating to unrecognized tax benefits;*  
*expectations regarding our net revenue and industry unit shipments in the March quarter;*  
*expectations regarding our capital expenditure plans and our depreciation and amortization expense in fiscal 2011; and*  
*beliefs regarding the sufficiency of our cash and cash equivalents to meet our working capital and capital expenditure needs.*

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

### **Our Company**

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

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We sell our products worldwide to original equipment manufacturers ( OEMs ) and original design manufacturers ( ODMs ) for use in computer systems, subsystems or CE devices, and to distributors, resellers and retailers. Our hard drives are used in desktop computers, notebook computers, and in enterprise applications such as servers, workstations, network attached storage, storage area networks, video surveillance equipment and cloud computing environments. Additionally, our hard drives are used in CE applications such as digital video recorders and satellite and cable set-top boxes. We also sell our hard drives as stand-alone storage products by integrating them into finished enclosures, embedding application software and offering the products as WD®-branded external storage appliances for personal data backup and portable or expanded storage for digital music, photographs, video and other digital 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 2.5-inch and 3.5-inch form factor drives, having capacities ranging from 80 gigabytes ( GB ) to 3 terabytes ( TB ), nominal rotation speeds up to 10,000 revolutions per minute ( RPM ), and offer interfaces including Enhanced Integrated Drive Electronics ( EIDE ), Serial Advanced Technology Attachment ( SATA ) and Serial Attached SCSI (Small Computer System Interface) ( SAS ). We also embed our hard drives into WD®-branded external storage appliances using interfaces such as Universal Serial Bus ( USB ) 2.0, USB 3.0, external SATA, FireWire™ and Ethernet network connections with capacities of 160 GB up to 8 TB. In addition, we offer a family of hard drives specifically designed to consume substantially less power than standard drives, utilizing our WD GreenPower Technology™.

In October 2010, we began shipping our 3.5-inch WD Caviar® Green™ 3 TB drive, a SATA hard drive utilizing 750 GB-per-platter areal density and Advanced Format technology.

We also design, develop, manufacture and sell solid-state drives and media players. A solid-state drive is a storage device that uses semiconductor, non-volatile media, rather than magnetic media and magnetic heads, to store and allow fast access to data. We sell our solid-state drives worldwide to OEMs and distributors for use in the embedded systems and client PC markets. A media player is a device that connects to a user's television, the Internet and/or home theater system and plays digital movies, music and photos from an integrated hard drive, any of our WD®-branded external hard drives, or other USB mass storage devices or content services accessed over the Internet. We sell our media players worldwide to resellers and retailers under the WD® brand.

**Second Quarter Overview**

For the December quarter, we believe that overall hard drive industry shipments totaled approximately 168 million units, up 4% from the prior-year period and up 2% sequentially from the September quarter. We also believe that the increase in the December quarter from the September quarter was characterized by seasonally stronger demand. The following table sets forth, for the periods presented, selected summary information from our condensed consolidated statements of income by dollars and percentage of net revenue (in millions, except percentages):

|                          | Three Months Ended |        |                 |        | Six Months Ended |        |                 |        |
|--------------------------|--------------------|--------|-----------------|--------|------------------|--------|-----------------|--------|
|                          | Dec. 31,<br>2010   |        | Jan. 1,<br>2010 |        | Dec. 31,<br>2010 |        | Jan. 1,<br>2010 |        |
| Net revenue              | \$ 2,475           | 100.0% | \$ 2,619        | 100.0% | \$ 4,871         | 100.0% | \$ 4,827        | 100.0% |
| Gross margin             | 475                | 19.2   | 687             | 26.2   | 912              | 18.7   | 1,201           | 24.9   |
| Total operating expenses | 235                | 9.5    | 214             | 8.2    | 461              | 9.5    | 409             | 8.5    |
| Operating income         | 240                | 9.7    | 473             | 18.1   | 451              | 9.3    | 792             | 16.4   |
| Net income               | 225                | 9.1    | 429             | 16.4   | 422              | 8.7    | 717             | 14.9   |

The following is a summary of our financial performance for the second quarter of 2011:

Consolidated net revenue totaled \$2.5 billion.

65% of our hard drive revenue was derived from non-desktop markets, including notebook computers, CE products, enterprise applications and WD®-branded products, as compared to 66% in the prior-year period.



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Hard drive unit shipments increased by 5% over the prior-year period to 52.2 million units.

Gross margin decreased to 19.2%, compared to 26.2% for the prior-year period.

Operating income was \$240 million, a decrease of \$233 million from the prior-year period.

We generated \$505 million in cash flow from operations in the second quarter of 2011, and we finished the quarter with \$3.1 billion in cash and cash equivalents.

Historically, the overall hard drive industry unit shipments in the March quarter have decreased from the December quarter. We believe that overall hard drive industry unit shipments in the March quarter will be down from the December quarter due to normal seasonality and inventory adjustments in PC manufacturers pipeline. Therefore, we expect our net revenue in the March quarter to be down from the December quarter.

**Results of Operations****Net Revenue**

| (in millions, except percentages and average selling price) | Three Months Ended |              |                   | Six Months Ended |              |                   |
|---|--------------------|--------------|-------------------|------------------|--------------|-------------------|
|   | Dec. 31, 2010      | Jan. 1, 2010 | Percentage Change | Dec. 31, 2010    | Jan. 1, 2010 | Percentage Change |
| Net revenue   | \$ 2,475           | \$ 2,619     | (5)%              | \$ 4,871         | \$ 4,827     | 1%                |
| Unit shipments*   | 52.2               | 49.5         | 5                 | 102.9            | 93.6         | 10                |
| Average selling price (per unit)*                           | \$ 47              | \$ 52        | (10)              | \$ 46            | \$ 51        | (10)              |

**Revenues by Geography(%)**

|                                |     |     |     |     |
|--------------------------------|-----|-----|-----|-----|
| Americas                       | 22% | 25% | 23% | 23% |
| Europe, Middle East and Africa | 25  | 25  | 24  | 24  |
| Asia                           | 53  | 50  | 53  | 53  |

**Revenues by Channel(%)**

|              |     |     |     |     |
|--------------|-----|-----|-----|-----|
| OEM          | 45% | 48% | 47% | 50% |
| Distributors | 33  | 30  | 33  | 30  |
| Retailers    | 22  | 22  | 20  | 20  |

**Revenues by Product(%)**

|                     |     |     |     |     |
|---------------------|-----|-----|-----|-----|
| Non-desktop sources | 65% | 66% | 65% | 65% |
| Desktop hard drives | 35  | 34  | 35  | 35  |

\* Based on sales of hard drive units only.

For the quarter ended December 31, 2010, net revenue was \$2.5 billion, a decrease of 5% from the prior-year period. Total hard drive shipments increased to 52.2 million units for the quarter ended December 31, 2010 as compared to 49.5 million units in the prior-year period. The decrease in net revenue resulted from a \$5 decrease in average selling price ( ASP ) from \$52 to \$47, partially offset by an increase in unit shipments. For the six months ended December 31, 2010, net revenue was \$4.9 billion, an increase of 1% over the prior-year period. Total hard drive shipments increased to 102.9 million units for the six months ended December 31, 2010, as compared to 93.6 million units for the prior-year period. The increase in net revenue resulted primarily from an increase in unit shipments, partially offset by a \$5 decrease in ASP from \$51 to \$46. The decrease in ASP for the three and six months ended December 31, 2010 as compared to the prior-year periods was a result of a competitive pricing environment.

Changes in revenue by geography and channel generally reflect normal fluctuations in market demand and competitive dynamics. For the three and six months ended December 31, 2010, 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 and six months ended December 31, 2010, these programs represented 10% and 11% of gross revenues, respectively, compared to 7% in both the comparative prior-year periods. These amounts generally vary according to several factors including industry conditions, seasonal demand, competitor actions, channel mix and overall availability of product.

**Gross Margin**

| (in millions, except percentages) | Three Months Ended |              |                   | Six Months Ended |              |                   |
|-----------------------------------|--------------------|--------------|-------------------|------------------|--------------|-------------------|
|                                   | Dec. 31, 2010      | Jan. 1, 2010 | Percentage Change | Dec. 31, 2010    | Jan. 1, 2010 | Percentage Change |
| Net revenue                       | \$ 2,475           | \$ 2,619     | (5)%              | \$ 4,871         | \$ 4,827     | 1%                |
| Gross margin                      | 475                | 687          | (31)              | 912              | 1,201        | (24)              |
| Gross margin %                    | 19.2%              | 26.2%        |                   | 18.7%            | 24.9%        |                   |

For the three months ended December 31, 2010, gross margin as a percentage of revenue decreased to 19.2% as compared to 26.2% for the prior-year period. For the six months ended December 31, 2010, gross margin as a percentage of revenue decreased to 18.7% as compared to 24.9% for the prior-year period. These decreases were a result of a competitive pricing environment.

**Operating Expenses**

| (in millions, except percentages) | Three Months Ended |              |                   | Six Months Ended |              |                   |
|-----------------------------------|--------------------|--------------|-------------------|------------------|--------------|-------------------|
|                                   | Dec. 31, 2010      | Jan. 1, 2010 | Percentage Change | Dec. 31, 2010    | Jan. 1, 2010 | Percentage Change |
| R&D expense                       | \$ 169             | \$ 154       | 10%               | \$ 336           | \$ 296       | 14%               |
| SG&A expense                      | 66                 | 60           | 10                | 125              | 113          | 11                |
| Total operating expenses          | \$ 235             | \$ 214       |                   | \$ 461           | \$ 409       |                   |

Research and development ( R&D ) expense was \$169 million for the three months ended December 31, 2010, an increase of \$15 million over the prior-year period. For the six months ended December 31, 2010, R&D expense was \$336 million, an increase of \$40 million over the prior-year period. As a percentage of net revenue, R&D expense increased to 6.8% and 6.9% in the three and six months ended December 31, 2010, respectively, compared to 5.9% and 6.1% in the prior-year periods. These increases were primarily due to the continued investment in product development to support new programs, partially offset by a decrease in variable incentive compensation. Selling, general and administrative ( SG&A ) expense was \$66 million for the three months ended December 31, 2010, an increase of \$6 million over the prior-year period. For the six months ended December 31, 2010, SG&A expense was \$125 million, an increase of \$12 million over the prior-year period. SG&A expense as a percentage of net revenue increased to 2.7% and 2.6% in the three and six months ended December 31, 2010, respectively, compared to 2.3% in both the comparative prior-year periods. These increases were primarily due to the expansion of sales and marketing to support new products and growing markets, partially offset by a decrease in variable incentive compensation.

**Other Income (Expense)**

Interest income for the three and six months ended December 31, 2010 increased by \$1 million and \$2 million, respectively, as compared to the prior-year periods primarily due to higher average daily invested cash balances for the periods as compared to the prior-year periods. Interest and other expense for the three months ended December 31, 2010 remained consistent with the prior-year period at \$3 million. Interest and other expense for the six months ended December 31, 2010 decreased by \$1 million as compared to the prior-year period primarily due to a lower amount of debt during the six months ended December 31, 2010 as compared to the prior-year period.





**Table of Contents****Income Tax Provision**

Our income tax provision for the three months ended December 31, 2010 was \$14 million as compared to \$42 million in the prior-year period. Our income tax provision for the six months ended December 31, 2010 was \$28 million as compared to \$71 million in the prior-year period. The tax provision for the three and six months ended December 31, 2010 reflects the retroactive extension of the R&D tax credit that was signed into law in December 2010. The 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 dates through 2023 and the current year generation of income tax credits. In the three months ended December 31, 2010, we recognized a net increase of \$11 million in our liability for unrecognized tax benefits. As of December 31, 2010, we had recognized a liability of approximately \$240 million of unrecognized tax benefits, which considers the status of the United States Internal Revenue Service (the IRS) examination as described below. Interest and penalties recognized on such amounts were not material.

The IRS is currently examining our fiscal years 2006 and 2007 and calendar years 2005 and 2006 for Komag, Incorporated, which was acquired by us on September 5, 2007. We anticipate that the IRS fieldwork will be completed in the March quarter ending April 1, 2011. To date, we have received one notice of proposed adjustment from the IRS related to the 2006 and 2007 audit of us which seeks an adjustment to income of approximately \$300 million. We disagree with the proposed adjustment, believe that our tax position is properly supported and will vigorously contest the position taken by the IRS.

Due to the risk that audit outcomes and the timing of audit settlements are subject to significant uncertainty, our current estimate of the total amounts of unrecognized tax benefits could increase or decrease for all open tax years. As of December 31, 2010, 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 second quarter of fiscal 2011 with total cash and cash equivalents of \$3.1 billion. The following table summarizes our statements of cash flows (in millions):

|   | <b>Six Months Ended</b>  |                         |
|---|--------------------------|-------------------------|
|   | <b>Dec. 31,<br/>2010</b> | <b>Jan. 1,<br/>2010</b> |
| Net cash flow provided by (used in):      |                          |                         |
| Operating activities                      | \$ 895                   | \$ 991                  |
| Investing activities                      | (450)                    | (372)                   |
| Financing activities                      | (69)                     | 22                      |
| Net increase in cash and cash equivalents | \$ 376                   | \$ 641                  |

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 believe our current cash, cash equivalents and cash generated from operations will be sufficient to meet our working capital and capital expenditure needs through the foreseeable future. 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.

**Operating Activities**

Net cash provided by operating activities during the six months ended December 31, 2010 was \$895 million as compared to \$991 million during the six months ended January 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 provided by working capital changes was \$134 million for the six months ended December 31, 2010 as compared to \$5 million 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:

|                           | <b>Three Months Ended</b> |                         |
|---------------------------|---------------------------|-------------------------|
|                           | <b>Dec. 31,<br/>2010</b>  | <b>Jan. 1,<br/>2010</b> |
| Days sales outstanding    | 46                        | 47                      |
| Days in inventory         | 26                        | 21                      |
| Days payables outstanding | (74)                      | (71)                    |
| Cash conversion cycle     | (2)                       | (3)                     |

For the three months ended December 31, 2010, our days sales outstanding ( DSOs ) decreased by 1 day, days in inventory ( DIOs ) increased by 5 days, and days payable outstanding ( DPOs ) increased by 3 days as compared to the prior-year period. The decrease in DSOs was primarily a result of changes in the linearity of shipments in the current quarter as compared to the prior-year period. The increase in DIOs was primarily due to the timing of inventory builds and the change in DPOs was generally related to the timing of purchases during the period in support of production volume. The June 2010 acquisition of additional magnetic media sputtering operations also contributed slightly to the increases in DIOs and DPOs. 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.

**Table of Contents*****Investing Activities***

Cash used in investing activities for the six months ended December 31, 2010 consisted of \$450 million of capital expenditures. Net cash used in investing activities for the six months ended January 1, 2010 was \$372 million which consisted of capital expenditures of \$375 million, offset by \$3 million from the sale of investments.

For fiscal 2011, we expect capital expenditures to be between 7% and 8% of revenue, plus up to \$200 million related to the conversion of our head wafer fabrication facilities to utilize 8-inch wafers from 6-inch wafers and minor expenditures to optimize the output from our recently acquired magnetic media sputtering operations. We expect depreciation and amortization to be approximately \$620 million for fiscal 2011.

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 auction-rate securities that are classified as long-term investments as they are expected to be held until secondary markets become available. These investments are currently accounted for as available-for-sale securities and recorded at fair value within other non-current assets in the condensed consolidated balance sheets. The estimated market values of these investments are subject to fluctuation. The carrying value of our investments in auction-rate securities was \$15 million as of December 31, 2010.

***Financing Activities***

Net cash used in financing activities for the six months ended December 31, 2010 was \$69 million as compared to \$22 million provided by financing activities in the prior-year period. Net cash used in financing activities for the six months ended December 31, 2010 consisted of \$50 million used to repurchase shares of our common stock and \$50 million used to repay long-term debt, offset by a net \$31 million related to employee stock plans. Net cash provided by financing activities for the six months ended January 1, 2010 consisted of a net \$60 million related to employee stock plans, offset by \$38 million used to repay long-term debt.

***Off-Balance Sheet Arrangements***

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

***Contractual Obligations and Commitments***

**Long-Term Debt** In February 2008, Western Digital Technologies, Inc. ( WDTI ), our wholly-owned subsidiary, entered into a five-year credit agreement that provided for a \$500 million term loan facility. As of December 31, 2010, the remaining balance of the term loan facility was \$350 million, which requires principal payments totaling \$56 million through the remainder of 2011, \$144 million in 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.

**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.

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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 2, 2010, for further discussion of our purchase orders and purchase agreements and the associated dollar amounts. See Part II, Item 1A of this Quarterly Report on Form 10-Q for a discussion of the risks associated with these commitments.

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

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

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

*Unrecognized Tax Benefits* As of December 31, 2010, the cash portion of our total liability for unrecognized tax benefits was \$139 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 December 31, 2010, 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 December 31, 2010. 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.

**Table of Contents****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 involve judgment and estimates made by us. If these estimates differ significantly from actual results, the impact to the consolidated financial statements may be material.

***Revenue and Accounts Receivable***

In accordance with standard industry practice, we provide distributors and retailers (collectively referred to as resellers) with limited price protection for inventories held by resellers at the time of published list price reductions, and we provide resellers and OEMs with other sales incentive programs. At the time we recognize revenue to resellers and OEMs, we record a reduction of revenue for estimated price protection until the resellers sell such inventory to their customers and we also record a reduction of revenue for the other programs in effect. We base these adjustments on several factors including anticipated price decreases during the reseller holding period, resellers' sell-through and inventory levels, estimated amounts to be reimbursed to qualifying customers, historical pricing information and customer claim processing. If customer demand for hard drives or market conditions differ from our expectations, our operating results could be materially affected. We also have programs under which we reimburse qualified distributors and retailers for certain marketing expenditures, which are recorded as a reduction of revenue. These amounts generally vary according to several factors including industry conditions, seasonal demand, competitor actions, channel mix and overall availability of product. Since the first quarter of fiscal 2010, total sales incentive and marketing programs have ranged from 7% to 11% of gross revenues per quarter. Changes in future customer demand and market conditions may require us to adjust our incentive programs as a percentage of gross revenue from the current range. Adjustments to revenues due to changes in accruals for these programs related to revenues reported in prior periods have averaged 0.2% of quarterly gross revenue since the first quarter of fiscal 2010.

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

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

***Warranty***

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

included in this Quarterly Report on Form 10-Q.

**Table of Contents*****Inventory***

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

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

***Litigation and Other Contingencies***

We disclose material 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. The ability to predict the ultimate outcome of such matters involves judgments, estimates and inherent uncertainties. The actual outcome of such matters could differ materially from management's estimates. Refer to Part I, Item 1, Note 5 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

***Income Taxes***

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

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

***Stock-Based Compensation***

We account for all stock-based compensation at fair value. Stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. The fair values of all stock options granted are estimated using a binomial model, and the fair values of all Employee Stock Purchase Plan ( ESPP ) purchase rights are 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. We are required to use judgment in estimating the amount of stock-based awards that are expected to be forfeited. If actual forfeitures differ significantly from the original estimate, stock-based compensation expense and our results of operations could be materially affected.





**Table of Contents****Recent Accounting Pronouncements**

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

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

Although the majority of our transactions are in U.S. dollars, some transactions are based in various foreign currencies. We purchase short-term, foreign exchange contracts to hedge the impact of foreign currency exchange fluctuations on certain underlying assets, revenue, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedge transactions is to minimize the impact of foreign currency fluctuations on our results of operations. The contract maturity dates do not exceed 12 months. We do not purchase foreign exchange contracts for trading purposes. Currently, we focus on hedging our foreign currency risk related to the Thai Baht, Malaysian Ringgit, Euro and British Pound Sterling. Malaysian Ringgit contracts are designated as cash flow hedges. Euro and British Pound Sterling contracts are designated as fair value hedges. Thai Baht contracts are designated as either cash flow or fair value hedges. See Part I, Item 1, Note 8 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. As of December 31, 2010, we had outstanding the following purchased foreign exchange contracts (in millions, except weighted average contract rate):

|  | <b>Contract<br/>Amount</b> | <b>Weighted<br/>Average<br/>Contract Rate*</b> | <b>Unrealized<br/>Gain</b> |
|--|----------------------------|--|----------------------------|
| <b>Foreign exchange contracts:</b>       |                            |  |                            |
| Thai Baht cash flow hedges               | \$ 954                     | 30.91  | \$ 16                      |
| Thai Baht fair value hedges              | \$ 97                      | 30.14  |                            |
| Malaysian Ringgit cash flow hedges       | \$ 242                     | 3.20   | \$ 5                       |
| Euro fair value hedges                   | \$ 13                      | 0.75   |                            |
| British Pound Sterling fair value hedges | \$ 3                       | 0.65   |                            |

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

During the three and six month periods ended December 31, 2010, total net realized transaction and foreign exchange contract currency gains and losses were not material to the condensed consolidated financial statements.

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

Borrowings under the term loan facility bear interest at a rate equal to, at the option of WDTI, either (a) a LIBOR rate determined by reference to the cost of funds for Eurodollar deposits for the interest period relevant to such borrowing, adjusted for certain additional costs (the Eurocurrency Rate ) or (b) a base rate determined by reference to the higher of (i) the federal funds rate plus 0.50% and (ii) the prime rate as announced by JPMorgan Chase Bank, N.A. (the Base Rate ); in each case plus an applicable margin. The applicable margin for borrowings under the term loan facility ranges from 1.25% to 1.50% with respect to borrowings at the Eurocurrency Rate and 0.0% to 0.125% with respect to borrowings at the Base Rate. The applicable margins for borrowings under the term loan facility are determined based upon a leverage ratio of the Company and its subsidiaries calculated on a consolidated basis. If the federal funds rate, prime rate or LIBOR rate increase, our interest payments could also increase. A one percent increase in the variable rate of interest on the term loan facility would increase interest expense by approximately \$4 million annually.



**Table of Contents****Item 4. CONTROLS AND PROCEDURES**

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

Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective. There has been no change in our internal control over financial reporting during the quarter ended December 31, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION****Item 1. LEGAL PROCEEDINGS**

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

**Item 1A. RISK FACTORS**

We have updated a number of the risk factors affecting our business since those presented in our Annual Report on Form 10-K, Part I, Item 1A, for the fiscal year ended July 2, 2010. Except for revisions to the first three risk factors below, there have been no material changes in our assessment of our risk factors from those set forth in our Annual Report on Form 10-K for the fiscal year ended July 2, 2010. For convenience, all of our risk factors are included below.

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

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

*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, increasing areal density has become more difficult in the hard drive industry. If we are not able to increase areal density at the same rate as our competitors or at a rate that is expected by our customers, we may be required to include more components in our drives to meet demand without corresponding incremental revenue, which could negatively impact our operating margins and make achieving historical levels of

cost reduction difficult or unlikely. Additionally, increases in areal density may require us to make further capital expenditures on items such as new testing equipment needed as a result of an increased number of GB per platter. Our inability to achieve cost reductions could adversely affect our operating results.

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

As a result of our cost structure and strategy of vertical integration, we conduct our manufacturing operations at large, high volume, purpose-built facilities. For example, approximately 80% of our requirement for heads is satisfied by wafers fabricated in our Fremont, California facility. Also, we manufacture the majority of our substrates for magnetic media in our Johor, Malaysia facility, and we finish a majority of our magnetic media in our facilities in Penang, Malaysia and Tuas, Singapore. A majority of our high volume hard drive manufacturing operations are conducted in our two facilities in Thailand, with the balance conducted in our Kuala Lumpur, Malaysia facility and the facilities of our contract manufacturers in Brazil, Europe and the United States. The manufacturing facilities of many of our customers, our suppliers and our customers' suppliers are also concentrated in certain geographic locations in Asia and elsewhere. A fire, flood, earthquake, tsunami or other disaster, condition or event such as political instability, civil unrest or a power outage that adversely affects any of these facilities would significantly affect our ability to manufacture and/or sell hard drives, which would result in a substantial loss of sales and revenue and a substantial harm to our operating results. For example, if tensions in the Korean Peninsula escalate, it could impact the supply of DRAM, which could adversely affect our ability to manufacture hard drives and the ability of our customers to manufacture systems that include our products, both of which would harm our operating results. Similarly, a localized health risk affecting our employees at these facilities or the staff of our or our customers' other suppliers, such as the spread of the Influenza A (H1N1) or a new pandemic influenza, could impair the total volume of hard drives that we are able to manufacture and/or sell, which would result in substantial harm to our operating results.

*Negative or uncertain global economic conditions could result in a decrease in our sales and revenue and an increase in our operating costs, which could adversely affect our business and operating results.*

Negative or uncertain global economic conditions could cause many of our direct and indirect customers to delay or reduce their purchases of our products and systems containing our products. In addition, many of our customers in each of the OEM, distribution and retail channels rely on credit financing in order to purchase our products. If negative conditions in the global credit markets prevent our customers' access to credit, product orders in these channels may decrease, which could result in lower revenue. Likewise, if our suppliers face challenges in obtaining credit, in selling their products or otherwise in operating their businesses, they may be unable to offer the materials we use to manufacture our products. These actions could result in reductions in our revenue, increased price competition and increased operating costs, which could adversely affect our business, results of operations and financial condition. *If industry demand slows significantly as a result of negative or uncertain global economic conditions or otherwise, we may have to take steps to align our cost structure with demand, which could result in impairment charges and have a negative impact on our operating results.*

If demand slows significantly as a result of a deterioration in economic conditions or otherwise, we may need to execute restructuring activities to realign our cost structure with softening demand. The occurrence of restructuring activities could result in impairment charges and other expenses, which could adversely impact our results of operations or financial condition.

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*Negative or uncertain global economic conditions increase the risk that we could suffer unrecoverable losses on our customers' accounts receivable, which would adversely affect our financial results.*

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

*If our long-lived assets or goodwill become impaired, it may adversely affect our operating results.*

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

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

Historically, the hard drive industry 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. When ASPs in the hard drive industry decline, our ASPs are also likely to decline, which adversely affects 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.*

The PC industry, which comprises a substantial portion of our revenue, is experiencing a shift in demand from 3.5-inch to 2.5-inch form factor disk drives. As a result, the market for 2.5-inch form factor drives is becoming increasingly dominated by large brand OEM customers. These OEM customers may be able to command increased leverage in negotiating prices and other terms of sale. If we are not successful in responding to these changes in the market for smaller form factor drives, our business may suffer.

In addition, during past economic downturns, as well as over the past few years, the consumer market for computers has shifted significantly towards lower priced systems, and we therefore expect this trend to continue in light of current global economic conditions. 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 converts to digital technology from the older analog technology, the technology of computers and consumer electronics will continue to converge, and hard drives may be found in many products other than computers, such as various CE devices. However, there has also been a recent rapid growth in CE devices that do not contain a hard drive (such as tablet computers and smartphones). If device-makers are successful in achieving customer acceptance of these devices as a replacement for traditional computing applications that contain hard drives, or if we are not successful in adapting our product offerings to include alternative storage solutions that address these devices, then demand for our products may decrease, which could adversely affect our operating results. Moreover, some devices such as personal video recorders and digital video recorders, or some new PC operating systems which allow greater consumer choice in levels of functionality and therefore greater market differentiation, may require attributes not currently offered in our products, resulting in a need to develop new interfaces, form factors, technical specifications or product 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 emerging markets such as the CE market, or if we are required to incur significant costs in developing such products, it may harm our operating results.





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*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 or operating efficiencies.*

The data storage industry faces difficulties in accurately forecasting market and customer demand for its products. Accurately forecasting demand has become increasingly difficult for us, our customers and our suppliers in light of the volatility in global economic conditions. In addition, because hard drives are designed to be largely substitutable, our demand forecasts may be impacted significantly by the strategic actions of our competitors. 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 or beyond our ability to add manufacturing capacity, then we may not be able to satisfy customer product needs, which could result in a loss of market share if our competitors are able to meet customer demands.

Although we receive forecasts from our customers, they are not generally obligated to purchase the forecasted amounts. Sales volumes in the distribution and retail channels are volatile and harder to predict than sales to our OEM or ODM 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.

In order to efficiently and timely meet the demands of many of our OEM customers, we position our products in multiple strategic locations based on the amounts forecasted by such customers. If an OEM customer's actual product demands decrease significantly from its forecast, then we may incur additional costs in relocating the products that have not been purchased by the OEM. This could result in a delay in our product sales and an increase in our operating costs, which may negatively impact our operating results.

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

As we expand our product line to sell into additional storage markets, the overall complexity of our business increases at an accelerated rate and we must make necessary adaptations to our business model to address these complexities. For example, as we have previously disclosed, we entered the traditional enterprise market in November 2009. In addition to requiring significant capital expenditures, our entry into the traditional enterprise market adds complexity to our business that requires us to effectively adapt our business and management processes to address the unique challenges and different requirements of the traditional enterprise market, while maintaining a competitive operating cost model. If we fail to gain market acceptance in the traditional enterprise storage market, we will remain at a competitive disadvantage to the companies that succeed in this market and our ability to continue our growth will be negatively affected.

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

Our customers' demand for 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, the emergence of processes such as cloud computing, data deduplication and storage virtualization, economic conditions or otherwise. In addition, the rate of increase in areal density may be greater than the increase in our customers' demand for storage capacity. These factors could lead to our customers' storage capacity needs being satisfied at lower prices with lower capacity hard drives or solid-state storage products that we do not offer, thereby decreasing our revenue or putting us at a disadvantage to competing storage technologies. As a result, even with increasing aggregate demand for storage capacity, our ASPs could decline, which could adversely affect our operating results.

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

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

*If we fail to successfully manage our new product development or new market expansion, or if we fail to anticipate the issues associated with such development or expansion, our business may suffer.*

While we continue to develop new products and look to expand into new markets, the success of our new product introductions depends on a number of factors, including our ability to anticipate and manage a variety of issues associated with these new products and new markets, such as:

difficulties faced in manufacturing ramp;

market acceptance;

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

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

Further, we need to identify how any of the new markets into which we are expanding may have different characteristics from the markets in which we currently exist and properly address these differences. These characteristics may include:

demand volume requirements;

demand seasonality;

product generation development rates;

customer concentrations;

warranty expectations and product return policies; and

cost, performance and compatibility requirements.



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Our business may suffer if we fail to successfully anticipate and manage these issues associated with our product development and market expansion. For example, our branded products are designed to attach to and interoperate with a wide variety of PC and CE devices, and therefore their functionality relies on the manufacturer of such devices, or the associated operating systems, enabling the manufacturer's devices to operate with our branded products. If our branded products are not compatible with a wide variety of devices, or if device manufacturers design their devices so that our branded products cannot operate with them, and we cannot quickly and efficiently adapt our branded products to address these compatibility issues, our business could suffer.

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

The CE and retail markets have different seasonal pricing and volume demand cycles as compared to the PC market. By expanding into these markets, we became exposed to seasonal fluctuations that are different from, and in addition to, those of the PC market. For example, because the primary customer for our branded products are individual consumers, this market has historically experienced a dramatic increase in demand during the winter holiday season. If we do not properly adjust our supply to these new demand cycles, we risk having excess inventory during periods of low demand and insufficient inventory during periods of high demand, which could adversely affect our operating results.

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

Selling branded products is an important part of our business, and as our branded products revenue increases as a portion of our overall revenue, our success in the retail market becomes increasingly important to our operating results. If consumer spending decreases as a result of the recent uncertainty and volatility in global economic conditions or otherwise, our operating results could suffer because of the increased importance of our branded products business.

We sell our branded products directly to a select group of major retailers, such as 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 a small number of major retailers that have strong buying power and pricing leverage. Some of our competitors in the branded product market are large, diversified companies with well-established brands. If we are unable to maintain effective working relationships with major retailers and online resellers, or if we fail to successfully expand into and gain market acceptance of our products in multiple channels, our competitive position in the branded product market may suffer and our operating results may be adversely affected.

Our success in the retail market also depends on our ability to maintain our brand image and corporate reputation. Adverse publicity, whether or not justified, or allegations of product quality issues, even if false or unfounded, could tarnish our reputation and cause our customers to choose products offered by our competitors. In addition, the proliferation of new methods of mass communication facilitated by the Internet makes it easier for false or unfounded allegations to adversely affect our brand image and reputation. If customers no longer maintain a preference for WD<sup>®</sup>-brand products, our operating results may be adversely affected.

Additionally, we face strong competition in maintaining and trying to grow our market share in the retail market, particularly because of the relatively low barriers to entry in this market. For example, several additional hard drive manufacturers have recently disclosed plans to expand into the external storage market. As these companies attempt to gain market share, we may have difficulty in maintaining or growing our market share and there may be increased downward pressure on pricing. There can be no assurance that any new products we introduce into the retail market will gain market acceptance, and if they do not, our operating results could suffer.

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

During the quarter ended December 31, 2010, a large percentage of our revenue, 48%, came from sales to our top 10 customers. These customers have a variety of suppliers to choose from and therefore can make substantial demands on us, including demands on product pricing and on contractual terms, which often results in the allocation of risk to us as the supplier. Even if we successfully qualify a product with a customer, the customer is not generally 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 competitors or if a key customer suffers financial hardship, our operating results would likely be harmed.

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

*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. We may be at a competitive disadvantage to any companies that are able to gain these advantages.

*Further industry consolidation could provide competitive advantages to our competitors.*

The hard drive industry has experienced consolidation over the past several years. 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.

*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. Additionally, if the distribution market weakens as a result of a slowing PC growth rate, technology transitions or a significant change in consumer buying preference, or if we experience significant price declines due to 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. 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.



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*Some of our competitors with diversified business units outside the hard drive industry may over extended periods of time sell hard drives at prices that we cannot profitably 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 sell hard drives at lower prices and operate their hard drive business unit at a loss over an extended period of time while still remaining profitable overall. In addition, if these competitors can increase sales of non-hard drive products to the same customers, they may benefit from selling their hard drives at lower prices. Our operating results may be adversely affected if we cannot successfully compete with the pricing by these companies.

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

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

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

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

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

*A competitive cost structure is critical to our operating results, and increased costs may adversely affect our operating margin.*

A competitive 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 that we are unable to match, we could be at a competitive disadvantage to those competitors.

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*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.*

While we make most of our own heads and magnetic media for some of our product families, we do, according to our sourcing strategy, purchase some percentage of our required heads and magnetic media from our external supply base. In addition, we purchase a majority of our other components, including all mechanical and electronic components, from our external supply base. For certain components, we use multiple suppliers that deploy different technology or processes, and we must successfully integrate components from these suppliers in our products. Accordingly, we must maintain effective relationships with our supply base to source our component needs, develop compatible technology, and maintain continuity of supply at reasonable costs. If we fail to maintain effective relationships with our supply base, or if we fail to integrate components from our suppliers effectively, this may adversely affect our ability to develop and deliver the best products to our customers and our profitability could suffer. For example, 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 channel devices could be designed into our products. Similar disputes with other strategic component suppliers could adversely affect our operating results.

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

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

interrupting or otherwise disrupting the shipment of our product components;

damaging our reputation;

forcing us to find alternate component sources;

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

exposing us to potential liability for our supplier's wrongdoings.

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

Our future operating results may depend substantially on our suppliers' ability to timely qualify their components in our programs, and their ability to supply us with these components in sufficient volumes to meet our production requirements. A number of the components that we use are available from only a single or limited number of qualified suppliers, and may be used across multiple product lines. 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, if 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. If we are unable to obtain sufficient quantities of materials used in the manufacture of magnetic components, 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 and consumables we use in our manufacturing or testing processes are available only from a limited number of suppliers. Some of this equipment and consumables use materials that at times could be in short supply. If these materials are not available, or are not available in the quantities we require for our manufacturing and testing processes, our ability to manufacture our products could be impacted, and we could suffer



significant loss of revenue.

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

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

consolidation of key suppliers;

failure of a key supplier's business process;

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

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

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

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

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

We rely on suppliers for various component parts that we integrate into our hard drives but do not manufacture ourselves, such as semiconductors, motors, flex circuits and suspensions. Likewise, we rely on suppliers for certain technology and equipment necessary for advanced development technology for future products. Some of these components, and most of this technology and production equipment, must be specifically designed to be compatible for use in our products or for developing and manufacturing our future products, and are only available from a limited number of suppliers, some of with whom we are sole sourced. We are therefore dependent on these suppliers to be able and willing to dedicate adequate engineering resources to develop components that can be successfully integrated with our products, and technology and production equipment that can be used to develop and manufacture our next-generation products efficiently. The failure of these suppliers to effectively and efficiently develop and manufacture components that can be integrated into our products or technology and production equipment that can be used to develop or manufacture next generation products may cause us to experience inability or delay in our manufacturing and shipment of hard drive products, our expansion into new technology and markets, or our ability to remain competitive with alternative storage technologies, therefore adversely affecting our business and financial results.

*There are certain additional capital expenditure costs and asset utilization risks to our business associated with our strategy to vertically integrate our operations.*

Our vertical integration of head and magnetic media manufacturing resulted in a fundamental change in our operating structure, as we now manufacture heads and magnetic media for use in many of the hard drives we manufacture. Consequently, we make more capital investments and carry a higher percentage of fixed costs than we would if we were not vertically integrated. If the overall level of production decreases for any reason, and we are unable to reduce our fixed costs to match sales, our head or magnetic media manufacturing assets may face under-utilization that may impact our operating results. We are therefore subject to additional risks related to overall asset utilization, including the need to operate at high levels of utilization to drive competitive costs and the need for assured supply of components that we do not manufacture ourselves.

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In addition, we may incur additional risks, including:

failure to continue to leverage the integration of our magnetic media technology with our head technology;

insufficient third party sources to satisfy our needs if we are unable to manufacture a sufficient supply of heads or magnetic media;

third party head or magnetic media 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 or magnetic media may infringe certain intellectual property rights of other companies; and

difficulties locating in a timely manner suitable manufacturing equipment for our head or magnetic media manufacturing processes and replacement parts for such equipment.

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

*If we are unable to timely and cost-effectively develop heads and magnetic media with leading technology and overall quality, our ability to sell our products may be significantly diminished, which could materially and adversely affect our business and financial results.*

Under our business plan, we are developing and manufacturing a substantial portion of the heads and magnetic media used in the hard drive products we manufacture. Consequently, we are more dependent upon our own development and execution efforts and less able to take advantage of head and magnetic media technologies developed by other manufacturers. Technology transition for head and magnetic media designs is critical to increasing our volume production of heads and magnetic media. There can be no assurance, however, that we will be successful in timely and cost-effectively developing and manufacturing heads or magnetic media for products using future technologies. We also may not effectively transition our head or magnetic media design and technology to achieve acceptable manufacturing yields using the technologies necessary to satisfy our customers' product needs, or we may encounter quality problems with the heads or magnetic media we manufacture. In addition, we may not have access to external sources of supply without incurring substantial costs which would negatively impact our business and financial results.

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

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

*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 magnetic media technology to be improved or new technologies 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 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.



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*We make significant investments in research and development, and unsuccessful investments could materially adversely affect our business, financial condition and results of operations.*

Over the past several years, our business strategy has been to derive a competitive advantage by moving from being a follower of new technologies to being a leader in the innovation and development of new technologies. This strategy requires us to make significant investments in research and development. There can be no assurance that these investments will result in viable technologies or products, or if these investments do result in viable technologies or products, that they will be profitable or accepted by the market. Significant investments in unsuccessful research and development efforts could materially adversely affect our business, financial condition and results of operations.

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

Historically, when the industry experiences a fundamental change in technology, any manufacturer that fails to successfully and timely adjust its designs and processes to accommodate the new technology fails to remain competitive. There are some revolutionary technologies, such as current-perpendicular-to-plane giant magnetoresistance, shingle magnetic recording, energy assisted magnetic recording, patterned magnetic media and advanced signal processing, that if implemented by a competitor on a commercially viable basis ahead of the industry, could put us at a competitive disadvantage. As a result of these technology shifts, we could incur substantial costs in developing new technologies, such as heads, magnetic media, and tools to remain competitive. If we fail to successfully implement these new technologies, or if we are significantly slower than our competitors at implementing new technologies, we may not be able to offer products with capacities that our customers desire. For example, new recording technology requires changes in the manufacturing process of heads and magnetic media, which may cause longer production times and reduce the overall availability of magnetic media in the industry. Additionally, the new technology requires a greater degree of integration between heads and magnetic media which may lengthen our time of development of hard drives using this technology.

Furthermore, as we attempt to develop and implement new technologies, we may become more dependent on suppliers to ensure our access to components, technology and production equipment that accommodate the new technology. For example, advanced wafer and magnetic media manufacturing technologies have historically been developed for use in the semiconductor industry prior to the hard drive industry. However, successful implementation of the use of patterned magnetic media with hard drive magnetic media currently presents a significant technical challenge facing the hard drive industry but not the semiconductor industry. Therefore, our suppliers may not be willing to dedicate adequate engineering resources to develop manufacturing equipment for patterned magnetic media prior to a need for the equipment in the semiconductor industry. We believe that if new technologies, such as energy assisted magnetic recording, are not successfully implemented in the hard drive industry, then alternative storage technologies like solid-state storage may more rapidly overtake hard drives as the preferred storage solution for higher capacity storage needs. This result would put us at a competitive disadvantage and negatively impact our operating results.

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

The storage markets in which we offer our products continuously undergo technology transitions which we must anticipate and adapt our products to address in a timely manner. For example, serial interfaces normally go through cycles in which their maximum speeds double. We must effectively manage the transition of the features of our products to address these faster interface speeds in a timely manner in order to remain competitive and cost effective. If we fail to successfully and timely manage the transition to faster interface speeds, we may be at a competitive disadvantage to other companies that have successfully adapted their products in a timely manner and our operating results may suffer.

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

Our success depends in part on our ability to develop and introduce new products in a timely manner in order to keep pace with competing technologies. Alternative storage technologies like solid-state storage technology have successfully served digital entertainment markets for products such as digital cameras, MP3 players, USB flash drives, mobile phones and tablet devices that require a relatively low amount of storage capacity that cannot be economically serviced using hard drive technology. Typically, storage needs for higher capacity and performance, with lower cost-per-gigabyte, have been better served by hard drives. However, advances in semiconductor technology have resulted in solid-state storage emerging as a technology that is competitive with hard drives for niche high performance needs in advanced digital computing markets such as enterprise servers and storage, in spite of the associated challenges in the attributes of cost, capacity and reliability. Solid-state storage is produced by large semiconductor companies who can then sell their storage products at lower prices while still remaining profitable overall. This can help them improve their market share at the expense of the competition. In addition, these semiconductor companies may choose to supply companies like us with semiconductor media at prices that make it difficult, if not impossible, for us to compete with them on a profitable basis. As a result, there can be no assurance that we will be successful in anticipating and developing new products for the desktop, mobile, enterprise, CE and external storage markets in response to solid-state storage, as well as other competing technologies. If our hard drive technology fails to offer higher capacity, performance and reliability with lower cost-per-gigabyte than solid-state storage for the desktop, mobile, enterprise, CE and external storage markets, we will be at a competitive disadvantage to companies using semiconductor technology to serve these markets and our business will suffer.

*Spending to improve our technology and develop new technology to remain competitive may negatively impact our financial results.*

In attempting to remain competitive, we may need to increase our capital expenditures and expenses above our historical run-rate model in order to attempt to improve our existing technology and develop new technology. Increased investments in technology could cause our cost structure to fall out of alignment with demand for our products which would have a negative impact on our financial results.

*Our operating results will 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, we must balance several key attributes such as time-to-market, time-to-volume, quality, cost, service, price and a broad product portfolio. Our operating results will be adversely affected if we fail to:

- maintain overall quality of products in 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;

- obtain customer qualification of these products 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; or

- 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.



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*Manufacturing outside the United States and marketing our products globally subjects us to numerous risks.*

We are subject to risks associated with our global manufacturing operations and global marketing efforts, including:  
obtaining requisite U.S. 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;

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

exchange, currency and tax controls and reallocations;

increasing labor and overhead costs; and

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

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

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

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

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

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

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

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

As part of our growth strategy, we may pursue acquisitions of, investment opportunities in or other significant transactions with companies that are complementary to our business. In order to pursue this strategy successfully, we must identify attractive acquisition or investment opportunities, successfully complete the transaction, some of which may be large and complex, and manage post-closing issues such as integration of the acquired company or employees.



We may not be able to identify or complete appealing acquisition or investment opportunities given the intense competition for these transactions. Even if we identify and complete suitable corporate transactions, we may not be able to successfully address any integration challenges in a timely manner, or at all. If we fail to successfully integrate an acquisition, we may not realize all or any of the anticipated benefits of the acquisition, and our future results of operations could be adversely affected.

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

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

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

The data storage industry has been characterized by significant litigation. This includes litigation relating to patent and other intellectual property rights, product liability claims and other types of litigation. Litigation can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of litigation are inherently uncertain and may result in adverse rulings or decisions. We may enter into settlements or be subject to judgments that may, individually or in the aggregate, have a material adverse effect on our business, financial condition or operating results.

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

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

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

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

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

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

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

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

We have attempted to manage the impact of foreign currency exchange rate changes by, among other things, entering into short-term, foreign exchange contracts. However, these contracts do not cover our full exposure and can be canceled by the counterparty if currency controls are put in place. Currently, we hedge the Thai Baht, Malaysian Ringgit, Euro and British Pound Sterling with foreign exchange contracts.

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

Some of our OEM customers have adopted a subcontractor model that requires us to contract directly with companies, such as ODMs, that provide manufacturing and fulfillment services to our OEM customers. Because these

subcontractors are generally not as well capitalized as our direct OEM customers, this subcontractor model exposes us to increased credit risks. Our agreements with our OEM customers may not permit us to increase our product prices to alleviate this increased credit risk. Additionally, as we attempt to expand our OEM and distribution channel sales into emerging economies such as Brazil, Russia, India and China, the customers with the most success in these regions may have relatively short operating histories, making it more difficult for us to accurately assess the associated credit risks. 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 and lead times for 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:

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 warranty costs related to product defects;

accruals for litigation and other contingencies;

liabilities for unrecognized tax benefits; and

expensing of stock-based compensation.

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*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:

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;

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

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

macroeconomic conditions that affect the market generally.

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

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

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

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

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

Our most recent evaluation resulted in our conclusion that as of July 2, 2010, in compliance with Section 404 of the Sarbanes-Oxley Act of 2002, our internal control over financial reporting was effective. We believe that we currently have adequate internal control procedures in place for future periods; however, if our internal control over financial reporting is found to be ineffective or if we identify a material weakness or significant deficiency in our financial reporting, investors may lose confidence in the reliability of our financial statements, which may adversely affect our financial results or our stock price.

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

We are subject to income taxes in the United States and certain foreign jurisdictions, and our determination of our tax liability is subject to review by applicable domestic and foreign tax authorities. For example, as we have previously disclosed, we are under examination of certain of our fiscal years by the IRS, and in connection with that examination, we received the notice of proposed adjustment disclosed in Part I, Item 1, Note 6 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. Although we believe our tax positions are properly supported, the final timing and resolution of the notice of proposed adjustment and the audits are subject to significant uncertainty and could result in our having to pay amounts to the applicable tax authority in order to resolve examination of our tax positions, which could result in an increase or decrease of our current estimate of unrecognized tax benefits and may negatively impact our financial position, results of operations, net income or cash flows.

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**Item 6. EXHIBITS**

**Exhibit**

| <b>No.</b> | <b>Description</b>   |
|------------|--|
| 3.1        | Amended and Restated Certificate of Incorporation of Western Digital Corporation, as amended to date (Incorporated by reference to the Company's Quarterly Report on Form 10-Q (File No. 1-08703), as filed with the Securities and Exchange Commission on February 8, 2006) |
| 3.2        | Amended and Restated Bylaws of Western Digital Corporation, as amended effective as of November 5, 2007 (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 8, 2007) |
| 10.1       | Western Digital Corporation Summary of Compensation Arrangements for Named Executive Officers and Directors *  |
| 10.2       | Western Digital Corporation Executive Severance Plan, as amended November 10, 2010 *   |
| 10.3       | Separation and General Release Agreement, dated December 1, 2010, between Western Digital Corporation and Martin Finkbeiner *  |
| 10.4       | Amended and Restated Deferred Compensation Plan, as amended November 10, 2010 *  |
| 31.1       | Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2       | Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1       | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2       | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101.INS    | XBRL Instance Document**   |
| 101.SCH    | XBRL Taxonomy Extension Schema Document**  |
| 101.CAL    | XBRL Taxonomy Extension Calculation Linkbase Document**  |
| 101.LAB    | XBRL Taxonomy Extension Label Linkbase Document**  |
| 101.PRE    | XBRL Taxonomy Extension Presentation Linkbase Document**   |
| 101.DEF    | XBRL Taxonomy Extension Definition Linkbase Document**   |

Exhibit filed with this Report.



- \* Management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to applicable rules of the Securities and Exchange Commission.
- \*\* Furnished herewith. In accordance with Rule 406T of Regulation S-T, the information in these exhibits shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, except as expressly set forth by specific reference in such filing.

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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/ Wolfgang U. Nickl  
Wolfgang U. Nickl  
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: January 27, 2011

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