

WESTERN DIGITAL CORP
Form 10-Q
November 04, 2014
Table of Contents

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended October 3, 2014

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

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

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

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

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

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

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

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

As of the close of business on October 30, 2014, 232,201,114 shares of common stock, par value \$.01 per share, were outstanding.

Table of ContentsWESTERN DIGITAL CORPORATION
INDEX

	PAGE NO.
<u>PART I. FINANCIAL INFORMATION</u>	<u>3</u>
<u>Item 1. Financial Statements (unaudited)</u>	<u>3</u>
<u>Condensed Consolidated Balance Sheets — October 3, 2014 and June 27, 2014</u>	<u>3</u>
<u>Condensed Consolidated Statements of Income — Three Months Ended October 3, 2014 and September 27, 2013</u>	<u>4</u>
<u>Condensed Consolidated Statements of Comprehensive Income — Three Months Ended October 3, 2014 and September 27, 2013</u>	<u>5</u>
<u>Condensed Consolidated Statements of Cash Flows — Three Months Ended October 3, 2014 and September 27, 2014</u>	<u>6</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>7</u>
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>23</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>30</u>
<u>Item 4. Controls and Procedures</u>	<u>31</u>
<u>PART II. OTHER INFORMATION</u>	<u>31</u>
<u>Item 1. Legal Proceedings</u>	<u>31</u>
<u>Item 1A. Risk Factors</u>	<u>31</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>48</u>
<u>Item 6. Exhibits</u>	<u>49</u>

Our fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every six years, we report a 53-week fiscal year to align our fiscal year with the foregoing policy. Our fiscal first quarters ended October 3, 2014 and September 27, 2013 consisted of 14 weeks and 13 weeks, respectively. Fiscal year 2014 was comprised of 52 weeks and ended on June 27, 2014. Fiscal year 2015 will be comprised of 53 weeks and will end on July 3, 2015. Fiscal year 2016 will be comprised of 52 weeks and will end on July 1, 2016. Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters, and references to financial information are on a consolidated basis. As used herein, the terms “we,” “us,” “our,” the “Company,” “WDC” and “Western Digital” refer to Western Digital Corporation and its subsidiaries, unless we state, or the context indicates, otherwise.

WDC, a Delaware corporation, is the parent company of our storage business, which operates under two independent subsidiaries – HGST and WD. Our principal executive offices are located at 3355 Michelson Drive, Suite 100, Irvine, California 92612. Our telephone number is (949) 672-7000 and our Web site is www.westerndigital.com. The information on our Web site is not incorporated in this Quarterly Report on Form 10-Q.

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

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

WESTERN DIGITAL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions, except par values; unaudited)

	October 3, 2014	June 27, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$5,159	\$4,804
Short-term investments	222	284
Accounts receivable, net	1,915	1,989
Inventories	1,272	1,226
Other current assets	422	417
Total current assets	8,990	8,720
Property, plant and equipment, net	3,202	3,293
Goodwill	2,559	2,559
Other intangible assets, net	406	454
Other non-current assets	495	473
Total assets	\$15,652	\$15,499
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$2,016	\$1,971
Accrued arbitration award	772	758
Accrued expenses	433	412
Accrued compensation	438	460
Accrued warranty	134	119
Current portion of long-term debt	125	125
Total current liabilities	3,918	3,845
Long-term debt	2,281	2,313
Other liabilities	490	499
Total liabilities	6,689	6,657
Commitments and contingencies (Notes 4 and 5)		
Shareholders' equity:		
Preferred stock, \$.01 par value; authorized — 5 shares; issued and outstanding — none	—	—
Common stock, \$.01 par value; authorized — 450 shares; issued — 261 shares; outstanding — 234 shares	3	3
Additional paid-in capital	2,285	2,331
Accumulated other comprehensive income (loss)	(14) 12
Retained earnings	8,394	8,066
Treasury stock — common shares at cost; 27 shares	(1,705) (1,570
Total shareholders' equity	8,963	8,842
Total liabilities and shareholders' equity	\$15,652	\$15,499

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

Table of Contents

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

	Three Months Ended	
	October 3, 2014	September 27, 2013
Revenue, net	\$3,943	\$3,804
Cost of revenue	2,794	2,705
Gross profit	1,149	1,099
Operating expenses:		
Research and development	437	401
Selling, general and administrative	220	132
Charges related to arbitration award	14	13
Employee termination, asset impairment and other charges	9	11
Total operating expenses	680	557
Operating income	469	542
Other income (expense):		
Interest income	4	3
Interest and other expense	(13) (13
Total other expense, net	(9) (10
Income before income taxes	460	532
Income tax provision	37	37
Net income	\$423	\$495
Income per common share:		
Basic	\$1.81	\$2.10
Diluted	\$1.76	\$2.05
Weighted average shares outstanding:		
Basic	234	236
Diluted	240	242

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

Table of Contents

WESTERN DIGITAL CORPORATION
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (in millions; unaudited)

	Three Months Ended	
	October 3, 2014	September 27, 2013
Net income	\$423	\$495
Other comprehensive income (loss), net of tax:		
Net unrealized gain (loss) on foreign exchange contracts	(26) 16
Other comprehensive income (loss)	(26) 16
Total comprehensive income	\$397	\$511

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

Table of Contents

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

	Three Months Ended	
	October 3, 2014	September 27, 2013
Cash flows from operating activities		
Net income	\$423	\$495
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	289	312
Stock-based compensation	39	42
Deferred income taxes	10	(10)
Gain from insurance recovery	—	(65)
Loss on disposal of assets	4	—
Non-cash portion of employee termination, asset impairment and other charges	1	7
Changes in:		
Accounts receivable, net	74	25
Inventories	(46)	(21)
Accounts payable	49	22
Accrued arbitration award	14	13
Accrued expenses	16	(52)
Accrued compensation	(22)	(65)
Other assets and liabilities	(24)	(23)
Net cash provided by operating activities	827	680
Cash flows from investing activities		
Purchases of property, plant and equipment	(160)	(136)
Proceeds from sales and maturities of investments	166	—
Purchases of investments	(120)	—
Acquisitions, net of cash acquired	—	(263)
Other investing activities, net	(12)	39
Net cash used in investing activities	(126)	(360)
Cash flows from financing activities		
Issuance of stock under employee stock plans	39	22
Taxes paid on vested stock awards under employee stock plans	(57)	(22)
Excess tax benefits from employee stock plans	20	7
Repurchases of common stock	(223)	(150)
Dividends paid to shareholders	(94)	(59)
Proceeds from debt, net of issuance costs	—	500
Repayment of debt	(31)	(58)
Net cash provided by (used in) financing activities	(346)	240
Net increase in cash and cash equivalents	355	560
Cash and cash equivalents, beginning of period	4,804	4,309
Cash and cash equivalents, end of period	\$5,159	\$4,869
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$10	\$63
Cash paid for interest	\$12	\$11
Supplemental disclosure of non-cash financing activities:		
Accrual of cash dividend declared	\$94	\$59

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

Table of Contents

WESTERN DIGITAL CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (unaudited)

1. Basis of Presentation

The accounting policies followed by Western Digital Corporation (the "Company") are set forth in Part II, Item 8, Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended June 27, 2014. In the opinion of management, all adjustments necessary to fairly state the unaudited condensed consolidated financial statements have been made. All such adjustments are of a normal, recurring nature. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended June 27, 2014. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year. The Company's fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every six years, the Company reports a 53-week fiscal year to align its fiscal year with the foregoing policy. The Company's fiscal first quarters ended October 3, 2014 and September 27, 2013 consisted of 14 weeks and 13 weeks, respectively. Fiscal year 2015 will be comprised of 53 weeks and will end on July 3, 2015.

The Company acquired Virident Systems, Inc. ("Virident") on October 17, 2013, sTec, Inc. ("sTec") on September 12, 2013, and VeloBit, Inc. ("VeloBit") on July 9, 2013. These acquisitions are further described in Note 11 below. In connection with the acquisitions, Virident, sTec and VeloBit became indirect wholly-owned subsidiaries of the Company. Virident, sTec and VeloBit's results of operations since their respective dates of acquisition are included in the condensed consolidated financial statements.

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

2. Supplemental Financial Statement Data

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

	October 3, 2014	June 27, 2014
	(in millions)	
Inventories:		
Raw materials and component parts	\$ 178	\$ 168
Work-in-process	509	493
Finished goods	585	565
Total inventories	\$ 1,272	\$ 1,226
Property, plant and equipment:		
Property, plant and equipment	\$ 8,244	\$ 8,123
Accumulated depreciation	(5,042)	(4,830)
Property, plant and equipment, net	\$ 3,202	\$ 3,293
Other intangible assets:		
Other intangible assets	\$ 980	\$ 984
Accumulated amortization	(574)	(530)
Other intangible assets, net	\$ 406	\$ 454

Warranty

The Company records an accrual for estimated warranty costs when revenue is recognized. The Company generally warrants its products for a period of one to five years. The warranty provision considers estimated product failure rates

and trends, estimated replacement costs, estimated repair costs which include scrap costs, and estimated costs for customer compensatory claims related to product quality issues, if any. A statistical warranty tracking model is used to help prepare estimates and assist the Company in exercising judgment in determining the underlying estimates. The statistical tracking model captures specific detail on hard drive reliability, such as factory test data, historical field return rates, and costs to repair by product type. Management's judgment is subject to a greater degree of subjectivity with respect to newly introduced products because of limited field experience with those products upon which to base warranty estimates. Management reviews the warranty accrual

Table of Contents

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 profit and income. Such changes are generally a result of differences between forecasted and actual return rate experience and costs to repair. If actual product return trends, costs to repair returned products or costs of customer compensatory claims differ significantly from estimates, future results of operations could be materially affected. Changes in the warranty accrual were as follows (in millions):

	Three Months Ended	
	October 3, 2014	September 27, 2013
Warranty accrual, beginning of period	\$ 182	\$ 187
Warranty liability assumed as a result of acquisition	—	3
Charges to operations	49	40
Utilization	(49) (49
Changes in estimate related to pre-existing warranties	19	14
Warranty accrual, end of period	\$ 201	\$ 195

The long-term portion of the warranty accrual classified in other liabilities was \$67 million at October 3, 2014 and \$63 million at June 27, 2014.

Investments

The following table summarizes, by major type, the fair value and cost basis of the Company's investments as of October 3, 2014 (in millions):

	Cost Basis	Unrealized Gains (Losses)	Fair Value
Available-for-sale securities:			
U.S. Treasury securities	\$ 203	\$—	\$ 203
U.S. Government agency securities	79	—	79
Commercial paper	119	—	119
Certificates of deposit	53	—	53
Total	\$ 454	\$—	\$ 454
Short-term investments			\$ 222
Included in other non-current assets			232
Total			\$ 454

The fair value of the Company's investments classified as available-for-sale securities at October 3, 2014, by remaining contractual maturity, were as follows (in millions):

	Cost Basis	Fair Value
Due in less than one year:	\$ 222	\$ 222
Due in one to five years:	232	232
Total	\$ 454	\$ 454

Table of Contents

The following table summarizes, by major type, the fair value and cost basis of the Company's investments as of June 27, 2014 (in millions):

	Cost Basis	Unrealized Gains (Losses)	Fair Value
Available-for-sale securities:			
U.S. Treasury securities	\$180	\$—	\$180
U.S. Government agency securities	88	—	88
Commercial paper	165	—	165
Certificates of deposit	66	—	66
Total	\$499	\$—	\$499
Short-term investments			
Included in other non-current assets			\$284
Total			\$499

The fair value of the Company's investments classified as available-for-sale securities at June 27, 2014, by remaining contractual maturity, were as follows (in millions):

	Cost Basis	Fair Value
Due in less than one year:	\$284	\$284
Due in one to five years:	215	215
Total	\$499	\$499

The Company determined no available-for-sale securities were other-than-temporarily impaired in the three months ended October 3, 2014. For more information on the Company's available-for-sale securities, see Note 7 below.

In addition, the Company enters into certain strategic investments for the promotion of business and strategic objectives. These strategic investments are recorded at cost within other non-current assets in the consolidated balance sheets and were not material to the condensed consolidated financial statements as of October 3, 2014 and June 27, 2014.

Other Comprehensive Income (Loss)

Other comprehensive income (loss) refers to revenue, expenses, gains and losses that are recorded as an element of shareholders' equity but are excluded from net income. The Company's other comprehensive income (loss) is comprised of unrealized gains and losses on foreign exchange contracts. There were no unrealized gains or losses on the Company's available-for-sale securities or actuarial gains and losses related to pensions in the three months ended October 3, 2014. In addition, the income tax impact on components of other comprehensive income (loss) is immaterial for all periods presented.

The following table illustrates the changes in the balances of each component of accumulated other comprehensive income (loss) for the three months ended October 3, 2014 (in millions):

	Actuarial Pension Gain	Unrealized Gain (Loss) on Foreign Exchange Contracts	Accumulated Other Comprehensive Income (Loss)
Balance at June 27, 2014	\$7	\$5	\$12
Other comprehensive income (loss) before reclassifications	—	(22)	(22)
Amounts reclassified from accumulated other comprehensive income (loss)	—	(4)	(4)
Net current-period other comprehensive income (loss)	—	(26)	(26)
Balance at October 3, 2014	\$7	\$(21)	\$(14)

Table of Contents

The following table illustrates the changes in the balances of each component of accumulated other comprehensive income (loss) for the three months ended September 27, 2013 (in millions):

	Actuarial Pension Gain	Unrealized Gain (Loss) on Foreign Exchange Contracts	Accumulated Other Comprehensive Income (Loss)
Balance at June 28, 2013	\$11	\$(46)	\$(35)
Other comprehensive income (loss) before reclassifications	—	(11)	(11)
Amounts reclassified from accumulated other comprehensive income (loss)	—	27	27
Net current-period other comprehensive income	—	16	16
Balance at September 27, 2013	\$11	\$(30)	\$(19)

3. Income per Common Share

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

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

	Three Months Ended	
	October 3, 2014	September 27, 2013
Net income	\$423	\$495
Weighted average shares outstanding:		
Basic	234	236
Employee stock options and other	6	6
Diluted	240	242
Income per common share:		
Basic	\$1.81	\$2.10
Diluted	\$1.76	\$2.05
Anti-dilutive potential common shares excluded*	—	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

On January 9, 2014, Western Digital Ireland, Ltd. ("WDI") used existing cash to repay the outstanding term loan balance of \$1.8 billion, and the Company, Western Digital Technologies, Inc. ("WDT") and WDI entered into a new credit agreement with JPMorgan Chase Bank, N.A., as administrative agent, and the lenders party thereto (the "Credit Agreement"). The Credit Agreement provides for \$4.0 billion of unsecured loan facilities consisting of a \$2.5 billion term loan facility to WDT and a \$1.5 billion revolving credit facility to WDT and WDI (the "Borrowers"). The revolving credit facility includes a \$100 million sublimit for letters of credit and a \$50 million sublimit for swing line loans. Subject to certain conditions, a Borrower may elect to expand the credit facilities by, or obtain incremental term loans of, up to \$1.0 billion if existing or new lenders provide additional term or revolving commitments. The loans under the Credit Agreement have a five-year term. The obligations of the Borrowers under the Credit Agreement are guaranteed by the Company and its material domestic subsidiaries, and the obligations of WDI under the Credit Agreement are also guaranteed by WDT.

As of October 3, 2014, no amounts were outstanding under the revolving credit facility and the term loan facility had an outstanding balance of \$2.4 billion and a variable interest rate of 1.66%. The Company is required to make quarterly principal

10

Table of Contents

payments on the term loan facility totaling \$94 million for the remainder of fiscal 2015, \$156 million in fiscal 2016, \$219 million in fiscal 2017, \$250 million in fiscal 2018 and the remaining balance of \$1.7 billion in fiscal 2019. The Credit Agreement requires the Company to comply with a leverage ratio and an interest coverage ratio calculated on a consolidated basis for the Company and its subsidiaries. In addition, the Credit Agreement contains customary covenants, including covenants that limit or restrict the Company's and its subsidiaries' ability to incur liens, incur indebtedness, make certain restricted payments, merge or consolidate and enter into certain speculative hedging arrangements, and customary events of default. As of October 3, 2014, the Company was in compliance with all covenants.

5. Legal Proceedings

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

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

Intellectual Property Litigation

On June 20, 2008, plaintiff Convole, Inc. ("Convole") filed a complaint in the Eastern District of Texas against WD, HGST, and one other company alleging infringement of U.S. Patent Nos. 6,314,473 and 4,916,635. The complaint sought unspecified monetary damages and injunctive relief. On October 10, 2008, Convole amended its complaint to allege infringement of only the '473 patent. The '473 patent allegedly relates to interface technology to select between certain modes of a disk drive's operations relating to speed and noise. A trial in the matter began on July 18, 2011 and concluded on July 26, 2011 with a verdict against WD and HGST in an amount that is not material to the Company's financial position, results of operations or cash flows, for which the Company previously recorded an accrual. WD and HGST have filed post-trial motions challenging the verdict. On January 17, 2014, the Court denied the Company's motion for judgment as a matter of law on invalidity. On May 20, 2014, the Court ordered supplemental briefing on post-trial motions related to infringement. Convole and the Company filed their supplemental briefs on May 30, 2014 and June 6, 2014, respectively. Additional post-trial motions are pending, and the Company will evaluate its options for appeal after the Court rules on the remaining post-trial motions. The Company intends to continue to defend itself vigorously in this matter.

On August 1, 2011, plaintiff Guzik Technical Enterprises ("Guzik") filed a complaint in the Northern District of California against WD and various of its subsidiaries alleging infringement of U.S. Patent Nos. 6,023,145 and 6,785,085, breach of contract and misappropriation of trade secrets. The complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The patents asserted by Guzik allegedly relate to devices used to test hard disk drive heads and media. On November 30, 2013, WD entered into a settlement agreement for an amount that is not material to the Company's financial position, results of operations or cash flows, for which the Company recorded an accrual in the three months ended December 27, 2013. Guzik is disputing the enforceability of the

agreement and on December 27, 2013, WD filed a motion to enforce the agreement. The Court heard oral argument on WD's motion on January 23, 2014. The Court granted WD's motion to enforce the settlement agreement on March 21, 2014. On April 14, 2014, Guzik filed a Notice of Appeal to the Federal Circuit. On June 17, 2014, Guzik filed its opening appellate brief. WD filed its appellate brief on August 14, 2014. On September 11, 2014, Guzik filed its reply brief in support of its opening appellate brief. WD intends to continue to defend itself vigorously in this matter. On July 9, 2012, Siemens Aktiengesellschaft ("Siemens") filed a complaint in German court against WD, Western Digital GmbH, and Digital River International, S.a.r.l. alleging patent infringement of European patent no. EP 674769, which claims an

Table of Contents

artificial antiferromagnetic (AAF) (aka, synthetic antiferromagnetic) structure for magneto-resistive sensors. On March 14-15, 2013, Western Digital GmbH filed a response of non-infringement and also filed a separate nullity action. Siemens separately served WD with the complaint on July 15, 2013. The patent expired on December 16, 2013 and, on March 10, 2014, Siemens withdrew its motion for injunctive relief. On March 7, 2014, Siemens extended the complaint including WDT as a defendant. On August 25, 2014, the parties reached a settlement agreement for an amount that is not material to the Company's financial position, results of operations or cash flows, which the Company recorded in the three months ended October 3, 2014. On August 27, 2014, the Company withdrew the nullity action which was confirmed by the Federal Patent Court on August 29, 2014. On August 27, 2014 Siemens withdrew the infringement action which was confirmed by the infringement court on September 3, 2014. This matter is now closed.

On September 5, 2013, plaintiff Lake Cherokee Hard Drive Technologies, LLC ("Lake Cherokee") filed a complaint in the Eastern District of Texas against: Marvell Asia PTE, Ltd., Samsung Semiconductor, Inc., Seagate Tech. LLC, Seagate Tech. Int'l., Toshiba Corp., Toshiba Am. Elec. Components, Toshiba Am. Inf. Sys., Inc., Toshiba Am. Inf. Equip. (Philippines), Inc., and WDT alleging infringement of US Patent Nos. 5,844,738 and 5,978,162. Lake Cherokee alleges that WDT's hard disk drive products that contain Marvell read channel systems-on-a-chip (SOCs) infringe its '738 and '162 patents. The complaint seeks unspecified monetary damages, fees and costs. On April 3, 2014, Lake Cherokee and Marvell Semiconductor, Inc. ("MSI") engaged in mediation which resulted in a settlement-in-principle on April 8, 2014. On April 21, 2014, Lake Cherokee and MSI filed a motion to stay deadlines while the parties finalized a settlement agreement. In this motion, Lake Cherokee and MSI represented to the Court that the settlement between Lake Cherokee and MSI will result in a with-prejudice dismissal of Lake Cherokee's claims against each of the defendants, including WDT, with respect to their sale or use of Marvell chips. On April 23, 2014, the Court granted a stay of deadlines. The parties submitted a Joint Stipulation of Dismissal with Prejudice, and on September 5, 2014, the Court ordered that the Stipulation of Dismissal is granted and that the claims are dismissed with prejudice. This matter is now closed.

On September 25, 2013, plaintiff Lake Cherokee filed a complaint in the Eastern District of Texas against: Marvell Semiconductor, Inc., Marvell Asia PTE, Ltd., Dell Inc., and WDT alleging infringement of US Patent No. 5,583,706. Lake Cherokee alleges that WDT's hard disk drive products that contain Marvell read channel systems-on-a-chip (SOCs) infringe its '706 patent. The complaint seeks an injunction, unspecified monetary damages, fees and costs. On April 3, 2014, Lake Cherokee and MSI engaged in mediation which resulted in a settlement-in-principle on April 8, 2014. On April 21, 2014, Lake Cherokee and MSI filed a motion to stay deadlines while the parties finalized a settlement agreement. In this motion, Lake Cherokee and MSI represented to the Court that the settlement between Lake Cherokee and MSI will result in a with-prejudice dismissal of Lake Cherokee's claims against each of the defendants, including WDT, with respect to their sale or use of Marvell chips. On April 23, 2014, the Court granted a stay of deadlines. The parties submitted a Joint Stipulation of Dismissal with Prejudice, and on August 27, 2014, the Court ordered that the Stipulation of Dismissal is granted and that the claims are dismissed with prejudice. This matter is now closed.

On March 24, 2014, plaintiff Steven F. Reiber ("Reiber") filed a complaint in the Eastern District of California against the Company, alleging infringement of U.S. Patent Nos. 7,124,927 and 7,389,905. On September 16, 2014, Reiber filed an amended complaint in the Eastern District of California against the Company alleging infringement of three additional patents-U.S. Patent Nos. 6,935,548, 6,651,864, and 6,354,479. Reiber alleges that WD products (including hard disk drive heads, head gimbal assemblies, head stack assemblies and SSDs) infringe these patents based on the allegation that the manufacturing of these products involves the use of certain bonding tools (e.g., wire-bonding tips, capillary tips, and flip-chip handling tools) that have electrically "dissipative" properties, and which are used when bonding components, such as leads, wires and flip chips. The complaint seeks an injunction, unspecified monetary damages, interests, fees and costs. On September 30, 2014, the Company filed a motion to dismiss Reiber's claims for induced infringement and contributory infringement. The parties' initial case management conference is set for February 5, 2015. The Company intends to defend itself vigorously in this matter.

On October 20, 2014, plaintiff SOTA Semiconductor LLC (“SOTA”) filed a complaint in the Central District of California against the Company, Marvell Semiconductor, Inc., Belkin International, Inc., Dell Inc., Hewlett-Packard Company, Hisense USA Corp., Konica Minolta Business Solutions U.S.A., Inc., Lenovo (United States) Inc., Netgear, Inc., Samsung Electronics America, Inc., and Seagate Technology LLC, alleging infringement of U.S. Patent No. 5,991,545 (“’545 patent”). SOTA alleges that the Company’s devices that incorporate Marvell Thumb Processors, including WD’s My Cloud EX2 network attached storage devices, which include model numbers WDBVKW0080JCH, WDBVKW0060JCH, WDBVKW0040JCH and WDBVKW0000NCH, infringe the ’545 patent. The complaint seeks unspecified monetary damages, interests, fees, costs and expenses. The Company intends to defend itself vigorously in this matter.

Table of Contents

Seagate Matter

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

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

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

On October 30, 2012, Seagate initiated an appeal of the Court’s decision with the Minnesota Court of Appeals. On July 22, 2013, the Minnesota Court of Appeals reversed the District Court’s decision and remanded for entry of an order and judgment confirming the arbitration award. On August 20, 2013, the Company filed a petition for review with the Minnesota Supreme Court and, on October 15, 2013, the Minnesota Supreme Court granted the Company’s petition. The appeal before the Minnesota Supreme Court was fully briefed, and oral argument was held on February 5, 2014. On October 8, 2014, the Minnesota Supreme Court affirmed the decision of the Minnesota Court of Appeals; the Minnesota Supreme Court’s decision is not subject to appeal. As a result, on October 14, 2014, the Company paid Seagate \$773.4 million to satisfy the full amount of the final arbitration award plus interest accrued through October 13, 2014. This amount was paid by one of the Company’s foreign subsidiaries using cash held outside of the United States.

Seagate disputes the method the Company used for calculating post-award interest. If not resolved, the interest dispute, which involves an amount that is not material to the Company's financial position, results of operations or cash flows, will be determined by the Minnesota courts.

Other Matters

On December 22, 2011 the German Central Organization for Private Copying Rights (Zentralstelle für private Überspielungsrechte), (“ZPÜ”), an organization consisting of several levy collecting societies, submitted a pleading to the Copyright Arbitration Board (“CAB”) in Munich claiming retroactive copyright levies for multimedia hard drives, external hard drives and network hard drives sold or introduced into commerce in Germany by WD from January 2008 through December 2010. The CAB was required to issue a settlement proposal within one year of the initiation of the action, failed to do so and requested the parties to consent to continue the deadline. WD declined to provide consent and, on February 1, 2013, WD filed a declaratory relief against ZPÜ in the Higher Regional Court of Munich

(the “Higher Court”), seeking an order from the court to determine the copyright levy issue. On May 21, 2013, ZPÜ filed a counter-claim against WD with the Higher Court, seeking copyright levies for multimedia hard drives, external hard drives and network hard drives sold or introduced into commerce from January 2008 through December 2010 based on tariffs published by ZPÜ on November 3, 2011. On May 22, 2014, oral argument on the pleadings occurred. A decision from the Higher Court is expected by January 15, 2015, which either party may appeal. WD intends to defend itself vigorously in this matter.

Table of Contents

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 both the three months ended October 3, 2014 and September 27, 2013 was \$37 million. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia, the Philippines, Singapore and Thailand that expire at various dates from 2015 through 2025 and the current year generation of income tax credits.

In the three months ended October 3, 2014, the Company recorded a net increase of \$7 million in its liability for unrecognized tax benefits. As of October 3, 2014, the Company's liability for unrecognized tax benefits was approximately \$307 million. Interest and penalties recognized on such amounts were not material to the condensed consolidated financial statements during the three months ended October 3, 2014.

The Internal Revenue Service ("IRS") previously completed its field examination of the Company's federal income tax returns for fiscal years 2006 and 2007, and the Company and the IRS reached agreement with respect to all matters except on the proposed adjustments to income before income taxes relating to intercompany payable balances. The proposed adjustments relating to intercompany payable balances for fiscal years 2006 and 2007 will be addressed in conjunction with the IRS's examination of the Company's fiscal years 2008 and 2009, which commenced in January 2012. In addition, in January 2012, the IRS commenced an examination of the 2007 fiscal period ended September 5, 2007 of Komag, Incorporated, which was acquired by the Company on September 5, 2007. The Company anticipates that the IRS fieldwork will be completed in the fourth quarter of fiscal year 2015. With respect to the 2008 and 2009 audit, the Company received a notice of proposed adjustment from the IRS relating to intercompany payable balances. The proposed adjustments to income before income taxes relating to intercompany payable balances for fiscal years 2006, 2007, 2008 and 2009 total approximately \$200 million. The Company disagrees with the proposed adjustments, believes that its tax position is properly supported and will vigorously contest the position taken by the IRS. The IRS examined calendar years 2010 and 2011 of HGST, which was acquired by the Company on March 8, 2012, and completed the examination with no material adjustments.

The Company believes that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs. As of October 3, 2014, 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 liability for unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of the Company's tax returns.

7. Fair Value Measurements

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

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

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

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

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of October 3, 2014, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

14

Table of Contents

Fair Value Measurements at
Reporting Date Using
Level 1 Level 2