WESTERN DIGITAL CORP
Form 10-Q
May 09, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended April 1, 2016
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 incorporation or organization)	(I.R.S. Employer Identification No.)
3355 Michelson Drive, Suite 100 Irvine, California	92612
(Address of principal executive offices)	(Zip Code)

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý 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 ý 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 ý	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 ý
As of the close of business on May 4, 2016, 232,996,715 shares of common stock, par value $.01 per share, were outstanding.

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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 data storage business. Our principal executive offices are located at 3355 Michelson Drive, Suite 100, Irvine, California 92612. Our telephone number is (949) 672-7000 and our website is www.westerndigital.com. The information on our website is not incorporated in this Quarterly Report on Form 10-Q.

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

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PART I. FINANCIAL INFORMATION
Item 1. FINANCIAL STATEMENTS
WESTERN DIGITAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions, except par values; unaudited)

	April 1, 2016	July 3, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$5,887	$5,024
Short-term investments	146	262
Accounts receivable, net	1,254	1,532
Inventories	1,227	1,368
Other current assets	226	331
Total current assets	8,740	8,517
Property, plant and equipment, net	2,687	2,965
Goodwill	2,766	2,766
Other intangible assets, net	268	332
Other non-current assets	486	601
Total assets	$14,947	$15,181
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,571	$1,881
Accrued expenses	579	470
Accrued compensation	282	330
Accrued warranty	146	150
Revolving credit facility	—	255
Current portion of long-term debt	203	156
Total current liabilities	2,781	3,242
Long-term debt	2,000	2,156
Other liabilities	557	564
Total liabilities	5,338	5,962
Commitments and contingencies (Notes 4, 5 and 6)		
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 — 233 and 230 shares, respectively	3	3
Additional paid-in capital	2,454	2,428
Accumulated other comprehensive income (loss)	32	(20)
Retained earnings	9,363	9,107
Treasury stock — common shares at cost; 28 and 31 shares, respectively	(2,243)	(2,299)
Total shareholders' equity	9,609	9,219
Total liabilities and shareholders' equity	$14,947	$15,181

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

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

	Three Months Ended		Nine Months Ended	
	April 1, 2016	April 3, 2015	April 1, 2016	April 3, 2015
Revenue, net	$2,822	$3,550	$9,499	$11,381
Cost of revenue	2,069	2,518	6,885	8,090
Gross profit	753	1,032	2,614	3,291
Operating expenses:				
Research and development	359	402	1,133	1,265
Selling, general and administrative	166	199	565	583
Charges related to arbitration award	—	—	32	15
Employee termination, asset impairment and other charges	140	10	223	72
Total operating expenses	665	611	1,953	1,935
Operating income	88	421	661	1,356
Other income (expense):				
Interest and other income	6	3	17	11
Interest and other expense	(14)	(12)	(40)	(37)
Total other expense, net	(8)	(9)	(23)	(26)
Income before income taxes	80	412	638	1,330
Income tax expense	6	28	30	85
Net income	$74	$384	$608	$1,245
Income per common share:				
Basic	$0.32	$1.66	$2.62	$5.34
Diluted	$0.32	$1.63	$2.60	$5.23
Weighted average shares outstanding:				
Basic	233	231	232	233
Diluted	234	236	234	238
Cash dividends declared per share	$0.50	$0.50	$1.50	$1.30

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

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

	Three Months Ended		Nine Months Ended	
	April 1, 2016	April 3, 2015	April 1, 2016	April 3, 2015
Net income	$74	$ 384	$608	$1,245
Other comprehensive income (loss), net of tax:				
Net unrealized gain (loss) on foreign exchange contracts	39	29	52	(15)
Other comprehensive income (loss), net of tax	39	29	52	(15)
Total comprehensive income	$113	$ 413	$660	$1,230

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

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

	Nine Months Ended	
	April 1, 2016	April 3, 2015
Operating Activities		
Net income	$608	$1,245
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	734	864
Stock-based compensation	121	117
Deferred income taxes	(17)	9
Gain from insurance recovery	—	(37)
Loss on disposal of assets	13	14
Non-cash portion of employee termination, asset impairment and other charges	36	12
Changes in:		
Accounts receivable, net	278	294
Inventories	138	(96)
Accounts payable	(301)	8
Accrued arbitration award	—	(758)
Accrued expenses	137	83
Accrued compensation	(68)	(63)
Other assets and liabilities, net	(51)	62
Net cash provided by operating activities	1,628	1,754
Investing Activities		
Purchases of property, plant and equipment	(433)	(456)
Proceeds from sale of property, plant and equipment	—	7
Proceeds from sales and maturities of investments	907	665
Purchases of investments	(462)	(687)
Acquisitions, net of cash acquired	—	(247)
Other investing activities, net	(23)	6
Net cash used in investing activities	(11)	(712)
Financing Activities		
Issuance of stock under employee stock plans	64	146
Taxes paid on vested stock awards under employee stock plans	(45)	(61)
Excess tax benefits from employee stock plans	(2)	27
Repurchases of common stock	(60)	(772)
Dividends paid to shareholders	(347)	(280)
Repayment of revolving credit facility	(255)	—
Repayment of long-term debt	(109)	(94)
Net cash used in financing activities	(754)	(1,034)
Net increase in cash and cash equivalents	863	8
Cash and cash equivalents, beginning of period	5,024	4,804
Cash and cash equivalents, end of period	$5,887	$4,812
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$38	$39
Cash paid for interest	$33	$33
Supplemental disclosure of non-cash financing activities:		

Accrual of cash dividend declared	$116	$116

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 3, 2015. 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 3, 2015. 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 third quarters ended April 1, 2016 and April 3, 2015 both consisted of 13 weeks. The nine months ended April 1, 2016 and April 3, 2015 consisted of 39 and 40 weeks, respectively. Fiscal 2016 will be comprised of 52 weeks and will end on July 1, 2016. Fiscal year 2015 was comprised of 53 weeks and ended on July 3, 2015.

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

Accounts Receivable

From time to time, in connection with a factoring agreement, the Company sells trade accounts receivable without recourse to a third party purchaser in exchange for cash. During the three and nine months ended April 1, 2016, the Company sold trade accounts receivable and received cash proceeds of $35 million and $235 million, respectively. During both the three and nine months ended April 3, 2015, the Company sold trade accounts receivable and received cash proceeds of $67 million. The discounts on the sales of trade accounts receivable were not material and were recorded within interest and other expense in the condensed consolidated statements of income.

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

	April 1, 2016	July 3, 2015
	(in millions)	
Inventories:		
Raw materials and component parts	$132	$168
Work-in-process	440	500
Finished goods	655	700
Total inventories	$1,227	$1,368
Property, plant and equipment:		
Property, plant and equipment	$8,778	$8,604
Accumulated depreciation	(6,091)	(5,639)
Property, plant and equipment, net	$2,687	$2,965
Other intangible assets:		
Other intangible assets	$1,018	$1,008
Accumulated amortization	(750)	(676)
Other intangible assets, net	$268	$332

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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 product reliability, such as factory test data, historical field return rates and costs to repair by product type. Management's judgment is subject to a greater degree of subjectivity with respect to newly introduced products because of limited field experience with those products upon which to base warranty estimates. Management reviews the warranty accrual quarterly for products shipped in prior periods and which are still under warranty. Any changes in the estimates underlying the accrual may result in adjustments that impact current period gross 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		Nine Months Ended	
	April 1, 2016	April 3, 2015	April 1, 2016	April 3, 2015
Warranty accrual, beginning of period	$225	$ 222	$221	$ 182
Warranty liability assumed as a result of acquisition	—	1	—	1
Charges to operations	36	46	124	145
Utilization	(42)	(47)	(137)	(140)
Changes in estimate related to pre-existing warranties	2	(1)	13	33
Warranty accrual, end of period	$221	$ 221	$221	$ 221

The long-term portion of the warranty accrual classified in other liabilities was $75 million as of April 1, 2016 and $71 million as of July 3, 2015.

Investments

The following tables summarize, by major type, the fair value and cost basis of the Company's investments (in millions):

	April 1, 2016		
	Cost Basis	Unrealized Gains (Losses)	Fair Value
Available-for-sale securities:			
Certificates of deposit	$146	$ —	$ 146
Total	$146	$ —	$ 146

	July 3, 2015		
	Cost Basis	Unrealized Gains (Losses)	Fair Value
Available-for-sale securities:			
U.S. Treasury securities	$287	$ —	$ 287
U.S. Government agency securities	95	—	95
Commercial paper	109	—	109
Certificates of deposit	99	—	99
Total	$590	$ —	$ 590

The fair value of the Company's investments classified as available-for-sale securities at April 1, 2016, by remaining contractual maturity, were as follows (in millions):

	Cost Basis	Fair Value
Due in less than one year (short-term investments):	$ 146	$ 146
Total	$ 146	$ 146

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The Company determined no available-for-sale securities were other-than-temporarily impaired during the three and nine months ended April 1, 2016 and April 3, 2015. The Company sold the majority of its existing investments in the three months ended April 1, 2016, resulting in an immaterial realized loss that was included within interest and other expense in the condensed consolidated statements of income. For more information on the Company's available-for-sale securities, see Note 7 to these condensed consolidated financial statements.

From time to time, 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 condensed consolidated balance sheets and were not material to the condensed consolidated financial statements as of April 1, 2016 and July 3, 2015.

Joint Venture

In November 2015, the Company entered into an agreement to form a joint venture with Unisplendour Corporation Limited ("Unis") to market and sell the Company's current data center storage systems in China and to develop data storage systems for the Chinese market in the future. The joint venture will be 51% owned by Unis and its subsidiary, Unissoft (Wuxi) Group Co. Ltd., and 49% by the Company. The joint venture is expected to become operational during the fourth quarter of fiscal 2016, pending regulatory approvals.

Other Comprehensive Income (Loss), Net of Tax

Other comprehensive income (loss), net of tax refers to revenue, expenses, gains and losses that are recorded as an element of shareholders' equity but are excluded from net income. The income tax impact on components of other comprehensive income 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 nine months ended April 1, 2016 (in millions):

	Actuarial Pension Gain	Unrealized Gain (Loss) on Foreign Exchange Contracts	Accumulated Other Comprehensive Income (Loss)
Balance at July 3, 2015	$ 5	$ (25)	$ (20)
Other comprehensive loss before reclassifications	—	(9)	(9)
Amounts reclassified from accumulated other comprehensive income (loss)	—	61	61
Net current-period other comprehensive income	—	52	52
Balance at April 1, 2016	$ 5	$ 27	$ 32

The following table illustrates the changes in the balances of each component of accumulated other comprehensive income (loss) for the nine months ended April 3, 2015 (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 loss before reclassifications	—	(39)	(39)
Amounts reclassified from accumulated other comprehensive income (loss)	—	24	24
Net current-period other comprehensive loss	—	(15)	(15)
Balance at April 3, 2015	$ 7	$ (10)	$ (3)

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 dilutive outstanding employee stock options, rights to purchase shares of common stock under the Company’s Employee Stock Purchase Plan (“ESPP”) and awards of restricted stock units.

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

	Three Months Ended		Nine Months Ended	
	April 1, 2016	April 3, 2015	April 1, 2016	April 3, 2015
Net income	$74	$ 384	$608	$ 1,245
Weighted average shares outstanding:				
Basic	233	231	232	233
Employee stock options and other	1	5	2	5
Diluted	234	236	234	238
Income per common share:				
Basic	$0.32	$ 1.66	$2.62	$ 5.34
Diluted	$0.32	$ 1.63	$2.60	$ 5.23
Anti-dilutive potential common shares excluded*	6	1	5	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

The Company's credit agreement, which was entered into in January 2014 and subsequently amended (the “Credit Agreement”), provides for $4.0 billion of unsecured loan facilities consisting of a $2.5 billion term loan facility and a $1.5 billion revolving credit facility. The loans under the Credit Agreement have a five-year term. Subject to certain conditions, the credit facilities may be expanded by, or incremental term loans may be obtained for, up to $1.0 billion if existing or new lenders provide additional term or revolving commitments.

The term loans and the revolving credit loans may be prepaid in whole or in part at any time without premium or penalty, subject to certain conditions. The Company repaid the $255 million outstanding balance under the revolving credit facility in January 2016. As of April 1, 2016, the term loan facility had a variable interest rate of 1.9% and a remaining outstanding balance of $2.2 billion. The Company is required to make quarterly principal payments on the term loan facility totaling $47 million for the remainder of 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 April 1, 2016, the Company was in compliance with all applicable financial covenants under the Credit Agreement.

For information related to the debt entered into in connection with the planned merger (the “Merger”) with SanDisk Corporation (“SanDisk”), see Note 14 to these condensed consolidated financial statements.

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.

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Solely for purposes of this note, “WD” refers to Western Digital Corporation or one or more of its subsidiaries excluding HGST prior to the closing of the Company's acquisition of HGST on March 8, 2012 (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

In June 2008, Convolve, Inc. (“Convolve”) filed a complaint in the Eastern District of Texas against WD, HGST, and two other companies alleging infringement of U.S. Patent Nos. 6,314,473 and 4,916,635. The complaint sought unspecified monetary damages and injunctive relief. In October 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. In July 2011, a verdict was rendered 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. In March 2015, WD and HGST filed Notices of Appeal with the United States District Court for the Federal Circuit (“Federal Circuit”). In April 2015, Convolve filed a motion for reconsideration of the final judgment, and in May 2015, the Federal Circuit deactivated the appeal pending the Court’s decision on reconsideration. WD and HGST intend to continue to defend themselves vigorously in this matter.

In May 2016, Lambeth Magnetic Structures, LLC (“Lambeth”) filed a complaint in the Western District of Pennsylvania against the Company and certain of its subsidiaries alleging infringement of U.S. Patent No. 7,128,988. The complaint seeks unspecified monetary damages and injunctive relief. The ’988 patent, entitled “Magnetic Material Structures, Devices and Methods,” allegedly relates to a magnetic material structure for hard disk drive devices. The Company intends to defend itself vigorously in this matter.

Seagate Matter

In October 2006, Seagate Technology LLC (“Seagate”) brought an action against the Company and a now former employee, alleging misappropriation of confidential information and trade secrets. In January 2012, an arbitrator issued a final award against the Company, including pre-award interest, of $630.4 million. The matter was appealed and, in October 2014, the Minnesota Supreme Court upheld the arbitrator’s award. In October 2014, the Company paid Seagate $773.4 million to satisfy the final arbitration award and interest accrued through October 2014. This amount was paid by one of the Company’s foreign subsidiaries using cash held outside of the United States.

Seagate disputed the method the Company used for calculating post-award interest and contended that the Company owed Seagate approximately $29 million in additional interest. The Company denied Seagate’s contention. In April 2015, the District Court declared that all amounts due and owing from the Company to Seagate had been paid, and a corresponding judgment was entered. In May 2015, Seagate appealed the decision and judgment to the Minnesota Court of Appeals. On January 25, 2016, the Minnesota Court of Appeals reversed the District Court’s decision, determined that Seagate is owed additional post-award interest, and directed the District Court to enter judgment in accordance with its opinion. The Company had no automatic right to appeal and, on January 27, 2016, the Company paid the additional post-award interest, which was not material to the Company’s financial position, results of operations or cash flows. The additional post-award interest was paid by one of the Company’s foreign subsidiaries using cash held outside of the United States. On February 1, 2016, the matter was dismissed with prejudice pursuant to a stipulation of dismissal filed by the Company and Seagate. This matter is now closed.

SanDisk Matters

In November 2015, plaintiffs filed two putative class action complaints in the Superior Court of the State of California, County of Santa Clara, challenging the Agreement and Plan of Merger the Company entered into with SanDisk on October 21, 2015 (the “Merger Agreement”). The complaints alleged, among other things, that the members of the SanDisk board breached their fiduciary duties to SanDisk’s shareholders by agreeing to sell SanDisk for inadequate consideration, failing to properly value SanDisk, agreeing to inappropriate deal protection provisions that may inhibit other bidders from coming forward with a superior offer, not protecting against alleged conflicts of interest resulting from the SanDisk directors’ own interrelationships or connection with the proposed transaction, and failing to disclose all material information regarding the proposed transaction. The complaints also alleged that the Company aided and abetted the SanDisk board members’ breaches of their fiduciary duties. The plaintiffs were seeking injunctive relief to prevent the Merger from closing. The plaintiffs were also seeking, among other things, to recover costs and disbursement from the defendants, including attorneys' fees and experts' fees. At the request of the plaintiffs, the court ordered one of these matters dismissed without prejudice on February 26, 2016, and the other on March 8, 2016.

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Other Matters

In December 2011, the German Central Organization for Private Copying Rights (Zentralstelle für private Überspielungsrechte), (“ZPÜ”), an organization consisting of several copyright collecting societies, instituted arbitration proceedings against Western Digital's German subsidiary (“WD Germany”) before the Copyright Arbitration Board (“CAB”) claiming copyright levies for multimedia hard drives, external hard drives and network hard drives sold or introduced into commerce in Germany by WD Germany from January 2008 through December 2010. In February 2013, WD Germany filed a declaratory relief action 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 Germany 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. In January 2015, the Higher Court ruled in favor of ZPÜ. In its ruling, the Higher Court declared that WD Germany must pay certain levies on certain WD products which it sold in Germany between January 2008 and December 2010. The judgment specifies levy amounts on certain WD products sold from January 2008 through December 2010 and directs WD Germany to provide applicable sales data to ZPÜ. The exact amount of the judgment has not been determined. ZPÜ and WD Germany filed appeals with the German Federal Court of Justice in February 2015. WD intends to defend itself vigorously in this matter.

In December 2014, ZPÜ submitted a pleading to the CAB seeking copyright levies for multimedia hard drives, external hard drives and network hard drives sold or introduced into commerce in Germany by WD Germany between January 2012 and December 2013. WD intends to defend itself vigorously in this matter.

The Company has recorded an accrual for German copyright levies in an amount that is not material to the Company’s financial position, results of operations or cash flows. It is reasonably possible that the Company may incur losses totaling up to $119 million, including the amounts accrued.

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, 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, any monetary liability and financial impact to the Company from these other matters could differ materially from the Company's expectations.

6. Income Taxes

The Company had income tax expense of $6 million and $30 million in the three and nine months ended April 1, 2016, respectively. The Company's income tax expense for the three and nine months ended April 3, 2015 was $28 million and $85 million, respectively. The Company’s tax provision for the three months ended April 1, 2016 reflects a tax benefit of $10 million for deductible acquisition expenses. The Company's tax provision for the nine months ended April 1, 2016 reflects a tax benefit of $34 million from restructuring activities and a tax benefit of $10 million for deductible acquisition expenses. The difference between the effective tax rate and the U.S. Federal statutory rate is primarily due to tax holidays in Malaysia, the Philippines, Singapore and Thailand that expire at various dates from 2016 through 2025 and the current year generation of income tax credits.

In the three and nine months ended April 1, 2016, the Company recorded a net decrease of $16 million and a net increase of $9 million, respectively, in its liability for unrecognized tax benefits. As of April 1, 2016, the Company's liability for unrecognized tax benefits was approximately $359 million. Interest and penalties recognized on such amounts were not material to the condensed consolidated financial statements during the three and nine months ended April 1, 2016.

The Internal Revenue Service (“IRS”) previously completed its field examination of the Company's federal income tax returns for fiscal years 2006 through 2009 and proposed certain adjustments. The Company has received Revenue Agent Reports (“RARs”) from the IRS that seek to increase the Company's U.S. taxable income which would result in additional federal tax expense totaling approximately $795 million, subject to interest. The issues in dispute relate primarily to transfer pricing with the Company’s foreign subsidiaries and intercompany payable balances. The Company disagrees with the proposed adjustments and in September 2015, filed a protest with the IRS Appeals Office. The Company believes that its tax positions are properly supported and will vigorously contest the position taken by the IRS. In September 2015, the IRS commenced an examination of the Company's fiscal years 2010 through 2012. During the nine months ended April 1, 2016, the IRS completed the examination of the fiscal period ended September 5, 2007 of Komag, Incorporated, which the Company acquired on September 5, 2007, with no material adjustments.

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The Company believes that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax examinations cannot be predicted with certainty. If any issues addressed in the Company's tax examinations 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 April 1, 2016, 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 tables present information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of April 1, 2016 and July 3, 2015, and indicate the fair value hierarchy of the valuation techniques utilized to determine such values (in millions):

	Fair Value Measurements at April 1, 2016 Using			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents:				
Money market funds	$ 231	$ —	$ —	$ 231
Total cash equivalents	231	—	—	231
Short-term investments:				
Certificates of deposit	—	146	—	146
Total short-term investments	—	146	—	146
Foreign exchange contracts	—	31	—	31
Total assets at fair value	$ 231	$ 177	$ —	$ 408

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	Fair Value Measurements at July 3, 2015 Using			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents:				
Money market funds	$ 135	$ —	$ —	$ 135
Total cash equivalents	135	—	—	135
Short-term investments:				
U.S. Treasury securities	—	50	—	50
U.S. Government agency securities	—	4	—	4
Commercial paper	—	109	—	109
Certificates of deposit	—	99	—	99
Total short-term investments	—	262	—	262
Long-term investments:				
U.S. Treasury securities	—	237	—	237
U.S. Government agency securities	—	91	—	91
Total long-term investments	—	328	—	328
Total assets at fair value	$ 135	$ 590	$ —	$ 725
Liabilities:				
Foreign exchange contracts	$ —	$ 31	$ —	$ 31
Total liabilities at fair value	$ —	$ 31	$ —	$ 31

Money Market Funds. The Company’s money market funds are funds that invest in U.S. Treasury and U.S. Government Agency securities. Money market funds are valued based on quoted market prices.

U.S. Treasury Securities. The Company’s U.S. Treasury securities are direct obligations of the U.S. federal government and are held in custody by a third party. 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 and are held in custody by a third party. 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.

Commercial Paper. The Company’s commercial paper securities are investments issued by corporations which are held in custody by a third party. Commercial paper securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

Certificates of Deposit. The Company’s certificates of deposit are investments which are held in custody by a third party. Certificates of deposit are valued using fixed interest rates.

Foreign Exchange Contracts. The Company’s foreign exchange contracts are short-term contracts to hedge the Company’s foreign currency risk. For contracts that have a right of offset by its individual counterparties under master netting arrangements, the Company presents its foreign exchange contracts on a net basis by counterparty in the consolidated balance sheets. Foreign exchange contracts are valued using an income approach that is based on a present value of future cash flows model. The market-based observable inputs for the model include forward rates and credit default swap rates. For more information on the Company's foreign exchange contracts, see Note 8 to these condensed consolidated financial statements.

In the three and nine months ended April 1, 2016, there were no transfers between levels. 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. As of April 1, 2016, the carrying amount of debt approximated fair value because of its variable interest rate.

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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, 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 speculative or trading purposes. As of April 1, 2016, the Company had outstanding foreign exchange contracts with commercial banks for British Pound Sterling, Euro, Japanese Yen, Malaysian Ringgit, Philippine Peso, Singapore Dollar and Thai Baht, which were designated as either cash flow or fair value hedges.

If the derivative is designated as a cash flow hedge, the effective portion of the change in fair value of the derivative is initially deferred in accumulated other comprehensive income (loss), net of tax. These amounts are subsequently recognized into earnings when the underlying cash flow being hedged is recognized into earnings. Recognized gains and losses on foreign exchange contracts entered into for manufacturing-related activities are reported in cost of revenue and presented within cash flow from operations. Hedge effectiveness is measured by comparing the hedging instrument’s cumulative change in fair value from inception to maturity to the underlying exposure’s terminal value. The Company determined the ineffectiveness associated with its cash flow hedges to be immaterial to the condensed consolidated financial statements for the three and nine months ended April 1, 2016 and April 3, 2015.

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 cost of revenue or operating expenses, depending on the nature of the underlying hedged item. All fair value hedges were determined to be effective as of April 1, 2016 and July 3, 2015. The changes in fair value on these contracts were immaterial to the condensed consolidated financial statements during the three and nine months ended April 1, 2016 and April 3, 2015.

As of April 1, 2016, the net amount of unrealized gains with respect to the Company’s foreign exchange contracts that is expected to be reclassified into earnings within the next twelve months was $27 million. In addition, as of April 1, 2016, the Company did not have any foreign exchange contracts with credit-risk-related contingent features. The Company opened $996 million and $2.9 billion, and closed $1.0 billion and $3.1 billion, in foreign exchange contracts during the three and nine months ended April 1, 2016, respectively. The Company opened $1.5 billion and $3.5 billion, and closed $1.3 billion and $3.5 billion, in foreign exchange contracts during the three and nine months ended April 3, 2015, respectively. The fair value and balance sheet location of the Company's foreign exchange contracts as of April 1, 2016 and July 3, 2015 were as follows (in millions):

	Asset Derivatives				Liability Derivatives			
	April 1, 2016		July 3, 2015		April 1, 2016		July 3, 2015	
Derivatives Designated as Hedging Instruments	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Foreign exchange contracts	Other current assets	$ 31	Other current assets	$ —	Accrued expenses	$ —	Accrued expenses	$ 31

The following table presents the gross amounts of the Company's derivative instruments, amounts offset due to master netting arrangements with the Company's various counterparties and the net amounts recognized in the condensed consolidated balance sheet as of April 1, 2016 (in millions):

Derivatives Designated as Hedging Instruments	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets Presented in the Balance Sheet
Foreign exchange contracts			

Financial assets	$ 34	$ (3)	$ 31
Financial liabilities	(3)	3	—
Total derivative instruments	$ 31	$ —	$ 31

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The Company had a gross and net liability of $31 million related to its derivative instruments outstanding at July 3, 2015. There were no amounts offset due to master netting arrangements in place at July 3, 2015.

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

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in Accumulated OCI on Derivatives				Location of Gain (Loss) Reclassified from Accumulated OCI into Income	Amount of (Gain) Loss Reclassified From Accumulated OCI into Income			
	Three Months Ended April 1, 2016	Nine Months Ended April 1, 2016	Three Months Ended April 3, 2015	Nine Months Ended April 3, 2015		Three Months Ended April 1, 2016	Nine Months Ended April 1, 2016	Three Months Ended April 3, 2015	Nine Months Ended April 3, 2015
Foreign exchange contracts	$31	$ (9)	$19	$ (39)	Cost of revenue	$ 8	$ 61	$ 10	$ 24

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 nine months ended April 1, 2016 and April 3, 2015.

9. Shareholders' Equity

Stock-Based Compensation Expense

The following table presents the Company's stock-based compensation and related tax benefit for the three and nine months ended April 1, 2016 and April 3, 2015 (in millions):

	Three Months Ended				Nine Months Ended			
	April 1, 2016		April 3, 2015		April 1, 2016		April 3, 2015	
	Expense	Tax Benefit	Expense	Tax Benefit	Expense	Tax Benefit	Expense	Tax Benefit
Options and ESPP	$19	$ 5	$17	$ 8	$51	$ 13	$53	$ 20
RSUs	23	6	21	6	70	18	64	17
Total	$42	$ 11	$38	$ 14	$121	$ 31	$117	$ 37

As of April 1, 2016, total compensation cost related to unvested stock options and ESPP rights issued to employees but not yet recognized was $99 million and will be amortized on a straight-line basis over a weighted average service period of approximately 2.3 years.

For purposes of this footnote, references to restricted stock unit awards (“RSUs”) include performance stock unit awards (“PSUs”). PSUs are granted to certain employees only after the achievement of pre-determined performance metrics. Once the PSU is granted, vesting is then subject to continued service by the employee, and expense is recognized over the vesting period. At the end of each reporting period, the Company evaluates the probability that PSUs will be earned. The Company records stock-based compensation expense based on the probability that the performance metrics will be achieved. As of April 1, 2016, the aggregate unamortized fair value of all unvested RSUs was $178 million, which will be recognized on a straight-line basis over a weighted average vesting period of approximately 1.9 years, assuming the performance metrics are met for the PSUs.

Stock Option Activity

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

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Options outstanding at July 3, 2015	6.8	$ 50.00		

Granted	1.7	82.68		
Exercised	(1.2)	25.10		
Canceled or expired	(0.3)	63.04		
Options outstanding at April 1, 2016	7.0	$ 61.68	4.2	$ 45
Exercisable at April 1, 2016	3.8	$ 47.36	3.1	$ 41
Vested and expected to vest after April 1, 2016	6.8	$ 61.16	4.2	$ 45

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Options granted during the three and nine months ended April 1, 2016 had a weighted average fair value per share of $12.46 and $22.54, respectively. As of April 1, 2016, the Company had options outstanding to purchase an aggregate of 3.1 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 $45 million at that date. During the three and nine months ended April 1, 2016, the aggregate intrinsic value of options exercised under the Company’s stock option plans was $13 million and $49 million, respectively, determined as of the date of exercise, as compared to $73 million and $236 million in the respective prior-year periods.

RSU Activity

The following table summarizes RSU activity under the Company's stock plans (in millions, except weighted average grant date fair value):

	Number of Shares	Weighted Average Grant-Date Fair Value
RSUs outstanding at July 3, 2015	3.0	$ 73.80
Granted	2.5	68.16
Vested	(1.6)	62.43
Forfeited	(0.2)	84.57
RSUs outstanding at April 1, 2016	3.7	$ 74.48
Expected to vest after April 1, 2016	3.4	$ 74.98

Outstanding RSU awards have dividend equivalent rights which entitle holders of RSUs to the same dividend value per share as holders of common stock. Dividend equivalent rights are subject to the same vesting and other terms and conditions as the corresponding unvested RSUs. Dividend equivalent rights are accumulated and paid in additional shares when the underlying shares vest.

RSUs are generally settled in an equal number of shares of the Company’s common stock at the time of vesting of the units. The fair value of the shares underlying the RSU awards at the date of grant or assumption was $51 million and $160 million for awards granted in the three and nine months ended April 1, 2016. These amounts are being recognized to expense over the corresponding vesting periods.

Included in the table above, the Company granted 1.0 million PSUs in the three months ended April 1, 2016, at a weighted average grant-date fair value of $50.06 per share. The total number of PSUs outstanding as of April 1, 2016 was 1.2 million, with a weighted average fair value per share of $55.78.

SARs Activity

During the three and nine months ended April 1, 2016, the Company recognized a $7 million and $18 million benefit, respectively, related to adjustments to fair market value of stock appreciation rights (“SARs”), as compared to a $9 million benefit and $3 million expense in the respective prior-year periods. The tax expense realized as a result of the aforementioned SARs benefit was $1 million and $2 million during the three and nine months ended April 1, 2016, respectively, as compared to a $2 million expense and $1 million benefit during the three and nine months ended April 3, 2015, respectively. The Company's SARs will be settled in cash upon exercise. The Company had a total liability of $22 million and $41 million related to SARs included in accrued expenses in the condensed consolidated balance sheet as of April 1, 2016 and July 3, 2015, respectively. As of April 1, 2016, all SARs issued to employees were fully vested, and the fair values are now solely subject to market price fluctuations. As of April 1, 2016, 0.5 million SARs were outstanding with a weighted average exercise price of $7.87. There were no SARs granted during the three and nine months ended April 1, 2016.

Stock Repurchase Program

The Company's Board of Directors (the “Board”) previously authorized $5.0 billion for the repurchase of the Company's common stock and approved the extension of its stock repurchase program to February 3, 2020. Effective October 21, 2015, in connection with the Merger, the stock repurchase program was suspended. The Company did not repurchase any shares during the three months ended April 1, 2016. The Company repurchased 0.7 million shares for a total cost of $60 million during the nine months ended April 1, 2016. The remaining amount available to be purchased under the Company’s stock repurchase program as of April 1, 2016 was $2.1 billion.

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Dividends to Shareholders

On September 13, 2012, the Company announced that the Board had authorized the adoption of a quarterly cash dividend policy. Under the cash dividend policy, holders of the Company's common stock receive dividends when and as declared by the Board. In the three months ended April 1, 2016, the Company declared a cash dividend of $0.50 per share to shareholders of record as of April 1, 2016, totaling $116 million, which was paid on April 15, 2016. In the nine months ended April 1, 2016, the Company declared total cash dividends of $1.50 per share for a total of $347 million. The Company may modify, suspend or cancel its cash dividend policy in any manner and at any time.

Termination of Investment by Unis

On September 29, 2015, the Company entered into an agreement (the "Stock Purchase Agreement") with Unis (the "Guarantor") and Unis Union Information System Ltd., a subsidiary of Unis (the "Investor"), pursuant to which, subject to the conditions in the agreement, the Company agreed to issue and sell to the Investor 40,814,802 shares of the Company's common stock (the "Shares") for $92.50 per share, for an aggregate purchase price of approximately $3.775 billion, and the Guarantor agreed to guarantee the payment and performance of Investor's obligations therein (collectively, the "Transaction").

The closing of the Transaction was subject to certain closing conditions. These closing conditions included clearance by the U.S. Committee on Foreign Investment in the United States ("CFIUS") and the receipt of requisite regulatory approvals, including clearance by U.S. antitrust authorities and certain Chinese regulatory approvals, including clearance by the Ministry of Commerce of the People's Republic of China, the Ministry of Education of the People's Republic of China, the National Development and Reform Commission of the People's Republic of Chin