

WESTERN DIGITAL CORP

Form 10-Q

February 08, 2006

**Table of Contents**

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

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

**For the quarterly period ended December 30, 2005**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 1-8703**

**WESTERN DIGITAL CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**33-0956711**

(I.R.S. Employer  
Identification No.)

**20511 Lake Forest Drive**

**Lake Forest, California**

(Address of principal executive offices)

**92630**

(Zip code)

**(949) 672-7000**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of the close of business on January 27, 2006, 219.3 million shares of common stock, par value \$.01 per share, were issued and outstanding.

**WESTERN DIGITAL CORPORATION  
INDEX**

	<b>PAGE NO.</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements (unaudited)</u></b>	
<u>Condensed Consolidated Balance Sheets December 30, 2005 and July 1, 2005</u>	3
<u>Condensed Consolidated Statements of Income Three and Six Months Ended December 30, 2005 and December 31, 2004</u>	4
<u>Condensed Consolidated Statements of Cash Flows Six Months Ended December 30, 2005 and December 31, 2004</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	33
<u>Item 4. Controls and Procedures</u>	34
<b><u>PART II. OTHER INFORMATION</u></b>	
<u>Item 1. Legal Proceedings</u>	35
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	35
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	36
<u>Item 6. Exhibits</u>	37
<u>Signatures</u>	39
<u>Exhibit 3.1</u>	
<u>Exhibit 10.1.3</u>	
<u>Exhibit 10.6</u>	
<u>Exhibit 10.7</u>	
<u>Exhibit 10.27.3</u>	
<u>Exhibit 10.29.2</u>	
<u>Exhibit 10.29.3</u>	
<u>Exhibit 10.35.1</u>	
<u>Exhibit 31.1</u>	
<u>Exhibit 31.2</u>	
<u>Exhibit 32.1</u>	
<u>Exhibit 32.2</u>	

Western Digital Corporation (the "Company", "Western Digital" or "WD") has a 52 or 53-week fiscal year, which typically ends on the Friday nearest to June 30. However, approximately every six years, the Company reports a 53-week fiscal year to align its fiscal quarters with calendar quarters by adding a week to its fourth fiscal quarter. The quarters ended December 30, 2005, and December 31, 2004, were 13 weeks. Fiscal year 2006 will be comprised of 52 weeks and will end on June 30, 2006. Unless otherwise indicated, references herein to specific years and quarters are to the Company's fiscal years and fiscal quarters, and references to financial information are on a consolidated basis.

The information on the Company's Web site, <http://www.westerndigital.com>, is not incorporated by reference in this Quarterly Report on Form 10-Q.

Western Digital® is a registered trademark, and the Western Digital logo is a trademark, of Western Digital Technologies, Inc. and/or its affiliates. All other trademarks mentioned are the property of their respective owners.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS**

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

	<b>DEC. 30, 2005</b>	<b>JUL. 1, 2005</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 550.2	\$ 485.2
Short-term investments	94.5	113.2
Accounts receivable, net	428.3	402.9
Inventories	168.3	152.9
Other	83.3	27.0
Total current assets	1,324.6	1,181.2
Property and equipment, net	433.7	395.0
Intangible and other assets	20.1	12.4
Total assets	\$ 1,778.4	\$ 1,588.6
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 580.2	\$ 569.1
Accrued expenses	135.3	154.1
Accrued warranty	76.6	75.2
Current portion of long-term debt	24.9	20.1
Total current liabilities	817.0	818.5
Long-term debt	31.9	32.6
Other liabilities	35.5	35.4
Total liabilities	884.4	886.5
Commitments and contingent liabilities (Note 8)		
Shareholders' equity:		
Preferred stock, \$.01 par value; authorized 5.0 shares; Outstanding None		
Common stock, \$.01 par value; authorized 450.0 shares; Outstanding 217.5 and 214.6 shares, respectively	2.2	2.1
Additional paid-in capital	704.0	696.2
Retained earnings	188.6	15.5
Treasury stock - common shares at cost; 0.1 and 0.9 shares, respectively	(0.8)	(11.7)
Total shareholders' equity	894.0	702.1
Total liabilities and shareholders' equity	\$ 1,778.4	\$ 1,588.6

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		SIX MONTHS ENDED	
	DEC. 30, 2005	DEC. 31, 2004	DEC. 30, 2005	DEC. 31, 2004
Revenue, net	\$ 1,117.1	\$ 954.9	\$ 2,127.0	\$ 1,778.5
Cost of revenue	888.8	804.7	1,720.4	1,515.2
Gross margin	228.3	150.2	406.6	263.3
Operating expenses:				
Research and development	76.2	59.7	146.2	113.7
Selling, general and administrative	47.8	33.9	88.2	61.8
Total operating expenses	124.0	93.6	234.4	175.5
Operating income	104.3	56.6	172.2	87.8
Non-operating income:				
Interest income	3.7	1.7	7.1	2.5
Interest and other expense	0.9	0.9	1.8	1.7
Total non-operating income	2.8	0.8	5.3	0.8
Income before income taxes	107.1	57.4	177.5	88.6
Income tax provision	2.8	1.4	4.4	2.2
Net income	\$ 104.3	\$ 56.0	\$ 173.1	\$ 86.4
<b>Income per common share:</b>				
Basic	\$ .49	\$ .27	\$ .81	\$ .42
Diluted	\$ .47	\$ .26	\$ .78	\$ .41
<b>Weighted average shares outstanding:</b>				
Basic	212.8	205.1	212.9	205.1
Diluted	221.5	213.6	221.3	213.1

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)

	<b>SIX MONTHS ENDED</b>	
	<b>DEC.</b>	<b>DEC. 31,</b>
	<b>30,</b>	<b>2004</b>
	<b>2005</b>	<b>2004</b>
<b>Cash flows from operating activities</b>		
Net income	\$ 173.1	\$ 86.4
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	74.2	61.0
Stock-based compensation	15.8	0.5
Asset abandonment charge	7.0	
Changes in:		
Accounts receivable	(25.4)	(77.3)
Inventories	(15.4)	30.4
Accounts payable	11.1	86.6
Accrued expenses	(17.4)	52.8
Prepaid expenses	(56.3)	0.2
Other	(10.5)	(4.5)
Net cash provided by operating activities	156.2	236.1
<b>Cash flows from investing activities</b>		
Capital expenditures, net	(102.2)	(105.5)
Purchases of short-term investments	(54.0)	(73.7)
Sales of short-term investments	72.7	
Net cash used in investing activities	(83.5)	(179.2)
<b>Cash flows from financing activities</b>		
Issuance of common stock under employee plans	29.2	17.1
Repurchase of common stock	(26.3)	(23.3)
Repayment of long-term debt	(10.6)	(9.7)
Net cash used in financing activities	(7.7)	(15.9)
Net increase in cash and cash equivalents	65.0	41.0
Cash and cash equivalents, beginning of period	485.2	345.5
Cash and cash equivalents, end of period	\$ 550.2	\$ 386.5
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid during the period for income taxes	\$ 2.8	\$ 1.1
Cash paid during the period for interest	\$ 1.5	\$ 1.0
<b>Supplemental disclosure of non-cash investing and financing activities:</b>		
Equipment additions funded by capital lease obligations	\$ 14.7	\$ 4.3

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 the Company are set forth in Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K as of and for the year ended July 1, 2005. In the opinion of management, all adjustments necessary to fairly state the unaudited condensed consolidated financial statements have been made. All such adjustments are of a normal recurring nature. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K as of and for the year ended July 1, 2005. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year. Certain prior period amounts have been reclassified to conform to current period presentation.

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

**2. Supplemental Financial Statement Data (in millions)**

	<b>DEC. 30, 2005</b>	<b>JUL. 1, 2005</b>
Inventories:		
Raw materials and component parts	\$ 17.6	\$ 14.5
Work in process	58.4	59.7
Finished goods	92.3	78.7
	\$ 168.3	\$ 152.9

The Company records an accrual for estimated warranty costs when revenue is recognized. Warranty covers costs of repair or replacement of the hard disk drive over the warranty period, which generally ranges from one to five years. This accrual is based on estimated future returns within the warranty period and costs to repair, using factory test data, historical field returns and current average repair costs by product type. If actual product return trends or costs to repair returned products demonstrate significant differences from expectations at any time during the warranty period, a change in the warranty provision is made. Changes in the warranty accrual for the three and six months ended December 30, 2005, and December 31, 2004, were as follows (in millions):

	<b>THREE MONTHS ENDED</b>		<b>SIX MONTHS ENDED</b>	
	<b>DEC. 30, 2005</b>	<b>DEC. 31, 2004</b>	<b>DEC. 30, 2005</b>	<b>DEC. 31, 2004</b>
Warranty accrual, beginning of period	\$ 96.3	\$ 65.3	\$ 91.9	\$ 56.8
Charges to operations	19.4	25.3	40.8	43.7
Utilization	(10.3)	(11.5)	(20.0)	(24.1)
Changes in estimate related to pre-existing warranties	(10.1)	2.4	(17.4)	5.1
Warranty accrual, end of period	\$ 95.3	\$ 81.5	\$ 95.3	\$ 81.5

Accrued warranty also includes amounts classified in non-current liabilities of \$18.7 million at December 30, 2005, \$16.7 million at July 1, 2005, and \$15.0 million at December 31, 2004.

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

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

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	DEC. 30, 2005	DEC. 31, 2004	DEC. 30, 2005	DEC. 31, 2004
Net income	\$ 104.3	\$ 56.0	\$ 173.1	\$ 86.4
Weighted average shares outstanding:				
Basic	212.8	205.1	212.9	205.1
Employee stock options and other	8.7	8.5	8.4	8.0
Diluted	221.5	213.6	221.3	213.1
Income per share:				
Basic	\$ .49	\$ .27	\$ .81	\$ .42
Diluted	\$ .47	\$ .26	\$ .78	\$ .41

For purposes of computing diluted income per share, common share equivalents with an exercise price that exceeded the average fair market value of common stock for the period are considered antidilutive and have been excluded from the calculation for employee stock options. These antidilutive common share equivalents totaled 5.5 million and 8.8 million for the three months ended December 30, 2005, and December 31, 2004, respectively, and 5.7 million and 8.2 million for the six months ended December 30, 2005, and December 31, 2004, respectively.

**4. Stock-Based Compensation***Stock-Based Compensation Expense*

Effective July 2, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share Based Payment ( SFAS 123-R ). SFAS 123-R establishes the financial accounting and reporting standards for stock-based compensation plans. As required by SFAS 123-R, the Company recognized the cost resulting from all share-based payment transactions including shares issued under the Company's stock option plans and employee stock purchase plan ( ESPP ) in the financial statements. As a result of adopting SFAS 123-R, the Company's income before income taxes and net income for the three months ended December 30, 2005, were \$4.2 million and \$4.1 million lower, respectively, than if the Company had continued to account for share-based compensation under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and its related interpretations ( APB 25 ). Income before income taxes and net income for the six months ended December 30, 2005, were \$8.9 million and \$8.7 million lower, respectively, than if the Company had continued to account for share-based payment under APB 25. Basic and diluted net income per share would have been \$0.51 and \$0.49 for the three months ended December 30, 2005, if the Company had not adopted SFAS 123-R. Basic and diluted net income per share would have been \$0.85 and \$0.82, respectively, for the six months ended December 30, 2005, if the Company had not adopted SFAS 123-R. At December 30, 2005, the total compensation cost related to unvested stock options granted to employees but not yet recognized was \$31.6 million and will be amortized on a straight-line basis over a weighted average period of approximately 2.2 years.

Prior to July 2, 2005, the Company accounted for stock-based employee compensation plans (including shares issued under the Company's stock option plans and ESPP) in accordance with APB 25 and followed the pro forma net income, pro forma income per share, and stock-based compensation plan disclosure requirements set forth in the Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ). The

following table sets forth the computation of basic and diluted income per share for the three and six months ended December 31, 2004, and illustrates the effect on net income and income per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation (in millions, except per share data):

7

---

**Table of Contents**

	<b>THREE MONTHS ENDED DEC. 31, 2004</b>	<b>SIX MONTHS ENDED DEC. 31, 2004</b>
Net income, as reported	\$ 56.0	\$ 86.4
Add: Stock-based employee compensation included in reported net income, net of related taxes	0.3	0.5
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(7.3)	(13.2)
Pro forma net income	\$ 49.0	\$ 73.7
Basic income per share:		
As reported	\$ .27	\$ .42
Pro forma	\$ .24	\$ .36
Diluted income per share:		
As reported	\$ .26	\$ .41
Pro forma	\$ .23	\$ .35

*Fair Value Disclosures*

The fair value of stock options granted during the three and six months ended December 30, 2005, was estimated using a binomial option pricing model. The binomial model requires the input of highly subjective assumptions including the expected stock price volatility, the expected price multiple at which employees are likely to exercise stock options and the expected employee termination rate. The Company uses historical data to estimate option exercise, employee termination, and expected stock price volatility within the binomial model. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

The fair value of stock options granted during the six months ended December 30, 2005, was estimated using the following weighted average assumptions:

	<b>THREE MONTHS ENDED DEC. 30, 2005</b>	<b>SIX MONTHS ENDED DEC. 30, 2005</b>
Suboptimal exercise factor	1.52	1.54
Range of risk-free interest rates	4.35% to 4.41%	4.01% to 4.41%
Range of expected volatility	0.42 to 0.81	0.38 to 0.82
Weighted average expected volatility	0.67	0.67
Post-vesting termination rate	15.01%	15.13%
Dividend yield		
Fair value	\$5.37	\$5.52

The pro forma income per share information for all stock options granted on or prior to December 31, 2004, as well as all ESPP shares was estimated using the Black-Scholes-Merton option-pricing model. The Black-Scholes-Merton model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are

fully transferable. This model also requires the input of highly subjective assumptions including the expected stock price volatility and expected period until options are exercised.

The fair value of stock options granted during the six months ended December 31, 2004, has been estimated at the date of grant using a Black-Scholes-Merton model with the following weighted average assumptions:

8

---

**Table of Contents**

	<b>THREE MONTHS ENDED DEC. 31, 2004</b>	<b>SIX MONTHS ENDED DEC. 31, 2004</b>
Option life (in years)	4.52	4.51
Risk-free interest rate	3.25%	3.23%
Stock price volatility	0.76	0.74
Dividend yield		
Fair value	\$ 5.41	\$ 5.33

The fair value of ESPP shares granted during the three and six months ended December 30, 2005, and December 31, 2004, have been estimated at the date of grant using a Black-Scholes-Merton model with the following assumptions:

	<b>DEC. 30, 2005</b>	<b>DEC. 31, 2004</b>
Option life (in years)	1.25	1.25
Risk-free interest rate	4.38%	2.02%
Stock price volatility	0.42	0.58
Dividend yield		
Fair value	\$ 3.70	\$ 2.81

*Stock Options*

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

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price Per Share</b>	<b>Remaining Contractual Life (in years)</b>	<b>Aggregate Intrinsic Value</b>
<b>Options outstanding at July 1, 2005</b>	19.5	\$ 9.39		
Granted	0.2	14.27		
Exercised	(0.7)	7.24		
Canceled or expired	(0.4)	10.32		
<b>Options outstanding at September 30, 2005</b>	18.6	9.52	6.05	\$ 81.8
Granted	0.5	13.62		
Exercised	(2.3)	7.15		
Canceled or expired	(0.1)	11.63		
<b>Options outstanding at December 30, 2005</b>	16.7	9.96	6.01	\$ 154.4
<b>Exercisable at December 30, 2005</b>	10.4	\$ 9.59	5.45	

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

quoted price. As of December 30, 2005, the Company had options outstanding to purchase an aggregate of 15.5 million shares with an exercise price below the quoted price of the Company's stock resulting in an aggregate intrinsic value of \$154.4 million. During the three and six months ended December 30, 2005, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$22.1 million and \$27.5 million, respectively, determined as of the date of exercise. The aggregate intrinsic value of options exercised during the three and six months ended December 31, 2004, was \$19.3 million and \$20.5 million, respectively.

*Employee Stock Purchase Plan*

During the second quarter of 2006, the Company adopted the Western Digital Corporation 2005 Employee Stock Purchase Plan whereby eligible employees may authorize payroll deductions of up to 10% of their eligible compensation to purchase shares of the Company's common stock at 95% of the fair market value of common stock on the date of grant or on the exercise date, whichever is less. The Company's ESPP operates in accordance with



**Table of Contents**

Section 423 of the Internal Revenue Code. The 1993 Employee Stock Purchase Plan, which was previously suspended by the Board of Directors, terminated upon stockholder approval of the 2005 ESPP. ESPP activity under both the 2005 and 1993 ESPP plans was immaterial to the condensed consolidated financial statements for the three and six months ended December 30, 2005.

*Deferred Stock Compensation*

During the three and six months ended December 30, 2005, the Company expensed \$3.7 million and \$5.9 million, respectively, related to unvested restricted stock awards. Of these amounts, \$1.9 million and \$2.7 million represented the incremental cost from pre-existing awards modified in the first quarter of 2006 for the three and six months ended December 30, 2005, respectively. Additionally, the Company granted 0.4 million and 1.7 million shares of restricted stock during the three and six months ended December 30, 2005, respectively. The aggregate market value of these awards was \$5.6 million and \$24.1 million, respectively, for the three and six months ended December 30, 2005. As of December 30, 2005, the aggregate unamortized fair value of all unvested restricted stock awards was \$31.4 million and will be amortized on a straight-line basis over a weighted average vesting period of approximately 1.9 years.

**5. Short-term Borrowings and Long-term Debt**

Short-term borrowings and long-term debt consisted of the following as of December 30, 2005, and July 1, 2005 (in millions):

	<b>DEC. 30, 2005</b>	<b>JUL. 1, 2005</b>
Term loan	\$ 31.3	\$ 37.5
Capital lease obligations	25.5	15.2
Total	56.8	52.7
Less amounts due in one year	(24.9)	(20.1)
	<b>\$ 31.9</b>	<b>\$ 32.6</b>

The Company has a \$125 million credit facility ( Senior Credit Facility ) consisting of a revolving credit line (subject to outstanding letters of credit and a borrowing base calculation) and a term loan of \$31 million as of December 30, 2005. Both the revolving credit facility and the term loan mature on September 19, 2008, and are secured by the Company's accounts receivable, inventory, 65% of its stock in its foreign subsidiaries and other assets. For the three months ended December 30, 2005, the Company had no borrowings on the revolving credit line and the average variable rate on the Company's term loan was 6.3%. The term loan requires quarterly principal payments of approximately \$3 million. Principal payments made on the term loan increase the amount of revolving credit available. At December 30, 2005, \$91 million was available for borrowing under the revolving credit line and the Company had \$3 million in outstanding letters of credit. As of December 30, 2005, the Company was in compliance with all covenants related to the Senior Credit Facility.

**6. Amortization of Intangibles**

In June 2003, Read-Rite Corporation ( Read-Rite ), then one of the Company's suppliers of magnetic recording heads, commenced voluntary Chapter 7 bankruptcy proceedings. On July 31, 2003, Western Digital purchased substantially all of the assets of Read-Rite, including its wafer fabrication equipment in Fremont, California and manufacturing facility in Bang Pa-In, Thailand. Approximately \$38.8 million of the purchase price related to purchased technology, which is being amortized over a weighted average period of three years. During the three and six months ended December 30, 2005, the Company recorded \$0.8 million and \$2.6 million, respectively, of amortization expense related to these intangible assets. Amortization expense is estimated to be \$4.4 million, \$3.4 million and \$3.4 million for fiscal years 2006, 2007 and 2008, respectively.

**7. Software Abandonment Charge**

On October 1, 2005, the Company implemented a planned upgrade to its enterprise resource planning (ERP) system. All internal development costs associated with this upgrade were accounted for in accordance with



**Table of Contents**

Use, which requires that certain internal-use computer software costs be capitalized and amortized over the useful life of the asset. In connection with this upgrade, the Company licensed additional software modules from the ERP vendor to replace certain legacy supply chain and trade management information systems. Some of the modules were not delivered as management had expected, while other modules, once configured, did not function as management had expected. As a result, during the quarter ended December 30, 2005, management concluded that the modules would not provide the overall functionality originally anticipated and abandoned the modules. The Company recorded a non-cash charge to selling, general and administrative expense of \$7.0 million for the three months ended December 30, 2005, to write off the associated capitalized costs of these abandoned modules. This write-off included the cost of the licenses as well as capitalized development costs related to these modules prior to abandonment.

**8. Legal Proceedings**

In the normal course of business, the Company is subject to legal proceedings, lawsuits and other claims. Although the ultimate aggregate amount of monetary liability or financial impact with respect to these matters is subject to many uncertainties and is therefore not predictable with assurance, management believes that any monetary liability or financial impact to the Company from these matters, individually and in the aggregate, beyond that provided for at December 30, 2005, would not be material to the Company's financial condition. However, there can be no assurance with respect to such result, and monetary liability or financial impact to the Company from these legal proceedings, lawsuits and other claims could differ materially from those projected.

**9. New Accounting Standards**

In June 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). SFAS 154 replaces Accounting Principles Board Opinion No. 20, Accounting Changes (APB 20) and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, applies to all voluntary changes in accounting principle and changes the requirements for accounting and reporting of a change in accounting principle. APB 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of change a cumulative effect of changing to the new accounting principle whereas SFAS 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle, unless it is impracticable. SFAS 154 enhances the consistency of financial information between periods, and is effective for fiscal years beginning after December 15, 2005. The Company does not expect the adoption of SFAS 154 to have a material impact on its financial statements.

**Table of Contents**

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

This information should be read in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included in this Quarterly Report on Form 10-Q, and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K as of and for the year ended July 1, 2005.

Unless otherwise indicated, references herein to specific years and quarters are to the Company's fiscal years and fiscal quarters. As used herein under Risk Factors That May Affect Future Results, the terms we, us and our refer to Western Digital Corporation and its subsidiaries.

**Forward-Looking Statements**

This report contains forward-looking statements within the meaning of the federal securities laws. The statements that are not purely historical should be considered forward-looking statements. Often they can be identified by the use of forward-looking words, such as may, will, could, project, believe, anticipate, expect, estimate, contain, plan, forecasts, and the like. Statements concerning current conditions may also be forward-looking if they imply a continuation of current conditions.

Examples of forward-looking statements include, but are not limited to statements concerning: growth in demand for and unit shipments of hard disk drives in the desktop PC market and factors contributing to such growth; the growth rate of the mobile computing market relative to the desktop PC market; expansion of the market for consumer applications for hard disk drives; the Company's expansion into the CE market and use of hard disk drives in consumer products; expansion of the SATA interface in desktop PCs and growth and acceptance of SATA interfaces in enterprise hard disk drives; growth in demand for hard disk drives in the CE market (including multi-media applications) and mobile markets; increase in sales of notebook systems and the Company's on-going volume ramp of its Scorpio 2.5-inch hard disk drives; the ramping of manufacturing volumes and increasing the storage capacity of the Company's 1.0-inch hard disk drive; the Company's planned use of new recording technologies; trends regarding areal density growth rates; the Company's introduction of new products into the retail market; impacts of further industry consolidation; expansion of the Company's sales into emerging markets; the Company's expectations regarding traditional seasonal demand trends for the hard disk drive industry in the March quarter; the Company's expectations for revenue and gross margin percentage for the March quarter; future levels of customer returns under warranty; the Company's expectations of seasonal price declines and expected operational efficiencies; the Company's expectations regarding capital expenditures for 2006; the Company's expectations regarding its repurchase of stock under its stock repurchase program; the Company's beliefs regarding the sufficiency of its cash, cash equivalents and short-term investments to meet its working capital needs; management's judgment and estimates regarding critical accounting policies and the impact of significant differences from actual results; the Company's expectations regarding its utilization of its liquidity and cash flows; and the Company's expectations regarding the impact of new accounting standards.

Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Readers are urged to carefully review the disclosures made by the Company concerning risks and other factors that may affect the Company's business and operating results, including those made in this report under the caption Risk Factors That May Affect Future Results as well as the Company's other reports filed with the SEC. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company does not intend, and undertakes no obligation, to publish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

**The Company**

Western Digital Corporation designs, develops, manufactures and sells hard disk drives. A hard disk drive is a device that stores data on one or more rotating magnetic disks to allow fast access to data. Hard disk drives are one of the key components found in most computers and data storage subsystems.

The Company's hard disk drives are used in applications such as desktop personal computers (PCs), notebook computers, enterprise applications such as servers, workstations, network attached storage devices and storage area

networks, and in consumer electronics ( CE ) applications such as personal/digital video recorders ( DVRs ) and satellite and cable set-top boxes ( STBs ). In addition, the Company s hard disk drives are used in external hard disk drive products that feature high speed buses such as 1394/FireWire /iLink , Universal Serial Bus ( USB ) and Ethernet.

**Table of Contents**

Hard disk drives provide non-volatile data storage, which means that the data is present when power is no longer applied to the device. The Company's hard disk drive products primarily consist of 3.5-inch and 2.5-inch form factor drives. The 3.5-inch form factor drives have capacities ranging from 40 gigabytes ( GB ) to the recently announced 500 GB drive. The 3.5-inch form factor drives have nominal rotation speeds of 7200 and 10,000 revolutions per minute ( RPM ), and offer interfaces including Enhanced Integrated Drive Electronics ( EIDE ) and Serial Advanced Technology Attachment ( SATA ). The 2.5-inch form factor drives have capacities ranging from 40 GB to 120 GB, nominal rotation speed of 5400 RPMs, and offer the EIDE interface. The recently announced 2.5-inch 120 GB form factor drives also offer the SATA interface and a nominal rotation speed of 5400 RPMs. In addition, as previously announced, the Company began production of 1.0-inch 6 GB hard disk drives with nominal rotation speed of 3600 RPMs in December 2005. The Company anticipates that 1.0-inch hard disk drive products may be used in a variety of handheld consumer devices such as digital audio players, digital still image cameras, digital video cameras and mobile phones. In addition, some mobile phone manufacturers and service providers have begun to integrate telephony, Internet and broadcast media generating increased demand for storage.

The Company sells its products worldwide to original equipment manufacturers ( OEMs ) for inclusion in computer systems or subsystems and consumer electronics applications and to distributors, resellers and retailers. The Company's hard disk drive products are currently manufactured in Malaysia and Thailand. The Company also designs and manufactures a substantial portion of its requirements for magnetic heads, head gimbal assemblies ( HGAs ) and head stack assemblies ( HSAs ) in Fremont, California and Bang Pa-In, Thailand.

**Market Overview**

For calendar year 2005, the Company believes that the total market for hard disk drives was more than 375 million units, or almost \$26 billion in sales. Over half of these unit shipments were to the desktop PC market. Total hard disk drive unit growth depends greatly on developments in the PC market. WD believes that the demand for hard disk drives in the PC market will continue to grow in part due to:

the overall growth of PC sales in established markets;

the growth in emerging economies, such as Brazil, Russia, India and China, driving the increased deployment of PCs;

the increasing needs of businesses and individuals to store larger amounts of data on their PCs;

the increasing sales of notebook computers that may have shorter replacement cycles and/or additional sales for individuals to have both a desktop and a notebook computer;

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

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

The Company believes the rate of hard disk drive unit growth in the desktop PC market at present is affected by several factors, including maturing PC markets in North America and Western Europe, an increase in first-time buyers of PCs in Asia, Eastern Europe and Latin America, the lengthening of PC replacement cycles and an increasing preference for notebook computers.

The Company currently expects the mobile computing market, which is primarily notebook computers, to grow faster than the desktop PC market in the near term. WD entered the mobile hard disk drive market in the first quarter of fiscal year 2005, commencing volume production of its WD Scorpio family of 2.5-inch hard disk drives for notebook computers.

As the market for consumer applications expands, additional investments by the Company will be required. For example, CE products such as handheld digital audio players currently utilize sub-2.5-inch form factor hard disk drives. In addition, while CE products may require hard disk drives that are similar in nature to desktop hard disk



**Table of Contents**

drives, these products have often required specialized features or functions requiring additional development versus desktop products. The Company began production of 1.0-inch hard disk drives for the CE market in December 2005.

The enterprise market for hard disk drives focuses on customers that make workstations, servers, network attached storage devices, storage area networks, and other computing systems or subsystems. Western Digital serves this market with hard disk drives using the SATA interface, which is similar in performance in some applications to the small-computer-systems-interface, or SCSI, but more cost effective than SCSI. WD believes that the enterprise market has two distinct segments: a marketplace for high performance enterprise hard disk drives and a marketplace for high capacity enterprise hard disk drives. The Company believes that acceptance of SATA in both of these enterprise market segments is growing. Additionally, WD offers high capacity, high reliability Parallel Advanced Technology Attachment ( PATA ) enterprise products to service video surveillance and similar PATA-based systems.

**Second Quarter Overview**

WD's net revenue for the second quarter of 2006 totaled \$1.1 billion, an increase of 17% over the prior year's second quarter and 11% over the first quarter of 2006. During the December quarter, 26% of WD's revenue was derived from non-desktop PC sources, including CE products, enterprise applications, notebook computers and retail sales, as compared to 19% in the prior year and 25% in the September quarter. Gross margin increased to 20.4% in the second quarter of 2006 from 15.7% in the second quarter of 2005 and 17.7% in the first quarter of 2006 due to ongoing improvements in quality and cost efficiencies, more moderate price declines and an improved product mix. Operating income for the second quarter was \$104 million, an increase of \$48 million over the same period in the prior year and \$36 million over the September quarter. Operating margins increased to 9.3% as a percentage of net revenue in the second quarter of 2006 compared with 5.9% in the second quarter of 2005 and 6.7% in the September quarter. WD generated \$117 million in cash flow from operations during the second quarter of 2006, finishing the quarter with \$645 million in cash, cash equivalents and short-term investments, an increase of \$46 million from July 1, 2005.

Historically, the hard disk drive industry has experienced lower demand in the March quarter as compared to the December quarter. Western Digital currently anticipates that these traditional March quarter seasonal demand trends will be somewhat tempered given the industry's balanced supply-demand environment, WD's expectation of continued execution and strong new product momentum. Given these factors, the Company currently estimates revenue for the March quarter to be between \$1.025 billion and \$1.075 billion. WD also anticipates that the impact of modest seasonal price declines in the March quarter will be partially offset by continued operational efficiencies. As a result of these factors, gross margin percentage for the March quarter is currently estimated to be approximately 19%.

**Results of Operations**

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

	THREE MONTHS ENDED				SIX MONTHS ENDED			
	DEC. 30, 2005		DEC. 31, 2004		DEC. 30, 2005		DEC. 31, 2004	
Revenue, net	\$1,117.1	100.0%	\$954.9	100.0%	\$2,127.0	100.0%	\$1,778.5	100.0%
Gross margin	228.3	20.4	150.2	15.7	406.6	19.1	263.3	14.8
Total operating expenses	124.0	11.1	93.6	9.8	234.4	11.0	175.5	9.9
Operating income	104.3	9.3	56.6	5.9	172.2	8.1	87.8	4.9
Net income	104.3	9.3	56.0	5.9	173.1	8.1	86.4	4.9



**Table of Contents***Net Revenue*

Net revenue was \$1.1 billion for the second quarter of 2006, an increase of 17% or \$162 million over the second quarter of 2005. Total unit shipments increased to 18.1 million for the second quarter of 2006 as compared to 16.2 million for the second quarter of 2005. This unit increase resulted from increased overall demand for hard disk drives as well as WD's increasing focus on the non-desktop PC markets. For example, WD shipped 1.4 million units to the mobile PC market in the second quarter of 2006 as compared to 0.2 million units in the second quarter of 2005. WD also shipped 1.5 million units to the DVR market in the second quarter of 2006 as compared to 0.8 million units in the second quarter of 2005. The increase in net revenue was also impacted by a \$3 per unit increase in average selling prices ( ASPs ) over the second quarter of 2005 to \$62 per unit for the second quarter of 2006. This improvement in ASPs was primarily attributable to an increase in the average storage capacity of hard disk drives sold during the quarter offset by moderate price declines.

Revenue contribution by geographic region for the second quarter of 2006 was 32% from the Americas, 34% from Europe and 34% from Asia compared to 38%, 32% and 30%, respectively, for the second quarter of 2005. These changes reflect the Company's continued focus on revenue growth in emerging geographic markets, primarily in Asia and Eastern Europe.

Revenue contribution by sales channel for the second quarter of 2006 was 56% from OEMs, 39% from distributors and 5% from the retail channel, compared to 58%, 35% and 7%, respectively, for the second quarter of 2005.

For the six months ended December 30, 2005, net revenue was \$2.1 billion, an increase of 20%, or \$349 million, from the six months ended December 31, 2004. During this period, total unit shipments increased to 35.2 million from 30.4 million during the same period last year. This unit increase resulted from increased overall demand for hard disk drives as well as WD's increasing focus on the non-desktop PC markets. For example, WD shipped 2.5 million units to the mobile PC market in the six months ended December 30, 2005, as compared to 0.2 million units in the six months ended December 31, 2004. WD also shipped 2.8 million units to the DVR market in the second quarter of 2006 as compared to 1.4 million units in the second quarter of 2005. The increase in net revenue was also impacted by a \$1 per unit increase in ASPs to \$60 per unit for the six months ended December 30, 2005, from \$59 per unit for the six months ended December 31, 2004. This increase in ASPs was attributable to an increase in the average storage capacity of hard disk drives sold offset by moderate price declines.

*Gross Margin*

Gross margin percentage increased to 20.4% for the three months ended December 30, 2005, from 15.7% for the three months ended December 31, 2004. For the six months ended December 30, 2005, gross margin percentage increased to 19.1% from 14.8% for the six months ended December 31, 2004. The increase in gross margin percentage over the prior year was due to several factors, including:

- manufacturing efficiencies,

- lower customer returns resulting from ongoing quality improvements, which favorably impacted warranty obligations,

- more moderate price declines, and

- an increase in the average storage capacity of hard disk drives sold during the quarter.

During the three and six months ended December 30, 2005, the Company's warranty accrual for prior quarters shipments was favorably adjusted by approximately \$10 million and \$17 million, respectively, as a result of improvements in quality and customer return rates and their expected impact on future levels of customer returns under warranty.

**Table of Contents***Operating Expenses*

R&D expense was \$76 million for the three months ended December 30, 2005, an increase of \$17 million over the three months ended December 31, 2004. This increase was primarily related to development of new product platforms in support of entry into new markets, expenditures for advanced head technologies and an increase of \$5 million in incentive compensation, \$2 million of which related to the adoption of SFAS 123-R. R&D expense for the six months ended December 30, 2005, was \$146 million, an increase of \$33 million over the same period last year. The increase in R&D expense was primarily due to the aforementioned factors including a \$12 million increase in incentive compensation, of which \$5 million related to the adoption of SFAS 123-R.

SG&A expense was \$48 million for the three months ended December 30, 2005, an increase of \$14 million over the prior year's comparable period. This increase was attributable to a \$7 million software abandonment charge, an expansion of sales resources to support increasing PC demand in certain geographic regions and the growing mobile and CE markets, a \$2 million increase in bad debt expense and an increase of \$7 million in incentive compensation, \$2 million of which related to the adoption of SFAS 123-R. These increases were partially offset by decreases in other areas. SG&A expense for the six months ended December 30, 2005 was \$88 million, an increase of \$26 million over the same period last year. The increase in SG&A expense was primarily due to the \$7 million software abandonment charge, an expansion of sales resources to support increasing PC demand in certain geographic regions and the growing mobile and CE markets, a \$5 million increase in bad debt expense and an increase of \$16 million in incentive compensation, of which \$4 million related to the adoption of SFAS 123-R.

*Income Tax Provision*

The Company's income tax provision for the three months ended December 30, 2005, was \$2.8 million or 2.6% of income before taxes. For the six months ended December 30, 2005, the income tax provision was \$4.4 million or 2.5% of income before taxes. Differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia and Thailand that expire at various times ranging from 2008 to 2019 and the partial utilization of net operating loss carryforwards.

**Liquidity and Capital Resources**

The Company's investment policy is to manage its investment portfolio to preserve principal and liquidity while maximizing return through the full investment of available funds. A large portion of Western Digital's available funds is invested in auction rate securities, which are short-term investments in bonds with original maturities greater than 90 days. WD ended the second quarter of 2006 with total cash, cash equivalents and short-term investments of \$645 million, an increase of \$46 million from July 1, 2005. The increase in cash, cash equivalents and short-term investments was comprised of a \$65 million increase in cash and cash equivalents partially offset by a decrease in short-term investments of \$19 million (see *Investing Activities* below). The following table summarizes the Company's statements of cash flows for the six months ended December 30, 2005, and December 31, 2004 (in millions):

	<b>SIX MONTHS ENDED</b>	
	<b>DEC.</b>	
	<b>30,</b>	<b>DEC. 31,</b>
	<b>2005</b>	<b>2004</b>
Net cash flow provided by (used in):		
Operating activities	\$ 156	\$ 236
Investing activities	(83)	(179)
Financing activities	(8)	(16)
Net increase in cash and cash equivalents	\$ 65	\$ 41

*Operating Activities*

Net cash provided by operating activities during the six months ended December 30, 2005, was \$156 million as compared to \$236 million during the six months ended December 31, 2004. Cash flow from operations consists of net

income, adjusted for non-cash charges, plus or minus working capital changes. This represents the Company's principal source of cash. Net cash used to fund working capital changes was \$114 million for the six months ended December 30, 2005, as compared to net cash provided by working capital changes of \$88 million during the prior year's comparable period.

**Table of Contents**

Western Digital's working capital requirements depend upon the effective management of its cash conversion cycle, which measures how quickly a company can convert its products into cash through sales. The cash conversion cycles for the six months ended December 30, 2005, and December 31, 2004, were as follows:

	<b>SIX MONTHS ENDED</b>	
	<b>DEC. 30, 2005</b>	<b>DEC. 31, 2004</b>
Days sales outstanding	38	41
Days in inventory	18	16
Days payables outstanding	(65)	(64)
Cash conversion cycle	(9)	(7)

The improvement in the cash conversion cycle for the first six months of 2006 as compared to the first six months of 2005 was primarily due to better alignment in the timing of the Company's inventory build and sales schedules. The impact of this improvement in the Company's cash conversion cycle on operating cash flows was offset by payments for incentive compensation, a legal settlement, and prepayments to suppliers during the first six months of 2006.

The Company, from time to time, modifies the timing of payments to its vendors. The Company makes these modifications primarily to manage its vendor relationships and to manage its cash flows, including quarterly cash balances. Generally, the Company makes the payment modifications through negotiations with or by granting to or receiving from its vendors payment term accommodations. Modification of payment terms did not have a material impact on the Company's liquidity or operating cash flows for the six months ended December 30, 2005.

*Investing Activities*

Net cash used in investing activities for the six months ended December 30, 2005, was approximately \$83 million as compared to \$179 million for the six months ended December 31, 2004. During the first six months of 2006, cash used for investing activities consisted of \$102 million for capital expenditures, partially offset by \$19 million in net sales of short-term investments. Net cash used in investing activities for the six months ended December 31, 2004, consisted of \$105 million for capital expenditures and \$74 million for the purchase of short-term investments. Capital expenditures in the first six months of both 2006 and 2005 were primarily related to assets purchased to upgrade the Company's head manufacturing capabilities, increased desktop and 2.5-inch hard disk drive production capabilities and for the normal replacement of existing assets. For 2006, capital expenditures are expected to be approximately \$275 million to \$300 million. This increase in capital expenditures is expected to consist primarily of investments in advanced head technologies, new product platforms and capacity for WD's broadening and growing product portfolio.

*Financing Activities*

Net cash used in financing activities for the first six months of 2006 was \$8 million as compared to net cash used in financing activities of \$16 million for the first six months of 2005. Net cash used in financing activities for the first six months of 2006 consisted of \$26 million used for common stock repurchases and \$11 million for debt payments partially offset by \$29 million received upon issuance of common stock under employee plans. Net cash used in financing activities for the first six months of 2005 consisted primarily of \$23 million used for common stock repurchases and \$10 million for debt payments partially offset by \$17 million received upon issuance of common stock under employee plans.

*Capital Commitments*

*Line of Credit* The Company has a \$125 million credit facility ( Senior Credit Facility ) consisting of a revolving credit line (subject to outstanding letters of credit and a borrowing base calculation) and a term loan of \$31 million as of December 30, 2005. Both the revolving credit facility and the term loan mature on September 19, 2008, and are secured by the Company's accounts receivable, inventory, 65% of its stock in its foreign subsidiaries and other assets. For the three months ended December 30, 2005, the Company had no borrowings on the revolving credit line and the average variable rate on the Company's term loan was 6.3%. The term loan requires quarterly principal payments of approximately \$3 million. Principal payments made on the term loan increase the amount of revolving credit

available. At December 30, 2005, \$91 million was available for borrowing under the revolving

**Table of Contents**

credit line and the Company had \$3 million in outstanding letters of credit. As of December 30, 2005, the Company was in compliance with all covenants related to the Senior Credit Facility.

*Purchase Orders* In the normal course of business, the Company enters into purchase orders with suppliers for the purchase of hard disk drive components used to manufacture the Company's products. These purchase orders generally cover forecasted component supplies needed for production during the next quarter, are recorded as a liability upon receipt of the components, and generally may be changed or canceled at any time prior to shipment of the components. In some cases the Company may be obligated to pay for certain costs related to changes to, or cancellation of, a purchase order, such as costs incurred for raw materials or work in process.

The Company has entered into long-term purchase agreements with various component suppliers, which contain minimum quantity requirements. However, the dollar amount of the purchases may depend on the specific products ordered, achievement of pre-defined quantity or quality specifications or future price negotiations. In conjunction with these agreements, the Company has advanced approximately \$74 million related to future purchase commitments, of which \$10 million has been classified as a long-term asset at December 30, 2005.

See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital Commitments in the Company's Annual Report on Form 10-K as of and for the year ended July 1, 2005, for further discussion of the Company's purchase orders and purchase agreements and the associated dollar amounts.

The Company enters into, from time to time, other long-term purchase agreements for components with certain vendors. Generally, future purchases under these agreements are not fixed and determinable as they depend on the Company's overall unit volume requirements and are contingent upon the prices, technology and quality of the supplier's products remaining competitive. See below under the heading Risk Factors That May Affect Future Results for a discussion of these commitments.

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

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

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

*Stock Repurchase Program* On November 21, 2005, WD announced that its Board of Directors had authorized the Company to repurchase an additional \$150 million of the Company's common stock in open market transactions. The new \$150 million authorization is in addition to the Company's Board of Director's original authorization to purchase \$100 million of the Company's common stock announced on May 5, 2004. The term of the program is a five year period from November 17, 2005, to November 17, 2010. Stock repurchases are expected to be funded principally from operating cash flows. During the second quarter of 2006, WD repurchased 1.0 million shares of common stock at a total cost of \$12 million. Since the inception of the program in May 2004 and through February 3, 2006, the Company has repurchased 8.8 million shares for a total cost of \$87 million (including commissions). WD may continue to repurchase its stock as it deems appropriate and market conditions allow.

**Table of Contents**

WD believes its current cash, cash equivalents and short-term investments will be sufficient to meet its working capital needs through the foreseeable future. There can be no assurance that the Senior Credit Facility will continue to be available to the Company. Also, WD's ability to sustain its working capital position is dependent upon a number of risks and other factors that may affect the Company's business. See below under the heading **Risk Factors That May Affect Future Results**. The Company currently anticipates that it will continue to utilize its liquidity and cash flows primarily to improve the efficiency and capability of its existing hard disk drive and head manufacturing operations.

**Critical Accounting Policies**

The Company has prepared the accompanying unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. The preparation of the financial statements requires the use of judgment and estimates that affect the reported amounts of revenues, expenses, assets, liabilities and equity. The Company has adopted accounting policies and practices that are generally accepted in the industry in which it operates. The Company believes the following are its most critical accounting policies that affect significant areas and involve management's judgment and estimates. If these estimates differ significantly from actual results, the impact to the consolidated financial statements may be material.

*Revenue and Accounts Receivable*

In accordance with standard industry practice, WD has agreements with resellers that provide limited price protection for inventories held by resellers at the time of published list price reductions and other incentive programs. In accordance with current accounting standards, the Company recognizes revenue upon shipment or delivery to resellers and records a reduction to revenue for estimated price protection and other programs in effect until the resellers sell such inventory to their customers. Adjustments are based on anticipated price decreases during the reseller holding period, estimated amounts to be reimbursed to qualifying customers, as well as historical pricing information. If end-market demand for hard disk drives declines significantly, the Company may have to increase sell-through incentive payments to resellers, resulting in an increase in price protection allowances, which could adversely impact operating results.

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

Western Digital records provisions against revenue and cost of revenue for estimated sales returns in the same period that the related revenue is recognized. The Company bases these provisions on existing product return notifications as well as historical returns by product type (see **Warranty**). If actual sales returns exceed expectations, an increase in the sales return provision would be required, which could negatively affect operating results.

*Warranty*

WD records an accrual for estimated warranty costs when revenue is recognized. Warranty covers costs of repair or replacement of the hard disk drive over the warranty period, which generally ranges from one to five years. The Company has comprehensive processes with which to estimate accruals for warranty, which include specific detail on hard disk drive reliability, such as factory test data, historical field return rates, and costs to repair by product type. If actual product return trends or costs to repair returned products demonstrate significant differences from expectations at any time during the warranty period, a change in the warranty provision is made. If these estimates differ significantly from actual results, the impact to the consolidated financial statements may be material. For a summary of historical changes in estimates related to pre-existing warranty provisions, refer to Part I, Item 1, Notes to Condensed Consolidated Financial Statements, Note 2 **Supplemental Financial Statement Data** included in this Quarterly Report on Form 10-Q.

**Table of Contents**

*Inventory*

Inventories are valued at the lower of cost (first-in, first-out basis) or net realizable value. Inventory write-downs are recorded for the valuation of inventory at the lower of cost or net realizable value by analyzing market conditions and estimates of future sales prices as compared to inventory costs and inventory balances.

The Company evaluates inventory balances for excess quantities and obsolescence on a regular basis by analyzing backlog, estimated demand, inventory on hand, sales levels and other information, and reduces inventory balances to net realizable value for excess and obsolete inventory based on the analysis. Unanticipated changes in technology or customer demand could result in a decrease in demand for one or more of the Company's products, which may require an increase in inventory balance adjustments that could negatively affect operating results.

*Litigation and Other Contingencies*

WD applies SFAS No. 5, Accounting for Contingencies, to determine when and how much to accrue for and disclose related to legal and other contingencies. Accordingly, the Company accrues loss contingencies when management, in consultation with its legal advisors, concludes that a loss is probable and reasonably estimable (Refer to Part I, Item 1, Notes to Condensed Consolidated Financial Statements, Note 8 Legal Proceedings, included in this Quarterly Report on Form 10-Q). The ability to predict the ultimate outcome of such matters involves judgments, estimates and inherent uncertainties. The actual outcome of such matters could differ materially from management's estimates.

*Income Taxes*

The Company records estimated liabilities for tax uncertainties to the extent the contingencies are probable and can be reasonably estimated. However, the actual liability in any such tax contingencies may be materially different from the estimates, which could result in the need to record additional tax liabilities or potentially adjust previously recorded tax liabilities.

WD's deferred tax assets, which consist primarily of net operating loss and tax credit carryforwards, are fully reserved in the form of a valuation allowance due to management's determination that it is more likely than not that these assets will not be realized. This determination is based on the weight of available evidence, the most significant of which is the Company's loss history in the related tax jurisdictions.

Recent operating performance and general industry conditions have resulted in improved operating results in these tax jurisdictions. If this continues, the Company may determine that it is more likely than not that these deferred tax assets will be realized. At that point, the Company will release all or a portion of the valuation allowance. The release of the valuation allowance will result in an income tax benefit in the period of the release, and a higher financial statement effective tax rate in periods after the release. However, the Company anticipates that the actual effective tax rate in future periods will remain less than the U.S. federal statutory rate. While the timing of any such release is dependent on future events and circumstances, the Company believes that it may be necessary to release the valuation allowance in the near term.

*Stock-Based Compensation*

Western Digital accounts for stock-based compensation in accordance with the fair value recognition provisions of SFAS 123-R. Under the fair value recognition provisions of SFAS 123-R, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period.



**Table of Contents**

Under SFAS 123-R, the Company is required to use judgment in estimating the amount of stock-based awards that are expected to be forfeited. If actual forfeitures differ significantly from the original estimate, stock-based compensation expense and the Company's results of operations could be materially impacted.

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

The fair values of all stock options granted subsequent to December 31, 2004, were estimated using a binomial model and the fair values of all options granted prior to December 31, 2004, and all ESPP shares were estimated using the Black-Scholes-Merton option pricing model. Both the binomial and the Black Scholes models require the input of highly subjective assumptions.

*New Accounting Standards*

In June 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections ( SFAS 154 ). SFAS 154 replaces Accounting Principles Board Opinion No. 20, Accounting Changes ( APB 20 ) and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements , applies to all voluntary changes in accounting principle and changes the requirements for accounting and reporting of a change in accounting principle. APB 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of change a cumulative effect of changing to the new accounting principle whereas SFAS 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle, unless it is impracticable. SFAS 154 enhances the consistency of financial information between periods, and is effective for fiscal years beginning after December 15, 2005. The Company does not expect the adoption of SFAS 154 to have a material impact on its financial statements.

**Risk Factors That May Affect Future Results**

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

The hard disk drive industry historically has experienced declining ASPs. Our ASPs tend to decline when competitors lower prices as a result of decreased costs or to absorb excess capacity, liquidate excess inventories, restructure or attempt to gain market share. Our ASPs also decline when there is a shift in the mix of product sales, and sales of lower priced products increase relative to those of higher priced products.

*Our operating results depend on optimizing time-to-market and time-to-volume, overall quality, and costs of new and established products.*

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

maintain overall quality of products on new and established programs,

maintain competitive cost structures on new and established products,

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

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

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

**Table of Contents**

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

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

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

consistently meet stated quality requirements on delivered products,

our operating results could be adversely affected.

*Product life cycles influence our financial results.*

Product life cycles have been extending since the middle of calendar year 2002 due in large part to a decrease in the rate of hard disk drive areal density growth. However, there can be no assurance that this trend will continue. If longer product life cycles continue, we may need to develop new technologies or programs to reduce our costs on any particular product in order to maintain competitive pricing for that product. This may result in an increase in our overall expenses and a decrease in our gross margins, both of which could adversely affect our operating results. If product life cycles shorten, it may be more difficult to recover the cost of product development before the product becomes obsolete. Our failure to recover the cost of product development in the future could adversely affect our operating results.

*Product life cycles in the hard disk drive market require continuous technical innovation associated with higher areal densities.*

New products in the hard disk drive market may require higher areal densities than previous product generations, posing formidable technical and manufacturing challenges. Higher areal densities require existing head technology to be improved or new technology developed to accommodate more data on a single disk. In addition, our introduction of new products during a technology transition increases the likelihood of unexpected quality concerns. Our failure to bring high quality new products to market on time and at acceptable costs may put us at a competitive disadvantage to companies that achieve these results.

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

Currently the hard disk drive industry uses giant magnetoresistive head technology, which allows significantly higher storage capacities than the previously utilized thin-film head technology. However, the industry is developing and now implementing new recording technologies that may enable greater recording densities than currently available using magnetoresistive head technology, including perpendicular, current perpendicular-to-plane, and tunneling junction technology, each of which represent a significant change in fundamental recording technology. The industry is experiencing a fundamental shift in recording technology, and hard disk drive manufacturers need to timely adjust their designs and processes to accommodate the new technology in order to remain competitive. As a result, we could incur substantial costs in developing new technologies, such as, heads, media, and tools to remain competitive. We may also become more dependent on suppliers to ensure our access to components that accommodate the new technology. For example, this new technology requires changes in the manufacturing process of media, which may cause longer production times and reduce the overall availability of media in the industry. Additionally, the new technology requires a greater degree of integration between heads and media which may lengthen our time of development of hard disk drives using this technology. These results would increase our operating costs, which may negatively impact our operating results.

**Table of Contents**

*The difficulty of introducing hard disk drives with higher levels of areal density and the challenges of reducing other costs may impact our ability to achieve historical levels of cost reduction.*

Storage capacity of the hard disk drive, as manufactured by us, is determined by the number of disks and each disk's areal density. Areal density is a measure of the amount of magnetic bits that can be stored on the recording surface of the disk. Generally, the higher the areal density, the more information can be stored on a single platter. Historically, we have been able to achieve a large percentage of cost reduction through increases in areal density. Increases in areal density mean that the average drive we sell has fewer heads and disks for the same capacity and, therefore, may result in a lower component cost. However, because increases in areal density have become more difficult in the hard disk drive industry, such increases may require increases in component costs. In addition, other opportunities to reduce costs may not continue at historical rates. Our inability to achieve cost reductions could adversely affect our operating results.

*Increases in areal density may outpace customers' demand for storage capacity.*

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

*Changes in the markets for hard disk drives require us to develop new products and new technology.*

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

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

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

*Current or future competitors may gain a technology advantage or develop an advantageous cost structure that we cannot match.*

It may be possible for our current or future competitors to gain an advantage in product technology, manufacturing technology, or process technology, which may allow them to offer products or services that have a significant advantage over the products and services that we offer. Advantages could be in capacity, performance, reliability, serviceability, or other attributes. For example, a competitor recently introduced a product with increased capacity using perpendicular recording technology. If we are unable to match technology advantages such as this due to the proprietary nature of the technology, limitations on process capability or other factors, we could be at a competitive disadvantage to those competitors.

Higher capacity storage needs have typically been better served by magnetic hard disk drives than flash memory as hard disk drive manufacturers can offer better value at high capacities, while lower capacity needs have been successfully served by solid state storage such as NAND flash memory technology. Advances in magnetic, optical,



**Table of Contents**

semiconductor or other data storage technologies could result in competitive products that have better performance or lower cost per unit of capacity than our products. If we fail to be cost competitive against flash memory, we could be at a competitive disadvantage to competitors using semiconductor technology. For example, we believe flash memory manufacturers recently achieved improvements in their cost structure and reduced their pricing, thus more effectively competing with our 1.0-inch hard disk drive product. If we are unable to lower the cost structure of future generations of sub-2.5-inch form factor hard drive products through technology advances such as increased storage capacity, this product category could be at a competitive disadvantage to flash technology.

A low cost structure is important to the success of our business. If our competitors are able to achieve a lower cost structure for manufacturing hard disk drives, and we are unable to match their cost structure, we could be at a competitive disadvantage to those competitors as they may be able to sell their products at lower prices while remaining profitable.

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

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

*If we do not successfully expand into new hard disk drive markets, our business may suffer.*

To remain a significant supplier of hard disk drives, we will need to offer a broad range of hard disk drive products to our customers. We currently offer a variety of 3.5-inch hard disk drives for the desktop computer, enterprise, CE and external storage markets, and we also offer 2.5-inch form factor hard disk drives for the mobile, CE and external storage markets. However, demand for hard disk drives may shift to products in smaller form factors, which our competitors may already offer. We recently entered into the sub-2.5-inch hard disk drive market with a 1.0-inch hard disk drive product. We face various challenges in ramping the manufacturing volume of our 1.0-inch hard disk drive and if we do not adequately address these challenges, our continued shipment of this product may be delayed, impairing our ability to realize revenue from this product. Additionally, we face various challenges in increasing the storage capacity of our 1.0-inch hard disk drive product, and if we are not successful in increasing its storage capacity, we may not be able to decrease the cost structure of this product, which could put us at a competitive disadvantage.

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

While we continue to develop new products and look to expand into other hard disk drive markets, the success of our new product introductions is dependent on a number of factors, including difficulties faced in manufacturing ramp, market acceptance, effective management of inventory levels in line with anticipated product demand, and the risk that our new products may have quality problems or other defects in the early stages of introduction that were not anticipated in the design of those products. Further, we need to identify how any of the hard disk drive markets that we are expanding into may have different characteristics from the desktop computer hard disk drive market, such as, demand volume growth rates, product generations development rates, customer concentrations, and cost and performance requirements, and we must properly address these differences. If we fail to successfully develop and manufacture new products and expand into new hard disk drive markets, customers may decrease the amount of our products that they purchase, and we may lose business to our competitors who offer these products.

**Table of Contents**

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

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

*Sales in the distribution channel are important to our business, and if we fail to maintain brand preference with our distributors or if distribution markets for hard disk drives weaken, our operating results could suffer.*

Our distribution customers typically sell to small computer manufacturers, dealers, systems integrators and other resellers. We face significant competition in this channel as a result of limited product qualification programs and a significant focus on price and availability of product. If we fail to remain competitive in terms of our technology, quality, service and support, our distribution customers may favor our competition, and our operating results could suffer. We also face significant risk in the distribution market for hard disk drives. If the distribution market weakens as a result of a slowing PC growth rate, technology transitions or a significant change in consumer buying preference from white box to branded PCs, or we experience significant price declines due to oversupply in the distribution channel, then our operating results would be adversely affected.

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

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

*To develop new products, we must maintain effective partner relationships with our major component suppliers.*

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

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

Certain components are available from a limited number of suppliers. Because we depend on a limited number of suppliers for certain hard disk drive components and manufacturing equipment, an increase in the cost of such components or equipment, an extended shortage of required components or equipment, failure of a key supplier's business process, or the failure of key suppliers to remain in business, adjust to market conditions, or to meet our quality, yield or production requirements could significantly harm our operating results. Our future operating results may also depend substantially on our suppliers' ability to timely qualify their components in our programs, and their

ability to supply us with these components in sufficient volumes to meet our production requirements. A number of  
25

---

**Table of Contents**

the components that we use are available from only a single or limited number of qualified outside suppliers, and may be used across multiple product lines. In addition, some of the components (or component types) used in our products are used in other devices, such as mobile telephones and digital cameras. If there is a significant simultaneous upswing in demand for such a component (or component type) from several high volume industries, resulting in a supply reduction, or a component is otherwise in short supply, or if a supplier fails to qualify or has a quality issue with a component, we may experience delays or increased costs in obtaining that component. For example, the hard disk drive industry is currently facing a tightness in the availability of media (rotating magnetic disks) components, and there are currently only three suppliers of aluminum media and three suppliers of glass media in the market. We may experience production delays if we are unable to obtain the necessary components or sufficient quantities of components. If a component becomes unavailable, we could suffer significant loss of revenue.

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

To reduce the risk of component shortages, we attempt to provide significant lead times when buying these components. As a result, we may be subject to cancellation charges if we cancel orders, which may occur when we make technology transitions or when our component needs change. In addition, we have entered into contractual commitments with component suppliers, such as suppliers of media, and may enter into contractual commitments with other component suppliers, in an effort to increase and stabilize the supply of those components, and enable us to purchase such media components at favorable prices. Some of these commitments require and may require us to buy a substantial number of components from the supplier or make significant cash advances to the supplier, however these commitments may not result in a satisfactory increase or stabilization of the supply of such components.

In addition, certain equipment we use in our manufacturing or testing processes is available only from a limited number of suppliers. Some of this equipment uses materials that at times could be in short supply. If these materials are not available, or are not available in the quantities we require for our manufacturing and testing processes, our ability to manufacture our products could be impacted, and we could suffer significant loss of revenue.

*Rising costs of commodity materials may result in lower operating margins.*

The cost and availability of certain commodity materials used to manufacture hard disk drives and key components is critical to our success. Shortages of materials such as steel and aluminum increase our costs and may result in lower operating margins if we are unable to find ways to mitigate these increased costs. The rising cost of oil also increases our costs and may result in lower operating margins if we are unable to pass such increased costs through to our customers.

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

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

In addition, we may incur additional risks, including:

insufficient head sources in the event that we are unable to manufacture a sufficient supply of heads to satisfy our needs;

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



**Table of Contents**

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

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

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

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

Under our business plan, we are developing and manufacturing a substantial portion of the heads used in some of the product families of hard disk drives we manufacture. Consequently, we are more dependent upon our own development and execution efforts and less able to take advantage of head technologies developed by other head manufacturers. Technology transition for head designs is critical to increasing our volume production of heads. There can be no assurance, however, that we will be successful in timely and cost-effectively developing and manufacturing heads for products using perpendicular recording technology, or other future technologies. We also may not effectively transition our head design and head technology in order to achieve acceptable manufacturing yields using such technologies necessary to satisfy our customers' product needs, or we may encounter quality problems with the heads we manufacture. In addition, we may not have access to external sources of supply without incurring substantial costs. For example, we anticipate using perpendicular recording heads in certain products in the future. If we fail to develop new technologies such as perpendicular recording in a timely manner, or if we encounter quality problems with the heads we manufacture, and if we do not have access to external sources of supply that incorporate new technologies, we would have a competitive disadvantage to companies that are successful in this regard, and our business and financial results could suffer.

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

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

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

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

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

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

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

**Table of Contents**

currency exchange rate fluctuations or restrictions;

political instability and civil unrest;

limited transportation availability, delays, and extended time required for shipping, which risks may be compounded in periods of price declines;

higher freight rates;

labor problems;

trade restrictions or higher tariffs;

exchange, currency and tax controls and reallocations;

increasing labor and overhead costs; and

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

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

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

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

If the U.S. dollar exhibits sustained weakness against most foreign currencies, the U.S. dollar equivalents of unhedged manufacturing costs could increase because a significant portion of our production costs are foreign-currency denominated. Conversely, there would not be an offsetting impact to revenues since revenues are substantially U.S. dollar denominated.

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

We regularly engage in new product qualification with our customers. To be considered for qualification, we must be among the leaders in time-to-market with our new products. Once a product is accepted for qualification testing, failures or delays in the qualification process can result in our losing sales to that customer until the next generation of products is introduced. The effect of missing a product qualification opportunity is magnified by the limited number of high volume computer manufacturers, which continue to consolidate their share of the PC market. If product life cycles continue to be extended due to a decrease in the rate of areal density growth, we may have a significantly longer period to wait before we have an opportunity to qualify a new product with a customer, which could harm our competitive position. These risks are increased because we expect cost improvements and competitive pressures to result in declining gross margins on our current generation products.

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

The price of hard disk drives has fallen over time due to increases in supply, cost reductions, technological advances and price reductions by competitors seeking to liquidate excess inventories or attempting to gain market share. In addition, rapid technological changes often reduce the volume and profitability of sales of existing products



**Table of Contents**

and increase the risk of inventory obsolescence. We also face competition from other companies that produce alternative storage technologies like flash memory. These factors, taken together, may result in significant and rapid shifts in market share among the industry's major participants. In addition, product recalls can lead to a loss of market share, which could adversely affect our operating results.

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

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

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

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

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

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

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

*We depend on our key personnel and skilled employees.*

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

**Table of Contents**

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

Demand for our hard disk drives depends on the demand for systems manufactured by our customers and on storage upgrades to existing systems. The demand for systems has been volatile in the past and often has had an exaggerated effect on the demand for hard disk drives in any given period. As a result, the hard disk drive market has experienced periods of excess capacity which can lead to liquidation of excess inventories and intense price competition. If intense price competition occurs, we may be forced to lower prices sooner and more than expected, which could result in lower revenue and gross margins.

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

The hard disk drive industry faces difficulties in accurately forecasting market and customer demand for its products. The variety and volume of products we manufacture is based in part on these forecasts. If our forecasts exceed actual market demand, or if market demand decreases significantly from our forecasts, then we could experience periods of product oversupply and price decreases, which could impact our financial performance. If our forecasts do not meet actual market demand, or if market demand increases significantly beyond our forecasts, then we may not be able to satisfy customer product needs, which could result in a loss of market share if our competitors are able to meet customer demands.

We also use forecasts in making decisions regarding investment of our resources. For example, as the hard disk drive industry transitions from the PATA interface to the SATA interface, we may invest more resources in the development of products using the SATA interface. If our forecasts regarding the replacement of the PATA interface with the SATA interface are inaccurate, we may not have products available to meet our customers' needs.

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

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

A majority of our revenue comes from about a dozen customers. For example, during the second quarter of 2006, one customer, Dell, accounted for 13% of our revenue, and sales to our top 10 customers, including Dell, accounted for 48% of revenue. These customers have a variety of suppliers to choose from and therefore can make substantial demands on us, including demands on product pricing and on contractual terms, which often results in the allocation of risk to us as the supplier. Even if we successfully qualify a product with a customer, the customer generally is not obligated to purchase any minimum volume of products from us and is able to cancel an order or terminate its relationship with us at any time. Our ability to maintain strong relationships with our principal customers is essential to our future performance. If we lose a key customer, if any of our key customers reduce their orders of our products or require us to reduce our prices before we are able to reduce costs, if a customer is acquired by one of our competitors or if a key customer suffers financial hardship then our operating results would likely be harmed. In addition, if customer pressures require us to reduce our pricing such that our gross margins are diminished, we could decide not to sell our products to a particular customer, which could result in a decrease in our revenue.

*Environmental regulation costs could harm our operating results.*

We may be subject to various state, federal and international laws and regulations governing the environment, including those restricting the presence of certain substances in electronic products and making producers of those products financially responsible for the collection, treatment, recycling and disposal of certain products. Such laws and regulations have been passed in several jurisdictions in which we operate, including various European Union member countries. For example, the European Union has enacted the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) and the Waste Electrical and Electronic Equipment (WEEE) directives. RoHS prohibits the use of certain substances, including lead, in certain products, including hard disk drives, put on the market after July 1, 2006. The WEEE directive obligates parties that place electrical and



**Table of Contents**

electronic equipment onto the market in the EU to put a clearly identifiable mark on the equipment, register with and report to EU member countries regarding distribution of the equipment, and provide a mechanism to take-back and properly dispose of the equipment. Each EU member country has enacted, or is expected to soon enact, legislation clarifying what is and what is not covered by the WEEE directive in that country. However, there is still some uncertainty in certain EU countries as to which party involved in the manufacture, distribution and sale of electronic equipment will be ultimately responsible for registration, reporting and disposal. Similar legislation may be enacted in other locations where we manufacture or sell our products. We will need to ensure that we comply with such laws and regulations as they are enacted, and that our component suppliers also timely comply with such laws and regulations. If we fail to timely comply with the legislation, our customers may refuse to purchase our products, which would have a materially adverse effect on our business, financial condition and results of operations.

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

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

We warrant our products for up to five years. We test our hard disk drives in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market. Accordingly, there is a risk that product defects will occur, which could require a product recall. Product recalls can be expensive to implement and, if a product recall occurs during the product's warranty period, we may be required to replace the defective product. In addition, a product recall may damage our relationship with our customers, and we may lose market share with our customers, including our OEM customers.

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

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

Some of our OEM customers have adopted a subcontractor model that requires us to contract directly with companies that provide manufacturing services to our OEM customers. Because these subcontractors are generally not as well capitalized as our direct OEM customers, this subcontractor model exposes us to increased credit risks. Our agreements with our OEM customers may not permit us to increase our product prices to alleviate this increased credit risk. Additionally, as we attempt to expand our sales into emerging economies such as Brazil, Russia, India and China, the customers in these regions may have a relatively short operating history, making it more difficult for us to accurately assess the associated credit risks. Any credit losses we may suffer as a result of these increased risks, or as a result of credit losses from any significant customer, would increase our operating costs, which may negatively impact our operating results.

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

The continued threat of terrorist activity and other acts of war or hostility, including the war in Iraq, have created uncertainty in the financial and insurance markets and have significantly increased the political, economic and social instability in some of the geographic areas in which we operate. Acts of terrorism, either domestically or abroad, could create further uncertainties and instability. To the extent this results in disruption or delays of our manufacturing capabilities or shipments of our products, our business, operating results and financial condition could be adversely affected.





**Table of Contents**

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

We often ship a high percentage of our total quarterly sales in the third month of the quarter, which makes it difficult for us to forecast our financial results prior to the end of the quarter. In addition, our quarterly projections and results may be subject to significant fluctuations as a result of a number of other factors including:

the timing of orders from and shipment of products to major customers;

our product mix;

changes in the prices of our products;

manufacturing delays or interruptions;

acceptance by customers of competing products in lieu of our products;

variations in the cost of components for our products;

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

competition and consolidation in the data storage industry;

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

availability and rates of transportation.

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

We have made and continue to make a number of estimates and assumptions relating to our consolidated financial reporting. The highly technical nature of our products and the rapidly changing market conditions with which we deal means that actual results may differ significantly from our estimates and assumptions. These changes have impacted our financial results in the past and may continue to do so in the future. Key estimates and assumptions for us include:

accruals for warranty costs related to product defects;

price protection adjustments and other sales promotions and allowances on products sold to retailers, resellers and distributors;

inventory adjustments for write-down of inventories to lower of cost or market value (net realizable value);

reserves for doubtful accounts;

accruals for product returns;

accruals for litigation and other contingencies; and

reserves for deferred tax assets.

*The market price of our common stock is volatile.*

The market price of our common stock has been, and may continue to be, extremely volatile. Factors such as the following may significantly affect the market price of our common stock:

actual or anticipated fluctuations in our operating results;

announcements of technological innovations by us or our competitors which may decrease the volume and profitability of sales of our existing products and increase the risk of inventory

obsolescence;

new products introduced by us or our competitors;

32

---

**Table of Contents**

periods of severe pricing pressures due to oversupply or price erosion resulting from competitive pressures or industry consolidation;

developments with respect to patents or proprietary rights;

conditions and trends in the hard disk drive, computer, data and content management, storage and communication industries; and

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

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

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

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

Due to the risks described herein, in the future we may be unable to maintain adequate financial resources for capital expenditures, expansion or acquisition activity, working capital and research and development. We have a credit facility which matures on September 19, 2008. If we decide to increase or accelerate our capital expenditures or research and development efforts, or if results of operations do not meet our expectations, we could require additional debt or equity financing. However, we cannot ensure that additional financing will be available to us or available on acceptable terms. An equity financing could also be dilutive to our existing stockholders.

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

Our evaluation resulted in our conclusion that as of December 30, 2005, in compliance with Section 302 of the Sarbanes-Oxley Act of 2002, our disclosure controls and procedures were effective at the reasonable assurance level. We believe that we currently have adequate internal control procedures in place for future periods; however, if our internal controls are found to be ineffective in future periods, our financial results or our stock price may be adversely affected.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Disclosure About Foreign Currency Risk**

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, forward exchange contracts to hedge the impact of foreign currency fluctuations on certain underlying assets, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedge transactions is to minimize the impact of foreign currency fluctuations on the results of operations. The resulting impact from these hedge contracts is to offset a majority of the currency gains and losses in the Company's local currency expenses. The contract maturity dates do not exceed six months. The Company does not purchase short-term forward exchange contracts for speculative purposes. Currently, the Company focuses on hedging its foreign currency risk related to the Thai Baht, the Euro and the British Pound Sterling. Thai Baht contracts are designated as cash flow hedges under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, while all other contracts are designated as fair value hedges under Statement of Financial Accounting Standards No. 52, Foreign Currency Translation.

**Table of Contents**

As of December 30, 2005, the Company had the following purchased foreign currency forward exchange contracts outstanding (in millions, except weighted average contract rate):

	<b>Contract</b>	<b>December 30, 2005 Weighted Average</b>	<b>Unrealized Gain (Loss)</b>
	<b>Amount</b>	<b>Contract Rate*</b>	
<b>Foreign currency forward contracts:</b>			
Thai Baht	\$ 191.2	40.94	\$ 0.2
Euro	\$ 1.1	0.84	
British Pound Sterling	\$ 1.7	0.58	

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

During the three month periods ended December 30, 2005, and December 31, 2004, total realized transaction and forward exchange contract currency gains and losses were not material to the condensed consolidated financial statements.

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

At the option of the Company, borrowings under the Senior Credit Facility would bear interest at either LIBOR (with option periods of one to three months) or a base rate, plus a margin. If LIBOR or the base rate increases, the Company's interest payments would also increase. At December 30, 2005, the Company had a \$31 million term loan outstanding under the Senior Credit Facility. A one percent increase in the variable rate of interest on the Senior Credit Facility would increase interest expense by approximately \$0.3 million annually.

**Item 4. CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that as of December 30, 2005, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

On October 1, 2005, the Company implemented a planned upgrade to its enterprise resource planning (ERP) system. This upgrade resulted in a change to processes and controls in the following ERP system modules: general ledger, accounts payable, accounts receivable, fixed assets, inventory, purchasing and order management. The Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, assessed the design and operating effectiveness of internal controls over financial reporting affected by the system upgrade. As a result of this assessment, the Company's Chief Executive Officer and Chief Financial Officer believe that the

Company maintained adequate internal controls over financial reporting during the most recent fiscal quarter.

Except as described above, there has been no change in the Company's internal controls over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. LEGAL PROCEEDINGS**

In the normal course of business, the Company is subject to legal proceedings, lawsuits and other claims. Although the ultimate aggregate amount of monetary liability or financial impact with respect to these matters is subject to many uncertainties and is therefore not predictable with assurance, management believes that any monetary liability or financial impact to the Company from these matters, individually and in the aggregate, beyond that provided for at December 30, 2005, would not be material to the Company's financial condition. However, there can be no assurance with respect to such result, and monetary liability or financial impact to the Company from these legal proceedings, lawsuits and other claims could differ materially from those projected.

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

(c) The following table provides information about repurchases by the Company of its common stock during the quarter ended December 30, 2005:

		Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased As Part of Publicly Announced Program	Maximum Value of Shares that May Yet be Purchased Under the Program(1)
Oct. 1, 2005	Oct. 28, 2005		\$		\$ 25,185,277
Oct. 29, 2005	Nov. 25, 2005	1,000,000	\$ 12.0261	1,000,000	\$ 163,159,179
Nov. 25, 2005	Dec. 30, 2005		\$		\$ 163,159,179
Total		1,000,000	\$ 12.0261	1,000,000	\$ 163,159,179

(1) On November 21, 2005, the Company announced that its Board of Directors had authorized the Company to repurchase an additional \$150 million of the Company's common stock in open market transactions. The new \$150 million authorization is

in addition to  
the Company's  
Board of  
Directors  
original  
authorization to  
purchase  
\$100 million of  
the Company's  
common stock  
announced on  
May 5, 2004.  
The term of the  
program is a  
five year period  
from  
November 17,  
2005 to  
November 17,  
2010.

The Company's \$125 million Senior Credit Facility prohibits the Company from paying cash dividends on its common stock.

**Table of Contents****Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

The annual meeting of shareholders was held on November 17, 2005. The shareholders elected the following nine directors to hold office until the next annual meeting and until their successors are elected and qualified:

	<b>FOR</b>	<b>WITHHELD</b>
Peter D. Behrendt	192,092,723	6,478,876
Kathleen A. Cote	197,874,911	696,688
Henry T. DeNero	197,379,834	1,191,765
William L. Kimsey	192,949,918	5,621,681
Michael D. Lambert	197,133,248	1,438,351
Matthew E. Massengill	192,806,928	5,764,671
Roger H. Moore	197,080,897	1,490,702
Thomas E. Pardun	192,821,421	5,750,178
Arif Shakeel	192,750,922	5,820,677

In addition, the shareholders approved the following proposals:

	<b>FOR</b>	<b>AGAINST</b>	<b>ABSTAIN</b>	<b>BROKER NON-VOTES</b>
1. To approve the Western Digital Corporation 2005 Employee Stock Purchase Plan	141,134,948	21,768,471	195,268	35,472,911
2. To approve an amendment to the Western Digital Corporation 2004 Performance Incentive Plan	136,578,887	26,324,377	195,423	35,472,911
3. To ratify the selection of KPMG LLP as independent accountants for the Company for the fiscal year ending June 30, 2006	191,361,039	7,077,735	131,824	



**Table of Contents**

**Item 6. EXHIBITS**

<b>Exhibit No.</b>	<b>Description</b>
3.1	Amended and Restated Certificate of Incorporation of Western Digital Corporation, as amended to date
3.3	Amended and Restated Bylaws of Western Digital Corporation, as adopted September 20, 2005, Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on September 26, 2005)
10.1	Western Digital Corporation Amended and Restated 2004 Performance Incentive Plan, effective as of November 17, 2005 (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 23, 2005)*
10.1.3	Western Digital Corporation Amended and Restated 2004 Performance Incentive Plan Non-Employee Director Option Grant Program, effective as of November 17, 2005, and Form of Notice of Grant of Stock Option and Option Agreement Non-Employee Directors *
10.5	Western Digital Corporation 2005 Employee Stock Purchase Plan, effective as of November 17, 2005 (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 23, 2005)*
10.6	Amended and Restated Western Digital Corporation Non-Employee Directors Stock-For-Fees Plan, effective as of November 17, 2005 *
10.7	Western Digital Corporation Amended and Restated 2004 Performance Incentive Plan Non-Employee Director Restricted Stock Unit Program, effective as of November 17, 2005 *
10.9	Western Digital Corporation Summary of Compensation Arrangements for Named Executive Officers and Directors (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 23, 2005)*
10.27.3	Fourth Amendment to Lease, dated as of December 21, 2005, between Trinet Essential Facilities XXVI, Inc. and Western Digital Technologies, Inc.
10.29.2	Amendment No. 2 to Volume Purchase Agreement, dated as of November 29, 2005, by and between Komag USA (Malaysia) Sdn., Komag, Incorporated, and Western Digital Technologies, Inc. §
10.29.3	Amendment No. 3 to Volume Purchase Agreement, dated as of January 31, 2006, by and between Komag USA (Malaysia) Sdn., Komag, Incorporated, and Western Digital Technologies, Inc. §
10.35	Letter Agreement, dated May 25, 2005, between the Company and John F. Coyne (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 23, 2005)*
10.35.1	Letter Agreement, dated November 17, 2005, between the Company and John F. Coyne *
31.1	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**Table of Contents**

Exhibit filed  
with this Report.

\* Compensation  
plan, contract or  
arrangement  
required to be  
filed as an  
exhibit pursuant  
to applicable  
rules of the  
Securities and  
Exchange  
Commission.

§ Certain portions  
of this exhibit  
have been  
omitted  
pursuant to a  
confidential  
treatment  
request filed  
separately with  
the Securities  
and Exchange  
Commission.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

WESTERN DIGITAL CORPORATION  
Registrant

/s/ Stephen D. Milligan

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

/s/ Joseph R. Carrillo

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

Date: February 7, 2006

**Table of Contents****EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
3.1	Amended and Restated Certificate of Incorporation of Western Digital Corporation, as amended to date
3.3	Amended and Restated Bylaws of Western Digital Corporation, as adopted September 20, 2005, Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on September 26, 2005)
10.1	Western Digital Corporation Amended and Restated 2004 Performance Incentive Plan, effective as of November 17, 2005 (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 23, 2005)*
10.1.3	Western Digital Corporation Amended and Restated 2004 Performance Incentive Plan Non-Employee Director Option Grant Program, effective as of November 17, 2005, and Form of Notice of Grant of Stock Option and Option Agreement Non-Employee Directors *
10.5	Western Digital Corporation 2005 Employee Stock Purchase Plan, effective as of November 17, 2005 (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 23, 2005)*
10.6	Amended and Restated Western Digital Corporation Non-Employee Directors Stock-For-Fees Plan, effective as of November 17, 2005 *
10.7	Western Digital Corporation Amended and Restated 2004 Performance Incentive Plan Non-Employee Director Restricted Stock Unit Program, effective as of November 17, 2005 *
10.9	Western Digital Corporation Summary of Compensation Arrangements for Named Executive Officers and Directors (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 23, 2005)*
10.27.3	Fourth Amendment to Lease, dated as of December 21, 2005, between Trinet Essential Facilities XXVI, Inc. and Western Digital Technologies, Inc.
10.29.2	Amendment No. 2 to Volume Purchase Agreement, dated as of November 29, 2005, by and between Komag USA (Malaysia) Sdn., Komag, Incorporated, and Western Digital Technologies, Inc. §
10.29.3	Amendment No. 3 to Volume Purchase Agreement, dated as of January 31, 2006, by and between Komag USA (Malaysia) Sdn., Komag, Incorporated, and Western Digital Technologies, Inc. §
10.35	Letter Agreement, dated May 25, 2005, between the Company and John F. Coyne (Incorporated by reference to the Company's Current Report on Form 8-K (File No. 1-08703), as filed with the Securities and Exchange Commission on November 23, 2005)*
10.35.1	Letter Agreement, dated November 17, 2005, between the Company and John F. Coyne *
31.1	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Edgar Filing: WESTERN DIGITAL CORP - Form 10-Q

- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
  - 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
  - 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
-

**Table of Contents**

Exhibit filed  
with this Report.

\* Compensation  
plan, contract or  
arrangement  
required to be  
filed as an  
exhibit pursuant  
to applicable  
rules of the  
Securities and  
Exchange  
Commission.

§ Certain portions  
of this exhibit  
have been  
omitted  
pursuant to a  
confidential  
treatment  
request filed  
separately with  
the Securities  
and Exchange  
Commission.