WESTERN DIGITAL CORP
Form 10-Q
February 10, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended January 2, 2015
Or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number: 1-8703

WESTERN DIGITAL CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or other jurisdiction of incorporation or organization)	33-0956711 (I.R.S. Employer Identification No.)
3355 Michelson Drive, Suite 100 Irvine, California	92612
(Address of principal executive offices)	(Zip Code)

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý
As of the close of business on February 5, 2015, 231,031,533 shares of common stock, par value $.01 per share, were outstanding.

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Our fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every six years, we report a 53-week fiscal year to align our fiscal year with the foregoing policy. Our fiscal second quarters ended January 2, 2015 and December 27, 2013 both consisted of 13 weeks. Fiscal year 2014 was comprised of 52 weeks and ended on June 27, 2014. Fiscal year 2015 will be comprised of 53 weeks and will end on July 3, 2015. Fiscal year 2016 will be comprised of 52 weeks and will end on July 1, 2016. Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters, and references to financial information are on a consolidated basis. As used herein, the terms "we," "us," "our," the "Company," "WDC" and "Western Digital" refer t Western Digital Corporation and its subsidiaries, unless we state, or the context indicates, otherwise.

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

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

	January 2, 2015	June 27, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$4,902	$4,804
Short-term investments	241	284
Accounts receivable, net	1,880	1,989
Inventories	1,282	1,226
Other current assets	355	417
Total current assets	8,660	8,720
Property, plant and equipment, net	3,099	3,293
Goodwill	2,566	2,559
Other intangible assets, net	359	454
Other non-current assets	455	473
Total assets	$15,139	$15,499
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$2,071	$1,971
Accrued arbitration award	—	758
Accrued expenses	496	412
Accrued compensation	451	460
Accrued warranty	146	119
Current portion of long-term debt	125	125
Total current liabilities	3,289	3,845
Long-term debt	2,250	2,313
Other liabilities	518	499
Total liabilities	6,057	6,657
Commitments and contingencies (Notes 4 and 5)		
Shareholders' equity:		
Preferred stock, $.01 par value; authorized — 5 shares; issued and outstanding — none	—	—
Common stock, $.01 par value; authorized — 450 shares; issued — 261 shares; outstanding — 232 and 234 shares, respectively	3	3
Additional paid-in capital	2,318	2,331
Accumulated other comprehensive income (loss)	(32)	12
Retained earnings	8,738	8,066
Treasury stock — common shares at cost; 29 and 27 shares, respectively	(1,945)	(1,570)
Total shareholders' equity	9,082	8,842
Total liabilities and shareholders' equity	$15,139	$15,499

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

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

	Three Months Ended		Six Months Ended	
	January 2, 2015	December 27, 2013	January 2, 2015	December 27, 2013
Revenue, net	$3,888	$3,972	$7,831	$7,776
Cost of revenue	2,778	2,816	5,572	5,521
Gross profit	1,110	1,156	2,259	2,255
Operating expenses:				
Research and development	426	416	863	817
Selling, general and administrative	164	226	384	358
Charges related to arbitration award	1	13	15	26
Employee termination, asset impairment and other charges	53	23	62	34
Total operating expenses	644	678	1,324	1,235
Operating income	466	478	935	1,020
Other income (expense):				
Interest income	4	3	8	6
Interest and other expense	(12)	(14)	(25)	(27)
Total other expense, net	(8)	(11)	(17)	(21)
Income before income taxes	458	467	918	999
Income tax provision	20	37	57	74
Net income	$438	$430	$861	$925
Income per common share:				
Basic	$1.88	$1.82	$3.70	$3.92
Diluted	$1.84	$1.77	$3.60	$3.81
Weighted average shares outstanding:				
Basic	233	236	233	236
Diluted	238	243	239	243

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

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

	Three Months Ended		Six Months Ended	
	January 2, 2015	December 27, 2013	January 2, 2015	December 27, 2013
Net income	$438	$430	$861	$925
Other comprehensive loss, net of tax:				
Net unrealized loss on foreign exchange contracts	(18)	(30)	(44)	(14)
Other comprehensive loss	(18)	(30)	(44)	(14)
Total comprehensive income	$420	$400	$817	$911

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

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

	Six Months Ended	
	January 2, 2015	December 27, 2013
Cash flows from operating activities		
Net income	$861	$925
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	579	629
Stock-based compensation	80	84
Deferred income taxes	31	(39)
Gain from insurance recovery	(37)	(65)
Loss on disposal of assets	12	29
Non-cash portion of employee termination, asset impairment and other charges	19	9
Changes in:		
Accounts receivable, net	109	(145)
Inventories	(56)	(66)
Accounts payable	94	86
Accrued arbitration award	(758)	26
Accrued expenses	70	(36)
Accrued compensation	(9)	3
Other assets and liabilities	75	(34)
Net cash provided by operating activities	1,070	1,406
Cash flows from investing activities		
Purchases of property, plant and equipment	(306)	(306)
Proceeds from sale of property, plant and equipment	7	—
Proceeds from sales and maturities of investments	630	—
Purchases of investments	(595)	—
Acquisitions, net of cash acquired	(6)	(823)
Other investing activities, net	16	4
Net cash used in investing activities	(254)	(1,125)
Cash flows from financing activities		
Issuance of stock under employee stock plans	112	97
Taxes paid on vested stock awards under employee stock plans	(59)	(24)
Excess tax benefits from employee stock plans	11	25
Repurchases of common stock	(532)	(300)
Dividends paid to shareholders	(187)	(118)
Proceeds from debt	—	500
Repayment of debt	(63)	(115)
Net cash provided by (used in) financing activities	(718)	65
Net increase in cash and cash equivalents	98	346
Cash and cash equivalents, beginning of period	4,804	4,309
Cash and cash equivalents, end of period	$4,902	$4,655
Supplemental disclosure of cash flow information:		
Cash paid (received) for income taxes	$(45)	$122
Cash paid for interest	$23	$24
Supplemental disclosure of non-cash financing activities:		

Accrual of cash dividend declared	$93	$71

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

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

1. Basis of Presentation

The accounting policies followed by Western Digital Corporation (the “Company”) are set forth in Part II, Item 8, Note 1 of the Notes to Consolidated Financial Statements included in the Company’s Annual Report on Form 10-K for the year ended June 27, 2014. In the opinion of management, all adjustments necessary to fairly state the unaudited condensed consolidated financial statements have been made. All such adjustments are of a normal, recurring nature. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended June 27, 2014. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year. The Company's fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every six years, the Company reports a 53-week fiscal year to align its fiscal year with the foregoing policy. The Company's fiscal second quarters ended January 2, 2015 and December 27, 2013 both consisted of 13 weeks. Fiscal year 2015 will be comprised of 53 weeks and will end on July 3, 2015.

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

2. Supplemental Financial Statement Data

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

	January 2, 2015	June 27, 2014
	(in millions)	
Inventories:		
Raw materials and component parts	$154	$168
Work-in-process	510	493
Finished goods	618	565
Total inventories	$1,282	$1,226
Property, plant and equipment:		
Property, plant and equipment	$8,353	$8,123
Accumulated depreciation	(5,254)	(4,830)
Property, plant and equipment, net	$3,099	$3,293
Other intangible assets:		
Other intangible assets	$983	$984
Accumulated amortization	(624)	(530)
Other intangible assets, net	$359	$454

Warranty

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

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returned products or costs of customer compensatory claims differ significantly from estimates, future results of operations could be materially affected. Changes in the warranty accrual were as follows (in millions):

	Three Months Ended		Six Months Ended	
	January 2, 2015	December 27, 2013	January 2, 2015	December 27, 2013
Warranty accrual, beginning of period	$201	$195	$182	$187
Warranty liability assumed as a result of acquisition	—	1	—	4
Charges to operations	50	44	99	84
Utilization	(44)	(57)	(93)	(106)
Changes in estimate related to pre-existing warranties	16	7	35	21
Warranty accrual, end of period	$223	$190	$223	$190

The long-term portion of the warranty accrual classified in other liabilities was $77 million as of January 2, 2015 and $63 million as of June 27, 2014.

Investments

The following table summarizes, by major type, the fair value and cost basis of the Company's investments as of January 2, 2015 (in millions):

	Cost Basis	Unrealized Gains (Losses)	Fair Value
Available-for-sale securities:			
U.S. Treasury securities	$159	$—	$159
U.S. Government agency securities	126	—	126
Commercial paper	154	—	154
Certificates of deposit	26	—	26
Total	$465	$—	$465
Short-term investments			$241
Included in other non-current assets			224
Total			$465

The fair value of the Company's investments classified as available-for-sale securities at January 2, 2015, by remaining contractual maturity, were as follows (in millions):

	Cost Basis	Fair Value
Due in less than one year:	$241	$241
Due in one to five years:	224	224
Total	$465	$465

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

	Cost Basis	Unrealized Gains (Losses)	Fair Value
Available-for-sale securities:			
U.S. Treasury securities	$180	$—	$180
U.S. Government agency securities	88	—	88
Commercial paper	165	—	165
Certificates of deposit	66	—	66
Total	$499	$—	$499
Short-term investments			$284
Included in other non-current assets			215
Total			$499

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

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

The Company determined no available-for-sale securities were other-than-temporarily impaired in the three and six months ended January 2, 2015. For more information on the Company's available-for-sale securities, see Note 7 below.

In addition, the Company enters into certain strategic investments for the promotion of business and strategic objectives. These strategic investments are recorded at cost within other non-current assets in the consolidated balance sheets and were not material to the condensed consolidated financial statements as of January 2, 2015 and June 27, 2014.

Other Comprehensive Income (Loss)

Other comprehensive income (loss) refers to revenue, expenses, gains and losses that are recorded as an element of shareholders’ equity but are excluded from net income. The Company’s other comprehensive income (loss) is comprised of unrealized gains and losses on foreign exchange contracts. There were no unrealized gains or losses on the Company's available-for-sale securities or actuarial gains and losses related to pensions in the six months ended January 2, 2015. In addition, the income tax impact on components of other comprehensive income (loss) is immaterial for all periods presented.

The following table illustrates the changes in the balances of each component of accumulated other comprehensive income (loss) for the six months ended January 2, 2015 (in millions):

	Actuarial Pension Gain	Unrealized Gain (Loss) on Foreign Exchange Contracts	Accumulated Other Comprehensive Income (Loss)
Balance at June 27, 2014	$7	$5	$12
Other comprehensive income (loss) before reclassifications	—	(57)	(57)
Amounts reclassified from accumulated other comprehensive income (loss)	—	13	13
Net current-period other comprehensive income (loss)	—	(44)	(44)
Balance at January 2, 2015	$7	$(39)	$(32)

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

	Actuarial Pension Gain	Unrealized Gain (Loss) on Foreign Exchange Contracts	Accumulated Other Comprehensive Income (Loss)
Balance at June 28, 2013	$11	$(46)	$(35)
Other comprehensive income (loss) before reclassifications	—	(11)	(11)
Amounts reclassified from accumulated other comprehensive income (loss)	—	(3)	(3)
Net current-period other comprehensive income (loss)	—	(14)	(14)
Balance at December 27, 2013	$11	$(60)	$(49)

3. Income per Common Share

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

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

	Three Months Ended		Six Months Ended	
	January 2, 2015	December 27, 2013	January 2, 2015	December 27, 2013
Net income	$438	$430	$861	$925
Weighted average shares outstanding:				
Basic	233	236	233	236
Employee stock options and other	5	7	6	7
Diluted	238	243	239	243
Income per common share:				
Basic	$1.88	$1.82	$3.70	$3.92
Diluted	$1.84	$1.77	$3.60	$3.81
Anti-dilutive potential common shares excluded*	1	2	2	1

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

4. Debt

On January 9, 2014, Western Digital Ireland, Ltd. ("WDI") used existing cash to repay the outstanding term loan balance of $1.8 billion under its previous credit agreement, dated March 8, 2012, and the Company, Western Digital Technologies, Inc. ("WDT") and WDI entered into a new credit agreement with JPMorgan Chase Bank, N.A., as administrative agent, and the lenders party thereto (the "Credit Agreement"). The Credit Agreement provides for $4.0 billion of unsecured loan facilities consisting of a $2.5 billion term loan facility to WDT and a $1.5 billion revolving credit facility to WDT and WDI (the "Borrowers"). The revolving credit facility includes a $100 million sublimit for letters of credit and a $50 million sublimit for swing line loans. Subject to certain conditions, a Borrower may elect to expand the credit facilities by, or obtain incremental term loans of, up to $1.0 billion if existing or new lenders provide additional term or revolving commitments. The loans under the Credit Agreement have a five-year term. The obligations of the Borrowers under the Credit Agreement are guaranteed by the Company and its material domestic subsidiaries, and the obligations of WDI under the Credit Agreement are also guaranteed by WDT.

As of January 2, 2015, no amounts were outstanding under the revolving credit facility and the term loan facility had an outstanding balance of $2.4 billion and a variable interest rate of 1.66%. The Company is required to make quarterly principal

payments on the term loan facility totaling $63 million for the remainder of fiscal 2015, $156 million in fiscal 2016, $219 million in fiscal 2017, $250 million in fiscal 2018 and the remaining balance of $1.7 billion in fiscal 2019.
The Credit Agreement requires the Company to comply with a leverage ratio and an interest coverage ratio calculated on a consolidated basis for the Company and its subsidiaries. In addition, the Credit Agreement contains customary covenants, including covenants that limit or restrict the Company's and its subsidiaries' ability to incur liens, incur indebtedness, make certain restricted payments, merge or consolidate and enter into certain speculative hedging arrangements, and customary events of default. As of January 2, 2015, the Company was in compliance with all covenants.

5. Legal Proceedings

When the Company becomes aware of a claim or potential claim, the Company assesses the likelihood of any loss or exposure. The Company discloses information regarding each material claim where the likelihood of a loss contingency is probable or reasonably possible. If a loss contingency is probable and the amount of the loss can be reasonably estimated, the Company records an accrual for the loss. In such cases, there may be an exposure to potential loss in excess of the amount accrued. Where a loss is not probable but is reasonably possible or where a loss in excess of the amount accrued is reasonably possible, the Company discloses an estimate of the amount of the loss or range of possible losses for the claim if a reasonable estimate can be made, unless the amount of such reasonably possible losses is not material to the Company's financial position, results of operations or cash flows. Unless otherwise stated below, for each of the matters described below, the Company has either recorded an accrual for losses that are probable and reasonably estimable or has determined that, while a loss is reasonably possible (including potential losses in excess of the amounts accrued by the Company), a reasonable estimate of the amount of loss or range of possible losses with respect to the claim or in excess of amounts already accrued by the Company cannot be made. The ability to predict the ultimate outcome of such matters involves judgments, estimates and inherent uncertainties. The actual outcome of such matters could differ materially from management's estimates.
Solely for purposes of this note, "WD" refers to Western Digital Corporation or one or more of its subsidiaries excluding HGST prior to the HGST Closing Date. HGST refers to Hitachi Global Storage Technologies Holdings Pte. Ltd. or one or more of its subsidiaries as of the HGST Closing Date, and "the Company" refers to Western Digital Corporation and all of its subsidiaries on a consolidated basis including HGST.

Intellectual Property Litigation

On June 20, 2008, plaintiff Convolve, Inc. ("Convolve") filed a complaint in the Eastern District of Texas against WD, HGST, and one other company alleging infringement of U.S. Patent Nos. 6,314,473 and 4,916,635. The complaint sought unspecified monetary damages and injunctive relief. On October 10, 2008, Convolve amended its complaint to allege infringement of only the '473 patent. The '473 patent allegedly relates to interface technology to select between certain modes of a disk drive's operations relating to speed and noise. A trial in the matter began on July 18, 2011 and concluded on July 26, 2011 with a verdict against WD and HGST in an amount that is not material to the Company's financial position, results of operations or cash flows, for which the Company previously recorded an accrual. WD and HGST have filed post-trial motions challenging the verdict. On January 17, 2014, the Court denied the Company's motion for judgment as a matter of law on invalidity. On May 20, 2014, the Court ordered supplemental briefing on post-trial motions related to infringement. Convolve and the Company filed their supplemental briefs on May 30, 2014 and June 6, 2014, respectively. Additional post-trial motions are pending, and the Company will evaluate its options for appeal after the Court rules on the remaining post-trial motions. The Company intends to continue to defend itself vigorously in this matter.
On August 1, 2011, plaintiff Guzik Technical Enterprises ("Guzik") filed a complaint in the Northern District of California against WD and various of its subsidiaries alleging infringement of U.S. Patent Nos. 6,023,145 and 6,785,085, breach of contract and misappropriation of trade secrets. The complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The patents asserted by Guzik allegedly relate to devices used to test hard disk drive heads and media. On November 30, 2013, WD entered into a settlement agreement for an amount that is not material to the Company's financial position, results of operations or cash flows, for which the Company recorded an accrual. Guzik is disputing the enforceability of the agreement and on December 27, 2013, WD filed a motion to enforce the agreement. The Court heard oral argument on WD's motion on January 23, 2014. The Court

granted WD’s motion to enforce the settlement agreement on March 21, 2014. On April 14, 2014, Guzik filed a Notice of Appeal to the Federal Circuit. On June 17, 2014, Guzik filed its opening appellate brief. WD filed its appellate brief on August 14, 2014. On September 11, 2014, Guzik filed its reply brief in support of its opening appellate brief. On January 7, 2015, the Federal Circuit heard oral argument on Guzik’ s appeal and on January 9, 2015, the Federal Circuit affirmed the Court’s decision granting WD’s motion to enforce the settlement agreement. WD intends to continue to defend itself vigorously in this matter.

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

On October 20, 2014, plaintiff SOTA Semiconductor LLC ("SOTA") filed a complaint in the Central District of California against the Company, Marvell Semiconductor, Inc., Belkin International, Inc., Dell Inc., Hewlett-Packard Company, Hisense USA Corp., Konica Minolta Business Solutions U.S.A., Inc., Lenovo (United States) Inc., Netgear, Inc., Samsung Electronics America, Inc., and Seagate Technology LLC, alleging infringement of U.S. Patent No. 5,991,545 ("'545 patent"). SOTA alleges that the Company's devices that incorporate Marvell Thumb Processors, including WD's My Cloud EX2 network attached storage devices, which include model numbers WDBVKW0080JCH, WDBVKW0060JCH, WDBVKW0040JCH and WDBVKW0000NCH, infringe the '545 patent. The complaint seeks unspecified monetary damages, interests, fees, costs and expenses. On December 12, 2014, the Company filed an answer and counterclaims to SOTA's complaint. The Company intends to defend itself vigorously in this matter.

Seagate Matter

On October 4, 2006, plaintiff Seagate Technology LLC ("Seagate") filed an action in the District Court of Hennepin County, Minnesota, naming as defendants WD and one of its now former employees previously employed by Seagate. The complaint in the action alleged claims based on misappropriation of trade secrets and sought injunctive relief and unspecified monetary damages, interest, fees and costs. On June 19, 2007, WD's former employee filed a demand for arbitration with the American Arbitration Association.

On January 23, 2012, the arbitrator issued a total final award, including pre-award interest of $630.4 million. On January 23, 2012, WD filed a petition in the District Court of Hennepin County, Minnesota to have the final arbitration award vacated, and, on October 12, 2012, the District Court of Hennepin County, Minnesota vacated, in full, the $630.4 million final arbitration award, ordering that a rehearing be held concerning the alleged trade secret claims before a new arbitrator.

Seagate appealed the District Court decision to the Minnesota Court of Appeals. On July 22, 2013, the Minnesota Court of Appeals reversed the District Court's decision and remanded for entry of an order and judgment confirming the arbitration award. On August 20, 2013, the Company filed a petition for review with the Minnesota Supreme Court and, on October 15, 2013, the Minnesota Supreme Court granted the Company's petition. On October 8, 2014, the Minnesota Supreme Court affirmed the decision of the Minnesota Court of Appeals. Because the Minnesota Supreme Court's decision is not subject to appeal, on October 14, 2014, the Company paid Seagate $773.4 million to satisfy the full amount of the final arbitration award plus interest accrued through October 13, 2014. This amount was paid during the quarter ended January 2, 2015 by one of the Company's foreign subsidiaries using cash held outside of the United States.

Seagate disputes the method the Company used for calculating post-award interest and contends that the Company owes Seagate approximately $28.9 million in additional interest. The Company denies Seagate's contention and believes it calculated interest properly in accordance with the arbitration award. On November 12, 2014, the Company filed a motion with the District Court seeking an order declaring that WD has paid to Seagate all amounts due under the arbitration award, including all pre-award and post-award interest, and all costs and disbursements assessed by the Minnesota Court of Appeals and the Minnesota Supreme Court. On December 23, 2014, Seagate filed a cross-motion seeking entry of judgment in the amount of $28.9 million, plus daily interest from October 15, 2014 until the date any judgment is paid. Both parties’ motions were fully briefed and, on January 9, 2015, the Court heard oral argument on both motions. The Court has not yet ruled on the matter.

Other Matters

On December 22, 2011, the German Central Organization for Private Copying Rights (Zentralstelle für private Überspielungsrechte), (“ZPÜ”), an organization consisting of several levy collecting societies, instituted arbitration proceedings against Western Digital's German subsidiary ("WD Germany") before to the Copyright Arbitration Board (“CAB”) claiming copyright levies for multimedia hard drives, external hard drives and network hard drives sold or introduced into commerce in Germany from January 2008 through December 2010. The CAB, which was required to issue a settlement proposal within one year

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of the initiation of the action, failed to do so and requested the parties consent to continue the deadline. WD Germany declined to provide consent and, on February 1, 2013, WD Germany filed a declaratory relief action against ZPÜ in the Higher Regional Court of Munich (the "Higher Court"), seeking an order from the court to determine the copyright levy issue. On May 21, 2013, ZPÜ filed a counter-claim against WD Germany with the Higher Court, seeking copyright levies for multimedia hard drives, external hard drives and network hard drives (collectively, "Covered Products") sold or introduced into commerce from January 2008 through December 2010 based on tariffs published by ZPÜ on November 3, 2011. On May 22, 2014, oral argument on the pleadings occurred. On January 15, 2015, the Higher Court ruled in favor of ZPÜ. In its ruling, the Higher Court declared that WD Germany must pay certain levies on certain WD products which it sold in Germany between January 1, 2008 and December 31, 2010. The judgment specifies levy amounts on certain WD products sold from 2008 to 2010 and directs WD Germany to provide applicable sales data to the ZPÜ. The exact amount of the judgment has not been determined. WD Germany intends to appeal this decision to the German Federal Court of Justice and defend itself vigorously in this matter.

On December 11, 2014, ZPÜ submitted a pleading to the CAB seeking copyright levies for Covered Products sold by WD or introduced into commerce in Germany from January 1, 2012 to December 31, 2013. WD Germany intends to defend itself vigorously in this matter.

In the three months ended January 2, 2015, the Company recorded an accrual for German copyright levies in an amount that is not material to the Company's financial position, results of operations or cash flows. It is reasonably possible that the Company may incur losses totaling up to $90 million, including the amount accrued.

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

6. Income Taxes

The Company's income tax provision for the three and six months ended January 2, 2015 was $20 million and $57 million, respectively, as compared to $37 million and $74 million in the respective prior-year periods. The Company's tax provision for both the three and six months ended January 2, 2015 reflects a tax benefit of $16 million as a result of the retroactive extension of the U.S. Federal R&D tax credit that was signed into law on December 19, 2014. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia, the Philippines, Singapore and Thailand that expire at various dates from 2015 through 2025 and the current year generation of income tax credits.

In the three months ended January 2, 2015, the Company recorded a net increase of $9 million in its liability for unrecognized tax benefits. In the six months ended January 2, 2015, the Company recorded a net increase of $16 million in its liability for unrecognized tax benefits. As of January 2, 2015, the Company's liability for unrecognized tax benefits was approximately $316 million. Interest and penalties recognized on such amounts were not material to the condensed consolidated financial statements during the three months and six months ended January 2, 2015.

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

The Company believes that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company’s tax audits are resolved in a manner not consistent with management’s expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs. As of January 2, 2015, it was not possible to estimate the amount of change, if any, in the unrecognized tax benefits that is reasonably possible within the next twelve months. Any significant change in the

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amount of the Company's liability for unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of the Company's tax returns.

7. Fair Value Measurements

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

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

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

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

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of January 2, 2015, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

	Fair Value Measurements at Reporting Date Using			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents:				
Money market funds	$1,677	$—	$—	$1,677
U.S. Government agency securities	—	15	—	15
Commercial paper	—	20	—	20
Total cash equivalents	1,677	35	—	1,712
Short-term investments:				
U.S. Government agency securities	—	61	—	61
Commercial paper	—	154	—	154
Certificates of deposit	—	26	—	26
Total short-term investments	—	241	—	241
Long-term investments:				
U.S. Treasury securities	—	159	—	159
U.S. Government agency securities	—	65	—	65
Total long-term investments	—	224	—	224
Total assets at fair value	$1,677	$500	$—	$2,177
Liabilities:				
Foreign exchange contracts	$—	$45	$—	$45
Total liabilities at fair value	$—	$45	$—	$45

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The following table presents information about the Company’s financial assets and liabilities that are measured at fair value on a recurring basis as of June 27, 2014, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

	Fair Value Measurements at Reporting Date Using			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents:				
Money market funds	$756	$—	$—	$756
Bank acceptances	—	1	—	1
Total cash equivalents	756	1	—	757
Short-term investments:				
U.S. Government agency securities	—	53	—	53
Commercial paper	—	165	—	165
Certificates of deposit	—	66	—	66
Total short-term investments	—	284	—	284
Long-term investments:				
U.S. Treasury securities	—	180	—	180
U.S. Government agency securities	—	35	—	35
Total long-term investments	—	215	—	215
Foreign exchange contracts	—	7	—	7
Total assets at fair value	$756	$507	$—	$1,263
Liabilities:				
Foreign exchange contracts	$—	$2	$—	$2
Total liabilities at fair value	$—	$2	$—	$2

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

Certificates of Deposit. The Company’s certificates of deposit are investments which are held in custody by a third party and recorded within short-term investments in the condensed consolidated balance sheets. Certificates of deposit are valued using fixed interest rates.

Commercial Paper. The Company’s commercial paper securities are investment grade debt issued by corporations which are held in custody by a third party with original maturities of twelve months or less and are recorded within cash and cash equivalents or short-term investments in the condensed consolidated balance sheets depending on their original maturities. Commercial paper securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

U.S. Government Agency Securities. The Company’s U.S. Government agency securities are investments in fixed income securities sponsored by the U.S. Government and are held in custody by a third party and recorded within cash and cash equivalents, short-term investments or other non-current assets in the condensed consolidated balance sheets depending on their original maturities. U.S. Government agency securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

U.S. Treasury Securities. The Company’s U.S. Treasury securities are direct obligations of the U.S. federal government, are held in custody by a third party and are recorded within other non-current assets in the condensed consolidated balance sheets. U.S. Treasury securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

Bank Acceptances. The Company’s bank acceptances are held in custody by a third party and recorded within cash and cash equivalents in the condensed consolidated balance sheets. Bank acceptances are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

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

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

8. Foreign Exchange Contracts

Although the majority of the Company’s transactions are in U.S. dollars, some transactions are based in various foreign currencies. The Company purchases short-term, foreign exchange contracts to hedge the impact of foreign currency exchange fluctuations on certain underlying assets, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedging transactions is to minimize the impact of foreign currency fluctuations on the Company’s results of operations. These contract maturity dates do not exceed 12 months. All foreign exchange contracts are for risk management purposes only. The Company does not purchase foreign exchange contracts for trading purposes. As of January 2, 2015, the Company had outstanding foreign exchange contracts with commercial banks for British Pound Sterling, Euro, Japanese Yen, Malaysian Ringgit, Philippine Peso, Singapore Dollar and Thai Baht, which were designated as either cash flow or fair value hedges.

If the derivative is designated as a cash flow hedge, the effective portion of the change in fair value of the derivative is initially deferred in other comprehensive income (loss), net of tax. These amounts are subsequently recognized into earnings when the underlying cash flow being hedged is recognized into earnings. Recognized gains and losses on foreign exchange contracts entered into for manufacturing-related activities are reported in cost of revenue and presented within cash flow from operations. Hedge effectiveness is measured by comparing the hedging instrument’s cumulative change in fair value from inception to maturity to the underlying exposure’s terminal value. The Company determined the ineffectiveness associated with its cash flow hedges to be immaterial to the condensed consolidated financial statements for the three and six months ended January 2, 2015 and December 27, 2013.

A change in the fair value of fair value hedges is recognized in earnings in the period incurred and is reported as a component of operating expenses. All fair value hedges were determined to be effective as of January 2, 2015 and June 27, 2014. The changes in fair value on these contracts were immaterial to the condensed consolidated financial statements during the three and six months ended January 2, 2015 and December 27, 2013.

As of January 2, 2015, the net amount of unrealized losses with respect to the Company’s foreign exchange contracts that is expected to be reclassified into earnings within the next 12 months was $39 million. In addition, as of January 2, 2015, the Company did not have any foreign exchange contracts with credit-risk-related contingent features. The Company opened $1.0 billion and $2.0 billion, and closed $1.1 billion and $2.1 billion, in foreign exchange contracts in the three and six months ended January 2, 2015, respectively. In addition, the Company opened $1.7 billion and $2.7 billion and closed $1.3 billion and $2.7 billion, in foreign exchange contracts in the three and six months ended December 27, 2013, respectively. The fair value and balance sheet location of the Company's foreign exchange contracts as of January 2, 2015 and June 27, 2014 were as follows (in millions):

	Asset Derivatives				Liability Derivatives			
	January 2, 2015		June 27, 2014		January 2, 2015		June 27, 2014	
Derivatives Designated as Hedging Instruments	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Foreign exchange contracts	Other current assets	$—	Other current assets	$7	Accrued expenses	$45	Accrued expenses	$2

The following table presents the gross amounts of the Company's derivative instruments, amounts offset due to master netting arrangements with the Company's various counterparties, and the net amounts recognized in the condensed consolidated balance sheet as of January 2, 2015 (in millions):

Derivatives Designated as Hedging Instruments	Gross Amounts of	Gross Amounts	Net Amounts of Assets

	Recognized Assets (Liabilities)	Offset in the Balance Sheet	(Liabilities) Presented in the Balance Sheet
Foreign exchange contracts			
Financial assets	$1	$(1)	$—
Financial liabilities	(46)	1	(45)
Total derivative instruments	$(45)	$—	$(45)

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The following table presents the gross amounts of the Company's derivative instruments, amounts offset due to master netting arrangements with the Company's various counterparties, and the net amounts recognized in the condensed consolidated balance sheet as of June 27, 2014 (in millions):

Derivatives Designated as Hedging Instruments	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets (Liabilities) Presented in the Balance Sheet
Foreign exchange contracts			
Financial assets	$9	$(2)	$7
Financial liabilities	(4)	2	(2)
Total derivative instruments	$5	$—	$5

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

Derivatives in Cash Flow Hedging Relationships	Amount of Loss Recognized in Accumulated OCI on Derivatives: Three Months Ended January 2, 2015	Six Months Ended January 2, 2015	Three Months Ended December 27, 2013	Six Months Ended December 27, 2013	Location of (Gain) Loss Reclassified from Accumulated OCI into Income	Amount of (Gain) Loss Reclassified From Accumulated OCI into Income: Three Months Ended January 2, 2015	Six Months Ended January 2, 2015	Three Months Ended December 27, 2013	Six Months Ended December 27, 2013
Foreign exchange contracts	$(35)	$(57)	$—	$(11)	Cost of revenue	$(17)	$(13)	$30	$3

The total net realized transaction and foreign exchange contract currency gains and losses were not material to the condensed consolidated financial statements during the three and six months ended January 2, 2015 and December 27, 2013.

9. Stock-Based Compensation

Stock-Based Compensation Expense

During the three and six months ended January 2, 2015, the Company recognized in expense $18 million and $37 million, respectively, for stock-based compensation related to the vesting of options issued under the Company’s stock plans and the ESPP, as compared to $24 million and $45 million in the respective prior-year periods. The tax benefit realized as a result of the aforementioned stock-based compensation expense was $7 million and $12 million in the three and six months ended January 2, 2015, respectively, as compared to $6 million and $11 million in the three and six months ended December 27, 2013, respectively. As of January 2, 2015, total compensation cost related to unvested stock options and ESPP rights issued to employees but not yet recognized was $129 million and will be amortized on a straight-line basis over a weighted average service period of approximately 2.2 years.

During the three and six months ended January 2, 2015, the Company recognized in expense $23 million and $43 million, respectively, for stock-based compensation related to the vesting of awards of RSUs issued under the Company's stock plans, as compared to $18 million and $39 million in the respective prior-year periods. The tax benefit realized as a result of the aforementioned stock-based compensation expense was $6 million and $11 million in the three and six months ended January 2, 2015, respectively, as compared to $5 million and $9 million in the three and six months ended December 27, 2013, respectively. As of January 2, 2015, the aggregate unamortized fair value of all unvested RSUs was $157 million, which will be recognized on a straight-line basis over a weighted average vesting period of approximately 1.7 years. RSUs include performance stock unit awards (“PSUs”). The effect of PSUs was immaterial to the condensed consolidated financial statements in the three and six months ended January 2, 2015 and December 27, 2013.

During the three and six months ended January 2, 2015, the Company recognized in expense $8 million and $12 million, respectively, related to adjustments to market value as well as the vesting of stock appreciation rights (“SARs”), as compared to $20 million and $24 million in the respective prior-year periods. The tax benefit realized as a result of the aforementioned SARs expense was $2 million and $3 million in the three and six months ended January 2, 2015, respectively, as compared to $4 million and $5 million in the three and six months ended December 27, 2013, respectively. The SARs will be settled in cash upon exercise. As a result, the Company had a total liability of $63 million related to SARs included in accrued expenses in the condensed consolidated balance sheet as of January 2, 2015. As of January 2, 2015, total compensation cost related to unvested SARs issued to employees but not yet recognized was not material to the Company's consolidated statement of income.

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Stock Option Activity

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

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Options outstanding at June 27, 2014	10.1	$37.03		
Granted	1.2	100.06		
Exercised	(1.3)	31.04		