WESTERN DIGITAL CORP
Form 10-Q
January 29, 2010

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

(Mark One)

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

For the quarterly period ended January 1, 2010

Or

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

For the transition period from to

Commission file number 1-8703
WESTERN DIGITAL CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**33-0956711**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

20511 Lake Forest Drive Lake Forest, California	**92630**
(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 þ No o

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

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

As of the close of business on January 22, 2010, 228,641,577 shares of common stock, par value $.01 per share, were outstanding.

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Our fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every five years, we report a 53-week fiscal year to align our fiscal year with the foregoing policy. The additional week is typically included in our fourth fiscal quarter results. Fiscal year 2009 and our fourth fiscal quarter of 2009 were comprised of 53 weeks and 14 weeks, respectively, and ended on July 3, 2009. Our fiscal second quarters ended January 1, 2010 and December 26, 2008 both consisted of 13 weeks. Fiscal year 2010 will be comprised of 52 weeks and will end on July 2, 2010. 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 and WD refer to Western Digital Corporation and its subsidiaries.

We are a Delaware corporation that operates as the parent company of our hard drive business, Western Digital Technologies, Inc., which was formed in 1970.

Our principal executive offices are located at 20511 Lake Forest Drive, Lake Forest, California 92630. Our telephone number is (949) 672-7000 and our Web site is http://www.westerndigital.com. The information on our Web site is not incorporated in this Quarterly Report on Form 10-Q.

Western Digital, WD, the WD logo, WD Caviar Black, WD VelociRaptor, WD Scorpio Blue, WD GreenPower Technology are trademarks of Western Digital Technologies, Inc. and/or its affiliates. All other trademarks mentioned are the property of their respective owners.

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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)

	Jan. 1, 2010	Jul. 3, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,435	$ 1,794
Accounts receivable, net	1,365	926
Inventories	453	376
Other current assets	163	134
Total current assets	4,416	3,230
Property and equipment, net	1,696	1,584
Goodwill	139	139
Other intangible assets, net	83	89
Other non-current assets	251	249
Total assets	$ 6,585	$ 5,291
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,507	$ 1,101
Accrued expenses	288	247
Accrued warranty	118	95
Current portion of long-term debt	94	82
Total current liabilities	2,007	1,525
Long-term debt	350	400
Other liabilities	237	174
Total liabilities	2,594	2,099
Commitments and contingencies (Notes 4 and 6)		
Shareholders equity:		
Preferred stock, $.01 par value; authorized 5 shares; outstanding none		
Common stock, $.01 par value; authorized 450 shares; outstanding 228 and 225 shares, respectively	2	2
Additional paid-in capital	976	896
Accumulated other comprehensive income	4	2
Retained earnings	3,009	2,292
Total shareholders equity	3,991	3,192
Total liabilities and shareholders equity	$ 6,585	$ 5,291

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	
	Jan. 1, 2010	Dec. 26, 2008	Jan. 1, 2010	Dec. 26, 2008
Revenue, net	$ 2,619	$ 1,823	$ 4,827	$ 3,933
Cost of revenue	1,932	1,533	3,626	3,219
Gross margin	687	290	1,201	714
Operating expenses:				
Research and development	154	119	296	252
Selling, general and administrative	60	42	113	99
Restructuring		113		113
Total operating expenses	214	274	409	464
Operating income	473	16	792	250
Other income (expense):				
Interest income	1	2	2	6
Interest and other expense	(3)	(11)	(6)	(19)
Total other expense, net	(2)	(9)	(4)	(13)
Income before income taxes	471	7	788	237
Income tax provision (benefit)	42	(7)	71	12
Net income	$ 429	$ 14	$ 717	$ 225
Income per common share:				
Basic	$ 1.89	$ 0.06	$ 3.17	$ 1.01
Diluted	$ 1.85	$ 0.06	$ 3.10	$ 1.00
Weighted average shares outstanding:				
Basic	227	222	226	222
Diluted	232	224	231	225

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	
	Jan. 1, 2010	**Dec. 26, 2008**
Cash flows from operating activities		
Net income	$ 717	$ 225
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	247	239
Stock-based compensation	27	21
Deferred income taxes	(5)	(7)
Loss on investments		9
Non-cash portion of restructuring		80
Changes in:		
Accounts receivable, net	(439)	84
Inventories	(77)	10
Accounts payable	428	(63)
Accrued expenses	57	11
Other assets and liabilities	36	(8)
Net cash provided by operating activities	991	601
Cash flows from investing activities		
Purchases of property and equipment	(375)	(302)
Sales and maturities of investments	3	1
Net cash used in investing activities	(372)	(301)
Cash flows from financing activities		
Issuance of stock under employee stock plans	47	12
Taxes paid on vested stock awards under employee stock plans	(7)	(3)
Increase in excess tax benefits from employee stock plans	20	4
Repurchases of common stock		(36)
Repayment of debt	(38)	(5)
Net cash provided by (used in) financing activities	22	(28)
Net increase in cash and cash equivalents	641	272
Cash and cash equivalents, beginning of period	1,794	1,104
Cash and cash equivalents, end of period	$ 2,435	$ 1,376

Supplemental disclosure of cash flow information:

Cash paid for income taxes	$	2	$	7
Cash paid for interest	$	2	$	4

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 Note 1 of the Notes to Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended July 3, 2009. 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 (U.S. GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended July 3, 2009. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year.

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

2. Supplemental Financial Statement Data

Inventories

	Jan. 1, 2010	Jul. 3, 2009
	(in millions)	
Raw materials and component parts	**$ 102**	$ 97
Work-in-process	**212**	154
Finished goods	**139**	125
Total inventories	**$ 453**	$ 376

Warranty

The Company records an accrual for estimated warranty costs when revenue is recognized. The Company generally warrants its products for a period of one to five years. The warranty provision considers estimated product failure rates and trends, estimated repair or replacement costs and estimated costs for customer compensatory claims related to product quality issues, if any. A statistical warranty tracking model is used to help with estimates and assists the Company in exercising judgment in determining the underlying estimates. The statistical tracking model captures specific detail on hard drive reliability, such as factory test data, historical field return rates, and costs to repair by product type. If actual product return trends, costs to repair returned products or costs of customer compensatory claims differ significantly from estimates, future results of operations could be materially affected. 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 margin and income. Such changes are generally a result of differences between forecasted and actual return rate experience and costs to repair. Changes in the warranty accrual for the three and six months ended January 1, 2010 and December 26, 2008 were as follows (in millions):

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	Jan. 1, 2010	**Dec. 26, 2008**	**Jan. 1, 2010**	**Dec. 26, 2008**
Warranty accrual, beginning of period	**$ 132**	$ 119	**$ 123**	$ 114
Charges to operations	**50**	30	**89**	61
Utilization	**(32)**	(26)	**(62)**	(48)
Changes in estimate related to pre-existing warranties	**5**	(2)	**5**	(6)
Warranty accrual, end of period	**$ 155**	$ 121	**$ 155**	$ 121

Accrued warranty also includes amounts classified in non-current other liabilities of $37 million at January 1, 2010 and $28 million at July 3, 2009.

Subsequent Events

The Company evaluated subsequent events through January 29, 2010, the date these financial statements were issued, and there were no material subsequent events that required recognition or disclosure in these financial statements.

3. Income per Common Share

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

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

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	Jan. 1, 2010	**Dec. 26, 2008**	**Jan. 1, 2010**	**Dec. 26, 2008**
Net income	**$ 429**	$ 14	**$ 717**	$ 225
Weighted average shares outstanding:				
Basic	**227**	222	**226**	222
Employee stock options and other	**5**	2	**5**	3
Diluted	**232**	224	**231**	225
Income per common share:				
Basic	**$ 1.89**	$ 0.06	**$ 3.17**	$ 1.01
Diluted	**$ 1.85**	$ 0.06	**$ 3.10**	$ 1.00
Anti-dilutive potential common shares excluded*	**1**	5	**1**	4

*

For purposes of computing diluted income per common share, common share equivalents with an exercise price that exceeded the average fair market value of common stock for the period are considered anti-dilutive and have been excluded from the calculation.

4. Debt

In February 2008, Western Digital Technologies, Inc. (WDTI), a wholly-owned subsidiary of the Company, entered into a five-year Credit Agreement (Credit Facility) that provides for a $750 million unsecured loan consisting of a $500 million term loan facility and a $250 million revolving credit facility. The revolving credit facility includes borrowing capacity available for letters of credit and for short-term borrowings referred to as swingline. In addition, WDTI may elect to expand the Credit Facility by up to $250 million if existing or new lenders provide additional term or revolving commitments. The $500 million term loan had a variable interest rate of 1.50% as of January 1, 2010 and requires sixteen quarterly principal payments, which began in June 2009, of

approximately $19 million, $25 million, $31 million and $50 million per quarter for each four-quarter increment. As of January 1, 2010, WDTI had $250 million available for future borrowings on the revolving credit facility and was in compliance with all covenants.

5. Stock-Based Compensation

During the three and six months ended January 1, 2010, the Company charged to expense $9 million and $17 million, respectively, for stock-based compensation related to options issued under stock option plans and the ESPP, compared to $5 million and $10 million in the comparative prior-year periods. At January 1, 2010, total compensation cost related to unvested stock options and ESPP rights issued to employees but not yet recognized was $67 million and will be amortized on a straight-line basis over a weighted average service period of approximately 2.39 years.

The Company granted approximately 0.6 million restricted stock units during the six months ended January 1, 2010, which are payable in an equal number of shares of the Company s common stock at the time of vesting of the units. The aggregate market value of the shares underlying the restricted stock unit awards was $20 million at the date of grant. As of January 1, 2010, the aggregate unamortized fair value of all restricted stock unit awards was $41 million and will be recognized on a straight-line basis over a weighted average vesting period of approximately 1.7 years. For the three and six months ended January 1, 2010, the Company recognized approximately $4 million and $10 million, respectively, in expense related to restricted stock unit awards that vested during the period, compared to $6 million and $11 million in the comparative prior-year periods.

Stock Option Activity

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

	Number of Shares	Weighted Average Exercise Price Per Share	Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Options outstanding at July 3, 2009	11.3	$ 17.00		
Granted	1.2	35.68		
Exercised	(1.0)	15.29		
Canceled or expired				
Options outstanding at October 2, 2009	11.5	$ 19.17		
Granted	0.2	38.40		
Exercised	(1.3)	13.80		
Canceled or expired	(0.1)	22.76		
Options outstanding at January 1, 2010	10.3	$ 20.08	5.32	$ 247
Exercisable at January 1, 2010	4.1	$ 14.05	4.29	$ 125

The aggregate intrinsic value is calculated based on 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 below the quoted price on the date the intrinsic value is determined. As of January 1, 2010, the Company had options outstanding to purchase an aggregate of 10.3 million shares with an exercise price below the quoted price of the Company s stock on that date resulting in an aggregate intrinsic value of $247 million. During the three and six months ended January 1, 2010, the aggregate intrinsic value of options exercised under the Company s stock option plans was $33 million and $50 million, respectively, determined as of the date of exercise, compared to $0.3 million and

$1.6 million in the comparative prior-year periods.

Fair Value Disclosures Stock Options and ESPP

The fair value of stock options granted during the three and six months ended January 1, 2010 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

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grant. The fair value of stock options granted during the three and six months ended January 1, 2010 and December 26, 2008 was estimated using the following weighted average assumptions:

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	Jan. 1, 2010	**Dec. 26, 2008**	**Jan. 1, 2010**	**Dec. 26, 2008**
Suboptimal exercise factor	**1.77**	1.73	**1.73**	1.73
Range of risk-free interest rates	**0.47% to 3.39%**	0.38% to 1.80%	**0.37% to 3.39%**	0.38% to 3.44%
Range of expected stock price volatility	**0.51 to 0.63**	0.49 to 0.71	**0.51 to 0.72**	0.43 to 0.71
Weighted average expected volatility	**0.54**	0.56	**0.57**	0.49
Post-vesting termination rate	**3.81%**	4.15%	**3.60%**	4.39%
Dividend yield				
Fair value	**$17.26**	$ 7.01	**$17.10**	$ 9.62

The weighted average expected term of the Company s stock options for the three and six months ended January 1, 2010 was 4.73 years and 4.60 years, respectively, compared to 4.79 years and 5.49 years in the comparative prior-year periods.

The fair value of ESPP purchase rights issued is estimated at the date of grant of the purchase rights using the Black-Scholes-Merton option-pricing model. The Black-Scholes-Merton option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. The Black-Scholes-Merton option-pricing model requires the input of highly subjective assumptions such as the expected stock price volatility and the expected period until options are exercised. Purchase rights under the current ESPP provisions are granted on either June 1 or December 1. ESPP activity was immaterial to the condensed consolidated financial statements for the three and six months ended January 1, 2010 and December 26, 2008.

6. Legal Proceedings

The Company discloses material loss contingencies deemed to be reasonably possible and accrues for loss contingencies when, in consultation with the Company s legal advisors, the Company concludes that a loss is probable and reasonably estimable. The ability to predict the ultimate outcome of such matters involves judgments, estimates and inherent uncertainties. The actual outcome of such matters could differ materially from management s estimates.

Intellectual Property Litigation

On June 20, 2008, plaintiff Convolve, Inc. (Convolve) filed a complaint in the Eastern District of Texas against the Company and two other companies alleging infringement of U.S. Patent Nos. 6,314,473 and 4,916,635. Plaintiff is seeking unspecified monetary damages and injunctive relief. On October 10, 2008, Convolve amended its complaint to allege infringement of only the 473 patent. The 473 patent allegedly relates to interface technology to select between certain modes of a disk drive s operations relating to speed and noise. The Company intends to defend itself vigorously in this matter.

On December 8, 2008, plaintiffs MagSil Corporation and the Massachusetts Institute of Technology filed a complaint in the District of Delaware against the Company and seven other companies in the disk drive industry alleging infringement of U.S. Patent Nos. 5,629,922 and 5,835,314. Plaintiffs are seeking unspecified monetary damages and injunctive relief. The asserted patents allegedly relate to tunneling magnetoresistive technology. The Company intends to defend itself vigorously in this matter.

On April 7, 2009, plaintiff Gregory Bender filed a complaint in the Northern District of California against the Company and Seagate Technology LLC alleging infringement of U.S. Patent No. 5,103,188. Plaintiff is seeking unspecified monetary damages. The asserted patent allegedly relates to buffered transconductance amplifier technology. The Company intends to defend itself vigorously in this matter.

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On July 15, 2009, plaintiffs Carl B. Collins and Farzin Davanloo filed a complaint in the Eastern District of Texas against the Company and ten other companies alleging infringement of U.S. Patent Nos. 5,411,797 and 5,478,650. Plaintiffs are seeking injunctive relief and unspecified monetary damages, fees, and costs. The asserted patents allegedly relate to nanophase diamond films. The Company intends to defend itself vigorously in this matter.

On December 7, 2009, plaintiff Nazomi Communications filed a complaint in the Eastern District of Texas against the Company and seven other companies alleging infringement of U.S. Patent Nos. 7,080,362 and 7,225,436. Plaintiffs are seeking injunctive relief and unspecified monetary damages, fees, and costs. The asserted patents allegedly relate to processor cores capable of Java hardware acceleration. The Company intends to defend itself vigorously in this matter.

On January 5, 2010, plaintiff Enova Technology Corporation filed a complaint in the District of Delaware against the Company and Initio Corporation alleging infringement of U.S. Patent Nos. 7,136,995 and 7,386,734. Plaintiffs are seeking injunctive relief and unspecified monetary damages, fees, and costs. The asserted patents allegedly relate to real time full disk encryption application specific integrated circuits, or ASICs. The Company intends to defend itself vigorously in this matter.

Employment Litigation

On March 20, 2009, plaintiff Ghazala H. Durrani, a former employee of the Company, filed a putative class action complaint in the Alameda County (California) Superior Court. The complaint alleges that certain of the Company s engineers have been misclassified as exempt employees under California state law and are, therefore, due unpaid hourly overtime wages and other amounts, as well as penalties for allegedly missed meal and rest periods. By court order dated April 24, 2009, the case was transferred to the Orange County (California) Superior Court, where it is now pending. On or about June 16, 2009, the Company was dismissed from the case without prejudice by stipulation, leaving WDTI as the sole remaining defendant. On or about June 4, 2009, WDTI filed its Answer to the complaint, denying the substantive allegations thereof and raising several affirmative defenses. The case is in the preliminary stages, with no formal discovery having occurred. A court hearing on whether the case should be certified as a class action will likely not occur until mid 2010 at the earliest. If the Company is unsuccessful in its defense of this matter, potential liability could include unpaid wages, interest, penalties, attorneys fees and costs. The Company intends to defend itself vigorously in this matter.

Other Matters

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

7. Income Taxes

The Company s income tax provision for the three months ended January 1, 2010 was $42 million compared to a benefit of $7 million in the prior-year period. The Company s income tax provision for the six months ended January 1, 2010 was $71 million as compared to $12 million in the prior-year period. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia and Thailand that expire at various dates through 2022 and the current year generation of income tax credits.

In the three months ended January 1, 2010, the Company recognized an increase of $26 million in liability for unrecognized tax benefits. As of January 1, 2010, the Company had approximately $178 million of unrecognized tax benefits. Interest and penalties recognized on such amounts were not material.

The United States Internal Revenue Service (the IRS) is currently examining fiscal years ended 2006 and 2007 for the Company and calendar years 2005 and 2006 for Komag, Incorporated, which was acquired by the Company on September 5, 2007. In the three months ended January 1, 2010, the local tax authorities completed, with no material adjustment, their examination of the Company s French subsidiary for fiscal years 2003 through 2005.

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Due to the risk that audit outcomes and the timing of audit settlements are subject to significant uncertainty, the Company s current estimate of the total amounts of unrecognized tax benefits could increase or decrease for all open tax years. As of January 1, 2010, it is not possible to estimate the amount of change, if any, in the unrecognized tax benefits that is reasonably possible within the next twelve months. Any significant change in the amount of the Company s unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of the Company s uncertain tax positions.

8. 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 categories:

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 1, 2010, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

	Fair Value Measurements at Reporting Date Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets				
Money market funds	$1,076	$	$	$1,076
U.S. Treasury securities		172		172
U.S. Government agency securities		221	1	222
Auction-rate securities			15	15
Foreign exchange contracts		7		7
Total assets at fair value	$1,076	$ 400	$ 16	$1,492

Money Market Funds. The Company s money market funds are AAA rated institutional money market funds that are invested in U.S. Treasury securities and are recorded within cash and cash equivalents in the condensed consolidated balance sheet. Money market funds are valued based on quoted market prices.

U.S. Treasury Securities. The Company s U.S. Treasury securities are investments in Treasury bills with original maturities of three months or less and are recorded within cash and cash equivalents in the condensed consolidated balance sheet. U.S. Treasury securities are valued based on broker quotations using observable inputs.

U.S. Government Agency Securities. The Company s U.S. Government agency securities are fixed income securities sponsored by the U.S. Government of which $221 million have original maturities of three months or less and are recorded within cash and cash equivalents and $1 million are classified as available-for-sale securities and are recorded within other current assets in the condensed consolidated balance sheet. U.S. Government agency securities

classified within Level 2 are valued based on broker quotations using observable inputs. U.S. Government agency securities classified as Level 3 are valued using a third party pricing service.

Auction-Rate Securities. The Company s auction-rate securities are primarily backed by insurance products and are expected to be held until secondary markets become available. As a result, they are classified as long-term investments. These investments are currently accounted for as available-for-sale securities and recorded within other non-current assets in the condensed consolidated balance sheet. Auction-rate securities are valued using a third party pricing service.

Foreign Exchange Contracts. The Company s foreign exchange contracts are short-term contracts to hedge the Company s foreign currency risk related to the Thai Baht, Malaysian Ringgit, Euro and British Pound Sterling. Foreign exchange contracts are classified within other current assets in the condensed consolidated balance sheet. Foreign exchange contracts are valued based on the present value of future cash flows using market-based observable inputs, including forward rates and credit default swap rates.

The following table presents the changes in Level 3 instruments measured on a recurring basis for the three months ended January 1, 2010 (in millions):

	U.S. Government agency securities	Auction-rate securities	Total
October 2, 2009	$ 1	$ 18	$ 19
Sales		(3)	(3)
January 1, 2010	$ 1	$ 15	$ 16

In the three months ended October 2, 2009, there were no changes in Level 3 instruments measured on a recurring basis. The Company had no liabilities that were re-measured and reported at fair value on a recurring basis at January 1, 2010.

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

9. Foreign Exchange Contracts

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

If a 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. As of January 1, 2010, the net amount of existing gains expected to be reclassified into earnings within the next twelve months was $4 million. The Company determined the ineffectiveness associated with its cash flow hedges to be immaterial.

A change in the fair value of fair value hedges is recognized in earnings in the period incurred and is reported as a component of operating expenses. All fair value hedges were determined to be effective. The fair value and the changes in fair value on these contracts were not material to the condensed consolidated financial statements.

As of January 1, 2010, the Company did not have any foreign exchange contracts with credit-risk-related contingent features. The Company opened $1.5 billion and $2.9 billion, and closed $1.2 billion and $1.9 billion, in

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foreign exchange contracts in the three and six months ended January 1, 2010, respectively. The fair value, balance sheet location and the impact on the condensed consolidated financial statements during the three and six months ended January 1, 2010 were as follows (in millions):

Derivatives Designated as Hedging Instruments	Asset Derivatives Jan. 1, 2010 Balance Sheet Location	Fair Value	Liability Derivatives Jan. 1, 2010 Balance Sheet Location	Fair Value
Foreign exchange contracts	Other current assets	$ 7	Accrued expenses	

Derivatives in Cash Flow Hedging Relationships	Amount of Gain Recognized in Accumulated OCI on Derivatives — Three Months Ended Jan. 1, 2010	Six Months Ended Jan. 1, 2010	Location of Gain Reclassified from Accumulated OCI into Income	Amount of Gain Reclassified from Accumulated OCI into Income — Three Months Ended Jan. 1, 2010	Six Months Ended Jan. 1, 2010
Foreign exchange contracts	$8	$22	Cost of revenue	$13	$20

The total net realized transaction and forward exchange contract currency gains and losses were not material to the condensed consolidated financial statements during this period.

10. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued ASC 820, Fair Value Measurements and Disclosures (ASC 820), which establishes a framework for measuring fair value under U.S. GAAP and expands disclosures about fair value measurement. In February 2008, FASB issued ASC 820-10-65-1, Fair Value Measurements and Disclosures Transition and Open Effective Date Information, which delayed the effective date of ASC 820 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, until fiscal years beginning after November 15, 2008 and interim periods within those years, which for the Company was the first quarter of fiscal 2010. The Company s adoption of the provisions of ASC 820 for non-financial assets and non-financial liabilities in the first quarter of fiscal 2010 had no impact on its consolidated financial statements.

In December 2007, the FASB issued ASC 805, Business Combinations (ASC 805). ASC 805 establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. ASC 805 also provides guidance for recognizing and measuring the goodwill acquired in the business combination or a gain from a bargain purchase and determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of the business combination. ASC 805 applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, which for the Company was the first quarter of fiscal 2010. ASC 805 will impact the Company s consolidated financial statements for business combinations with an acquisition date on or after adoption in the first quarter of fiscal 2010. The Company s adoption of ASC 805 in the first quarter of fiscal 2010 had no impact on its consolidated financial statements.

In April 2008, the FASB issued ASC 350-30-65-1, General Intangibles Other than Goodwill Transition and Open Effective Date Information (ASC 350-30-65-1), which amends the factors that should be considered in developing

renewal or extension assumptions used to determine the useful life of a recognized intangible asset under ASC 350, Intangibles Goodwill and Other. ASC 350-30-65-1 is effective for fiscal years beginning on or after December 15, 2008, which for the Company was the first quarter of fiscal year 2010. The Company s adoption of ASC 350-30-65-1 in the first quarter of fiscal 2010 had no impact on its consolidated financial statements.

In April 2009, the FASB issued ASC 825-10-65-1, Financial Instruments Transition and Open Effective Date Information (ASC 825-10-65-1), which amends ASC 825, Financial Instruments, and ASC 270, Interim Financial Reporting, to require disclosures about fair value of financial instruments in interim and annual reporting periods. The Company s adoption of ASC 825-10-65-1 in the first quarter of fiscal 2010 did not have a material impact on its consolidated financial statements.

In September 2009, the FASB issued Accounting Standards Update (ASU) 2009-13, Multiple-Deliverable Revenue Arrangements (ASU 2009-13), and ASU 2009-14, Certain Revenue Arrangements That Include Software Elements (ASU 2009-14). ASU 2009-13 amends the revenue guidance under Subtopic 605-25, Multiple Element Arrangements , and addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how arrangement consideration shall be measured and allocated to the separate units of accounting in the arrangement. ASU 2009-14 excludes tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of Subtopic 985-605, Revenue Recognition. ASU 2009-13 and ASU 2009-14 are effective for periods beginning after December 15, 2009 with earlier adoption permitted. The Company is currently evaluating the timing of its adoption of ASU 2009-13 and ASU 2009-14 and the impact that these new accounting standards will have on its consolidated financial statements.

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

This information should be read in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included in this Quarterly Report on Form 10-Q, and the audited consolidated financial statements and notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended July 3, 2009.

Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters. As used herein, the terms we, us, our, the Company and WD refer to Western Digital Corporation and its subsidiaries.

Forward-Looking Statements

This document contains forward-looking statements within the meaning of the federal securities laws. Any statements that do not relate to historical or current facts or matters are forward-looking statements. You can identify some of the forward-looking statements by the use of forward-looking words, such as may, will, could, would, project, believe, anticipate, expect, estimate, continue, potential, plan, forecasts, and the like, or the use of future tense. Statements concerning current conditions may also be forward-looking if they imply a continuation of current conditions. Examples of forward-looking statements include, but are not limited to, statements concerning:

- *demand for hard drives and solid-state drives in the various markets and factors contributing to such demand;*
- *our plans to continue to develop new products and expand into new storage markets and into emerging economic markets;*
- *emergence of new storage markets for hard drives;*
- *emergence of competing storage technologies;*
- *traditional seasonal demand and pricing trends;*
- *our beliefs regarding the adequacy of our facilities and fabrication capacity;*
- *our share repurchase plans;*
- *our stock price volatility;*
- *expectations regarding the outcome of legal proceedings in which we are involved;*
- *the timing of future payments, if any, relating to unrecognized tax benefits;*

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expectations regarding industry conditions and our financial results for the third quarter of fiscal 2010;

expectations regarding our capital expenditure plans and our depreciation and amortization expense in fiscal 2010; and

beliefs regarding the sufficiency of our cash and cash equivalents to meet our working capital and capital expenditure needs.

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

Our Company

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

We sell our products worldwide to original equipment manufacturers (OEMs) and original design manufacturers (ODMs) for use in computer systems, subsystems or CE devices, and to distributors, resellers and retailers. Our hard drives are used in desktop computers, notebook computers, and enterprise applications such as servers, workstations, network attached storage, storage area networks and video surveillance equipment. Additionally, our hard drives are used in CE applications such as digital video recorders (DVRs), and satellite and cable set-top boxes (STBs). We also sell our hard drives as stand-alone storage products and integrate them into finished enclosures, embedding application software and offering the products as WD®-branded external storage appliances for personal data backup and portable or expanded storage of digital music, photographs, video, and other digital data.

Hard drives provide non-volatile data storage, which means that the data remains present when power is no longer applied to the device. Our hard drives currently include 3.5-inch and 2.5-inch form factor drives, having capacities ranging from 80 gigabytes (GB) to 2 terabytes (TB), nominal rotation speeds up to 10,000 revolutions per minute (RPM), and offer interfaces including Enhanced Integrated Drive Electronics (EIDE), Serial Advanced Technology Attachment (SATA) and Serial Attached SCSI (Small Computer System Interface) (SAS). We also embed our hard drives into WD®-branded external storage appliances using interfaces such as Universal Serial Bus (USB) 2.0, USB 3.0, external SATA, FireWire and Ethernet network connections with capacities of 160 GB up to 8 TB. In addition, we offer a family of hard drives specifically designed to consume substantially less power than standard drives, utilizing our WD GreenPower Technology .

We also design, develop, manufacture and sell solid-state drives and media players. A solid-state drive is a storage device that uses semiconductor, non-volatile media, rather than magnetic disks and magnetic heads, to store and allow fast access to data. We sell our solid-state drives worldwide to OEMs and distributors for use in the embedded systems market which includes network-communications, industrial, embedded-computing, medical, military, aerospace, media-appliance and data-streaming applications. A media player is a device that connects to a user s television, the Internet or home theater system and plays digital movies, music and photos from any of our WD®-branded external hard drives, other USB mass storage devices or content services accessed over the Internet. We sell our media players worldwide to resellers and retailers under the WD® brand.

Technology and Product Development

Hard drives record, store and retrieve digital data. Performance attributes of hard drives, such as their ability to access and transmit data and storage capacity, are currently better than removable disks, optical hard drives and tapes, and they are more cost effective than semiconductor technology.

All of our hard drive products employ similar technology. The main components of the hard drive are a Head-Disk-Assembly (HDA) and a Printed Circuit Board Assembly (PCBA). The HDA includes heads, magnetic media (disks), head positioning mechanism (actuator) and spindle motor. A rigid base and top cover contain these components in a contamination-controlled environment. The PCBA includes both standard and custom integrated circuits, an interface connector to the host computer and a power connector.

Industry-standard interfaces allow the hard drive to communicate with the computer. Currently, the primary interfaces for PCs are EIDE (also known as Parallel Advanced Technology Attachment, or PATA) and SATA. The primary interfaces for enterprise systems are SATA and the following, which we refer to as traditional enterprise: Small Computer System Interface, or SCSI ; Serial Attached SCSI, or SAS ; and Fibre Channel-Arbitrated Loop, or FC-AL. As computer performance continues to improve, the hard drive will need to deliver information faster. We believe this will continue to drive the PC industry transition to higher speed interfaces, such as SATA and SAS, to facilitate the higher data transfer rates. We currently offer the SATA interface on our WD Caviar®, WD Scorpio®, WD® RE, WD VelociRaptor™ and WD® AV hard drive families; the EIDE (PATA) interface on WD Caviar®, WD Scorpio® and WD®AV hard drive families; and the SAS interface on the WD S25 hard drive family.

The number of disks and each disk s areal density (track density multiplied by bit density), which is a measure of the amount of data that can be stored on the recording surface of the disk per unit area, determines storage capacity of the hard drive. The higher the areal density, the more information can be stored on a single platter. Achieving a given drive capacity requires fewer disks and heads as the areal density increases, potentially reducing product costs over time through reduced component requirements. In July 2009, we began shipping our WD Scorpio® Blue™ 2.5-inch 1 TB drives at 333 GB per platter (approximately 525 gigabits per square inch) areal density. In September 2009, we began shipping our WD Caviar® Black ™ 3.5-inch 2 TB drives at 500 GB per platter (approximately 380 gigabits per square inch) areal density.

In November 2009, we entered the traditional enterprise market by shipping our WD S25, 2.5-inch, SAS interface hard drives. The WD S25 drive provides up to 300 GB of storage suitable for both mission-critical enterprise server and enterprise storage applications, as well as data centers and large data arrays.

Second Quarter Overview

For the third consecutive quarter, demand for hard drives was at the high end of expectations as the positive industry conditions that first materialized in the June quarter continued throughout the second half of the calendar year. In the December quarter, demand strength continued to be primarily consumer driven though we also saw some signs of recovery in the commercial sector. We believe that overall hard drive industry shipments in the December quarter totaled 160 million units, up 29% on the year-ago quarter and up 5% sequentially from the September quarter.

The following table sets forth, for the periods indicated selected summary information from our condensed consolidated statements of income and the related percentage of revenue (dollars in millions):

	THREE MONTHS ENDED				**SIX MONTHS ENDED**			
	Jan. 1, 2010		**Dec. 26, 2008**		**Jan. 1, 2010**		**Dec. 26, 2008**	
Net revenue	**$2,619**	**100.0%**	$1,823	100.0%	**$4,827**	**100.0%**	$3,933	100.0%
Gross margin	**687**	**26.2**	290	15.9	**1,201**	**24.9**	714	18.2
Total operating expenses	**214**	**8.2**	274	15.0	**409**	**8.5**	464	11.8
Operating income	**473**	**18.1**	16	0.9	**792**	**16.4**	250	6.4
Net income	**429**	**16.4**	14	0.8	**717**	**14.9**	225	5.7

The following is a summary of our financial performance for the second quarter of 2010:

Consolidated net revenue totaled $2.6 billion.

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

Hard drive unit shipments increased by 39% over the prior-year period to 49.5 million units.

Gross margin increased to 26.2%, compared to 15.9% for the prior-year period.

Operating income was $473 million, an increase of $457 million over the prior-year period. The prior-year period included a restructuring charge of $113 million.

We generated $557 million in cash flow from operations in the second quarter of 2010, and we finished the quarter with $2.4 billion in cash and cash equivalents.

Historically, March quarter industry unit demand has been down sequentially in a range from 5% to 7% from the December quarter. However, we believe that true demand in the December quarter was not entirely satisfied, and this coupled with an expectation of continuing strong demand for digital storage leads us to expect a sequential decline of 1% to 5% in the March quarter. Therefore, we expect our revenue in the March quarter to slightly decrease from the December quarter. Operating expenses for the March quarter are expected to slightly increase from the December quarter as we continue to invest in new products and technology.

Results of Operations

Net Revenue

	THREE MONTHS ENDED			SIX MONTHS ENDED		
(in millions, except percentages and ASP)	**Jan. 1, 2010**	**Dec. 26, 2008**	**Percentage Change**	**Jan. 1, 2010**	**Dec. 26, 2008**	**Percentage Change**
Net revenue	**$2,619**	$1,823	44%	**$4,827**	$3,933	23%
Unit shipments*	**49.5**	35.5	39	**93.6**	74.9	25
ASP (per unit)*	**$ 52**	$ 51	2	**$ 51**	$ 52	(2)
Revenues by Geography (%)						
Americas	**25%**	23%		**23%**	23%	
Europe, Middle East and Africa	**25**	29		**24**	29	
Asia	**50**	48		**53**	48	
Revenues by Channel (%)						
OEM	**48%**	57%		**50%**	57%	
Distributors	**30**	21		**30**	23	
Retailers	**22**	22		**20**	20	
Revenues by Product (%)						
Non-desktop sources	**66%**	65%		**65%**	63%	
Desktop hard drives	**34**	35		**35**	37	

* Based on sales of hard drive units only.

Non-hard drive units were not material.

For the quarter ended January 1, 2010, net revenue was $2.6 billion, an increase of 44% over the quarter ended December 26, 2008. Total hard drive shipments increased to 49.5 million units for the second quarter of 2010 as compared to 35.5 million units for the second quarter of 2009. For the six months ended January 1, 2010, net revenue was $4.8 billion, an increase of 23% over the six months ended December 26, 2008. Total hard drive shipments increased to 93.6 million for the six months ended January 1, 2010, as compared to 74.9 million for the

six months ended December 26, 2008. The increase in revenue resulted from the strong demand for hard drives. For example, we shipped 21.2 million and 40.3 million mobile drives in the three and six months ended January 1, 2010, respectively. This compares to 13.8 million and 28.4 million units in the three and six months ended December 26, 2008, respectively. The average selling price (ASP) for hard drives in the second quarter of 2010 was $52, an increase of $1 from the prior-year quarter.

Changes in revenue by geography and by channel generally reflected normal fluctuations in market demand and competitive dynamics, as well as demand strength in Asia, which continues to be driven by the concentration of global manufacturing in that region. For the three months ended January 1, 2010, Hewlett-Packard Company accounted for 10%, or more, of our revenue. For the six months ended January 1, 2010, Dell Inc. and Hewlett-Packard Company each accounted for 10%, or more, of our revenue.

We have sales incentive and marketing programs that provide customers with price protection and other incentives or reimbursements that are recorded as a reduction to gross revenue. For the three and six months ended January 1, 2010, these programs represented 7% of gross revenues compared to 12% in the comparative prior-year periods. These amounts generally vary according to several factors including industry conditions, seasonal demand, competitor actions, channel mix and overall availability of product.

Gross Margin

	THREE MONTHS ENDED			**SIX MONTHS ENDED**		
(in millions, except percentages)	**Jan. 1, 2010**	**Dec. 26, 2008**	**Percentage Change**	**Jan. 1, 2010**	**Dec. 26, 2008**	**Percentage Change**
Net revenue	**$2,619**	$1,823	44%	**$4,827**	$3,933	23%
Gross margin	**687**	290	137	**1,201**	714	68
Gross margin %	**26.2%**	15.9%		**24.9%**	18.2%	

For the three months ended January 1, 2010, gross margin as a percentage of revenue increased to 26.2% as compared to 15.9% for the prior-year period. For the six months ended January 1, 2010, gross margin as a percentage of revenue increased to 24.9% as compared to 18.2% for the prior-year period. These increases were primarily due to lower costs, a favorable product mix and moderate price declines.

Operating Expenses

	THREE MONTHS ENDED			**SIX MONTHS ENDED**		
(in millions, except percentages)	**Jan. 1, 2010**	**Dec. 26, 2008**	**Percentage Change**	**Jan. 1, 2010**	**Dec. 26, 2008**	**Percentage Change**
R&D expense	**$ 154**	$ 119	29%	**$ 296**	$ 252	17%
SG&A expense	**60**	42	43	**113**	99	14
Restructuring		113			113	
Total operating expenses	**$ 214**	$ 274		**$ 409**	$ 464	

Research and development (R&D) expense was $154 million for the three months ended January 1, 2010, an increase of $35 million over the prior-year period. This increase was primarily due to an increase in variable incentive compensation. For the six months ended January 1, 2010, R&D expense was $296 million, an increase of $44 million over the prior-year period. This increase was primarily due to an increase in variable incentive compensation and the investment in product development to support new programs.

Selling, general and administrative (SG&A) expense was $60 million for the three months ended January 1, 2010, an increase of $18 million over the prior-year period. This increase was primarily due to an increase in variable incentive compensation and the expansion of sales and marketing to support new products and growing markets. For

the six months ended January 1, 2010, SG&A expense was $113 million, an increase of $14 million over the prior-year period. This increase was primarily due to an increase in variable incentive compensation.

During the three months ended December 26, 2008, we recorded a $113 million restructuring charge related to our restructuring plan to realign our cost structure as a result of a softer demand environment. The restructuring plan was completed in fiscal 2009.

Other Income (Expense)

Interest income for the three and six months ended January 1, 2010 decreased $1 million and $4 million, respectively, as compared to the prior-year periods primarily due to a decrease in the rates of return on our investments. Interest and other expense for the three and six months ended January 1, 2010 decreased $8 million and $13 million, respectively, as compared to the prior-year periods. These decreases were primarily due to other-than-temporary impairment charges on our auction-rate securities of $6 million and $9 million in the three and six months ended December 26, 2008, respectively, and a decrease in the interest rate on a lower amount of debt.

Income Tax Provision

Our income tax provision for the three months ended January 1, 2010 was $42 million as compared to a $7 million benefit in the prior-year period. Our income tax provision for the six months ended January 1, 2010 was $71 million compared to $12 million in the prior-year period. Differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia and Thailand that expire at various dates through 2022 and the current year generation of income tax credits.

Liquidity and Capital Resources

We ended the second quarter of fiscal 2010 with total cash and cash equivalents of $2.4 billion. The following table summarizes our statements of cash flows for the six months ended January 1, 2010 and December 26, 2008 (in millions):

	SIX MONTHS ENDED	
	Jan. 1, 2010	**Dec. 26, 2008**
Net cash flow provided by (used in):		
Operating activities	**$ 991**	$ 601
Investing activities	**(372)**	(301)
Financing activities	**22**	(28)
Net increase in cash and cash equivalents	**$ 641**	$ 272

Our investment policy is to manage our investment portfolio to preserve principal and liquidity while maximizing return through the full investment of available funds. We believe our current cash, cash equivalents and cash generated from operations will be sufficient to meet our working capital and capital expenditure needs through the foreseeable future. Our ability to sustain our working capital position is subject to a number of risks that we discuss in Part II, Item 1A of this Quarterly Report on Form 10-Q.

Operating Activities

Net cash provided by operating activities during the six months ended January 1, 2010 was $991 million as compared to $601 million during the six months ended December 26, 2008. Cash flow from operating activities consists of net income, adjusted for non-cash charges, plus or minus working capital changes. This represents our principal source of cash. Net cash provided by working capital changes was $5 million for the six months ended January 1, 2010 as compared to $34 million for the prior-year period.

Our working capital requirements primarily depend on the effective management of our cash conversion cycle, which measures how quickly we can convert our products into cash through sales. The cash conversion cycles for the three months ended January 1, 2010 and December 26, 2008 were as follows:

	THREE MONTHS ENDED	
	Jan. 1, 2010	**Dec. 26, 2008**
Days sales outstanding	**47**	46
Days in inventory	**21**	27
Days payables outstanding	**(71)**	(64)
Cash conversion cycle	**(3)**	9

For the three months ended January 1, 2010, our days sales outstanding (DSOs) increased by 1 day, days in inventory (DIOs) decreased by 6 days, and days payable outstanding (DPOs) increased by 7 days as compared to the prior-year period. The decrease in DIOs and the increase in DPOs was primarily the result of the strong demand environment that continued through the end of the quarter. From time to time, we modify the timing of payments to our vendors. We make modifications primarily to manage our vendor relationships and to manage our cash flows, including our cash balances. Generally, we make the payment modifications through negotiations with our vendors or by granting to, or receiving from, our vendors payment term accommodations.

Investing Activities

Net cash used in investing activities for the six months ended January 1, 2010 was $372 million as compared to $301 million for the six months ended December 26, 2008. Investing activities for the six months ended January 1, 2010 consisted of capital expenditures of $375 million, offset by $3 million from the sale of investments. Investing activities for the six months ended December 26, 2008 consisted primarily of capital expenditures of $302 million.

We believe that demand for digital storage will continue to be strong throughout fiscal 2010. Consequently, we are increasing our capital expenditure forecast for fiscal 2010 to between $650 million and $750 million, compared with our previous projection of $650 million. Depreciation and amortization for fiscal 2010 is now expected to be about $550 million, as compared to our previous estimate of $540 million.

Our cash equivalents are invested primarily in readily accessible, AAA rated institutional money market funds which are invested in U.S. Treasury securities, U.S. Treasury bills and U.S. Government agency securities. We also have auction-rate securities that are classified as long-term investments as they are expected to be held until secondary markets become available. These investments are currently accounted for as available-for-sale securities and recorded at fair value within other non-current assets in the condensed consolidated balance sheet. The estimated market values of these investments are subject to fluctuation. During the three months ended January 1, 2010, we sold $3 million of auction-rate securities, reducing the carrying value of these investments to $15 million.

Financing Activities

Net cash provided by financing activities for the six months ended January 1, 2010 was $22 million as compared to net cash used in financing activities of $28 million in the prior-year period. Net cash provided by financing activities for the six months ended January 1, 2010 consisted of $47 million provided by the issuance of stock under employee stock plans and a $20 million increase in excess tax benefits from employee stock plans, offset by $38 million used to repay long-term debt and $7 million in tax withholding obligations paid in connection with the vesting of stock awards under employee stock plans. Net cash used in financing activities for the six months ended December 26, 2008 resulted from $36 million used to repurchase our common stock and $5 million in debt repayments offset by $13 million related to employee stock plans.

Off-Balance Sheet Arrangements

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

Additionally, we do not have an interest in, or relationships with, any special-purpose entities.

Contractual Obligations and Commitments

Credit Facility In February 2008, Western Digital Technologies, Inc. (WDTI), a wholly-owned subsidiary of the Company, entered into a five-year Credit Agreement (Credit Facility) that provides for a $750 million unsecured loan consisting of a $500 million term loan facility and a $250 million revolving credit facility. The revolving credit facility includes borrowing capacity available for letters of credit and for short-term borrowings referred to as swingline. In addition, WDTI may elect to expand the Credit Facility by up to $250 million if existing or new lenders provide additional term or revolving commitments. The $500 million term loan had a variable interest rate of 1.50% as of January 1, 2010 and requires sixteen quarterly principal payments, that began in June 2009, of approximately $19 million, $25 million, $31 million and $50 million per quarter for each four quarter increment. As of January 1, 2010, WDTI had $250 million available for future borrowings on the revolving credit facility and was in compliance with all covenants.

Purchase Orders In the normal course of business, we enter into purchase orders with suppliers for the purchase of hard drive components used to manufacture our products. These purchase orders generally cover forecasted component supplies needed for production during the next quarter, are recorded as a liability upon receipt of the components, and generally may be changed or canceled at any time prior to shipment of the components. We also enter into purchase orders with suppliers for capital equipment that are recorded as a liability upon receipt of the equipment. Our ability to change or cancel a capital equipment purchase order without penalty depends on the nature of the equipment being ordered. In some cases, we may be obligated to pay for certain costs related to changes to, or cancellation of, a purchase order, such as costs incurred for raw materials or work in process of components or capital equipment.

We have entered into long-term purchase agreements with various component suppliers, which contain minimum quantity requirements. However, the dollar amount of the purchases may depend on the specific products ordered, achievement of pre-defined quantity or quality specifications or future price negotiations. We have also entered into long-term purchase agreements with various component suppliers that carry fixed volumes and pricing which obligate us to make certain future purchases, contingent on certain conditions of performance, quality and technology of the vendor s components.

We enter into, from time to time, other long-term purchase agreements for components with certain vendors. Generally, future purchases under these agreements are not fixed and determinable as they depend on our overall unit volume requirements and are contingent upon the prices, technology and quality of the supplier s products remaining competitive.

See Item 7. Management