WESTERN DIGITAL CORP
Form 10-Q
May 03, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 29, 2013

Or

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

For the transition period from _________ to _________

Commission file number: 1-8703

WESTERN DIGITAL CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

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

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

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

As of the close of business on April 24, 2013, 236,383,177 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. Our fiscal third quarters ended March 29, 2013 and March 30, 2012 both consisted of 13 weeks. Fiscal year 2012 was comprised of 52 weeks and ended on June 29, 2012. Fiscal year 2013 will be comprised of 52 weeks and will end on June 28, 2013. 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 Di refer to Western Digital Corporation and its subsidiaries.

WDC, a Delaware corporation, is the parent company of our storage business, which operates under two independent subsidiaries WD and HGST.

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

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

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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)

	Mar. 29, 2013	Jun. 29, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,060	$ 3,208
Accounts receivable, net	1,700	2,364
Inventories	1,197	1,210
Other current assets	383	359
Total current assets	7,340	7,141
Property, plant and equipment, net	3,803	4,067
Goodwill	1,954	1,975
Other intangible assets, net	656	799
Other non-current assets	174	224
Total assets	$ 13,927	$ 14,206
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,037	$ 2,773
Accrued expenses	837	858
Accrued warranty	122	171
Current portion of long-term debt	230	230
Total current liabilities	3,226	4,032
Long-term debt	1,783	1,955
Other liabilities	495	550
Total liabilities	5,504	6,537
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 238 and 246 shares, respectively	3	3
Additional paid-in capital	2,232	2,223
Accumulated other comprehensive income (loss)	20	(15)
Retained earnings	7,073	6,012
Treasury stock common shares at cost; 23 shares and 15 shares, respectively	(905)	(554)
Total shareholders equity	8,423	7,669
Total liabilities and shareholders equity	$ 13,927	$ 14,206

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

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WESTERN DIGITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in millions, except per share amounts; unaudited)

	Three Months Ended		Nine Months Ended	
	Mar. 29, 2013	**Mar. 30, 2012**	**Mar. 29, 2013**	**Mar. 30, 2012**
Revenue, net	$ 3,764	$ 3,035	$ 11,623	$ 7,724
Cost of revenue	2,703	2,058	8,310	5,558
Gross margin	1,061	977	3,313	2,166
Operating expenses:				
Research and development	396	265	1,170	649
Selling, general and administrative	185	155	526	340
Employee termination benefits and other charges	63		130	
Charges related to flooding, net		15		214
Total operating expenses	644	435	1,826	1,203
Operating income	417	542	1,487	963
Other income (expense):				
Interest income	3	3	8	9
Interest and other expense	(14)	(7)	(43)	(17)
Total other expense, net	(11)	(4)	(35)	(8)
Income before income taxes	406	538	1,452	955
Income tax provision	15	55	207	88
Net income	$ 391	$ 483	$ 1,245	$ 867
Income per common share:				
Basic	$ 1.64	$ 2.00	$ 5.14	$ 3.67
Diluted	$ 1.60	$ 1.96	$ 5.02	$ 3.61
Weighted average shares outstanding:				
Basic	239	241	242	236
Diluted	245	246	248	240

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

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WESTERN DIGITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions; unaudited)

	Three Months Ended		Nine Months Ended	
	Mar. 29, 2013	Mar. 30, 2012	Mar. 29, 2013	Mar. 30, 2012
Net income	$ 391	$ 483	$ 1,245	$ 867
Other comprehensive income (loss), net of tax:				
Net unrealized gains on cash flow hedges	5	16	32	7
Change in net actuarial gains	6		7	
Translation losses		(6)	(4)	(6)
Other comprehensive income	11	10	35	1
Total comprehensive income	$ 402	$ 493	$ 1,280	$ 868

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)

	Nine Months Ended	
	Mar. 29, 2013	**Mar. 30, 2012**
Cash flows from operating activities		
Net income	$ 1,245	$ 867
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	931	486
Stock-based compensation	107	61
Deferred income taxes	59	42
Non-cash portion of employee termination benefits and other charges	16	
Non-cash portion of charges related to flooding		119
Changes in:		
Accounts receivable, net	665	122
Inventories	13	17
Accounts payable	(434)	227
Accrued expenses	(117)	(27)
Other assets and liabilities	(50)	24
Net cash provided by operating activities	2,435	1,938
Cash flows from investing activities		
Purchases of property, plant and equipment	(816)	(393)
Acquisitions, net	(1)	(3,541)
Purchase of investments	(17)	
Net cash used in investing activities	(834)	(3,934)
Cash flows from financing activities		
Issuance of stock under employee stock plans	123	41
Taxes paid on vested stock awards under employee stock plans	(10)	(14)
Excess tax benefits from employee stock plans	39	22
Repurchases of common stock	(607)	
Dividends to shareholders	(121)	
Proceeds from debt, net of issuance costs		2,775
Repayment of assumed debt		(585)
Repayment of debt	(173)	(350)
Net cash provided by (used in) financing activities	(749)	1,889
Effect of exchange rate changes on cash		(6)
Net increase (decrease) in cash and cash equivalents	852	(113)
Cash and cash equivalents, beginning of period	3,208	3,490
Cash and cash equivalents, end of period	$ 4,060	$ 3,377

Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 122	$ 10
Cash paid for interest	$ 16	$ 7
Supplemental disclosure of non-cash financing activities:		
Common stock issued in connection with acquisition	$	$ 877
Accrual of cash dividend declared	$ 60	$

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 29, 2012. 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 29, 2012. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year. During the three months ended March 29, 2013, the Company changed the date of its annual goodwill impairment test from the last day of May to the first day of the Company s fiscal fourth quarter. The Company believes changing the test date to the first day of its fiscal fourth quarter is preferable as it should allow the Company additional time to complete the impairment test. The Company did not record any impairment of goodwill during 2013 or 2012.

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

	Mar. 29, 2013	Jun. 29, 2012
	(in millions)	
Inventories:		
Raw materials and component parts	**$ 191**	$ 245
Work-in-process	**583**	552
Finished goods	**423**	413
Total inventories	**$ 1,197**	$ 1,210
Property, plant and equipment:		
Property, plant and equipment	**$ 7,561**	$ 7,173
Accumulated depreciation	**(3,758)**	(3,106)
Property, plant and equipment, net	**$ 3,803**	$ 4,067
Other intangible assets:		
Other intangible assets	**$ 948**	$ 933
Accumulated amortization	**(292)**	(134)
Other intangible assets, net	**$ 656**	$ 799

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Warranty

The Company records an accrual for estimated warranty costs when revenue is recognized. The Company generally warrants its products for a period of one to five years. The warranty provision considers estimated product failure rates and trends, estimated replacement costs, estimated repair costs which include scrap costs, and estimated costs for customer compensatory claims related to product quality issues, if any. A statistical warranty tracking model is used to help prepare estimates and assist the Company in exercising judgment in determining the underlying estimates. The statistical tracking model captures specific detail on 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 margin and income. Such changes are generally a result of differences between forecasted and actual return rate experience and costs to repair. If actual product return trends, costs to repair returned products or costs of customer compensatory claims differ significantly from estimates, future results of operations could be materially affected. Changes in the warranty accrual were as follows (in millions):

	Three Months Ended		**Nine Months Ended**	
	Mar. 29, 2013	**Mar. 30, 2012**	**Mar. 29, 2013**	**Mar. 30, 2012**
Warranty accrual, beginning of period	**$ 211**	$ 156	**$ 260**	$ 170
Warranty liabilities assumed as a result of the Acquisition (see Note 11)		139		139
Charges to operations	**44**	34	**134**	104
Utilization	**(56)**	(51)	**(167)**	(135)
Changes in estimate related to pre-existing warranties	**(7)**		**(35)**	
Warranty accrual, end of period	**$ 192**	$ 278	**$ 192**	$ 278

The long-term portion of the warranty accrual classified in other liabilities was $70 million at March 29, 2013 and $89 million at June 29, 2012.

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		Nine Months Ended	
	Mar. 29, 2013	Mar. 30, 2012	Mar. 29, 2013	Mar. 30, 2012
Net income	**$ 391**	$ 483	**$ 1,245**	$ 867
Weighted average shares outstanding:				
Basic	**239**	241	**242**	236
Employee stock options and other	**6**	5	**6**	4
Diluted	**245**	246	**248**	240
Income per common share:				
Basic	**$ 1.64**	$ 2.00	**$ 5.14**	$ 3.67
Diluted	**$ 1.60**	$ 1.96	**$ 5.02**	$ 3.61
Anti-dilutive potential common shares excluded*	**4**	3	**3**	5

* 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 March 8, 2012 (the Closing Date), the Company, in its capacity as the parent entity and guarantor, Western Digital Technologies, Inc. (WDT), a wholly owned subsidiary of the Company, and Western Digital Ireland, Ltd. (WDI), an indirect wholly owned subsidiary of the Company, entered into a five-year credit agreement (the Credit Facility) with Bank of America, N.A., as administrative agent, swing line lender and letter of credit issuer**,** and certain other participating lenders (collectively, the Lenders). The Credit Facility provides for $2.8 billion of unsecured loan facilities consisting of a $2.3 billion term loan facility and a $500 million revolving credit facility. The only borrower under the term loan facility is WDI and the revolving credit facility is available to both WDI and WDT (WDI and WDT are referred to as the Borrowers). The Borrowers may elect to expand the Credit Facility by up to an additional $500 million if existing or new lenders provide additional term or revolving commitments. The obligations of the Borrowers under the Credit Facility are guaranteed by the Company and the Company s material domestic subsidiaries, and the obligations of WDI under the Credit Facility are also guaranteed by WDT.

The term loans and the revolving credit loans may be prepaid in whole or in part at any time without premium or penalty, subject to certain conditions. As of March 29, 2013, the term loan facility had a variable interest rate of 2.20% and a remaining outstanding balance of $2.0 billion. The Company is required to make principal payments on the term loan facility totaling $230 million a year for fiscal 2013 through fiscal 2016, and the remaining $1.3 billion balance (subject to adjustment to reflect prepayments or an increase to its term loan facility) due and payable in full in fiscal 2017 on March 8, 2017. As of March 29, 2013, $500 million was available for future borrowings on the revolving credit facility.

The Credit Facility 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 Facility contains customary covenants, including covenants that limit or restrict, subject to certain exceptions, the Company s and its subsidiaries ability to incur liens, incur indebtedness, make certain restricted payments, merge, consolidate or dispose of substantially all of its assets, and enter into certain speculative hedging arrangements and make any material change in the nature of its business. Upon the occurrence of an event of default under the Credit Facility, the administrative agent at the request, or with the consent, of the Required Lenders (as defined in the Credit Facility) may cease making loans, terminate the Credit Facility and declare all amounts outstanding to be immediately due and payable, require the cash collateralization of letters of credit and/or exercise all other rights and remedies available to it, the Lenders and the letter of credit issuer. The Credit Facility specifies a number of events of default (some of which are subject to applicable grace or cure periods), including, among other things, non-payment defaults, covenant defaults, cross-defaults to other material indebtedness, bankruptcy and insolvency defaults, material judgment defaults and a change of control default. As of March 29, 2013, 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.

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Solely for purposes of this footnote, WD refers to Western Digital Corporation or one or more of its subsidiaries prior to the acquisition of Viviti Technologies Ltd., known until shortly before the acquisition as Hitachi Global Storage Technologies Holdings Pte. Ltd. (HGST), HGST refers to HGST or one or more of its subsidiaries as of the 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. WD and HGST have filed post-trial motions challenging the verdict and will evaluate their options for appeal after the Court rules on the post-trial motions.

On December 7, 2009, plaintiff Nazomi Communications (Nazomi) filed a complaint in the Eastern District of Texas against WD and seven other companies alleging infringement of U.S. Patent Nos. 7,080,362 and 7,225,436. Nazomi dismissed the Eastern District of Texas suit after filing a similar complaint in the Central District of California on February 8, 2010. The case was subsequently transferred to the Northern District of California on October 14, 2010. The complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to processor cores capable of Java hardware acceleration. In August 2012, the Court dismissed WD on summary judgment for non-infringement. Nazomi filed a notice of appeal on January 16, 2013. WD intends to continue to defend itself vigorously in this matter.

On January 5, 2010, plaintiff Enova Technology Corporation (Enova) filed a complaint in the District of Delaware against WD and Initio Corporation alleging infringement of U.S. Patent Nos. 7,136,995 and 7,386,734. Enova subsequently amended its complaint to include an additional party and additionally allege infringement of U.S. Patent No. 7,900,057. The amended complaint seeks 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. On February 20, 2013, WD and Enova reached a settlement in this matter for an amount that was not material to the Company s financial position, results of operations or cash flows.

On November 10, 2010, plaintiff Rembrandt Data Storage (Rembrandt) filed a complaint in the Western District of Wisconsin against WD alleging infringement of U.S. Patent Nos. 5,995,342 and 6,195,232. The complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The asserted patents allegedly relate to specific thin film heads having solenoid coils. After a favorable claim construction ruling by the court, WD secured a stipulation from Rembrandt to dismiss the case. Rembrandt appealed the Court s claim construction ruling, and the Federal Circuit issued a summary affirmance in favor of WD in December 2012. If Rembrandt appeals the decision, WD intends to continue to defend itself vigorously in this matter.

On December 1, 2010, Rambus, Inc. (Rambus) filed a complaint with the U.S. International Trade Commission pursuant to 19 U.S.C. Section 1337 alleging that six Primary Respondent semiconductor chip companies and twenty-seven Customer Respondents, including HGST, infringe various U.S. patents. On December 29, 2010, the U.S. International Trade Commission (ITC) initiated an investigation into Rambus s allegations in response to the complaint. HGST is accused of infringing U.S. Patent Nos. 6,591,353; 7,287,109; 7,602,857; 7,602,858; and 7,715,494. The complaint alleges that certain of HGST s hard drives that contain Double data rate-type memory controllers, Serial Advanced Technology Attachment interfaces, Peripheral Component Interconnect Express interfaces, DisplayPort interfaces, or Serial Attached SCSI interfaces infringe the patents. The complaint seeks to enjoin the importation into the U.S. of the allegedly infringing semiconductor chips and products. It also requests a cease-and-desist order preventing the parties from exhausting allegedly infringing inventory in the U.S. The ITC found in favor of the respondents in all matters and Rambus appealed to the Federal Circuit. On February 25, 2013, Rambus dismissed its claim against HGST based upon its recognition that HGST s use was licensed through patent exhaustion.

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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. WD has filed counterclaims against Guzik or patent infringement of U.S. Patent Nos. 5,844,420; 5,640,089; 6,891,696; and 7,480,116. The patents asserted by WD relate to devices and methods used in the testing of hard disk drive heads and media. WD 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 supposed misappropriation of trade secrets and sought injunctive relief and unspecified monetary damages, fees and costs. On June 19, 2007, WD s former employee filed a demand for arbitration with the American Arbitration Association. A motion to stay the litigation as against all defendants and to compel arbitration of all Seagate s claims was granted on September 19, 2007. On September 23, 2010, Seagate filed a motion to amend its claims and add allegations based on the supposed misappropriation of additional confidential information, and the arbitrator granted Seagate s motion. The arbitration hearing commenced on May 23, 2011 and concluded on July 11, 2011.

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

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

On October 30, 2012, Seagate initiated an appeal of the Court s decision with the Minnesota Court of Appeals. Oral arguments in the appeal were held on April 24, 2013, and a decision is expected within 90 days thereafter. The Company strongly believes that the Court s decision was correct and vigorously opposes Seagate s efforts to appeal the decision. Nevertheless, the Company cannot be certain it will be successful in a new arbitration of the three trade secret claims or in Seagate s efforts to appeal the decision. In the event Seagate is successful in its efforts to appeal the Court s decision, the original arbitration award could be reinstated. The statutory interest rate of 10% would apply from the date of the original arbitration award if the award should be reinstated.

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.

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6. Income Taxes

The Company s income tax provision for the three months ended March 29, 2013 was $15 million as compared to $55 million in the prior-year period. The Company s income tax provision for the nine months ended March 29, 2013 was $207 million as compared to $88 million in the prior-year period. The Company s income tax provision for both the three and nine months ended March 29, 2013 reflects a tax benefit of $34 million as a result of the retroactive extension of the U.S. Federal research and experimentation tax credit (R&D credit) that was signed into law on January 2, 2013 as part of the American Taxpayer Relief Act of 2012. The R&D credit, which had previously expired on December 31, 2011, was extended through December 31, 2013. 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 2014 through 2025, the current year generation of income tax credits and the effect of California Proposition 39 which was passed in November 2012.

On November 6, 2012, California voters approved California Proposition 39, which affects California state income tax apportionment for most multi-state taxpayers for tax years beginning on or after January 1, 2013. This proposition reduces the Company s future income apportioned to California, making it less likely for the Company to realize certain California deferred tax assets. As a result, the Company recorded an $88 million charge in the nine months ended March 29, 2013 to reduce its previously recognized California deferred tax assets as of December 28, 2012.

In the three months ended March 29, 2013, the Company recorded a net increase of $6 million in its liability for unrecognized tax benefits. In the nine months ended March 29, 2013, the Company recorded a net increase of $2 million in its liability for unrecognized tax benefits. As of March 29, 2013, the Company had a recorded liability for unrecognized tax benefits of approximately $282 million. Interest and penalties recognized on such amounts were not material to the condensed consolidated financial statements during the three and nine months ended March 29, 2013.

The Internal Revenue Service (IRS) has completed its field examination of the federal income tax returns for fiscal years 2006 and 2007 for the Company. The Company has received Revenue Agent Reports (RARs) from the IRS that seek adjustments to income before income taxes of approximately $970 million in connection with unresolved issues related primarily to transfer pricing and certain other intercompany transactions. The Company disagrees with the proposed adjustments. In May 2011, the Company filed a protest with the IRS Appeals Office regarding the proposed adjustments. Meetings with the Appeals Office began in February 2012. In January 2012, the IRS commenced an examination of the Company s fiscal years 2008 and 2009 and of the 2007 fiscal period ended September 5, 2007 of Komag, Incorporated (Komag), which was acquired by the Company on September 5, 2007. In February 2013, the IRS commenced an examination of calendar years 2010 and 2011 of HGST, which was acquired by the Company on March 8, 2012.

The Company believes that adequate provision has been made for any adjustments that may result from tax audits. 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 March 29, 2013, the Company believes that it is reasonably possible the liability for unrecognized tax benefits will decrease by $54 million within the next twelve months. Any significant change in the amount of the Company s liability for unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of the Company s tax returns.

7. Fair Value Measurements

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

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

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

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

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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 March 29, 2013, 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	$ 1,113	$	$	$ 1,113
U.S. Treasury securities		25		25
Total cash equivalents	1,113	25		1,138
Foreign exchange contracts		24		24
Auction-rate securities			14	14
Total assets at fair value	$ 1,113	$ 49	$ 14	$ 1,176