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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**Form 10-Q**

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

**For the quarterly period ended June 30, 2004**

**Commission file number 1-10962**

**Callaway Golf Company**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**95-3797580**

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

**2180 Rutherford Road, Carlsbad, CA 92008**

**(760) 931-1771**

*(Address, including zip code, and telephone number, including area code, of principal executive offices)*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the Registrant's Common Stock, \$.01 par value, as of July 23, 2004 was 75,218,527.

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**Important Notice to Investors:** Statements made in this report that relate to future plans, events, liquidity, financial results or performance including statements relating to future cash flows, liquidity, and the status of the Company's credit facilities, as well as estimated charges to earnings, and projected amortization expenses and contractual obligations, are forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. These statements are based upon current information and expectations. Actual results may differ materially from those anticipated as a result of certain risks and uncertainties. For details concerning these and other risks and uncertainties, see "Management's Discussion and Analysis of Financial Condition and Results of Operations — Certain Factors Affecting Callaway Golf Company" contained in this report, as well as the Company's other reports on Forms 10-K, 10-Q and 8-K subsequently filed with the Securities and Exchange Commission from time to time. Investors are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Investors should also be aware that while the Company from time to time does communicate with securities analysts, it is against the Company's policy to disclose to them any material non-public information or other confidential commercial information. Furthermore, the Company has a policy against issuing or confirming financial forecasts or projections issued by analysts and any reports issued by such analysts are not the responsibility of the Company. Investors should not assume that the Company agrees with any report issued by any analyst or with any statements, projections, forecasts or opinions contained in any such report.

**Callaway Golf Company Trademarks:** The following marks and phrases, among others, are trademarks of Callaway Golf Company: *A Passion For Excellence — Apex — Apex Edge — Apex Plus — Ben Hogan — BH design — Big Bertha — C design — CBI — CTU 30 — Callaway — Callaway Connect — Callaway Golf — Chevron Device — Dawn Patrol — Daytripper — Demonstrably Superior and Pleasingly Different — Deuce — DOT — DFX — Divine Nine — Dual Force — Dual Zone — Eagle — Edge CFT — Ely Would — ERC — Flying Lady — FTX — Fusion — Game Enjoyment System — Gems — GES — Ginty — Great Big Bertha — Hawk Eye — Heavenwood — Hogan — HX — Legacy — Legend — Magna — Molitor — Number One Putter In Golf — Odyssey — Pure Distance — RCH — Rossie — Rule 35 — S2H2 — Slickote — S.O.A.R. — Steelhead — Strata — Stronomic — STS — T design — The Longest Balls — The Most Played Name In Golf — Top-Flite — Tour 100 — Tour Blue — Tour Edition — Tour Impact — Tour Straight — Tour Ultimate — TriForce — TriHot — Tru Bore — VFT — Warbird — White Hot — World's Friendliest — X-12 — X-14 — X-16 — XL — XL 2000 — XL 3000 — X-SPANN — XWT — Z-Balata.*

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# CALLAWAY GOLF COMPANY

## INDEX

<b>PART I. FINANCIAL INFORMATION</b>		
Item 1.	Financial Statements	
	Consolidated Condensed Balance Sheets at June 30, 2004 and December 31, 2003	1
	Consolidated Condensed Statements of Operations for the three and six months ended June 30, 2004 and 2003	2
	Consolidated Condensed Statements of Cash Flows for the six months ended June 30, 2004 and 2003	3
	Consolidated Condensed Statement of Shareholders' Equity for the six months ended June 30, 2004	4
	Notes to Consolidated Condensed Financial Statements	5
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	20
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	43
Item 4.	Controls and Procedures	46
<b>PART II. OTHER INFORMATION</b>		
Item 1.	Legal Proceedings	46
Item 2.	Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities	48
Item 3.	Defaults Upon Senior Securities	48
Item 4.	Submission of Matters to a Vote of Security Holders	48
Item 5.	Other Information	49
Item 6.	Exhibits and Reports on Form 8-K	49

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**CALLAWAY GOLF COMPANY**

**CONSOLIDATED CONDENSED BALANCE SHEETS**  
(In thousands, except share and per share data)  
(Unaudited)

	June 30, 2004	December 31, 2003
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 35,745	\$ 47,340
Accounts receivable, net	261,065	100,664
Inventories, net	154,561	185,389
Deferred taxes	36,304	36,707
Other current assets	14,045	13,362
	<hr/>	<hr/>
Total current assets	501,720	383,462
Property, plant and equipment, net	145,271	164,763
Intangible assets, net	147,844	149,635
Goodwill	30,949	20,216
Deferred taxes	7,997	12,289
Other assets	16,826	18,201
	<hr/>	<hr/>
	\$ 850,607	\$ 748,566
	<hr/>	<hr/>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 100,309	\$ 79,787
Accrued employee compensation and benefits	30,567	25,544
Accrued warranty expense	13,468	12,627
Line of credit	20,000	—
Capital leases, current portion	53	240
Income taxes payable	8,859	11,962
	<hr/>	<hr/>
Total current liabilities	173,256	130,160
Long-term liabilities:		
Deferred compensation	8,849	8,947
Energy derivative valuation account	19,922	19,922
Capital leases, long-term portion	40	154
Commitments and contingencies (Note 10)		
Shareholders' equity:		
Preferred Stock, \$.01 par value, 3,000,000 shares authorized, none issued and outstanding at June 30, 2004 and December 31, 2003	—	—
Common Stock, \$.01 par value, 240,000,000 shares authorized, 83,781,194 and 83,710,094 issued at June 30, 2004 and December 31, 2003, respectively	838	837
Paid-in capital	358,897	400,939
Unearned compensation	(800)	—
Retained earnings	511,228	466,441
Accumulated other comprehensive income	5,033	2,890
Less: Grantor Stock Trust held at market value, 7,519,557 shares and 8,702,577 shares at June 30, 2004 and December 31, 2003, respectively	(85,272)	(146,638)
	<hr/>	<hr/>
	789,924	724,469
Less: Common Stock held in treasury, at cost, 8,497,667 and 8,144,667 shares at June 30, 2004 and December 31, 2003, respectively	(141,384)	(135,086)
	<hr/>	<hr/>
Total shareholders' equity	648,540	589,383
	<hr/>	<hr/>
	\$ 850,607	\$ 748,566
	<hr/>	<hr/>

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



CALLAWAY GOLF COMPANY

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS  
(Unaudited)  
(In thousands, except per share data)

	Three Months Ended June 30,				Six Months Ended June 30,			
	2004		2003		2004		2003	
Net sales	\$297,908	100%	\$242,077	100%	\$661,694	100%	\$513,796	100%
Cost of sales	170,072	57%	115,583	48%	367,667	56%	249,465	49%
Gross profit	127,836	43%	126,494	52%	294,027	44%	264,331	51%
Operating expenses:								
Selling expenses	74,496	25%	53,164	22%	145,691	22%	102,064	20%
General and administrative expenses	21,834	7%	14,629	6%	44,695	7%	28,470	6%
Research and development expenses	7,559	3%	6,242	3%	15,668	2%	12,914	3%
Total operating expenses	103,889	35%	74,035	31%	206,054	31%	143,448	28%
Income from operations	23,947	8%	52,459	22%	87,973	13%	120,883	24%
Other income (expense), net	(1,592)		1,472		(1,321)		288	
Income before income taxes	22,355	8%	53,931	22%	86,652	13%	121,171	24%
Provision for income taxes	8,640		19,788		32,392		44,550	
Net income	\$ 13,715	5%	\$ 34,143	14%	\$ 54,260	8%	\$ 76,621	15%
Earnings per common share:								
Basic	\$ 0.20		\$ 0.52		\$ 0.80		\$ 1.16	
Diluted	\$ 0.20		\$ 0.52		\$ 0.79		\$ 1.16	
Weighted-average shares outstanding:								
Basic	67,788		65,804		67,536		65,770	
Diluted	68,368		66,146		68,367		66,036	
Dividends declared per share	\$ 0.07		\$ 0.07		\$ 0.14		\$ 0.14	

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

**CALLAWAY GOLF COMPANY**

**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(In thousands)**

	Six Months Ended June 30,	
	2004	2003
Cash flows from operating activities:		
Net income	\$ 54,260	\$ 76,621
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	26,320	20,316
Loss on disposal of long-lived assets	1,619	391
Tax benefit from exercise of stock options	1,832	161
Non-cash compensation	2	15
Net non-cash foreign currency hedging gains	1,552	2,198
Net losses from sale of marketable securities	—	98
Deferred taxes	5,972	(18)
Changes in assets and liabilities:		
Accounts receivable, net	(160,441)	(129,678)
Inventories, net	32,298	34,209
Other assets	1,418	1,308
Accounts payable and accrued expenses	13,520	4,948
Accrued employee compensation and benefits	4,980	1,712
Accrued warranty expense	841	1,116
Income taxes payable	(3,520)	28,069
Deferred compensation	(98)	480
	(19,445)	41,946
Cash flows from investing activities:		
Business acquisitions, net of cash acquired	(9,215)	—
Capital expenditures	(7,739)	(3,956)
Proceeds from sale of capital assets	366	104
Proceeds from sale of marketable securities	—	24
	(16,588)	(3,828)
Cash flows from financing activities:		
Payments on financing arrangements	(301)	(1,552)
Net proceeds from line of credit	20,000	—
Issuance of Common Stock	16,691	4,387
Acquisition of Treasury Stock	(6,298)	(3,220)
Dividends paid, net	(4,728)	(9,212)
	25,364	(9,597)
Effect of exchange rate changes on cash and cash equivalents	(926)	486
Net increase (decrease) in cash and cash equivalents	(11,595)	29,007
Cash and cash equivalents at beginning of period	47,340	108,452
Cash and cash equivalents at end of period	\$ 35,745	\$ 137,459
Non-cash financing activities:		
Dividends payable	\$ 4,745	\$ —
Issuance of restricted stock	\$ 800	\$ —

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



CALLAWAY GOLF COMPANY

CONSOLIDATED CONDENSED STATEMENT OF SHAREHOLDERS' EQUITY  
(Unaudited)  
(In thousands)

	Common Stock		Paid-in Capital	Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Income	GST	Treasury Stock		Total
	Shares	Amount						Shares	Amount	
<b>Balance, December 31, 2003</b>	83,710	\$837	\$400,939	\$ —	\$466,441	\$ 2,890	\$(146,638)	(8,145)	\$(135,086)	\$589,383
Exercise of stock options	19	—	(3,706)	—	—	—	17,562	—	—	13,856
Tax benefit from exercise of stock options	—	—	1,832	—	—	—	—	—	—	1,832
Issuance of restricted common stock	53	1	800	(800)	—	—	—	—	—	1
Acquisition of treasury stock	—	—	—	—	—	—	—	(353)	(6,298)	(6,298)
Compensatory stock and stock options	—	—	2	—	—	—	—	—	—	2
Employee stock purchase plan	—	—	(914)	—	—	—	3,748	—	—	2,834
Cash dividends declared	—	—	—	—	(9,473)	—	—	—	—	(9,473)
Adjustment of Grantor Stock Trust shares to market value	—	—	(40,056)	—	—	—	40,056	—	—	—
Equity adjustment from foreign currency translation	—	—	—	—	—	(1,168)	—	—	—	(1,168)
Unrealized gain on cash flow hedges, net of tax	—	—	—	—	—	3,311	—	—	—	3,311
Net income	—	—	—	—	54,260	—	—	—	—	54,260
<b>Balance, June 30, 2004</b>	83,782	\$838	\$358,897	\$(800)	\$511,228	\$ 5,033	\$( 85,272)	(8,498)	\$(141,384)	\$648,540

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

## CALLAWAY GOLF COMPANY

### NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Unaudited)

#### 1. Basis of Presentation

The accompanying unaudited interim financial statements have been prepared by Callaway Golf Company (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Securities and Exchange Commission. These consolidated condensed financial statements, in the opinion of management, include all adjustments (consisting only of normal recurring accruals) necessary for the fair presentation of the financial position, results of operations and cash flows for the periods and dates presented. Interim operating results are not necessarily indicative of operating results for the full year.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates and assumptions.

Certain prior period amounts have been reclassified to conform with the current period presentation.

#### 2. Business Acquisitions

##### *FrogTrader Stock Purchase*

On May 28, 2004, the Company acquired all of the issued and outstanding shares of stock of FrogTrader, Inc. ("FrogTrader"). The Company's consolidated statement of operations include the financial results of FrogTrader for the period from the acquisition date of May 28, 2004 through the period ended June 30, 2004. FrogTrader has partnered with Callaway Golf and its participating retailers for the past two years to develop the industry leading Trade In! Trade Up! program. The Company acquired FrogTrader to better position the Company to stimulate purchases of new clubs by growing the Trade In! Trade Up! program and to enable the Company to better manage the distribution of pre-owned golf clubs and the Callaway Golf brand.

The FrogTrader acquisition was accounted for as a purchase in accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." Under SFAS No. 141, the estimated aggregate cost of the acquired stock is \$15,160,000, which includes cash paid (\$14,960,000) and transaction costs (approximately \$200,000). The aggregate acquisition costs exceeded the estimated fair value of the net assets acquired. As a result, the Company has preliminarily recorded goodwill of \$10,870,000. In accordance with applicable accounting rules, a full determination of the allocation of the aggregate acquisition costs will be made upon a final assessment of the estimated fair value of the acquired net assets. It is anticipated that the final assessment will be completed during the second half of 2004 and that the final allocation will not differ

**CALLAWAY GOLF COMPANY**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)**

**(Unaudited)**

materially from the preliminary allocation. The preliminary allocation as of June 30, 2004 is as follows (in thousands):

<b>Assets:</b>	
Cash	\$ 5,942
Accounts receivable	85
Inventory	1,962
Other current assets	312
Property, plant and equipment	258
Goodwill	10,870
<b>Liabilities:</b>	
Current liabilities	(4,263)
Long-term liabilities	(6)
Total net assets acquired	\$15,160

***Top-Flite Asset Purchase***

On September 15, 2003, the Company acquired through a court-approved sale substantially all of the golf-related assets of TFGC Estate Inc. (f/k/a The Top-Flite Golf Company, f/k/a Spalding Sports Worldwide, Inc.) and thereafter completed the valuation and settlement of certain additional assets related to the international operations of TFGC Estate Inc. (the “Top-Flite Acquisition”). The settlement of the international assets was effective October 1, 2003. Assets located in the United States were acquired by the Company’s newly-formed, wholly-owned subsidiary, The Top-Flite Golf Company. Foreign assets were acquired by the Company’s existing wholly-owned subsidiaries in the relevant countries.

The Company acquired the Top-Flite assets because they provided a unique opportunity to increase significantly the size and profitability of the Company’s golf ball business and the Company was able to purchase the acquired assets at less than their estimated fair value. The Company paid the cash purchase price for the Top-Flite Acquisition from cash on hand. The Company intends to continue the U.S. and foreign operations of the acquired golf assets, including the use of acquired assets in the manufacture of golf balls and golf clubs and the commercialization of the Top-Flite and Ben Hogan brands, patents and trademarks.

The Company’s consolidated statements of operations include the Company’s Top-Flite business results of operations for the three and six months ended June 30, 2004.

The Top-Flite Acquisition was accounted for as a purchase in accordance with SFAS No. 141. Under SFAS No. 141, the estimated aggregate cost of the acquired assets is \$182,879,000, which includes cash paid (\$154,145,000), transaction costs (approximately \$6,250,000), and assumed liabilities (approximately \$22,484,000). The estimated fair value of the net assets exceeded the estimated aggregate acquisition costs. As a result, the Company was required to reduce the carrying value of the acquired long-term assets on a pro rata basis. A final assessment of the estimated fair value of the acquired net assets was received during the second quarter of 2004. As a result of this assessment, a final determination of the allocation of the aggregate acquisition costs was also completed during the second quarter of 2004. As anticipated, the final allocation did

**CALLAWAY GOLF COMPANY**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)**

**(Unaudited)**

not differ materially from the preliminary allocation. The final allocation as of June 30, 2004 is as follows (in thousands):

<b>Assets Acquired:</b>	
Accounts receivable	\$ 44,702
Inventory	32,760
Other assets	1,147
Property and equipment	56,078
Intangible assets (Note 6)	48,192
<b>Liabilities Assumed:</b>	
Current liabilities	(17,398)
Long-term liabilities	(5,086)
Total net assets acquired	\$160,395

During the three and six month periods ended June 30, 2004, the Company recorded pre-tax charges of \$10,688,000 and \$15,796,000, respectively, associated with the integration of the Callaway Golf and Top-Flite operations. The integration charges included \$2,860,000 and \$5,698,000 of accelerated depreciation for the three and six month periods ended June 30, 2004, respectively, associated with golf ball manufacturing equipment that will no longer be in use upon completion of the Company's integration efforts to consolidate the Callaway Golf and Top-Flite golf ball manufacturing operations. The integration charges also include employee costs, professional fees and building consolidation expenses.

**3. Accounting for Stock-Based Compensation**

The Company accounts for its stock-based employee compensation plans using the recognition and measurement principles (intrinsic value method) of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. For the six months ended June 30, 2003, the Company recorded compensation expense of \$15,000, in net income as a result of the restricted stock awards granted in 1998. The restricted stock awards vested in January 2003. No expense was recorded during the three and six months ended June 30, 2004. All other employee stock-based awards were granted with an exercise price equal to the market value of the underlying common stock on the date of grant and no compensation cost is reflected in net income from operations for those awards. Pro forma disclosures of net income and earnings per share, as if the fair value-based recognition provisions of SFAS No. 123,

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

“Accounting for Stock-Based Compensation” had been applied in measuring stock-based employee compensation expense, are as follows (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net income:				
Net income, as reported	\$13,715	\$34,143	\$54,260	\$76,621
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	—	—	—	10
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,566)	(2,259)	(4,846)	(4,617)
Pro forma net income	\$11,149	\$31,844	\$49,414	\$72,014
Earnings per common share:				
Basic — as reported	\$ 0.20	\$ 0.52	\$ 0.80	\$ 1.16
Basic — pro forma	\$ 0.16	\$ 0.48	\$ 0.73	\$ 1.09
Diluted — as reported	\$ 0.20	\$ 0.52	\$ 0.79	\$ 1.16
Diluted — pro forma	\$ 0.16	\$ 0.48	\$ 0.72	\$ 1.09

The pro forma amounts reflected above may not be representative of future disclosures since the estimated fair value of stock options is amortized to expense as the options vest and additional options may be granted in future years. The fair value of employee stock options was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Dividend yield	1.8%	1.8%	1.8%	1.8%
Expected volatility	42.2%	48.9%	42.2%	48.3%
Risk free interest rates	2.11%-4.69%	1.22%-3.93%	2.11%-4.69%	1.22%-3.93%
Expected lives	3-4 years	3-4 years	3-4 years	3-4 years

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company’s employee stock options have characteristics significantly different from those of traded options, and because changes in subjective input assumptions can materially affect the fair value estimates, in management’s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of grants under the Company’s employee stock-based compensation plans.

**4. Marketable Securities and Other Investments**

The Company determines the appropriate classification of its investments at the time of purchase and reevaluates such determination at each balance sheet date. Trading securities are carried at quoted fair value, with unrealized gains and losses included in earnings. Available-for-sale securities are carried at quoted fair value, with unrealized gains and losses reported in shareholders’ equity as a component of accumulated other comprehensive income. Investments in limited partnerships that do not have readily determinable fair values

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

are stated at cost and are reported in other assets. Realized gains and losses are determined using the specific identification method and are included in other income (expense), net.

The Company held no marketable securities at June 30, 2004 or 2003. For the six months ended June 30, 2003, the Company recorded \$98,000 of realized losses on available-for-sale securities and trading securities in other income (expense), net. No gains or losses were recorded during the six months ended June 30, 2004.

5. Inventories

Inventories are summarized below (in thousands):

	June 30, 2004	December 31, 2003
Raw materials	\$ 70,282	\$ 76,122
Work-in-process	6,439	9,129
Finished goods	92,174	118,744
	168,895	203,995
Reserve for excess and obsolescence	(14,334)	(18,606)
	<u>\$154,561</u>	<u>\$185,389</u>

6. Goodwill and Intangible Assets

Effective January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets." As a result of adopting SFAS No. 142, the Company's goodwill and certain intangible assets are no longer amortized, but are subject to an annual impairment test. The following sets forth the intangible assets by major asset class (in thousands):

	Useful Life (Years)	June 30, 2004			December 31, 2003		
		Gross	Accumulated Amortization	Net Book Value	Gross	Accumulated Amortization	Net Book Value
Non-amortizing:							
Trade name, trademark and trade dress <sup>(1)(4)</sup>		\$121,974	\$ —	\$121,974	\$120,605	\$ —	\$120,605
Amortizing:							
Patents <sup>(2)</sup>	3-16	32,176	8,352	23,824	32,277	7,251	25,026
Other <sup>(3)(4)</sup>	1-9	3,092	1,046	2,046	4,386	382	4,004
Total intangible assets		<u>\$157,242</u>	<u>\$9,398</u>	<u>\$147,844</u>	<u>\$157,268</u>	<u>\$7,633</u>	<u>\$149,635</u>

(1) Acquired through acquisition transactions.

(2) The gross balance of patents at June 30, 2004 and December 31, 2003 acquired during business acquisition transactions was \$19,014,000 and \$19,114,000, respectively. The accumulated amortization balance of acquired patents at June 30, 2004 and December 31, 2003, was \$3,742,000 and \$3,131,000, respectively.

(3) The gross balance of other intangibles at June 30, 2004 and December 31, 2003 acquired during business acquisition transactions was \$2,999,000 and \$4,293,000, respectively. The accumulated amortization balance of other acquired intangibles at June 30, 2004 and December 31, 2003 was \$1,018,000 and \$364,000, respectively.

(4) Changes in gross value during the six months ended June 30, 2004 were affected by the final assessment of the estimated fair value of the acquired Top-Flite assets. See Note 2.

**CALLAWAY GOLF COMPANY**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)**

**(Unaudited)**

Intangible assets with definite lives are amortized using the straight-line method over periods ranging from 3 to 16 years. During the three months ended June 30, 2004 and 2003, aggregate amortization expense was approximately \$742,000 and \$352,000, respectively. During the six months ended June 30, 2004 and 2003, aggregate amortization expense was approximately \$1,765,000 and \$703,000, respectively. Amortization expense related to intangible assets at June 30, 2004 in each of the next five fiscal years and beyond is expected to be incurred as follows (in thousands):

Remainder of 2004	\$ 1,286
2005	2,552
2006	2,502
2007	2,498
2008	2,457
2009	2,374
Thereafter	12,201
	\$25,870

Changes in goodwill during the six months ended June 30, 2004 were primarily due to the acquisition of FrogTrader (see Note 2 for further details) which resulted in approximately \$10,870,000 of goodwill. The remaining change of \$137,000 related to a net decline in foreign currency exchange rates.

**7. Financing Arrangements**

Effective November 10, 2003, the Company obtained a \$100,000,000 revolving line of credit from Bank of America, N.A. and certain other lenders. The \$100,000,000 credit facility is scheduled to be available until November 9, 2004, subject to earlier termination in accordance with its terms and subject to extension upon agreement of all parties. Upon the expiration of the revolving credit facility, provided the Company is not in default of the terms of the revolving credit facility and subject to certain conditions, the Company has the option to convert the amounts outstanding under the revolving credit facility into a one-year term loan. At June 30, 2004, there were \$20,000,000 of borrowings outstanding under the \$100,000,000 line of credit and the Company was in compliance with the covenants and other terms thereof.

Subject to the terms of the credit facility, the Company can borrow up to a maximum of \$100,000,000. The Company is required to pay certain fees, including an unused commitment fee equal to 12.5 to 20.0 basis points per annum of the unused commitment amount, with the exact amount determined based upon the Company's Consolidated Leverage Ratio. For purposes of the credit facility, "Consolidated Leverage Ratio" means, as of any date of determination, the ratio of "Consolidated Funded Indebtedness" as of such date to "Consolidated EBITDA" for the four most recent fiscal quarters (as such terms are defined in the credit facility agreement). Outstanding borrowings under the credit facility accrue interest at the Company's election at (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, and in either case less a margin of 50.0 to 100.0 basis points depending upon the Company's Consolidated Leverage Ratio or (ii) the Eurodollar Rate (as such term is defined in the credit facility agreement) plus a margin of 75.0 to 125.0 basis points depending upon the Company's Consolidated Leverage Ratio. The Company has agreed that repayment of amounts under the credit facility will be guaranteed by certain of the Company's domestic subsidiaries and will be secured by the Company's pledge of 65% of the stock it holds in certain of its foreign subsidiaries and by certain intercompany debt securities and proceeds thereof.

The credit facility agreement requires the Company to maintain certain minimum financial covenants. Specifically, (i) the Company's Consolidated Leverage Ratio may not exceed 1.25 to 1.00 and (ii) Consolidated EBITDA (which would exclude certain non-cash charges related to the restructuring of the

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

Company's golf ball operations) for any four consecutive quarters may not be less than \$50,000,000. The credit facility agreement also includes certain other restrictions, including restrictions limiting additional indebtedness, dividends, stock repurchases, transactions with affiliates, capital expenditures, asset sales, acquisitions, mergers, liens and encumbrances and other restrictions that are customary in credit facility agreements of this type. The credit facility also contains other customary provisions, including affirmative covenants, representations and warranties and events of default.

Effective March 15, 2004, as a result of the Top-Flite Acquisition and normal seasonality of the Company's business, the Company obtained an additional \$25,000,000 unsecured line of credit with Bank of America. The purpose of this line of credit was to ensure an additional source of liquidity during the first part of the new golf season during which the Company typically uses more cash than it generates. This line of credit expired June 15, 2004.

In connection with the Top-Flite Acquisition, the Company assumed capital lease obligations which had an aggregate outstanding balance of \$93,000 at June 30, 2004, related primarily to computer and telecommunication systems. The lease agreements expire in 2006.

**8. Product Warranty**

The Company has a stated two-year warranty policy for its golf clubs, although the Company's historical practice has been to honor warranty claims well after the two-year stated warranty period. The Company's policy is to accrue the estimated cost of warranty coverage at the time the sale is recorded. In estimating its future warranty obligations the Company considers various relevant factors, including the Company's stated warranty policies and practices, the historical frequency of claims, and the cost to replace or repair its products under warranty. The following table provides a reconciliation of the activity related to the Company's reserve for warranty expense (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Beginning balance	\$13,891	\$14,798	\$12,627	\$13,464
Provision	3,015	3,598	7,147	7,701
Claims paid/costs incurred	(3,438)	(3,816)	(6,306)	(6,585)
Ending balance	\$13,468	\$14,580	\$13,468	\$14,580

**9. Earnings Per Share**

A reconciliation of the weighted average shares used in the basic and diluted earnings per common share computations for the three and six months ended June 30, 2004 and 2003 is presented below (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Weighted-average shares outstanding:				
Weighted-average shares outstanding — Basic	67,788	65,804	67,536	65,770
Dilutive securities	580	342	831	266
Weighted-average shares outstanding — Diluted	68,368	66,146	68,367	66,036

For the three months ended June 30, 2004 and 2003, options outstanding totaling 9,610,000 and 11,215,000 shares, respectively, were excluded from the calculations, as their effect would have been



## CALLAWAY GOLF COMPANY

### NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

antidilutive. For the six months ended June 30, 2004 and 2003, options outstanding totaling 6,637,000 and 13,181,000 shares, respectively, were excluded from the calculations, as their effect would have been antidilutive.

#### 10. Commitments and Contingencies

##### *Legal Matters*

In conjunction with the Company's program of enforcing its proprietary rights, the Company has initiated or may initiate actions against alleged infringers under the intellectual property laws of various countries, including, for example, the U.S. Lanham Act, the U.S. Patent Act, and other pertinent laws. Defendants in these actions may, among other things, contest the validity and/or the enforceability of some of the Company's patents and/or trademarks. Others may assert counterclaims against the Company. Historically, these matters individually and in the aggregate have not had a material adverse effect upon the financial position or results of operations of the Company. It is possible, however, that in the future one or more defenses or claims asserted by defendants in one or more of those actions may succeed, resulting in the loss of all or part of the rights under one or more patents, loss of a trademark, a monetary award against the Company or some other material loss to the Company. One or more of these results could adversely affect the Company's overall ability to protect its product designs and ultimately limit its future success in the marketplace.

In addition, the Company from time to time receives information claiming that products sold by the Company infringe or may infringe patent or other intellectual property rights of third parties. It is possible that one or more claims of potential infringement could lead to litigation, the need to obtain licenses, the need to alter a product to avoid infringement, a settlement or judgment, or some other action or material loss by the Company.

On April 6, 2001, a complaint was filed against Callaway Golf Company and Callaway Golf Sales Company in the Circuit Court of Sevier County, Tennessee, Case No. 2001-241-IV. The complaint seeks to assert a class action by plaintiff on behalf of himself and on behalf of consumers in Tennessee and Kansas who purchased select Callaway Golf products on or after March 20, 2000. Specifically, the complaint alleges that the Company adopted a New Product Introduction Policy governing the introduction of certain of the Company's new products in violation of Tennessee and Kansas antitrust and consumer protection laws. The plaintiff is seeking damages, restitution and punitive damages. The parties are engaged in discovery.

On November 4, 2002, Callaway Golf Sales Company was served with a complaint filed in the District Court of Sedgwick County, Kansas, Case No. 02C3607, seeking to assert an alleged class action on behalf of Kansas consumers who purchased select Callaway Golf products covered by the New Product Introduction Policy. Callaway Golf Company is also named in the Kansas case. The plaintiff in the Kansas case seeks damages and restitution for the alleged class under Kansas law. The trial court in the Kansas case has stayed the matter in light of the prior pending case in Tennessee.

On May 14, 2004, a complaint was served on Callaway Golf Sales Company captioned Michael K. Murray v. Callaway Golf Sales Co., Case No 04-CVS-8294. The plaintiff claims to be a golf-store proprietor whose business was damaged by the alleged refusal of Callaway Golf Sales Company to sell certain products to him because he chose not to follow the New Product Introduction Policy. Plaintiff seeks compensatory and punitive damages. On June 3, 2004, the case was removed to the United States District Court for the Western District of North Carolina, Charlotte Division as Civil Action Number 3:04CV274-H. Callaway Golf Sales Company has answered the complaint denying liability.

On October 3, 2001, the Company filed suit in the United States District Court for the District of Delaware, Civil Action No. 01-669, against Dunlop Slazenger Group Americas, Inc., d/b/a Maxfli

## CALLAWAY GOLF COMPANY

### NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

("Maxfli"), for infringement of a golf ball aerodynamics patent owned by the Company, U.S. Patent No. 6,213,898 (the "Aerodynamics Patent"). On October 15, 2001, Maxfli filed an answer to the complaint denying any infringement, and also filed a counterclaim against the Company asserting that former Maxfli employees hired by the Company had disclosed confidential Maxfli trade secrets to the Company, and that the Company had used that information to enter the golf ball business. Among other remedies, Maxfli is seeking compensatory damages; an additional award of punitive damages equal to two times the compensatory damages; prejudgment interest; attorneys' fees; a declaratory judgment; and injunctive relief. Both parties have amended their claims. The Company added a claim for false advertising and Maxfli added a claim for inequitable conduct before the Patent and Trademark Office. Maxfli's original report from its damages expert asserts that Maxfli is entitled to at least \$18,500,000 million in compensatory damages from the Company. Maxfli supplemented its damages report to seek an additional \$11,300,000 million in compensatory damages, for a total compensatory damages claim of approximately \$30,000,000 million. The Company has submitted its own expert report seeking damages for false advertising. On November 12, 2003, pursuant to an agreement between the Company and Maxfli, the court dismissed the Company's claim for infringement of the Aerodynamics Patent and all portions of Maxfli's counterclaim related to the Aerodynamics Patent, thereby resolving that part of the case. On May 13, 2004, the Court granted the Company's motion for summary judgment, eliminating that portion of the case asserting that the Company misappropriated trade secrets with respect to the use of polyurethane on the cover of golf balls. On July 12, 2004, the Court denied Maxfli's motion for reconsideration of that ruling. The effect of the Court's ruling is to reduce Maxfli's compensatory damages claim from approximately \$30,000,000 million to \$18,500,000 million. The Company's remaining motions for summary judgment were denied. Thus, absent a resolution by settlement, the parties will proceed to trial on August 2, 2004. An unfavorable resolution of Maxfli's counterclaim could have a significant adverse effect upon the Company's results of operations, cash flows and financial position.

On December 2, 2002, Callaway Golf Company was served with a complaint filed in the Circuit Court of the 19th Judicial District in and for Martin County, Florida, Case No. 935CA, by the Perfect Putter Co. and certain principals of the Perfect Putter Co. Plaintiffs have sued Callaway Golf Company, Callaway Golf Sales Company and a Callaway Golf Sales Company sales representative. Plaintiffs allege that the Company misappropriated certain alleged trade secrets of the Perfect Putter Co. and incorporated those purported trade secrets in the Company's Odyssey White Hot 2-Ball Putter. Plaintiffs also allege that the Company made false statements and acted inappropriately during discussions with plaintiffs. Plaintiffs are seeking compensatory damages, exemplary damages, attorney's fees and costs, pre- and post-judgment interest and injunctive relief. On December 20, 2002, Callaway Golf removed the case to the United States District Court for the Southern District of Florida, Case No. 02-14342. On April 29, 2003, the District Court denied plaintiffs' motion to remand the case to state court. Thereafter, on August 14, 2003, the plaintiffs filed a second amended complaint adding a new claim for civil theft under Florida law based on the alleged facts set forth in the original complaint. If successful on that claim, the plaintiffs will be entitled to treble damages. The Company has denied the allegations of the second amended complaint. The parties are currently engaged in discovery. Plaintiffs have served the Company with an expert report on damages seeking a compensatory damages recovery ranging from \$11,500,000 for alleged breach of contract to \$206,000,000 for alleged unjust enrichment. The Company will submit its own expert reports rebutting the assertions of plaintiffs' experts. The trial of the action was continued by the Court on its own motion and is now set to commence on or about February 1, 2005. An unfavorable resolution of plaintiffs' claims could have a material adverse effect upon the Company's results of operations, cash flows and financial position.

On July 3, 2003, Saso Golf, Inc. filed a lawsuit against the Company, Callaway Golf Sales Co., and an unrelated defendant in the United States District Court for the Northern District of Illinois, Case No. 03-CV-4646. Saso Golf alleges that sales of Callaway Golf's metal woods, including but not limited to the original Callaway Golf Biggest Big Bertha, and Great Big Bertha infringe U.S. Patent No. 5,645,495

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

and seeks compensatory damages, treble damages, attorney's fees, prejudgment interest, costs and injunctive relief. Effective May 14, 2004, the parties resolved the matter, Saso Golf released all of its claims, and the complaint was dismissed with prejudice.

The Company and its subsidiaries, incident to their business activities, are parties to a number of legal proceedings, lawsuits and other claims, including the matters specifically noted above. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. Consequently, management is unable to estimate the ultimate aggregate amount of monetary liability, amounts which may be covered by insurance, or the financial impact with respect to these matters. Except as discussed above with regard to the Maxfli litigation or Perfect Putter litigation, management believes at this time that the final resolution of these matters, individually and in the aggregate, will not have a material adverse effect upon the Company's consolidated annual results of operations, cash flows or financial position.

*Supply of Electricity and Energy Contracts*

In the second quarter of 2001, the Company entered into an agreement with Pilot Power Group, Inc. ("Pilot Power") as the Company's energy service provider and in connection therewith entered into a long-term, fixed-priced, fixed-capacity, energy supply contract (the "Enron Contract") with Enron Energy Services, Inc. ("EESI"), a subsidiary of Enron Corporation, as part of a comprehensive strategy to ensure the uninterrupted supply of energy while capping electricity costs in the volatile California energy market. The Enron Contract provided, subject to the other terms and conditions of the contract, for the Company to purchase nine megawatts of energy per hour from June 1, 2001 through May 31, 2006 (394,416 megawatts over the term of the contract). The total purchase price for such energy over the full contract term would have been approximately \$43,484,000.

At the time the Company entered into the Enron Contract, nine megawatts per hour was in excess of the amount the Company expected to be able to use in its operations. The Company agreed to purchase this amount, however, in order to obtain a more favorable price than the Company could have obtained if the Company had purchased a lesser quantity. The Company expected to be able to sell any excess supply through Pilot Power.

On November 29, 2001, the Company notified EESI that, among other things, EESI was in default of the Enron Contract and that based upon such default, and for other reasons, the Company was terminating the Enron Contract effective immediately. At the time of termination, the contract price for the remaining energy to be purchased under the Enron Contract through May 2006 was approximately \$39,126,000.

On November 30, 2001, EESI notified the Company that it disagreed that it was in default of the Enron Contract and that it was prepared to deliver energy pursuant to the Enron Contract. On December 2, 2001, EESI, along with Enron Corporation and numerous other related entities, filed for bankruptcy. Since November 30, 2001, the parties have not been operating under the Enron Contract and Pilot Power has been providing energy to the Company from alternate suppliers.

As a result of the Company's notice of termination to EESI, and certain other automatic termination provisions under the Enron Contract, the Company believes that the Enron Contract has been effectively and appropriately terminated. There can be no assurance that EESI or another party will not assert a future claim against the Company or that a bankruptcy court or arbitrator will not ultimately nullify the Company's termination of the Enron Contract. No provision has been made for contingencies or obligations, if any, under the Enron Contract beyond November 30, 2001.

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

***Vendor Arrangements***

The Company is dependent on a limited number of suppliers for its clubheads and shafts, some of which are single-sourced. In addition, some of the Company's products require specifically developed manufacturing techniques and processes which make it difficult to identify and utilize alternative suppliers quickly. The Company believes that suitable clubheads and shafts could be obtained from other manufacturers in the event its regular suppliers (because of financial difficulties or otherwise) are unable or fail to provide suitable components. However, any significant production delay or disruption caused by the inability of current suppliers to deliver or the transition to other suppliers could have a material adverse impact on the Company's results of operations. The Company is also single-sourced or dependent on a limited number of suppliers for the materials it uses to make its golf balls. Many of the materials are customized for the Company. Any delay or interruption in such supplies could have a material adverse impact upon the Company's golf ball business. If the Company did experience any such delays or interruptions, there is no assurance that the Company would be able to find adequate alternative suppliers at a reasonable cost or without significant disruption to its business.

***Golf Professional Endorsement Contracts***

The Company establishes relationships with professional golfers in order to evaluate and promote Callaway Golf, Odyssey, Top-Flite and Ben Hogan branded products. The Company has entered into endorsement arrangements with members of the various professional tours, including the Champions Tour, the PGA Tour, the LPGA Tour, the PGA European Tour, the Japan Golf Tour and the Nationwide Tour. Many of these contracts provide incentives for successful performances using the Company's products. For example, under these contracts, the Company could be obligated to pay a cash bonus to a professional who wins a particular tournament while playing the Company's golf clubs or golf balls. It is not possible to predict with any certainty the amount of such performance awards the Company will be required to pay in any given year. Such expenses, however, are an ordinary part of the Company's business and the Company does not believe that the payment of these performance awards will have a material adverse effect upon the Company.

***Other Contingent Contractual Obligations***

During its normal course of business, the Company has made certain indemnities, commitments and guarantees under which it may be required to make payments in relation to certain transactions. These include (i) intellectual property indemnities to the Company's customers and licensees in connection with the use, sale and/or license of Company products, (ii) indemnities to various lessors in connection with facility leases for certain claims arising from such facilities or leases, (iii) indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct of the Company and (iv) indemnities involving the accuracy of representations and warranties in certain contracts. In addition, the Company has made contractual commitments to certain employees providing for severance payments upon the occurrence of certain prescribed events. The Company also has consulting agreements that provide for payment of nominal fees upon the issuance of patents and/or the commercialization of research results. The Company has also issued a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain workers' compensation insurance policies. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation on the maximum amount of future payments the Company could be obligated to make. Historically, costs incurred to settle claims related to indemnities have not been material to the Company's financial position, results of operations or cash flows. In addition, the Company believes the likelihood is remote that material payments will be required under the commitments and guarantees described above. The fair value of indemnities, commitments and guarantees that the Company

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

issued during the six months ended June 30, 2004 was not material to the Company's financial position, results of operations or cash flows.

*Employment Contracts*

The Company has entered into employment contracts with each of the Company's officers. These contracts generally provide for severance benefits, including salary continuation, if employment is terminated by the Company for convenience or by the officer for substantial cause. In addition, in order to assure that the officers would continue to provide independent leadership consistent with the Company's best interests in the event of an actual or threatened change in control of the Company, the contracts also generally provide for certain protections in the event of such a change in control. These protections include the extension of employment contracts and the payment of certain severance benefits, including salary continuation, upon the termination of employment following a change in control. The Company is also generally obligated to reimburse such officers for the amount of any excise taxes associated with such benefits.

**11. Segment Information**

The Company's operating segments are organized on the basis of products and include Golf Clubs and Golf Balls. The Golf Clubs segment consists primarily of Callaway Golf, Top-Flite and Ben Hogan woods, irons, wedges and putters as well as Odyssey putters and other golf-related accessories. The Golf Balls segment consists primarily of Callaway Golf, Top-Flite and Ben Hogan golf balls that are designed, manufactured and sold by the Company. There are no significant intersegment transactions.

The table below contains information utilized by management to evaluate its operating segments for the interim periods presented (in thousands).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net sales <sup>(1)</sup>				
Golf clubs	\$223,377	\$226,494	\$515,067	\$484,522
Golf balls	74,531	15,583	146,627	29,274
	<u>\$297,908</u>	<u>\$242,077</u>	<u>\$661,694</u>	<u>\$513,796</u>
Income (loss) before provision for income taxes <sup>(1)</sup>				
Golf clubs	\$ 40,688	\$ 69,126	\$124,557	\$152,756
Golf balls <sup>(2)</sup>	3,958	(5,359)	2,577	(10,099)
Reconciling items <sup>(3)</sup>	(22,291)	(9,836)	(40,482)	(21,486)
	<u>\$ 22,355</u>	<u>\$ 53,931</u>	<u>\$ 86,652</u>	<u>\$121,171</u>
Additions to long-lived assets <sup>(1)</sup>				
Golf clubs	\$ 3,395	\$ 1,756	\$ 5,330	\$ 3,916
Golf balls	1,722	—	2,409	40
	<u>\$ 5,117</u>	<u>\$ 1,756</u>	<u>\$ 7,739</u>	<u>\$ 3,956</u>

(1) The information presented in this table includes the operations of Top-Flite for the three and six month periods ended June 30, 2004 but not the comparable period in 2003 as the Top-Flite Acquisition did not occur until the third quarter of 2003.

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

- (2) The Company's 2004 income (loss) before provision for income taxes includes the recognition of integration charges in the amount of approximately \$4,102,000 and \$7,069,000 for the three and six months ended June 30, 2004, respectively, related to the integration of the Callaway Golf and Top-Flite golf ball operations.
- (3) Represents corporate general and administrative expenses and other income (expense) not utilized by management in determining segment profitability. The reconciling items include the recognition of non-allocated integration charges in the amount of approximately \$6,586,000 and \$8,727,000 for the three and six months ended June 30, 2004, respectively, related to the integration of the Callaway Golf and Top-Flite operations. The increase in reconciling items for 2004 as compared to 2003 is primarily due to these integration charges and the addition of Top-Flite reconciling items in 2004.

**12. Derivatives and Hedging**

The Company uses derivative financial instruments to manage its exposures to foreign exchange rates. The Company also utilized a derivative commodity instrument to manage its exposure to electricity rates in the volatile California energy market during the period of June 2001 through November 2001. The derivative instruments are accounted for pursuant to SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." As amended, SFAS No. 133 requires that an entity recognize all derivatives as either assets or liabilities in the balance sheet, measure those instruments at fair value and recognize changes in the fair value of derivatives in earnings in the period of change unless the derivative qualifies as an effective hedge that offsets certain exposures.

*Foreign Currency Exchange Contracts*

The Company enters into foreign exchange contracts to hedge against exposure to changes in foreign currency exchange rates. Such contracts are designated at inception to the related foreign currency exposures being hedged, which include anticipated intercompany sales of inventory denominated in foreign currencies, payments due on intercompany transactions from certain wholly-owned foreign subsidiaries, and anticipated sales by the Company's wholly-owned European subsidiary for certain Euro-denominated transactions. Hedged transactions are denominated primarily in British Pounds, Euros, Japanese Yen, Korean Won, Canadian Dollars and Australian Dollars. To achieve hedge accounting, contracts must reduce the foreign currency exchange rate risk otherwise inherent in the amount and duration of the hedged exposures and comply with established risk management policies. Pursuant to its foreign exchange hedging policy, the Company may hedge anticipated transactions and the related receivables and payables denominated in foreign currencies using forward foreign currency exchange rate contracts and put or call options. Foreign currency derivatives are used only to meet the Company's objectives of minimizing variability in the Company's operating results arising from foreign exchange rate movements. The Company does not enter into foreign exchange contracts for speculative purposes. Hedging contracts mature within twelve months from their inception.

At June 30, 2004 and 2003, the notional amounts of the Company's foreign exchange contracts were approximately \$85,005,000 and \$87,722,000, respectively. The Company estimates the fair values of derivatives based on quoted market prices or pricing models using current market rates, and records all derivatives on the balance sheet at fair value. At June 30, 2004, the fair value of foreign currency-related derivatives were recorded as current assets of \$322,000 and current liabilities of \$421,000.

There were no notional amounts of the Company's foreign exchange contracts designated as cash flow hedges at June 30, 2004. At June 30, 2003, the notional amounts of the Company's foreign exchange contracts designated as cash flow hedges were approximately \$22,876,000. For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is initially recorded in accumulated other comprehensive income ("OCI") as a separate

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

component of shareholders' equity and subsequently reclassified into earnings in the period during which the hedged transaction is recognized in earnings. During the three and six months ended June 30, 2004 and 2003, the Company recorded the following activity in OCI (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Beginning OCI balance related to cash flow hedges	\$(649)	\$(1,477)	\$(2,518)	\$(1,362)
Add: Net gain/(loss) initially recorded in OCI	681	(159)	811	(1,344)
Deduct: Net gain/(loss) reclassified from OCI into earnings	289	(1,075)	(1,450)	(2,145)
Ending OCI balance related to cash flow hedges	\$(257)	\$(561)	\$(257)	\$(561)

During the three and six months ended June 30, 2004, no gains or losses were reclassified into earnings as a result of the discontinuance of cash flow hedges.

As of June 30, 2004, \$257,000 of deferred net losses related to derivative instruments designated as cash flow hedges were included in OCI. These derivative instruments hedge transactions that are expected to occur within the next twelve months. As the hedged transactions are completed, the related deferred net gain or loss is reclassified from OCI into earnings. The Company does not expect that such reclassifications will have a material effect on the Company's earnings, as any gain or loss on the derivative instruments generally would be offset by the opposite effect on the related underlying transactions.

The ineffective portion of the gain or loss for derivative instruments that are designated and qualify as cash flow hedges is immediately reported as a component of other income (expense), net. For foreign currency contracts designated as cash flow hedges, hedge effectiveness is measured using the spot rate. Changes in the spot-forward differential are excluded from the test of hedging effectiveness and are recorded currently in earnings as a component of other income (expense), net. During the three months ended June 30, 2004 and 2003, the Company recorded net losses of \$77,000 and net gains of \$27,000, respectively, as a result of changes in the spot-forward differential. During the six months ended June 30, 2004 and 2003, the Company recorded net losses of \$103,000 and \$86,000, respectively, as a result of changes in the spot-forward differential. Assessments of hedge effectiveness are performed using the dollar offset method and applying a hedge effectiveness ratio between 80% and 125%. Given that both the hedged item and the hedging instrument are evaluated using the same spot rate, the Company anticipates the hedges to be highly effective. The effectiveness of each derivative is assessed quarterly.

At June 30, 2004 and 2003, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$85,005,000 and \$64,846,000, respectively. The gains and losses on foreign currency contracts used to hedge balance sheet exposures are recognized as a component of other income (expense), net in the same period as the remeasurement gain and loss of the related foreign currency denominated assets and liabilities and thus offset these gains and losses. During the three months ended June 30, 2004 and 2003, the Company recorded net gains of \$1,143,000 and net losses of \$3,536,000, respectively, due to net realized and unrealized gains and losses on contracts used to hedge balance sheet exposures. During the six months ended June 30, 2004 and 2003, the Company recorded net gains of \$633,000 and net losses of \$4,304,000, respectively, due to net realized and unrealized gains and losses on contracts used to hedge balance sheet exposures.

**Energy Derivative**

In the second quarter of 2001, the Company entered into a long-term, fixed-price, fixed-capacity, energy supply contract as part of a comprehensive strategy to ensure the uninterrupted supply of electricity while

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

capping costs in the volatile California electricity market. The contract was originally effective through May 2006. This derivative did not qualify for hedge accounting treatment under SFAS No. 133. Therefore, the Company recognized in earnings the changes in the estimated fair value of the contract based on current market rates as unrealized energy derivative losses. During the fourth quarter of 2001, the Company notified the energy supplier that, among other things, the energy supplier was in default of the energy supply contract and that based upon such default, and for other reasons, the Company was terminating the energy supply contract. As a result, the Company adjusted the estimated fair value of this contract through the date of termination. As the contract is terminated and neither party to the contract is performing pursuant to the terms of the contract, the terminated contract ceased to represent a derivative instrument in accordance with SFAS No. 133. The Company, therefore, no longer records future valuation adjustments for changes in electricity rates. The Company continues to reflect the derivative valuation account on its balance sheet, subject to periodic review, in accordance with SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." Any non-cash unrealized gains to be recognized upon extinguishment of the derivative valuation account would be reported as non-operating income.

As of the date of termination of the energy supply contract, the derivative valuation account reflected \$19,922,000 of unrealized losses resulting from changes in the estimated fair value of the contract. The fair value of the contract was estimated at the time of termination based on market prices of electricity for the remaining period covered by the contract. The net differential between the contract price and estimated market prices for future periods was applied to the volume stipulated in the contract and discounted on a present value basis to arrive at the estimated fair value of the contract at the time of termination. The estimate was highly subjective because quoted market rates directly relevant to the Company's local energy market and for periods extending beyond a 10- to 12-month horizon were not quoted on a traded market. In making the estimate, the Company instead had to rely upon near-term market quotations and other market information to determine an estimate of the fair value of the contract. In management's opinion, there are no available contract valuation methods that provide a reliable single measure of the fair value of the energy derivative because of the lack of quoted market rates directly relevant to the terms of the contract and because changes in subjective input assumptions can materially affect the fair value estimates. See Note 10 for a discussion of contingencies related to the termination of the Company's derivative energy supply contract.

13. Comprehensive Income

Comprehensive income is defined as all changes in a company's net assets except changes resulting from transactions with shareholders. It differs from net income in that certain items currently recorded to equity would be a part of comprehensive income. The following table sets forth the computation of comprehensive income for the periods presented (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net income	\$13,715	\$34,143	\$54,260	\$76,621
Other comprehensive income:				
Foreign currency translation	(1,694)	2,468	(1,168)	2,485
Net unrealized gain on cash flow hedges, net of tax	392	453	3,311	1,120
Change in unrealized loss on marketable securities	—	—	—	92
Comprehensive income	\$12,413	\$37,064	\$56,403	\$80,318



## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion should be read in conjunction with the Consolidated Condensed Financial Statements and the related notes that appear elsewhere in this report. See also "Important Notice to Investors" on the inside cover of this report.*

### **Regulation G Disclosure**

The Company's discussion and analysis of its results of operations, financial condition and liquidity set forth in this Item 2 have been derived from financial statements prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). In addition to the GAAP results of operations, the Company has also provided additional information concerning the Company's results that includes certain financial measures not prepared in accordance with GAAP. The non-GAAP financial measures included in this discussion are pro forma net income and earnings per share amounts that exclude charges associated with the integration of the Top-Flite business. This discussion also includes results of the Callaway Golf brand (including Odyssey) operations and Top-Flite brand (including Ben Hogan) operations on a stand-alone basis and/or excluding such integration charges, although such operations are not reportable business segments. These non-GAAP financial measures should not be considered a substitute for any measure derived in accordance with GAAP. These non-GAAP financial measures may also be inconsistent with the manner in which similar measures are derived or used by other companies. Management believes that the presentation of such non-GAAP financial measures, when considered in conjunction with the most directly comparable GAAP financial measures, provides useful information to investors by permitting additional relevant period-to-period comparisons of the historical operations of the Callaway Golf business excluding the operations of the recently acquired Top-Flite business, as well as information concerning operations excluding the effect of significant special charges such as the 2004 Top-Flite integration charges. The Company has included in this discussion supplemental information which reconciles those non-GAAP financial measures to the most directly comparable financial measures prepared in accordance with GAAP.

### **Critical Accounting Policies and Estimates**

The Company's discussion and analysis of its results of operations, financial condition and liquidity are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may materially differ from these estimates under different assumptions or conditions. On an on-going basis, the Company reviews its estimates to ensure that the estimates appropriately reflect changes in its business or as new information becomes available.

Management believes the following critical accounting policies affect its more significant estimates and assumptions used in the preparation of its consolidated financial statements:

#### ***Revenue Recognition***

Sales are recognized when both title and risk of loss transfer to the customer. Sales are recorded net of an allowance for sales returns and sales programs. Sales returns are estimated based upon historical returns, current economic trends, changes in customer demands and sell-through of products. The Company also records estimated reductions to revenue for sales programs such as incentive offerings. Sales program accruals are estimated based upon the attributes of the sales program, management's forecast of future product demand, and historical customer participation in similar programs. If the actual costs of sales returns and sales programs significantly exceed the recorded estimated allowance, the Company's sales would be significantly adversely affected.

### ***Allowance for Doubtful Accounts***

The Company maintains an allowance for estimated losses resulting from the failure of its customers to make required payments. An estimate of uncollectable amounts is made by management based upon historical bad debts, current customer receivable balances, age of customer receivable balances, the customer's financial condition and current economic trends. If the actual uncollected amounts significantly exceed the estimated allowance, then the Company's operating results would be significantly adversely affected.

### ***Inventories***

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out (FIFO) method. The inventory balance, which includes material, labor and manufacturing overhead costs, is recorded net of an estimated allowance for obsolete or unmarketable inventory. The estimated allowance for obsolete or unmarketable inventory is based upon management's understanding of market conditions and forecasts of future product demand. If the actual amount of obsolete or unmarketable inventory significantly exceeds the estimated allowance, the Company's cost of sales, gross profit and net income would be significantly adversely affected.

### ***Long-Lived Assets***

In the normal course of business, the Company acquires tangible and intangible assets. The Company periodically evaluates the recoverability of the carrying amount of its long-lived assets (including property, plant and equipment, goodwill and other intangible assets) whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. An impairment is assessed when the undiscounted future cash flows estimated to be derived from an asset are less than its carrying amount. Impairments are recognized in operating earnings. The Company uses its best judgment based on the most current facts and circumstances surrounding its business when applying these impairment rules to determine the timing of the impairment test, the undiscounted cash flows used to assess impairments, and the fair value of a potentially impaired asset. Changes in assumptions used could have a significant impact on the Company's assessment of recoverability.

### ***Warranty***

The Company has a stated two-year warranty policy for its Callaway Golf clubs, although the Company's historical practice has been to honor warranty claims well after the two-year stated warranty period. The Company's policy is to accrue the estimated cost of satisfying future warranty claims at the time the sale is recorded. In estimating its future warranty obligations, the Company considers various relevant factors, including the Company's stated warranty policies and practices, the historical frequency of claims, and the cost to replace or repair its products under warranty. If the number of actual warranty claims or the cost of satisfying warranty claims significantly exceeds the estimated warranty reserve, the Company's cost of sales, gross profit and net income would be significantly adversely affected.

### ***Income Taxes***

Current income tax expense is the amount of income taxes expected to be payable for the current year. A deferred income tax asset or liability is established for the expected future consequences resulting from temporary differences in the financial reporting and tax bases of assets and liabilities. The Company provides a valuation allowance for its deferred tax assets when, in the opinion of management, it is more likely than not that such assets will not be realized. While the Company has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event the Company were to determine that it would be able to realize its deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made. Likewise, should the Company determine that it would not be able to realize all or part of its net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

## Results of Operations

### Three-Month Periods Ended June 30, 2004 and 2003

Net sales increased 23% to \$297.9 million for the three months ended June 30, 2004 as compared to \$242.1 million for the comparable period in the prior year. The overall increase in net sales was primarily due to a \$58.9 million (378%) increase in the sales of golf balls combined with a \$14.3 million (82%) increase in the sales of accessories and other products. The significant increase in golf ball sales was due to the addition of \$45.9 million of Top-Flite (including Ben Hogan) golf ball sales and a \$13.0 million improvement in Callaway Golf brand golf ball sales. The aggregate increases in net sales were partially offset by a \$17.0 million (37%) decrease in sales of putters and a \$1.5 million (2%) decrease in sales of woods in the second quarter of 2004 as compared to the second quarter of 2003. In addition, as compared to 2003, the translation of foreign currency sales into U.S. dollars for reporting purposes had a \$9.7 million positive impact upon net sales for the second quarter of 2004, as measured by applying 2003 exchange rates to 2004 reported net sales.

As compared to the second quarter of 2003, the Company's net sales for the second quarter of 2004 were significantly improved by the addition of \$70.4 million in sales of Top-Flite and Ben Hogan branded products. Excluding sales of Top-Flite and Ben Hogan branded products, sales of Callaway Golf and Odyssey branded products were \$227.5 million for the second quarter of 2004, a \$14.6 million (6%) decline as compared to the second quarter of 2003. The Company believes its sales of Callaway Golf (including Odyssey) branded products were negatively impacted by increased competitive pressures resulting in an overall decline in average selling prices. In addition, the Company's new club product introductions for 2004 were not sufficient to offset a decline in sales of the Company's older club products which were in their second and third years of their product life cycles. The decline in Callaway Golf club sales was partially offset by the increase in sales of Callaway Golf brand golf balls.

Net sales information by product category is summarized as follows (in millions):

	For the Three Months Ended June 30,		Growth/(Decline)	
	2004	2003	Dollars	Percent
Net sales:				
Woods	\$ 75.5	\$ 77.0	\$ (1.5)	(2)%
Irons <sup>(*)</sup>	87.0	85.9	1.1	1%
Putters	29.2	46.2	(17.0)	(37)%
Golf balls	74.5	15.6	58.9	378%
Accessories and other <sup>(*)</sup>	31.7	17.4	14.3	82%
	<u>\$297.9</u>	<u>\$242.1</u>	<u>\$ 55.8</u>	<u>23%</u>

(\*) Beginning with the first quarter of 2004, the Company includes wedge sales with iron sales. Previously, wedge sales were included as a component of the accessories and other category and prior periods have been reclassified to conform with the current period presentation.

The \$1.5 million (2%) decrease in net sales of woods to \$75.5 million was primarily due to a decrease in sales of titanium and steel woods, partially offset by sales of the Company's new fusion woods (woods comprised of multi-materials that are fused together). Although overall unit sales of woods increased during the quarter, the increase was not sufficient to offset the decline in dollar sales. The decline in dollar sales was primarily attributable to lower average selling prices as a result of increased competitive pressures.

The \$1.1 million (1%) increase in net sales of irons to \$87.0 million was primarily due to the addition of Top-Flite and Ben Hogan iron sales, partially offset by declines in sales of Callaway Golf steel irons. The decline in sales of the Callaway Golf irons was expected as such products generally sell better in the first year after introduction and most of the Callaway Golf iron products sold during the quarter were introduced more than one year ago.

The \$17.0 million (37%) decrease in net sales of putters to \$29.2 million is attributable to decreased sales of the Company's Odyssey White Hot 2-ball putter (which is in its third year of sales) and DFX line of Odyssey putters, partially offset by the addition of Top-Flite and Ben Hogan putters and the introduction of the Callaway Golf Tour Blue putter.

The \$58.9 million (378%) increase in net sales of golf balls to \$74.5 million was primarily attributable to the addition of sales of the Top-Flite and Ben Hogan golf ball products as a result of the Top-Flite acquisition in late 2003, as well as strong sales for the newly released Callaway Golf balls. Sales of the Top-Flite and Ben Hogan brand balls were \$45.9 million for the three months ended June 30, 2004. Callaway Golf ball sales during the second quarter of 2004 were \$28.6 million, an increase of \$13.0 million (83%) from the second quarter of 2003. The Company believes that the increase in Callaway Golf ball sales during the quarter were positively affected by the addition of two new products to the product line for the current year and the absence of any new Callaway Golf ball product introductions in the second quarter of 2003. The Company also believes that its overall golf ball sales benefited from an increase in rounds played in the United States. Golf Datatech has reported that the number of golf rounds played in the United States through May of 2004 increased 2.4%, as compared to the same period in 2003, and May 2004 marked the eighth consecutive month of year over year increases in rounds played in the United States.

The \$14.3 million (82%) increase in sales of accessories and other products was primarily attributable to sales of Top-Flite and Ben Hogan bags, gloves and other accessories combined with an increase in sales of Callaway Golf bags and accessories and the 2004 introduction of the Game Enjoyment System (GES) (a new product offering consisting of a golf bag, guidebook and seven golf clubs designed for players with slower swing speeds).

Net sales information by regions is summarized as follows (in millions):

	For the Three Months Ended June 30,		Growth/(Decline)	
	2004	2003	Dollars	Percent
Net sales:				
United States	\$171.3	\$143.2	\$28.1	20%
Europe	57.8	43.9	13.9	32%
Japan	16.6	21.4	(4.8)	(22)%
Rest of Asia	17.2	15.4	1.8	12%
Other foreign countries	35.0	18.2	16.8	92%
	<u>\$297.9</u>	<u>\$242.1</u>	<u>\$55.8</u>	<u>23%</u>

Net sales in the United States increased \$28.1 million (20%) to \$171.3 million during the second quarter of 2004 as compared to the second quarter of 2003. In addition, the Company's sales in regions outside of the United States increased \$27.7 million (28%) during the second quarter of 2004 to \$126.6 million versus the same period in 2003. As compared to the second quarter of 2003, net sales for the second quarter of 2004 in the United States and in regions outside of the United States were positively affected by the addition of sales of Top-Flite and Ben Hogan products in the amount of \$43.1 million (in the United States) and \$27.3 million (outside of the United States). In addition, as compared to 2003, the Company's 2004 reported net sales in regions outside of the United States were positively affected by the translation of foreign currency sales into U.S. dollars based upon 2004 exchange rates. As compared to 2003, the translation of foreign currency sales into U.S. dollars for reporting purposes had a \$9.7 million positive impact upon net sales for the second quarter of 2004, as measured by applying 2003 exchange rates to 2004 reported net sales.

For the second quarter of 2004, gross profit increased \$1.3 million to \$127.8 million from \$126.5 million in the second quarter of 2003. Gross profit as a percentage of net sales decreased to 43% of net sales in the second quarter of 2004 from 52% in the comparable period of 2003. This decline in the Company's gross profit percentage was primarily attributable to lower average selling prices as a result of increased competitive pressures, lower margins in the Top-Flite business (as compared to the Callaway Golf business) and the costs

related to the integration of the Top-Flite and Callaway Golf operations, partially offset by improved margins on the Callaway Golf ball business.

Selling expenses increased \$21.3 million (40%) to \$74.5 million in the second quarter of 2004 as compared to \$53.2 million in the comparable period of 2003. As a percentage of sales, the expenses increased to 25% in the second quarter of 2004 from 22% in the second quarter of 2003. The dollar increase in expenses in the second quarter of 2004 was primarily due to the addition of Top-Flite selling expenses of \$20.0 million and a \$5.2 million increase in Callaway Golf tour and promotional expenses, partially offset by a \$5.5 million decrease in Callaway Golf advertising expenses.

General and administrative expenses increased \$7.2 million (49%) in the second quarter of 2004 to \$21.8 million from \$14.6 million in the second quarter of 2003. As a percentage of sales, the expenses increased to 7% in the second quarter of 2004 from 6% in the second quarter of 2003. The dollar increase was primarily due to the addition of Top-Flite general and administrative expenses incurred in 2004 of \$6.3 million.

Research and development expenses increased \$1.3 million (21%) in the second quarter of 2004 to \$7.6 million from \$6.2 million in the comparable period of 2003. As a percentage of sales, the expenses remained constant at 3%. The dollar increase was primarily due to the addition of Top-Flite research and development expenses of \$1.0 million.

Other expense increased to \$1.6 million in the second quarter of 2004 as compared to other income of \$1.5 million in the second quarter of 2003. The \$3.1 million of additional other expense is primarily attributable to a \$7.3 million increase in foreign currency transaction losses partially offset by a \$4.6 million increase in foreign currency contract gains.

Net income for the second quarter of 2004 decreased 60% to \$13.7 million from \$34.1 million in the comparable period in 2003. Diluted earnings per share for the second quarter of 2004 decreased 62% to \$0.20 from \$0.52 in the comparable period of 2003. Net income and diluted earnings per share in 2004 were negatively affected by after-tax charges relating to the integration of the Callaway Golf and Top-Flite operations in the amount of \$6.7 million and \$0.10 per share, respectively. Excluding these integration charges, as compared to the second quarter of 2003, for the second quarter of 2004, (i) pro forma net income would have decreased 40% to \$20.4 million and (ii) pro forma diluted earnings per share would have decreased to \$0.30 per share.

In order to assist with period over period comparisons of the Callaway Golf business and to provide additional insight into the effect that the acquisition and integration of the Top-Flite business had on the Company's results, the Company has provided the following reconciling information in accordance with Regulation G (in thousands, except per share data):

	Quarter Ended June 30,				
	2004				2003 <sup>(*)</sup>
	Callaway Golf	Top-Flite Golf	Integration Charges	Total	Total
Net sales	\$227,485	\$70,423	\$ —	\$297,908	\$242,077
Gross profit	110,321	23,383	(5,868)	127,836	126,494
% of sales	48%	33%	n/a	43%	52%
Operating expenses	75,259	23,810	4,820	103,889	74,035
Income (loss) from operations	35,062	(427)	(10,688)	23,947	52,459
Other income (expense), net	(1,908)	316	—	(1,592)	1,472
Income (loss) before income taxes	33,154	(111)	(10,688)	22,355	53,931
Income tax provision (benefit)	12,696	(38)	(4,018)	8,640	19,788
Net income (loss)	\$ 20,458	\$ (73)	\$ (6,670)	\$ 13,715	\$ 34,143
Diluted earnings (loss) per share	\$ 0.30	\$ 0.00	\$ (0.10)	\$ 0.20	\$ 0.52
Weighted-average shares outstanding	68,368	68,368	68,368	68,368	66,146

(\*) During the latter part of 2003, the Callaway Golf Company completed the acquisition of substantially all of the golf-related assets of the Top-Flite Golf Company. Therefore, the results reported for the quarter ended June 30, 2003 reflect only the Callaway Golf and Odyssey brand operations as there were no Top-Flite Golf operating results or integration charges for such period.

#### *Six-Month Periods Ended June 30, 2004 and 2003*

Net sales increased 29% to \$661.7 million for the six months ended June 30, 2004 as compared to \$513.8 million for the comparable period in the prior year. The overall increase in net sales is primarily due to a \$117.3 million (401%) increase in the sales of golf balls combined with a \$29.4 million (17%) increase in the sales of woods, and a \$29.3 million (79%) increase in sales of the Company's accessories and other products. The significant increase in golf ball sales was due to the addition of \$90.7 million of Top-Flite (including Ben Hogan) golf ball sales and a \$26.6 million improvement in Callaway Golf brand golf ball sales. These increases were partially offset by a \$25.0 million (27%) decrease in sales of putters and a \$3.1 million (2%) decrease in sales of irons in the first half of 2004 as compared to the first half of 2003. In addition, as compared to the first half of 2003, the translation of foreign currency sales into U.S. dollars for reporting purposes had a \$25.4 million positive impact upon net sales for the first half of 2004, as measured by applying 2003 exchange rates to 2004 reported net sales.

As compared to the first half of 2003, the Company's net sales for the first half of 2004 were significantly affected by the addition of \$136.9 million in sales of Top-Flite and Ben Hogan branded products. Excluding sales of Top-Flite and Ben Hogan branded products, sales of Callaway Golf and Odyssey branded products were \$524.8 million for the first half of 2004, an \$11.0 million (2%) increase as compared to the first half of 2003. This increase is primarily due to the successful sell-in to the golf retail channel of the Company's products during the first quarter of 2004. This increase was partially offset by a decline in Callaway Golf (including Odyssey) sales during the second quarter of 2004 as compared to the second quarter of 2003. As discussed above, the Company believes this decline in sales during the second quarter was primarily attributable to a decline in average selling prices and a decline in sales of products that were in their second and third years of their product life cycles.

Net sales information by product category is summarized as follows (in millions):

	For the Six Months Ended June 30,		Growth (Decline)	
	2004	2003	Dollars	Percent
Net sales:				
Woods	\$199.3	\$169.9	\$ 29.4	17%
Irons <sup>(*)</sup>	183.5	186.6	(3.1)	(2)%
Putters	66.1	91.1	(25.0)	(27)%
Golf balls	146.6	29.3	117.3	401%
Accessories and other <sup>(*)</sup>	66.2	36.9	29.3	79%
	<u>\$661.7</u>	<u>\$513.8</u>	<u>\$147.9</u>	<u>29%</u>

(\*) Beginning with the first quarter of 2004, the Company includes wedge sales with iron sales. Previously, wedge sales were included as a component of the accessories and other category and prior periods have been reclassified to conform with the current period presentation.

The \$29.4 million (17%) increase in net sales of woods to \$199.3 million was primarily due to an increase in sales of steel woods and the Company's new fusion woods, partially offset by a decrease in titanium woods. The increase in steel and fusion woods was due to new product introductions. The Company believes the decrease in sales of titanium woods is primarily due to increased competitive pressures resulting in a decline in units sold as well as lower average selling prices.

The \$3.1 million (2%) decrease in net sales of irons to \$183.5 million was due primarily to a decrease in both unit and dollar sales of Callaway Golf brand steel irons. The decrease in Callaway Golf brand steel irons was expected as such products generally sell better in the first year after introduction and most of the steel iron products sold during the first half of 2004 were introduced more than one year ago. This decrease was partially offset by the addition of Top-Flite and Ben Hogan iron sales.

The \$25.0 million (27%) decrease in net sales of putters to \$66.1 million was attributable to decreased sales of the Company's Odyssey White Hot 2-ball putter (which is in its third year of sales) and DFX line of Odyssey putters partially offset by the addition of Top-Flite and Ben Hogan putters.

The \$117.3 million (401%) increase in net sales of golf balls to \$146.6 million was primarily attributable to the addition of sales of the Top-Flite and Ben Hogan golf ball products in the first half of 2004 as a result of the Top-Flite acquisition in late 2003, as well as strong sales for the newly released Callaway Golf balls. Sales of the Top-Flite and Ben Hogan brand balls were \$90.7 million for the six months ended June 30, 2004. Callaway Golf ball sales during the first half of 2004 were \$55.9 million, an increase of \$26.6 million (91%) from the first half of 2003. The Company believes that the increase in Callaway Golf ball sales during the first half of 2004 were positively affected by the addition of two new products to the product line for the current year and the absence of any new Callaway Golf ball product introductions in the first half of 2003. The Company also believes that its overall golf ball sales benefited from an increase in rounds played in the United States. Golf Datatech has reported that the number of golf rounds played in the United States through May of 2004 increased 2.4%, as compared to the same period in 2003, and May 2004 marked the eighth consecutive month of year over year increases in rounds played in the United States.

The \$29.3 million (79%) increase in sales of accessories and other products is primarily attributable to sales of Top-Flite and Ben Hogan bags, gloves and other accessories combined with an increase in sales of Callaway Golf bags and accessories and the 2004 introduction of the Game Enjoyment System (GES) (a new product offering consisting of a golf bag, guidebook and seven golf clubs designed for players with slower swing speeds).

Net sales information by regions is summarized as follows (in millions):

	For the Six Months Ended June 30,		Growth (Decline)	
	2004	2003	Dollars	Percent
Net sales:				
United States	\$389.0	\$292.5	\$ 96.5	33%
Europe	125.1	94.1	31.0	33%
Japan	48.3	54.5	(6.2)	(11)%
Rest of Asia	33.1	33.6	(0.5)	(1.5)%
Other foreign countries	66.2	39.1	27.1	69%
	\$661.7	\$513.8	\$147.9	29%

Net sales in the United States increased \$96.5 million (33%) to \$389.0 million during the first half of 2004 versus the first half of 2003. In addition, the Company's sales in regions outside of the United States increased \$51.4 million (23%) to \$272.7 million during the first half of 2004 versus the same period of 2003. As compared to the first half of 2003, net sales for the first half of 2004 in the United States and in regions outside of the United States were positively affected by the addition of sales of Top-Flite and Ben Hogan products in the amount of \$87.6 million (in the United States) and \$49.3 million (outside of the United States). In addition, as compared to 2003, the Company's 2004 reported net sales in regions outside of the United States were affected by the translation of foreign currency sales into U.S. dollars based upon 2004 exchange rates. As compared to 2003, the translation of foreign currency sales into U.S. dollars for reporting purposes had a \$25.4 million positive impact upon net sales for the first half of 2004, as measured by applying 2003 exchange rates to 2004 reported net sales.

For the six months ended June 30, 2004, gross profit increased \$29.7 million to \$294.0 million from \$264.3 million in the comparable period of 2003. Gross profit as a percentage of net sales decreased to 44% of net sales in the first six months of 2004 from 51% in the comparable period of 2003. This decline in the Company's gross profit percentage was primarily attributable to lower average selling prices as a result of increased competitive pressures and close-out products, lower margins in the Top-Flite business (as compared to the Callaway Golf business) and the costs related to the integration of the Top-Flite and Callaway Golf operations, partially offset by improved margins on the Callaway Golf ball business.

Selling expenses increased \$43.6 million (43%) in the first half of 2004 to \$145.7 million from \$102.1 million in the comparable period of 2003, and were 22% and 20% of net sales, respectively. The increase in expenses was primarily due to the addition of Top-Flite selling expenses of \$36.9 million and an \$8.6 million increase in Callaway Golf tour and promotional expenses, partially offset by a \$5.7 million decrease in Callaway Golf advertising expenses.

General and administrative expenses increased \$16.2 million (57%) in the first half of 2004 to \$44.7 million from \$28.5 million in the first half of 2003. As a percentage of sales, the expenses increased to 7% in the first half of 2004 from 6% in the first half of 2003. The dollar increase was primarily due to the addition of Top-Flite general and administrative expenses incurred in 2004 of \$12.1 million.

Research and development expenses increased \$2.8 million (21%) in the first half of 2004 to \$15.7 million from \$12.9 million in the comparable period of 2003. As a percentage of sales, the expenses decreased to 2% in the first half of 2004 from 3% in the first half of 2003. The dollar increase was primarily due to the addition of Top-Flite research and development expenses of \$2.2 million.

Other expense increased to \$1.3 million in the first half of 2004 as compared to other income of \$0.3 million in the first half of 2003. The \$1.6 million of additional other expense is primarily attributable to a \$7.0 million increase in foreign currency transaction losses partially offset by a \$4.9 million increase in foreign currency contract gains.



Net income for the first half of 2004 decreased 29% to \$54.3 million from \$76.6 million in the comparable period in 2003. Diluted earnings per share for the first half of 2004 decreased 32% to \$0.79 from \$1.16 in the comparable period in 2003. Net income and diluted earnings per share in 2004 were negatively affected by after-tax charges relating to the integration of the Callaway Golf and Top-Flite operations in the amount of \$9.9 million and \$0.15 per share, respectively. Excluding these integration charges, as compared to the first half of 2003, for the first half of 2004, (i) pro forma net income would have decreased 16% to \$64.2 million and (ii) pro forma diluted earnings per share would have decreased to \$0.94 per share.

In order to assist with period over period comparisons of the Callaway Golf business and to provide additional insight into the effect that the acquisition and the integration of the Top-Flite business had on the Company's results, the Company has provided the following reconciling information in accordance with Regulation G (in thousands, except per share data):

	Six Months Ended June 30,				
	2004				2003 <sup>(*)</sup>
	Callaway Golf	Top-Flite Golf	Integration Charges	Total	Total
Net sales	\$524,769	\$136,925	\$ —	\$661,694	\$513,796
Gross profit	256,382	46,983	(9,338)	294,027	264,331
% of sales	49%	34%	n/a	44%	51%
Operating expenses	152,962	46,634	6,458	206,054	143,448
Income (loss) from operations	103,420	349	(15,796)	87,973	120,883
Other income (expense), net	(1,735)	414	—	(1,321)	288
Income (loss) before income taxes	101,685	763	(15,796)	86,652	121,171
Income tax provision (benefit)	38,012	285	(5,905)	32,392	44,550
Net income (loss)	\$ 63,673	\$ 478	\$ (9,891)	\$ 54,260	\$ 76,621
Diluted earnings (loss) per share	\$ 0.93	\$ 0.01	\$ (0.15)	\$ 0.79	\$ 1.16
Weighted-average shares outstanding	68,367	68,367	68,367	68,367	66,036

(\*) During the latter part of 2003, the Callaway Golf Company completed the acquisition of substantially all of the golf-related assets of the Top-Flite Golf Company. Therefore, the results reported for the six months ended June 30, 2003 reflect only the Callaway Golf and Odyssey brand operations as there were no Top-Flite Golf operating results or integration charges for such period.

### Financial Condition

Cash and cash equivalents decreased \$11.6 million (24%) to \$35.7 million at June 30, 2004, from \$47.3 million at December 31, 2003. During the first half of 2004, the Company also utilized a line of credit, which had a balance of \$20.0 million at June 30, 2004. The overall decrease in cash primarily resulted from cash used in operating activities of \$19.4 million and cash used in investing activities of \$16.6 million, partially offset by cash provided by financing activities of \$25.4 million. Cash flows used in operating activities for the six months ended June 30, 2004, reflect a net \$160.4 million increase in accounts receivable, partially offset by net income of \$54.3 million, adjusted for depreciation and amortization of \$26.3 million, a \$32.3 million decrease in inventory, a \$13.5 million increase in accounts payable and accrued expenses and a \$5.0 million increase in employee compensation and benefits. Cash flows used in investing activities reflect the FrogTrader business acquisition (net of acquired cash) of \$9.2 million and capital expenditures of \$7.7 million. Cash flows provided by financing activities are primarily attributable to \$20.0 million of net proceeds from the line of credit and \$16.7 million of proceeds from the issuance of common stock in connection with the exercise of employee stock options and purchases under the employee stock purchase plan. During the three months ended June 30, 2004, the Company declared a \$0.07 per share dividend that was paid in the amount of \$4.7 million in July 2004.

At June 30, 2004 the Company had cash and cash equivalents of \$35.7 million, as compared to \$137.5 million at June 30, 2003. During the first half of 2004, the Company utilized its line of credit which had a balance of \$20 million at June 30, 2004. The decrease in cash and use of the line of credit is primarily due to the use of \$160.4 million of cash to purchase Top-Flite assets in the last half of 2003, which depleted cash reserves at the beginning of the current year, as well as increased the cash requirements to fund operations during the first half of 2004. In addition, cash flow from operations has been negatively impacted by lower net income, increased accounts receivable payment terms, and the timing of tax payments. The Company also utilized \$9.2 million in net cash to purchase FrogTrader.

At June 30, 2004, the Company's net accounts receivable increased \$160.4 million to \$261.1 million from \$100.7 million at December 31, 2003. The growth in receivables is primarily due to the general seasonality of the business (see below "Certain Factors Affecting Callaway Golf Company — Seasonality and Adverse Weather Conditions"). The Company's net accounts receivable increased \$64.5 million at June 30, 2004 as compared to the Company's net accounts receivable at June 30, 2003, primarily due to the addition of Top-Flite receivables. Excluding the Top-Flite balances, gross accounts receivable would have increased \$8.6 million. This increase is primarily attributable to extended terms offered in response to market conditions.

At June 30, 2004, the Company's net inventory decreased \$30.8 million to \$154.6 million from \$185.4 million at December 31, 2003. The decrease is consistent with seasonal trends (see below "Certain Factors Affecting Callaway Golf Company — Seasonality and Adverse Weather Conditions"). The Company's net inventory increased \$34.9 million at June 30, 2004 as compared to the Company's net inventory at June 30, 2003, primarily due to the addition of Top-Flite's inventory. Excluding Top-Flite's balances, net inventory levels would have decreased \$9.5 million as compared to net inventory levels at June 30, 2003.

At June 30, 2004, the Company's net property, plant and equipment decreased \$19.5 million to \$145.3 million from \$164.8 million at December 31, 2003. This decrease is primarily due to depreciation of \$24.6 million during the first half of 2004, asset disposals of \$2.6 million, partially offset by additions of \$7.7 million during the same period.

## **Liquidity**

### *Sources of Liquidity*

The Company's principal sources of liquidity, both on a short-term and long-term basis, for the periods presented generally have been cash flows provided by operations. The Company currently expects this to continue over the long-term. In the short term, however, given the significant amount of cash used in the Top-Flite Acquisition, the Company intends to supplement its cash provided by operations with its credit facilities. At June 30, 2004, the Company had a revolving line of credit with Bank of America and certain other lenders to borrow up to \$100.0 million (the "Credit Facility"). At June 30, 2004, there were \$20.0 million of borrowings outstanding under the credit facility and the Company was in compliance with the covenants prescribed by the Credit Facility.

The \$100.0 million Credit Facility is scheduled to be available until November 9, 2004, subject to earlier termination in accordance with its terms and subject to extension upon agreement of all parties. Upon the expiration of the Credit Facility, provided the Company is not in default of the terms of the Credit Facility and subject to certain conditions, the Company has the option to convert the amounts outstanding under the Credit Facility into a one-year term loan.

Subject to the terms of the Credit Facility, the Company can borrow up to a maximum of \$100.0 million. The Company is required to pay certain fees, including an unused commitment fee equal to 12.5 to 20.0 basis points per annum of the unused commitment amount, with the exact amount determined based upon the Company's Consolidated Leverage Ratio. For purposes of the Credit Facility, "Consolidated Leverage Ratio" means, as of any date of determination, the ratio of "Consolidated Funded Indebtedness" as of such date to "Consolidated EBITDA" for the four most recent fiscal quarters (as such terms are defined in the Credit Facility agreement). Outstanding borrowings under the Credit Facility accrue interest at the Company's

election at (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, and in either case less a margin of 50.0 to 100.0 basis points depending upon the Company's Consolidated Leverage Ratio or (ii) the Eurodollar Rate (as such term is defined in the Credit Facility agreement), plus a margin of 75.0 to 125.0 basis points depending upon the Company's Consolidated Leverage Ratio. The Company has agreed that repayment of amounts under the Credit Facility will be guaranteed by certain of the Company's domestic subsidiaries and will be secured by the Company's pledge of 65% of the stock it holds in certain of its foreign subsidiaries and by certain intercompany debt securities and proceeds thereof.

The Credit Facility agreement requires the Company to maintain certain minimum financial covenants. Specifically, (i) the Company's Consolidated Leverage Ratio may not exceed 1.25 to 1.00 and (ii) Consolidated EBITDA (which would exclude certain non-cash charges related to the restructuring of the Company's golf ball operations) for any four consecutive quarters may not be less than \$50.0 million. The Credit Facility agreement also includes certain other restrictions, including restrictions limiting additional indebtedness, dividends, stock repurchases, transactions with affiliates, capital expenditures, asset sales, acquisitions, mergers, liens and encumbrances and other matters customarily restricted in loan documents. The Credit Facility also contains other customary provisions, including affirmative covenants, representations and warranties and events of default.

### *Share Repurchases*

Repurchases of equity securities as reported on a settlement date basis during the quarter ended June 30, 2004 were as follows (in millions, except per share amounts):

Period	Total # of Shares Purchased(1)	Average Price Paid Per Share	Total # of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
April 1, 2004 – April 30, 2004	0.4	\$17.84	0.4	\$8.0
May 1, 2004 – May 31, 2004	—	—	—	\$8.0
June 1, 2004 – June 30, 2004	—	—	—	\$8.0

(1) All repurchases set forth in this table were made pursuant to the \$50.0 million stock repurchase program authorized and announced by the Board of Directors in May 2002.

### *Other Significant Cash and Contractual Obligations*

The following table provides, as of June 30, 2004 certain significant cash and contractual obligations that will affect the Company's future liquidity (in millions):

	Payments Due By Period				
	Total	Less than 1 Year	1-3 Years	4-5 Years	More than 5 Years
Line of credit	\$20.0	\$20.0	\$ —	\$ —	\$ —
Long-term debt obligations	—	—	—	—	—
Operating leases <sup>(1)</sup>	18.7	5.9	7.5	3.1	2.2
Capital leases <sup>(2)</sup>	0.1	0.1	—	—	—
Unconditional purchase obligations	(3)	(3)	—	—	—
Deferred compensation <sup>(4)</sup>	8.8	1.0	1.1	0.6	6.1
Total <sup>(5)</sup>	\$47.6	\$27.0	\$8.6	\$3.7	\$8.3

(1) The Company leases certain warehouse, distribution and office facilities, vehicles as well as office equipment under operating leases. The amounts presented in this line item represent commitments for minimum lease payments under non-cancelable operating leases and include operating leases assumed as part of the Top-Flite Acquisition.

- (2) The Company acquired certain capital lease obligations as a result of the Top-Flite Acquisition primarily related to computer and telecommunications systems. The amounts presented in this line item represent commitments for minimum lease payments under non-cancelable capital leases.
- (3) Occasionally the Company enters into long-term purchase commitments for production materials and other items; however, at June 30, 2004, the Company had no such outstanding commitments. The Company also enters into unconditional purchase obligations with various vendors and suppliers of goods and services in the normal course of operations through purchase orders or other documentation or are undocumented except for an invoice. Such obligations are generally outstanding for periods less than a year and are settled by cash payments upon delivery of goods and services and are not reflected in this line item.
- (4) The amounts presented in this line item represent the liability for the Company's unfunded, non-qualified deferred compensation plan. The plan allows officers, certain other employees and directors of the Company to defer all or part of their compensation, to be paid to the participants or their designated beneficiaries after retirement, death or separation from the Company. To support the deferred compensation plan, the Company has elected to purchase Company-owned life insurance. The cash surrender value of the Company-owned insurance related to deferred compensation is included in other assets and was \$9.7 million at June 30, 2004.
- (5) During the third quarter of 2001, the Company entered into a derivative commodity instrument to manage electricity costs in the volatile California energy market. The contract was originally effective through May 2006. During the fourth quarter of 2001, the Company notified the energy supplier that, among other things, the energy supplier was in default of the energy supply contract and that based upon such default, and for other reasons, the Company was terminating the energy supply contract. The Company continues to reflect the \$19.9 million derivative valuation account on its balance sheet, subject to periodic review, in accordance with SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." The \$19.9 million represents unrealized losses resulting from changes in the estimated fair value of the contract and does not represent contractual cash obligations. The Company believes the energy supply contract has been terminated and, therefore, the Company does not have any further cash obligations under the contract. Accordingly, the energy derivative valuation account is not included in the table. There can be no assurance, however, that a party will not assert a future claim against the Company or that a bankruptcy court or arbitrator will not ultimately nullify the Company's termination of the contract. No provision has been made for contingencies or obligations, if any, under the contract beyond November 2001. See below "Supply of Electricity and Energy Contracts."

In addition to the obligations listed above, the Company has entered into contracts with professional golfers to evaluate and promote Callaway Golf, Odyssey, Top-Flite and Ben Hogan branded products. Many of these contracts provide incentives for successful performances using the Company's products. For example, under these contracts, the Company could be obligated to pay a cash bonus to a professional who wins a particular tournament while playing the Company's golf clubs or golf balls. It is not possible to predict with any certainty the amount of such performance awards the Company will be required to pay in any given year. Such expenses, however, are an ordinary part of the Company's business and the Company does not believe that the payment of these performance awards will have a material adverse effect upon the Company. See below "Certain Factors Affecting Callaway Golf Company — Golf Professional Endorsements."

During its normal course of business, the Company has made certain indemnities, commitments and guarantees under which it may be required to make payments in relation to certain transactions. These include (i) intellectual property indemnities to the Company's customers and licensees in connection with the use, sale and/or license of Company products or trademarks, (ii) indemnities to various lessors in connection with facility leases for certain claims arising from such facilities or leases, (iii) indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct of the Company and (iv) indemnities involving the accuracy of representations and warranties in certain contracts. In addition, the Company has made contractual commitments to certain employees providing for severance payments upon the occurrence of certain prescribed events. The Company also has consulting agreements that provide for payment of nominal fees upon the issuance of patents and/or the commercialization of research results. The Company has also issued a guarantee in the form of a standby letter of credit as security for contingent

liabilities under certain workers' compensation insurance policies. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation on the maximum amount of future payments the Company could be obligated to make. Historically, costs incurred to settle claims related to indemnities have not been material to the Company's financial position, results of operations or cash flows. In addition, the Company believes the likelihood is remote that material payments will be required under the commitments and guarantees described above. The fair value of indemnities, commitments and guarantees that the Company issued during the six months ended June 30, 2004 was not material to the Company's financial position, results of operations or cash flows.

In addition to the cash and contractual obligations listed above, the Company's liquidity could also be adversely affected by an unfavorable outcome with respect to claims and litigation that the Company is subject to from time to time. See below "Part II, Item I — Legal Proceedings."

### ***Sufficiency of Liquidity***

Based upon its current operating plan, analysis of its consolidated financial position and projected future results of operations, the Company believes that its operating cash flows, together with its credit facility, will be sufficient to finance current operating requirements, planned capital expenditures, contractual obligations and commercial commitments, for the next twelve months. There can be no assurance, however, that future industry specific or other developments, general economic trends or other matters will not adversely affect the Company's operations or its ability to meet its future cash requirements. See below "Certain Factors Affecting Callaway Golf Company."

### **Supply of Electricity and Energy Contracts**

Beginning in the summer of 2000, the Company identified a future risk to ongoing operations as a result of the deregulation of the electricity market in California. In July 2000, the Company entered into a one-year supply agreement with Idaho Power Company ("Idaho Power"), a subsidiary of Idacorp, Inc., for the supply of electricity at \$64 per megawatt hour. During the second quarter of 2001, Idaho Power advised the Company that it was unwilling to renew the contract upon expiration in July 2001 due to concerns surrounding the volatility of the California electricity market at that time.

As a result, in the second quarter of 2001, the Company entered into an agreement with Pilot Power Group, Inc. ("Pilot Power") as the Company's energy service provider and in connection therewith entered into a long-term, fixed-priced, fixed-capacity, energy supply contract ("Enron Contract") with Enron Energy Services, Inc. ("EESI"), a subsidiary of Enron Corporation, as part of a comprehensive strategy to ensure the uninterrupted supply of electricity while capping costs in the volatile California electricity market. The Enron Contract provided, subject to the other terms and conditions of the contract, for the Company to purchase nine megawatts of energy per hour from June 1, 2001 through May 31, 2006 (394,416 megawatts over the term of the contract). The total purchase price for such energy over the full contract term would have been approximately \$43.5 million.

At the time the Company entered into the Enron Contract, nine megawatts per hour was in excess of the amount the Company expected to be able to use in its operations. The Company agreed to purchase this amount, however, in order to obtain a more favorable price than the Company could have obtained if the Company had purchased a lesser quantity. The Company expected to be able to sell any excess supply through Pilot Power.

Because the Enron Contract provided for the Company to purchase an amount of energy in excess of what it expected to be able to use in its operations, the Company accounted for the Enron Contract as a derivative instrument in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." The Enron Contract did not qualify for hedge accounting under SFAS No. 133. Therefore, the Company recognized changes in the estimated fair value of the Enron Contract currently in earnings. The estimated fair value of the Enron Contract was based upon a present value determination of the net differential between the contract price for electricity and the estimated future market prices for electricity

as applied to the remaining amount of unpurchased electricity under the Enron Contract. Through September 30, 2001, the Company had recorded unrealized pre-tax losses of \$19.9 million.

On November 29, 2001, the Company notified EESI that, among other things, EESI was in default of the Enron Contract and that based upon such default, and for other reasons, the Company was terminating the Enron Contract effective immediately. At the time of termination, the contract price for the remaining energy to be purchased under the Enron Contract through May 2006 was approximately \$39.1 million.

On November 30, 2001, EESI notified the Company that it disagreed that it was in default of the Enron Contract and that it was prepared to deliver energy pursuant to the Enron Contract. However, on December 2, 2001, EESI, along with Enron Corporation and numerous other related entities, filed for bankruptcy. Since November 30, 2001, the parties have not been operating under the Enron Contract and Pilot Power has been providing energy to the Company from alternate suppliers.

As a result of the Company's notice of termination to EESI, and certain other automatic termination provisions under the Enron Contract, the Company believes that the Enron Contract has been terminated. As a result, the Company adjusted the estimated value of the Enron Contract through the date of termination, at which time the terminated Enron Contract ceased to represent a derivative instrument in accordance with SFAS No. 133. Because the Enron Contract is terminated and neither party to the contract is performing pursuant to the terms of the contract, the Company no longer records future valuation adjustments for changes in electricity rates. The Company continues to reflect on its balance sheet the derivative valuation account of \$19.9 million, subject to periodic review, in accordance with SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities."

The Company believes the Enron Contract has been terminated, and as of June 30, 2004, EESI has not asserted any claim against the Company. There can be no assurance, however, that EESI or another party will not assert a future claim against the Company or that a bankruptcy court or arbitrator will not ultimately nullify the Company's termination of the Enron Contract. No provision has been made for contingencies or obligations, if any, under the Enron Contract beyond November 30, 2001.

### **Certain Factors Affecting Callaway Golf Company**

The financial statements contained in this report and the related discussion describe and analyze the Company's financial performance and condition for the periods presented. For the most part, this information is historical. The Company's prior results, however, are not necessarily indicative of the Company's future performance or financial condition. The Company has also included certain forward-looking statements concerning the Company's future performance or financial condition. These forward-looking statements are based upon current information and expectations and actual results could differ materially. The Company therefore has included the following discussion of certain factors that could cause the Company's future performance or financial condition to differ materially from its prior performance or financial condition or from management's expectations or estimates of the Company's future performance or financial condition. These factors, among others, should be considered in assessing the Company's future prospects and prior to making an investment decision with respect to the Company's stock.

#### ***Top-Flite Golf Company Asset Acquisition***

In September 2003, the Company acquired through a court-approved sale substantially all of the golf-related assets of the TFGC Estate Inc. (f/k/a The Top-Flite Golf Company, f/k/a Spalding Sports Worldwide, Inc.), which included golf ball manufacturing facilities, the Top-Flite and Ben Hogan brands, and all golf-related patents and trademarks. The Company faces certain challenges associated with this acquisition, including (i) reinvigorating the Top-Flite brands in the marketplace, (ii) the assimilation of the Top-Flite and Callaway Golf brands in the marketplace without negatively affecting the sales of either brand, (iii) the integration and consolidation of the Callaway Golf and Top-Flite golf ball manufacturing operations, (iv) the ability to maintain good customer relations and service as the Company integrates international Top-Flite sales and distribution operations with the Company's existing foreign subsidiaries, (v) operating all or almost all of the golf ball manufacturing operations in a mature facility that is located in a harsh climate across

the country from the Company's principal executive offices and that has a unionized workforce, and (vi) the employee and other issues inherent in any consolidation. Furthermore, the integration and consolidation of the acquired assets will require a considerable amount of time and attention of senior management and others, which could have an adverse effect upon the Company's club business.

In addition, in connection with the integration and consolidation of the golf ball manufacturing operations, the Company has incurred and expects to incur additional significant charges to earnings. During the fourth quarter of 2003, the Company recorded a charge of approximately \$0.25 per share related to the disposal of certain golf ball manufacturing equipment. During the first half of 2004, the Company incurred additional integration charges in the amount of approximately \$0.15 per share and on July 22, 2004, the Company announced that the total integration charges for 2004 (including the charges incurred during the first half) are estimated to be approximately \$0.25 per share. Additional integration charges are expected in 2005.

Finally, the Company has spent a considerable amount of cash to complete the Top-Flite Acquisition and there is no assurance that the Company will realize a satisfactory return on its investment.

#### ***Terrorist Activity and Armed Conflict***

Terrorist activities and armed conflicts in recent years (such as the attacks on the World Trade Center and the Pentagon, the incidents of Anthrax poisoning and the military actions in the Middle East, including the War in Iraq), as well as the threat of future conflict, have had a significant adverse effect upon the Company's business. Any such additional events would likely have an adverse effect upon the world economy and would likely adversely affect the level of demand for the Company's products as consumers' attention and interest are diverted from golf and become focused on these events and the economic, political, and public safety issues and concerns associated with such events. Also, such events could adversely affect the Company's ability to manage its supply and delivery logistics. If such events caused a significant disruption in domestic or international air, ground or sea shipments, the Company's ability to obtain the materials necessary to produce and sell its products and to deliver customer orders also would be materially adversely affected. Furthermore, such events have negatively impacted tourism, and if this negative impact upon tourism continues, the Company's sales to retailers at resorts and other vacation destinations would be materially adversely affected.

#### ***Pandemic Diseases***

The outbreak of a pandemic disease, such as Severe Acute Respiratory Syndrome ("SARS") or the Avian Flu, could significantly adversely affect the Company's business. A pandemic disease could significantly adversely affect both the demand for the Company's products as well as the supply of the components used to make the Company's products. Demand for golf products could be negatively affected as consumers in the affected regions restrict their recreational activities and as tourism to those areas declines. Moreover, the Company relies on many companies in Asia for its components. If the Company's suppliers experienced a significant disruption in their business as a result of a pandemic disease, the Company's ability to obtain the necessary components to make its products could be significantly adversely affected. In addition, the outbreak of any such disease generally restricts the travel to and from such countries making it more difficult in general to manage the Company's international operations.

#### ***Adverse Global Economic Conditions***

The Company sells golf clubs, golf balls and golf accessories. These products are recreational in nature and are therefore discretionary purchases for consumers. Consumers are generally more willing to make discretionary purchases of golf products during favorable economic conditions and when consumers are feeling confident and prosperous. Adverse economic conditions in the United States or in the Company's international markets (which represent almost half of the Company's total sales), or a decrease in prosperity among consumers, or even a decrease in consumer confidence as a result of anticipated adverse economic conditions, could cause consumers to forgo or to postpone purchasing new golf products. Such forgone or postponed purchases could have a material adverse effect upon the Company.

### ***Foreign Currency Risk***

Almost half of the Company's sales are international sales. As a result, the Company conducts transactions in approximately 12 currencies worldwide. Conducting business in such various currencies increases the Company's exposure to fluctuations in foreign currency exchange rates relative to the U.S. dollar. Changes in exchange rates may positively or negatively affect the Company's financial results. Overall, the Company is generally negatively affected by a stronger U.S. dollar in relation to the foreign currencies in which the Company conducts business. Conversely, overall, the Company is generally positively affected by a weaker U.S. dollar relative to such foreign currencies. For the effect of foreign currencies on the Company's financial results for the current reporting periods, see above "Results of Operations."

The effects of foreign currency fluctuations can be significant. The Company therefore engages in certain hedging activities to mitigate the impact of foreign currency fluctuations over time on the Company's financial results. The Company's hedging activities reduce, but do not eliminate, the effects of such foreign currency fluctuations. Factors that could affect the effectiveness of the Company's hedging activities include accuracy of sales forecasts, volatility of currency markets and the availability of hedging instruments. Since the hedging activities are designed to reduce volatility, they not only reduce the negative impact of a stronger U.S. dollar but they also reduce the positive impact of a weaker U.S. dollar. For the effect of the Company's hedging activities during the current reporting periods, see below "Quantitative and Qualitative Disclosures about Market Risk."

The Company's future financial results could be significantly negatively affected if the value of the U.S. dollar increases relative to the foreign currencies in which the Company conducts business. The degree to which the Company's financial results are affected will depend in part upon the effectiveness or ineffectiveness of the Company's hedging activities.

### ***Growth Opportunities***

*Golf Clubs.* In order for the Company to significantly grow its sales of golf clubs, the Company must either increase its share of the market for golf clubs or the market for golf clubs must grow. The Company already has a significant share of worldwide premium golf club sales and therefore opportunities for additional market share may be limited. The Company does not believe there has been any material increase in the number of golfers in the United States in over four years. Furthermore, the Company believes that since 1997 overall worldwide premium golf club sales have generally not experienced substantial growth in dollar volume from year to year. There is no assurance that the overall dollar volume of worldwide premium golf club sales will grow, or that it will not decline, in the future.

*Golf Balls.* In connection with the acquisition of the Top-Flite assets, the Company significantly increased its golf ball market share. Prior to the acquisition, however, both Callaway Golf's and Top-Flite's market shares had been declining. The Company's ability to reverse such decline and to obtain the market share previously enjoyed will depend in part upon the Company's ability to integrate the Top-Flite brands and operations with the Callaway Golf brands and operations. There is no assurance that the Company will be able to successfully or profitably integrate these brands or operations or maintain the combined market share previously enjoyed by the Top-Flite and Callaway Golf brands.

### ***Manufacturing Capacity***

The Company plans its manufacturing capacity based upon the forecasted demand for its products. Actual demand for such products may exceed or be less than forecasted demand. The Company's unique product designs often require sophisticated manufacturing techniques, which can require significant start-up expenses and/or limit the Company's ability to quickly expand its manufacturing capacity to meet the full demand for its products. If the Company is unable to produce sufficient quantities of new products in time to fulfill actual demand, especially during the Company's traditionally busy season, it could limit the Company's sales and adversely affect its financial performance. On the other hand, the Company invests in manufacturing capacity and commits to components and other manufacturing inputs for varying periods of time, which can limit the Company's ability to quickly react if actual demand is less than forecasted demand. This could result



in less than optimum capacity usage and/or in excess inventories and related obsolescence charges that could adversely affect the Company's financial performance. In addition, if the Company were to experience delays, difficulties or increased costs in its production of golf clubs or golf balls, including production of new products needed to replace current products, the Company's future golf club or golf ball sales could be adversely affected.

#### ***Dependence on Energy Resources***

The Company's golf club and golf ball manufacturing facilities in California use, among other resources, significant quantities of electricity to operate. In 2001, some companies in California, including the Company, experienced periods of blackouts during which electricity was not available. The Company has taken certain steps to provide access to alternative power supplies for certain of its operations, and believes that these measures could mitigate any impact resulting from possible future blackouts. The Company is currently purchasing for its California operations wholesale energy through the Company's California energy service provider under short-term contracts. From time to time, legislation has been introduced that would restrict the Company's ability to purchase wholesale energy through its energy service provider. If any such legislation were passed, the Company may be required to purchase energy from the local public utility, which could cause the Company's cost of energy to increase. If the Company's costs of energy were to increase as a result of such legislation or otherwise, the Company's results of operations would be adversely affected.

#### ***Dependence on Certain Suppliers and Materials***

The Company is dependent on a limited number of suppliers for its clubheads and shafts, some of which are single-sourced. In addition, some of the Company's products require specifically developed manufacturing techniques and processes which make it difficult to identify and utilize alternative suppliers quickly. The Company believes that suitable clubheads and shafts could be obtained from other manufacturers in the event its regular suppliers (because of financial difficulties or otherwise) are unable or fail to provide suitable components. However, there could be a significant production delay or disruption caused by the inability of current suppliers to deliver or the transition to other suppliers, which in turn could have a material adverse impact on the Company's results of operations. The Company is also single-sourced or dependent on a limited number of suppliers for the materials it uses to make its golf balls. Many of the materials are customized for the Company. Any delay or interruption in such supplies could have a material adverse impact upon the Company's golf ball business. If the Company did experience any such delays or interruptions, there is no assurance that the Company would be able to find adequate alternative suppliers at a reasonable cost or without significant disruption to its business.

The Company uses United Parcel Service ("UPS") for substantially all ground shipments of products to its U.S. customers. The Company uses air carriers and ships for most of its international shipments of products. Any significant interruption in UPS, air carrier or ship services could have a material adverse effect upon the Company's ability to deliver its products to its customers. If there were any significant interruption in such services, there is no assurance that the Company could engage alternative suppliers to deliver its products in a timely and cost-efficient manner. In addition, many of the components the Company uses to build its golf clubs, including clubheads and shafts, are shipped to the Company via air carrier and ship services. Any significant interruption in UPS services, air carrier services or shipping services into or out of the United States could have a material adverse effect upon the Company (see also below "International Risks").

The Company's size has made it a large consumer of certain materials, including steel, titanium alloys, carbon fiber and rubber. The Company does not make these materials itself, and must rely on its ability to obtain adequate supplies in the world marketplace in competition with other users of such materials. While the Company has been successful in obtaining its requirements for such materials thus far, there can be no assurance that it always will be able to do so at a reasonable price. An interruption in the supply of the materials used by the Company or a significant change in costs could have a material adverse effect on the Company.

## ***Competition***

*Golf Clubs.* The golf club business is highly competitive, and is served by a number of well-established and well-financed companies with recognized brand names, as well as new companies with popular products. New product introductions, price reductions, consignment sales, extended payment terms and “close-outs” (including close-outs of products that were recently commercially successful) by competitors continue to generate increased market competition. Furthermore, continued price compression in the club industry for new clubs could have a significant adverse affect on the Company’s pre-owned club business as the gap between the cost of a new club and a pre-owned club lessens. There can be no assurance that successful marketing activities, discounted pricing, consignment sales, extended payment terms or new product introductions by competitors will not negatively impact the Company’s future sales.

*Golf Balls.* The golf ball business is also highly competitive and may be becoming even more competitive. There are a number of well-established and well-financed competitors, including one competitor with an estimated U.S. market share in excess of 50%. As competition in this business increases, many of these competitors are substantially discounting the prices of their products and/or increasing advertising, tour or other promotional support. This increased competition has resulted in significant expenses for the Company in both tour and advertising support and product development. Unless there is a change in competitive conditions, these pricing pressures and increased costs will continue to adversely affect the profitability of the Company’s golf ball businesses.

On a consolidated basis, no one customer that distributes the Company’s golf clubs or balls in the United States accounted for more than 4% of the Company’s revenues in 2003, 2002 or 2001. On a segment basis, the Company’s golf ball customer base is much more concentrated than its golf club customer base. In 2004, it is expected that the top five golf ball customers will account for over 25% of the Company’s total golf ball sales. A loss of one or more of these customers could have a significant adverse effect upon the Company’s golf ball sales.

## ***Market Acceptance of Products***

A golf equipment manufacturer’s ability to compete is in part dependent upon its ability to satisfy the various subjective requirements of golfers, including a golf club’s and golf ball’s look and “feel,” and the level of acceptance that a golf club and ball has among professional and recreational golfers. The subjective preferences of golf club and ball purchasers are difficult to predict and may be subject to rapid and unanticipated changes. In addition, the Company’s products have tended to incorporate significant innovations in design and manufacture, which have often, but not always, resulted in higher prices for the Company’s products relative to other products in the marketplace. There can be no assurance that a significant percentage of the public will always be willing to pay premium prices for golf equipment or that the Company will be able to design and manufacture products that achieve market acceptance. In general, there can be no assurance as to whether or how long the Company’s golf clubs and golf balls will achieve and maintain market acceptance and therefore there can be no assurance that the demand for the Company’s products will permit the Company to experience growth in sales, or maintain historical levels of sales, in the future.

## ***New Product Introduction and Product Cyclicity***

The Company believes that the introduction of new, innovative golf clubs and golf balls is important to its future success. A major portion of the Company’s revenues is generated by products that are less than two years old. The Company faces certain risks associated with such a strategy. For example, in the golf industry, new models and basic design changes in golf equipment are frequently met with consumer rejection. In addition, prior successful designs have been rendered obsolete within a relatively short period of time as new products are introduced into the marketplace. Further, any new products that retail at a lower price than prior products may negatively impact the Company’s revenues unless unit sales increase. The rapid introduction of new golf club or golf ball products by the Company has resulted in close-outs of existing inventories at both the wholesale and retail levels. Such close-outs have resulted in reduced margins on the sale of older products, as well as reduced sales of new products, given the availability of older products at lower prices.

The Company's newly introduced golf club products generally, but not always, have a product life cycle of up to two years. These products generally sell significantly better in the first year after introduction as compared to the second year. In certain markets, such as Japan, the decline in sales occurs sooner in the product cycle and is more significant. The Company's fusion woods generally sell at higher price points than its titanium metal woods, and its titanium metal woods generally sell at higher price points than its steel metal woods. Historically, the Company's wood products generally have achieved better gross margins than its iron products. However, price compression in the woods market has made this differential less, and at times gross margins on woods may be less than other products. The Company's sales and gross margins for a particular period may be negatively or positively affected by the mix of new products sold in such period.

### ***Seasonality and Adverse Weather Conditions***

In addition to the effects of product cycles described above, the Company's business is also subject to the effects of seasonal fluctuations. The Company's first quarter sales generally represent the Company's sell-in to the golf retail channel of its golf club products for the new golf season. Orders for many of these sales are received during the fourth quarter of the prior year. The Company's second and third quarter sales generally represent re-order business for golf clubs. Sales of golf clubs during the second and third quarters therefore are significantly affected not only by the sell-through of the Company's products that were sold into the channel during the first quarter but also by the sell-through of the products of the Company's competitors. The Company's sales of golf balls are generally associated with the level of rounds played in the areas where the Company's products are sold. Therefore, golf ball sales tend to be greater in the second and third quarters, when the weather is good in most of these areas and rounds played are up. Golf ball sales are also stimulated by product introductions as the retail channel takes on initial supplies. Like golf clubs, re-orders of golf balls depend on the rate of sell-through. Retailers are sometimes reluctant to re-order the Company's products in significant quantity when they already have excess inventory of the Company's or its competitors' products. The Company's sales during the fourth quarter are generally significantly less than the other quarters because in general in many of the Company's principal markets less people are playing golf during that time of year due to cold weather. Furthermore, it previously was the Company's practice to announce its new product line at the beginning of each calendar year. The Company has departed from that practice and now generally announces its new product line in the fourth quarter to allow retailers to plan better. Such early announcements of new products could cause golfers, and therefore the Company's customers, to defer purchasing additional golf equipment until the Company's new products are available. Such deferrals could have a material adverse effect upon sales of the Company's current products and/or result in close-out sales at reduced prices.

Because of these seasonal trends, the Company's business can be significantly adversely affected by unusual or severe weather conditions. Unfavorable weather conditions generally result in less golf rounds played, which generally results in less demand for golf clubs and golf balls. Consequently, sustained adverse weather conditions, especially during the warm weather months, could materially affect the Company's sales.

### ***Conformance with the Rules of Golf***

New golf club and golf ball products generally seek to satisfy the standards established by the USGA and R&A because these standards are generally followed by golfers within their respective jurisdictions. The USGA rules are generally followed in the United States, Canada and Mexico, and the R&A rules are generally followed in most other countries throughout the world.

The Rules of Golf as published by the R&A and the USGA are virtually the same except with respect to the regulation of "driving clubs." The R&A rules currently permit drivers with a higher coefficient of restitution ("COR") than is permitted under the USGA rules. As a result, in jurisdictions where the R&A rules are followed the Company (like many of its competitors) has marketed and sold drivers with a higher COR that conform to the R&A rules but not the USGA rules (the "Plus Drivers"). In those jurisdictions where the USGA rules are followed the Company markets and sells its standard drivers that conform to both

the R&A and the USGA rules. All of the Company's other products are believed to conform to both the USGA and R&A rules.

Effective January 1, 2008, high COR drivers such as the Plus Drivers will not be conforming under the generally applicable Rules of Golf as published by the R&A. It is not clear what effect the change in rules will have upon demand for high COR drivers in R&A jurisdictions as 2008 approaches or subsequent to the implementation of the new restrictions. It is possible that some jurisdictions and/or golfers will choose not to follow the R&A's changes and will instead continue to use high COR drivers. This uncertainty adversely affects the Company's research and development and manufacturing operations which must plan and commit resources years in advance of a new product release. If the Company does not accurately anticipate consumer reaction to the new rules, the Company's sales in such jurisdictions could be adversely affected and the Company could be required to expend significant resources to change its product offerings at such time. The Company also believes that the general confusion created by the ruling bodies of golf as to what is a conforming or non-conforming driver and the limits imposed on new driver technology have hurt sales of drivers generally.

There is no assurance that the Company's future products will satisfy USGA and/or R&A standards, or that existing USGA and/or R&A standards will not be altered in ways that adversely affect the sales of the Company's products or the Company's brand. If a change in rules were adopted and caused one or more of the Company's current products to be non-conforming, the Company's sales of such products could be adversely affected. Furthermore, any such new rules could restrict the Company's ability to develop new products.

### ***Golf Professional Endorsements***

The Company establishes relationships with professional golfers in order to evaluate and promote Callaway Golf, Odyssey, Top-Flite and Ben Hogan branded products. The Company has entered into endorsement arrangements with members of the various professional tours, including the Champions Tour, the PGA Tour, the LPGA Tour, the PGA European Tour, the Japan Golf Tour and the Nationwide Tour. While most professional golfers fulfill their contractual obligations, some have been known to stop using a sponsor's products despite contractual commitments. If certain of the Company's professional endorsers were to stop using the Company's products contrary to their endorsement agreements, the Company's business could be adversely affected in a material way by the negative publicity or lack of endorsement.

The Company believes that professional usage of its golf clubs and golf balls contributes to retail sales. The Company therefore spends a significant amount of money to secure professional usage of its products. Many other companies, however, also aggressively seek the patronage of these professionals and offer many inducements, including significant cash rewards and specially designed products. There is a great deal of competition to secure the representation of tour professionals. As a result, it is becoming increasingly difficult and more expensive to attract and retain such tour professionals. The inducements offered by other companies could result in a decrease in usage of the Company's products by professional golfers or limit the Company's ability to attract other tour professionals. A decline in the level of professional usage of the Company's products could have a material adverse effect on the Company's sales and business.

### ***Intellectual Property and Proprietary Rights***

The golf club industry, in general, has been characterized by widespread imitation of popular club designs. The Company has an active program of enforcing its proprietary rights against companies and individuals who market or manufacture counterfeits and "knock off" products, and asserts its rights against infringers of its copyrights, patents, trademarks, and trade dress. However, there is no assurance that these efforts will reduce the level of acceptance obtained by these infringers. Additionally, there can be no assurance that other golf club manufacturers will not be able to produce successful golf clubs which imitate the Company's designs without infringing any of the Company's copyrights, patents, trademarks, or trade dress.

An increasing number of the Company's competitors have, like the Company itself, sought to obtain patent, trademark, copyright or other protection of their proprietary rights and designs for golf clubs and golf balls. As the Company develops new products, it attempts to avoid infringing the valid patents and other

intellectual property rights of others. Before introducing new products, the Company's legal staff evaluates the patents and other intellectual property rights of others to determine if changes are required to avoid infringing any valid intellectual property rights that could be asserted against the Company's new product offerings. From time to time, others have contacted or may contact the Company to claim that they have proprietary rights that have been infringed by the Company and/or its products. The Company evaluates any such claims and, where appropriate, has obtained or sought to obtain licenses or other business arrangements. To date, there have been no interruptions in the Company's business as a result of any claims of infringement. No assurance can be given, however, that the Company will not be adversely affected in the future by the assertion of intellectual property rights belonging to others. This effect could include alteration or withdrawal of existing products and delayed introduction of new products.

Various patents have been issued to the Company's competitors in the golf ball industry. As the Company develops its golf ball products, it attempts to avoid infringing valid patents or other intellectual property rights. Despite these attempts, it cannot be guaranteed that competitors will not assert and/or a court will not find that the Company's golf balls infringe certain patent or other rights of competitors. If the Company's golf balls are found to infringe on protected technology, there is no assurance that the Company would be able to obtain a license to use such technology, and it could incur substantial costs to redesign them and/or defend legal actions.

The Company has procedures to maintain the secrecy of its confidential business information. These procedures include criteria for dissemination of information and written confidentiality agreements with employees and suppliers. Suppliers, when engaged in joint research projects, are required to enter into additional confidentiality agreements. While these efforts are taken seriously, there can be no assurance that these measures will prove adequate in all instances to protect the Company's confidential information.

The Company's Code of Conduct prohibits misappropriation of trade secrets and confidential information of third parties. The Code of Conduct is contained in the Company's Employee Handbook and available to all employees on the Company's website. Employees also sign an Employee Invention and Confidentiality Agreement prohibiting disclosure of trade secrets and confidential information from third parties. Periodic training is provided to employees on this topic as well. Despite taking these steps, as well as others, the Company cannot guarantee that these measures will be adequate in all instances to prevent misappropriation of trade secrets from third parties or the accusation by a third party that such misappropriation has taken place.

### ***Brand Licensing***

The Company licenses its trademarks to third party licensees who produce, market and sell their products bearing the Company's trademarks. The Company chooses its licensees carefully and imposes upon such licensees various restrictions on the products, and on the manner, on which such trademarks may be used. Despite these restrictions, or if a licensee fails to adhere to these restrictions, the Company's brand could be damaged by the use or misuse of the Company's trademarks in connection with its licensees' products.

### ***Product Returns***

*Golf Clubs.* The Company supports all of its golf clubs with a limited two year written warranty. Since the Company does not rely upon traditional designs in the development of its golf clubs, its products may be more likely to develop unanticipated problems than those of many of its competitors that use traditional designs. For example, clubs have been returned with cracked clubheads, broken graphite shafts and loose medallions. While any breakage or warranty problems are deemed significant by the Company, the incidence of defective clubs returned to date has not been material in relation to the volume of clubs that have been sold.

The Company monitors the level and nature of any golf club breakage and, where appropriate, seeks to incorporate design and production changes to assure its customers of the highest quality available in the market. Significant increases in the incidence of breakage or other product problems may adversely affect the Company's sales and image with golfers. The Company believes that it has adequate reserves for warranty claims. If the Company were to experience an unusually high incidence of breakage or other warranty

problems in excess of these reserves, the Company's financial results would be adversely affected. See above, "Critical Accounting Policies and Estimates — Warranty."

*Golf Balls.* The Company has not experienced significant returns of defective golf balls, and in light of the quality control procedures implemented in the production of its golf balls, the Company does not expect a significant amount of defective ball returns. However, if future returns of defective golf balls were significant, it could have a material adverse effect upon the Company's golf ball business.

#### ***"Gray Market" Distribution***

Some quantities of the Company's products find their way to unapproved outlets or distribution channels. This "gray market" for the Company's products can undermine authorized retailers and foreign wholesale distributors who promote and support the Company's products, and can injure the Company's image in the minds of its customers and consumers. On the other hand, stopping such commerce could result in a potential decrease in sales to those customers who are selling Callaway Golf products to unauthorized distributors and/or an increase in sales returns over historical levels. While the Company has taken some lawful steps to limit commerce in its products in the "gray market" in both the U.S. and abroad, it has not stopped such commerce.

#### ***International Risks***

The Company's management believes that controlling the distribution of its products in certain major markets in the world has been and will be an element in the future growth and success of the Company. The Company sells and distributes its products directly (as opposed to through third party distributors) in many key international markets in Europe, Asia, North America and elsewhere around the world. These activities have resulted and will continue to result in investments in inventory, accounts receivable, employees, corporate infrastructure and facilities. In addition, there are a limited number of suppliers of golf club components in the United States and the Company has increasingly become more reliant on suppliers and vendors located outside of the United States. The operation of foreign distribution in the Company's international markets, as well as the management of relationships with international suppliers and vendors, will continue to require the dedication of management and other Company resources.

As a result of this international business, the Company is exposed to increased risks inherent in conducting business outside of the United States. In addition to foreign currency risks, these risks include (i) increased difficulty in protecting the Company's intellectual property rights and trade secrets, (ii) unexpected government action or changes in legal or regulatory requirements, (iii) social, economic or political instability, (iv) the effects of any anti-American sentiments on the Company's brands or sales of the Company's products, (v) increased difficulty in controlling and monitoring foreign operations from the United States, including increased difficulty in identifying and recruiting qualified personnel for its foreign operations, and (vi) increased exposure to interruptions in air carrier or shipping services which interruptions could significantly adversely affect the Company's ability to obtain timely delivery of components from international suppliers or to timely deliver its products to international customers. Although the Company believes the benefits of conducting business internationally outweigh these risks, any significant adverse change in circumstances or conditions could have a significant adverse effect upon the Company's operations and therefore financial performance and condition.

#### ***Credit Risk***

The Company primarily sells its products to golf equipment retailers directly and through wholly-owned domestic and foreign subsidiaries, and to foreign distributors. The Company performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral from these customers. Historically, the Company's bad debt expense has been low. However, a downturn in the retail golf equipment market could result in increased delinquent or uncollectable accounts for some of the Company's significant customers. In addition, as the Company integrates its foreign distribution its exposure to credit risks increases as it no longer sells to a few wholesalers but rather directly to many retailers. A failure by the Company's

customers to pay a significant portion of outstanding account receivable balances would adversely impact the Company's performance and financial condition.

### ***Information Systems***

All of the Company's major operations, including manufacturing, distribution, sales and accounting, are dependent upon the Company's information computer systems. The Callaway Golf business information systems and the acquired Top-Flite information systems are different and the Company is therefore currently operating multiple platforms. The Company is in the process of evaluating whether to integrate the two systems and the best manner of doing so. Any significant disruption in the operation of such systems, as a result of an internal system malfunction, infection from an external computer virus, or complications in connection with any attempted integration of the two systems, or otherwise, would have a significant adverse effect upon the Company's ability to operate its business. Although the Company has taken steps to mitigate the effect of any such disruptions, there is no assurance that such steps would be adequate in a particular situation. Consequently, a significant or extended disruption in the operation of the Company's information systems could have a material adverse effect upon the Company's operations and therefore financial performance and condition.

### ***Change In Accounting Rules***

The Company currently and historically has accounted for its stock based compensation under Accounting Principles Board Opinion No. 25 ("APB No. 25"). Under APB No. 25, the Company is not required to record compensation expense for stock option grants to employees when the exercise price of the award is equal to the fair market value of the common stock on the date of grant. The Financial Accounting Standards Board has recently proposed rules which, if adopted as anticipated, would require the Company in 2005 to begin recording compensation expense for such stock option awards based upon the fair value of such awards. As a result, beginning in 2005, it is anticipated that the Company will be required to record compensation expense for any such awards granted in 2005 as well as awards granted prior to 2005 which vest in 2005 or thereafter. Such noncash compensation expense is anticipated to have a significant effect upon the Company's reported earnings.

Although the Company has historically provided in the notes to its financial statements pro forma earnings information showing what the Company's results would have been had the Company been recording compensation expense for such awards, the amount of such expense was not reflected in its financial results. Consequently, if the Company begins recording such compensation expense in 2005, the period over period comparisons will be significantly affected by the inclusion of such expense in 2005 and the absence of such expense from 2004 and prior periods. If investors do not appropriately consider these changes in accounting rules, the price at which the Company's stock is traded could be significantly adversely affected.

### ***Analyst Guidance, Media Reports and Market Volatility***

The Company's stock is traded publicly, principally on the New York Stock Exchange. As a result, at any given time, there are usually various securities analysts which follow the Company and issue reports on the Company. These reports include information about the Company's historical financial results as well as the analysts' estimates of the Company's future performance. The analysts' estimates are based upon their own opinions and are often different from the Company's own estimates or expectations. The Company has a policy against confirming financial forecasts or projections issued by analysts and any reports issued by such analysts are not the responsibility of the Company. Investors should not assume that the Company agrees with any report issued by any analyst or with any statements, projections, forecasts or opinions contained in any such report. In addition to analyst reports, the media also reports its opinion on the Company's results. These media reports are often written quickly so as to be the first to the news wire and in an attempt to garner attention often lead with headlines that are not representative of the substance of the article. Furthermore, these media reports, which are often written by writers who are not financial experts, reflect only the writers' views of the Company's results. Investors should not assume that the Company agrees with such media reports or the manner in which the Company's results are presented or characterized in such reports.

The price at which the Company's stock is traded on the securities exchanges is based upon many factors. In the short-term, the price at which the Company's stock is traded can be significantly affected, positively or negatively, by analysts reports and media reports, regardless of the accuracy of such reports. Over the long-term, the price at which the Company's stock is traded should tend to reflect the Company's performance irrespective of such reports.

It is the Company's current practice to provide investors with estimates of anticipated revenues and earnings per share on an annual basis and to report each quarter on how the Company is progressing toward the achievement of those annual targets. The Company cannot predict its results with certainty. The Company's estimates are based upon the information available and management's expectations at the time such estimates are made and actual results could and often do differ materially. See "Important Notice to Investors" on the inside cover of this report.

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

The Company uses derivative financial instruments for hedging purposes to limit its exposure to changes in foreign exchange rates. Transactions involving these financial instruments are with credit-worthy firms. The use of these instruments exposes the Company to market and credit risk which may at times be concentrated with certain counterparties, although counterparty nonperformance is not anticipated. The Company also utilized a derivative commodity instrument, the Enron Contract, to manage electricity costs in the volatile California energy market during the period of June 2001 through November 2001. Pursuant to its terms, the Enron Contract was terminated. The Company is also exposed to interest rate risk from its credit facility.

#### **Foreign Currency Fluctuations**

In the normal course of business, the Company is exposed to foreign currency exchange rate risks that could impact the Company's results of operations. The Company's risk management strategy includes the use of derivative financial instruments, including forward contracts and purchased options, to hedge certain of these exposures. The Company's objective is to offset gains and losses resulting from these exposures with gains and losses on the derivative contracts used to hedge them, thereby reducing volatility of earnings. The Company does not enter into any trading or speculative positions with regard to foreign currency related derivative instruments.

The Company is exposed to foreign currency exchange rate risk inherent primarily in its sales commitments, anticipated sales and assets and liabilities denominated in currencies other than the U.S. dollar. The Company transacts business in 12 currencies worldwide, of which the most significant to its operations are the European currencies, Japanese Yen, Korean Won, Canadian Dollar, and Australian Dollar. For most currencies, the Company is a net receiver of foreign currencies and, therefore, benefits from a weaker U.S. dollar and is adversely affected by a stronger U.S. dollar relative to those foreign currencies in which the Company transacts significant amounts of business.

The Company enters into foreign exchange contracts to hedge against exposure to changes in foreign currency exchange rates. Such contracts are designated at inception to the related foreign currency exposures being hedged, which include anticipated intercompany sales of inventory denominated in foreign currencies, payments due on intercompany transactions from certain wholly-owned foreign subsidiaries, and anticipated sales by the Company's wholly-owned European subsidiary for certain Euro-denominated transactions. Hedged transactions are denominated primarily in British Pounds, Euros, Japanese Yen, Korean Won, Canadian Dollars and Australian Dollars. To achieve hedge accounting, contracts must reduce the foreign currency exchange rate risk otherwise inherent in the amount and duration of the hedged exposures and comply with established risk management policies. Pursuant to its foreign exchange hedging policy, the Company may hedge anticipated transactions and the related receivables and payables denominated in foreign currencies using forward foreign currency exchange rate contracts and put or call options. Foreign currency derivatives are used only to meet the Company's objectives of minimizing variability in the Company's operating results arising from foreign exchange rate movements. The Company does not enter into foreign



exchange contracts for speculative purposes. Hedging contracts mature within twelve months from their inception.

At June 30, 2004 and 2003, the notional amounts of the Company's foreign exchange contracts were approximately \$85.0 million and \$87.7 million, respectively. The Company estimates the fair values of derivatives based on quoted market prices or pricing models using current market rates, and records all derivatives on the balance sheet at fair value. At June 30, 2004, the fair value of foreign currency-related derivatives were recorded as current assets of \$0.3 million and current liabilities of \$0.4 million.

There were no notional amounts of the Company's foreign exchange contracts designated as cash flow hedges at June 30, 2004. At June 30, 2003, the notional amounts of the Company's foreign exchange contracts designated as cash flow hedges were approximately \$22.9 million. For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is initially recorded in accumulated other comprehensive income ("OCI") as a separate component of shareholders' equity and subsequently reclassified into earnings in the period during which the hedged transaction is recognized in earnings. During the three and six months ended June 30, 2004 and 2003, the Company recorded the following activity in OCI (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Beginning OCI balance related to cash flow hedges	\$(0.6)	\$(1.5)	\$(2.5)	\$(1.4)
Add: Net gain/(loss) initially recorded in OCI	0.6	(0.2)	0.8	(1.3)
Deduct: Net gain/(loss) reclassified from OCI into earnings	0.3	(1.1)	(1.4)	(2.1)
Ending OCI balance related to cash flow hedges	\$(0.3)	\$(0.6)	\$(0.3)	\$(0.6)

During the three and six months ended June 30, 2004, no gains or losses were reclassified into earnings as a result of the discontinuance of cash flow hedges.

As of June 30, 2004, \$0.3 million of deferred net losses related to derivative instruments designated as cash flow hedges were included in OCI. These derivative instruments hedge transactions that are expected to occur within the next twelve months. As the hedged transactions are completed, the related deferred net gain or loss is reclassified from OCI into earnings. The Company does not expect that such reclassifications will have a material effect on the Company's earnings, as any gain or loss on the derivative instruments generally would be offset by the opposite effect on the related underlying transactions.

The ineffective portion of the gain or loss for derivative instruments that are designated and qualify as cash flow hedges is immediately reported as a component of other income (expense), net. For foreign currency contracts designated as cash flow hedges, hedge effectiveness is measured using the spot rate. Changes in the spot-forward differential are excluded from the test of hedging effectiveness and are recorded currently in earnings as a component of other income (expense), net. During the three months ended June 30, 2004 and 2003, the Company recorded net losses of \$0.1 million and \$0.1 million, respectively, as a result of changes in the spot-forward differential. During the six months ended June 30, 2004 and 2003, the Company recorded net losses of less than \$0.1 million and less than \$0.1 million, respectively, as a result of changes in the spot-forward differential. Assessments of hedge effectiveness are performed using the dollar offset method and applying a hedge effectiveness ratio between 80% and 125%. Given that both the hedged item and the hedging instrument are evaluated using the same spot rate, the Company anticipates the hedges to be highly effective. The effectiveness of each derivative is assessed quarterly.

At June 30, 2004 and 2003, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$85.0 million and \$64.8 million, respectively. The gains and losses on foreign currency contracts used to hedge balance sheet exposures are recognized as a component of other income (expense), net in the same period as the remeasurement gain and loss of the related foreign currency denominated assets and liabilities and thus offset these gains and losses. During the

three months ended June 30, 2004 and 2003, the Company recorded net gains of \$1.1 million and net losses of \$3.5 million, respectively, due to net realized and unrealized gains and losses on contracts used to hedge balance sheet exposures. During the six months ended June 30, 2004 and 2003, the Company recorded net gains of \$0.6 million and net losses of \$4.3 million, respectively, due to net realized and unrealized gains and losses on contracts used to hedge balance sheet exposures.

Sensitivity analysis is the measurement of potential loss in future earnings of market sensitive instruments resulting from one or more selected hypothetical changes in interest rates or foreign currency values. The Company used a sensitivity analysis model to quantify the estimated potential effect of unfavorable movements of 10% in foreign currencies to which the Company was exposed at June 30, 2004 through its derivative financial instruments.

The sensitivity analysis model is a risk analysis tool and does not purport to represent actual losses in earnings that will be incurred by the Company, nor does it consider the potential effect of favorable changes in market rates. It also does not represent the maximum possible loss that may occur. Actual future gains and losses will differ from those estimated because of changes or differences in market rates and interrelationships, hedging instruments and hedge percentages, timing and other factors.

The estimated maximum one-day loss from the Company's foreign-currency derivative financial instruments, calculated using the sensitivity analysis model described above, is \$8.8 million at June 30, 2004. The portion of the estimated loss associated with the foreign exchange contracts that offset the remeasurement gain and loss of the related foreign currency denominated assets and liabilities is \$8.8 million at June 30, 2004 and would impact earnings. There would be no impact to OCI. The Company believes that such a hypothetical loss from its derivatives would be offset by increases in the value of the underlying transactions being hedged.

### **Electricity Price Fluctuations**

During the second quarter of 2001, the Company entered into the Enron Contract to manage electricity costs in the volatile California energy market. This derivative did not qualify for hedge accounting treatment under SFAS No. 133. Therefore, the Company recognized the changes in the estimated fair value of the contract based on current market rates as unrealized energy derivative losses. During the fourth quarter of 2001, the Company notified the energy supplier that, among other things, the energy supplier was in default of the energy supply contract and that based upon such default, and for other reasons, the Company was terminating the energy supply contract. As a result, the Company adjusted the estimated value of this contract through the date of termination. Because the contract is terminated and neither party to the contract is performing pursuant to the terms of the contract, the terminated contract ceased to represent a derivative instrument in accordance with SFAS No. 133. The Company, therefore, no longer records future valuation adjustments for changes in electricity rates. The Company continues to reflect the derivative valuation account on its balance sheet, subject to periodic review, in accordance with SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." See above "Supply of Electricity and Energy Contracts."

### **Interest Rate Fluctuations**

Additionally, the Company is exposed to interest rate risk from its \$100.0 million credit facility (see Note 7 to the Company's Consolidated Condensed Financial Statements). The credit facility is indexed to, at the Company's election, (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, and in either case less a margin of 50.0 to 100.0 basis points depending upon the Company's Consolidated Leverage Ratio or (ii) the Eurodollar Rate (as such term is defined in the Credit Facility agreement), plus a margin of 75.0 to 125.0 basis points depending upon the Company's Consolidated Leverage Ratio.

Note 7 to the Company's Consolidated Condensed Financial Statements outlines the principal amounts, if any, and other terms required to evaluate the expected cash flows and sensitivity to interest rate changes.

**Item 4.      *Controls and Procedures***

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information required to be included in the Company's periodic filings with the Commission.

There were no significant changes in the Company's internal controls over financial reporting or in other factors that could significantly affect these internal controls subsequent to the date of their most recent evaluation. Since there were no significant deficiencies or material weaknesses identified in the Company's internal controls, the Company did not take any corrective actions.

As a result of Section 404 of the Sarbanes-Oxley Act of 2002 and the rules issued thereunder (collectively, the "Section 404 requirements"), the Company will be required to include in its Annual Report on Form 10-K for the year ending December 31, 2004, a report on management's assessment of the effectiveness of the Company's internal controls over financial reporting. The Company's independent auditor will also be required to attest to and report on management's assessment. The Company has maintained an internal audit function since 1994 and regularly tests and evaluates its internal controls, and therefore believes that it will be able to complete the assessment required by Section 404. There is no assurance, however, that future changes to the Section 404 requirements or changes in the business operations of the Company will not adversely affect the Company's ability to complete the assessment by the date stipulated.

**PART II. OTHER INFORMATION****Item 1.      *Legal Proceedings***

In conjunction with the Company's program of enforcing its proprietary rights, the Company has initiated or may initiate actions against alleged infringers under the intellectual property laws of various countries, including, for example, the U.S. Lanham Act, the U.S. Patent Act, and other pertinent laws. Defendants in these actions may, among other things, contest the validity and/or the enforceability of some of the Company's patents and/or trademarks. Others may assert counterclaims against the Company. Historically, these matters individually and in the aggregate have not had a material adverse effect upon the financial position or results of operations of the Company. It is possible, however, that in the future one or more defenses or claims asserted by defendants in one or more of those actions may succeed, resulting in the loss of all or part of the rights under one or more patents, loss of a trademark, a monetary award against the Company or some other material loss to the Company. One or more of these results could adversely affect the Company's overall ability to protect its product designs and ultimately limit its future success in the marketplace.

In addition, the Company from time to time receives information claiming that products sold by the Company infringe or may infringe patent or other intellectual property rights of third parties. It is possible that one or more claims of potential infringement could lead to litigation, the need to obtain licenses, the need to alter a product to avoid infringement, a settlement or judgment, or some other action or material loss by the Company.

On April 6, 2001, a complaint was filed against Callaway Golf Company and Callaway Golf Sales Company in the Circuit Court of Sevier County, Tennessee, Case No. 2001-241-IV. The complaint seeks to assert a class action by plaintiff on behalf of himself and on behalf of consumers in Tennessee and Kansas who purchased select Callaway Golf products on or after March 20, 2000. Specifically, the complaint alleges that the Company adopted a New Product Introduction Policy governing the introduction of certain of the Company's new products in violation of Tennessee and Kansas antitrust and consumer protection laws. The plaintiff is seeking damages, restitution and punitive damages. The parties are engaged in discovery.

On November 4, 2002, Callaway Golf Sales Company was served with a complaint filed in the District Court of Sedgwick County, Kansas, Case No. 02C3607, seeking to assert an alleged class action on behalf of Kansas consumers who purchased select Callaway Golf products covered by the New Product Introduction Policy. Callaway Golf Company is also named in the Kansas case. The plaintiff in the Kansas case seeks damages and restitution for the alleged class under Kansas law. The trial court in the Kansas case has stayed the matter in light of the prior pending case in Tennessee.

On May 14, 2004, a complaint was served on Callaway Golf Sales Company captioned Michael K. Murray v. Callaway Golf Sales Co., Case No 04-CVS-8294. The plaintiff claims to be a golf-store proprietor whose business was damaged by the alleged refusal of Callaway Golf Sales Company to sell certain products to him because he chose not to follow the New Product Introduction Policy. Plaintiff seeks compensatory and punitive damages. On June 3, 2004, the case was removed to the United States District Court for the Western District of North Carolina, Charlotte Division as Civil Action Number 3:04CV274-H. Callaway Golf Sales Company has answered the complaint denying liability.

On October 3, 2001, the Company filed suit in the United States District Court for the District of Delaware, Civil Action No. 01-669, against Dunlop Slazenger Group Americas, Inc., d/b/a Maxfli ("Maxfli"), for infringement of a golf ball aerodynamics patent owned by the Company, U.S. Patent No. 6,213,898 (the "Aerodynamics Patent"). On October 15, 2001, Maxfli filed an answer to the complaint denying any infringement, and also filed a counterclaim against the Company asserting that former Maxfli employees hired by the Company had disclosed confidential Maxfli trade secrets to the Company, and that the Company had used that information to enter the golf ball business. Among other remedies, Maxfli is seeking compensatory damages; an additional award of punitive damages equal to two times the compensatory damages; prejudgment interest; attorneys' fees; a declaratory judgment; and injunctive relief. Both parties have amended their claims. The Company added a claim for false advertising and Maxfli added a claim for inequitable conduct before the Patent and Trademark Office. Maxfli's original report from its damages expert asserts that Maxfli is entitled to at least \$18.5 million in compensatory damages from the Company. Maxfli supplemented its damages report to seek an additional \$11.3 million in compensatory damages, for a total compensatory damages claim of approximately \$30.0 million. The Company has submitted its own expert report seeking damages for false advertising. On November 12, 2003, pursuant to an agreement between the Company and Maxfli, the court dismissed the Company's claim for infringement of the Aerodynamics Patent and all portions of Maxfli's counterclaim related to the Aerodynamics Patent, thereby resolving that part of the case. On May 13, 2004, the Court granted the Company's motion for summary judgment, eliminating that portion of the case asserting that the Company misappropriated trade secrets with respect to the use of polyurethane on the cover of golf balls. On July 12, 2004, the Court denied Maxfli's motion for reconsideration of that ruling. The effect of the Court's ruling is to reduce Maxfli's compensatory damages claim from approximately \$30.0 million to \$18.5 million. The Company's remaining motions for summary judgment were denied. Thus, absent a resolution by settlement, the parties will proceed to trial on August 2, 2004. An unfavorable resolution of Maxfli's counterclaim could have a significant adverse effect upon the Company's results of operations, cash flows and financial position.

On December 2, 2002, Callaway Golf Company was served with a complaint filed in the Circuit Court of the 19th Judicial District in and for Martin County, Florida, Case No. 935CA, by the Perfect Putter Co. and certain principals of the Perfect Putter Co. Plaintiffs have sued Callaway Golf Company, Callaway Golf Sales Company and a Callaway Golf Sales Company sales representative. Plaintiffs allege that the Company misappropriated certain alleged trade secrets of the Perfect Putter Co. and incorporated those purported trade secrets in the Company's Odyssey White Hot 2-Ball Putter. Plaintiffs also allege that the Company made false statements and acted inappropriately during discussions with plaintiffs. Plaintiffs are seeking compensatory damages, exemplary damages, attorney's fees and costs, pre- and post-judgment interest and injunctive relief. On December 20, 2002, Callaway Golf removed the case to the United States District Court for the Southern District of Florida, Case No. 02-14342. On April 29, 2003, the District Court denied plaintiffs' motion to remand the case to state court. Thereafter, on August 14, 2003, the plaintiffs filed a second amended complaint adding a new claim for civil theft under Florida law based on the alleged facts set forth in the original complaint. If successful on that claim, the plaintiffs will be entitled to treble damages. The Company

has denied the allegations of the second amended complaint. The parties are currently engaged in discovery. Plaintiffs have served the Company with an expert report on damages seeking a compensatory damages recovery ranging from \$11.5 million for alleged breach of contract to \$206 million for alleged unjust enrichment. The Company will submit its own expert reports rebutting the assertions of plaintiffs' experts. The trial of the action was continued by the Court on its own motion and is now set to commence on or about February 1, 2005. An unfavorable resolution of plaintiffs' claims could have a material adverse effect upon the Company's results of operations, cash flows and financial position.

On July 3, 2003, Saso Golf, Inc. filed a lawsuit against the Company, Callaway Golf Sales Co., and an unrelated defendant in the United States District Court for the Northern District of Illinois, Case No. 03-CV-4646. Saso Golf alleges that sales of Callaway Golf's metal woods, including but not limited to the original Callaway Golf Biggest Big Bertha, and Great Big Bertha infringe U.S. Patent No. 5,645,495 and seeks compensatory damages, treble damages, attorney's fees, prejudgment interest, costs and injunctive relief. Effective May 14, 2004, the parties resolved the matter, Saso Golf released all of its claims, and the complaint was dismissed with prejudice.

The Company and its subsidiaries, incident to their business activities, are parties to a number of legal proceedings, lawsuits and other claims, including the matters specifically noted above. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. Consequently, management is unable to estimate the ultimate aggregate amount of monetary liability, amounts which may be covered by insurance, or the financial impact with respect to these matters. Except as discussed above with regard to the Maxfli litigation or Perfect Putter litigation, management believes at this time that the final resolution of these matters, individually and in the aggregate, will not have a material adverse effect upon the Company's consolidated annual results of operations, cash flows or financial position.

**Item 2. *Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities***

Repurchases of equity securities as reported on a settlement date basis during the quarter ended June 30, 2004 were as follows (in millions, except per share amounts):

Period	Total # of Shares Purchased(1)	Average Price Paid Per Share	Total # of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
April 1, 2004 - April 30, 2004	0.4	\$17.84	0.4	\$8.0
May 1, 2004 - May 31, 2004	—	—	—	\$8.0
June 1, 2004 - June 30, 2004	—	—	—	\$8.0

(1) All repurchases set forth in this table were made pursuant to the \$50.0 million stock repurchase program authorized and announced by the Board of Directors in May 2002.

**Item 3. *Defaults Upon Senior Securities***

None

**Item 4. *Submission of Matters to a Vote of Security Holders***

On May 25, 2004, the Company held its 2004 Annual Meeting of Shareholders. Ronald A. Drapeau, Samuel H. Armacost, William C. Baker, Ronald S. Beard, John C. Cushman, III, Yotaro Kobayashi, Richard Rosenfield and Anthony S. Thornley were elected to the Board of Directors. In addition, the Company's shareholders approved: (i) the 2004 Equity Incentive Plan; and (ii) the amended and restated Employee Stock Purchase Plan.

The voting results for the election of directors were as follows:

Name	Votes For	Votes Withheld
Ronald A. Drapeau	68,500,066	1,561,600
Samuel H. Armacost	68,484,283	1,577,383
William C. Baker	65,204,115	4,857,551
Ronald S. Beard	64,696,751	5,364,915
John C. Cushman, III	69,243,413	818,253
Yotaro Kobayashi	46,716,033	23,345,633
Richard Rosenfield	66,020,556	4,041,110
Anthony S. Thornley	69,398,288	663,378

The voting results for the proposal to approve the 2004 Equity Incentive Plan are as follows:

Votes For	Votes Against	Abstain	Broker Non-Vote
48,381,616	13,209,426	98,070	8,372,554

The voting results for the proposal to approve the amended and restated Employee Stock Purchase Plan are as follows:

Votes For	Votes Against	Abstain	Broker Non-Vote
56,061,282	5,531,825	96,004	8,372,555

**Item 5. Other Information**

None

**Item 6. Exhibits and Reports on Form 8-K**

a. Exhibits

- 3.1 Certificate of Incorporation, incorporated herein by this reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, as filed with the Securities and Exchange Commission ("Commission") on July 1, 1999 (file no. 1-10962).
- 3.2 Third Amended and Restated Bylaws, as amended and restated as of December 3, 2003, incorporated herein by this reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the Commission on March 15, 2004 (file no. 1-10962).
- 4.1 Dividend Reinvestment and Stock Purchase Plan, incorporated herein by this reference to the Prospectus in the Company's Registration Statement on Form S-3, as filed with the Commission on March 29, 2004 (file no. 33-77024).
- 4.2 Rights Agreement by and between the Company and Mellon Investor Services LLC (f/k/a Chemical Mellon Shareholder Services) as Rights Agent, dated as of June 21, 1995, incorporated herein by this reference to Exhibit 4.0 to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1995, as filed with the Commission on August 12, 1995 (file no. 1-10962).
- 4.3 First Amendment to Rights Agreement, effective June 22, 2001, by and between the Company and Mellon Investor Services LLC, as Rights Agent, incorporated herein by this reference to Exhibit 4.3 to the Company's Annual Report on Form 10-K for the year ended December 31, 2001, as filed with the Commission on March 21, 2002 (file no. 1-10962).
- 4.4 Certificate of Determination of Rights, Preferences, Privileges and Restrictions of Series A Junior Participating Preferred Stock, incorporated herein by this reference to Exhibit 3.1.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1995, as filed with the Commission on August 12, 1995 (file no. 1-10962).

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31.1	Certification of Ronald A. Drapeau pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.†
31.2	Certification of Bradley J. Holiday pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.†
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.†

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(†) Included with this Report.

b. *Reports on Form 8-K*

Form 8-K, dated June 15, 2004, was furnished to the Securities and Exchange Commission reporting the issuance of a press release of even date therewith, which press release was captioned, “Callaway Golf Lowers Guidance for 2004; Conference Call Scheduled to Discuss Business Trends.”

Form 8-K, dated April 22, 2004, was furnished to the Securities and Exchange Commission reporting the issuance of a press release of even date therewith, which press release was captioned, “Callaway Golf Announces Record First Quarter Sales; Core Business Strengthens During Top-Flite Integration; Company Reiterates 2004 Guidance for Sales and Earnings.”

Form 8-K, dated April 7, 2004, reporting the issuance of a press release of even date therewith, which press release was captioned, “Anthony S. Thornley Named to Callaway Golf Company’s Board of Directors.”

## SIGNATURES

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

CALLAWAY GOLF COMPANY

By:

/s/ BRADLEY J. HOLIDAY

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Bradley J. Holiday  
*Senior Executive Vice President and  
Chief Financial Officer*

Date: July 28, 2004



## EXHIBIT INDEX

Exhibit	Description
31.1	Certification of Ronald A. Drapeau pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.†
31.2	Certification of Bradley J. Holiday pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.†
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.†

## CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Ronald A. Drapeau, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Callaway Golf Company;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ RONALD A. DRAPEAU

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Ronald A. Drapeau  
*Chairman and Chief Executive Officer*

Dated: July 28, 2004

A signed original of this Certification has been provided to Callaway Golf Company and will be retained by Callaway Golf Company and furnished to the Securities and Exchange Commission or its staff upon request.

## CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Bradley J. Holiday, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Callaway Golf Company;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ BRADLEY J. HOLIDAY

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Bradley J. Holiday  
Senior Executive Vice President and  
Chief Financial Officer

Dated: July 28, 2004

A signed original of this Certification has been provided to Callaway Golf Company and will be retained by Callaway Golf Company and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION PURSUANT  
TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO SECTION 906  
OF THE SARBANES-OXLEY ACT OF 2002**

Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, each of the undersigned officers of Callaway Golf Company, a Delaware corporation (the "Company"), does hereby certify with respect to the Quarterly Report of the Company on Form 10-Q for the period ended June 30, 2004, as filed with the Securities and Exchange Commission (the "10-Q Report"), that:

(1) the 10-Q Report fully complies with the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) the information contained in the 10-Q Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

The undersigned have executed this Certification effective as of July 28, 2004.

/s/ RONALD A. DRAPEAU

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Ronald A. Drapeau  
*Chairman and Chief Executive Officer*

/s/ BRADLEY J. HOLIDAY

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Bradley J. Holiday  
*Senior Executive Vice President and  
Chief Financial Officer*

A signed original of this Certification has been provided to Callaway Golf Company and will be retained by Callaway Golf Company and furnished to the Securities and Exchange Commission or its staff upon request.