

INNOVATION TECHNOLOGY



PERFORMANCE MOMENTUM

"True visionaries are random and rare.

But no other word better describes Ely Callaway and his impact on golf. In an ever-changing game, design INNOVATIONS developed under his leadership were so far ahead of their time they still serve as the core to almost every club we make.

That vision and passion are what drive us to continue developing TECHNOLOGY that fuels the most advanced equipment in the game.

The original Big Bertha Driver launched a revolution in PERFORMANCE, and it carries on today with products like the FT-i Drivers and the Tour i Series Golf Balls.

After a very successful 2007, the Company is riding a wave of MOMENTUM into 2008 and beyond. Some would be satisfied, but getting complacent isn't who we are.

With every new and innovative product we introduce, we're building on our legacy of helping every golfer become a better golfer so they can enjoy the game. I think our founder would be proud."

George Fellows
President and CEO





Callaway
GOLF

TE

Ben Hogan

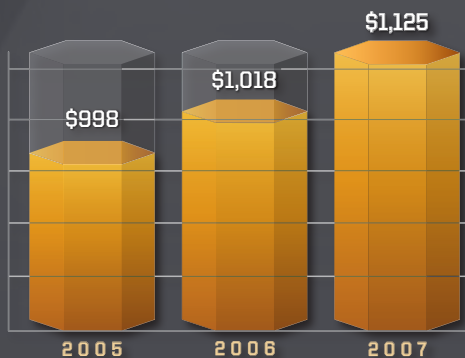
ODYSSEY

TO MY FELLOW SHAREHOLDERS:

Last year represented a watershed moment for Callaway Golf. We started by taking a nostalgic look at history, celebrating our 25th Anniversary and the legacy built by our founder Ely Callaway. We finished 2007 by cementing our position as the industry leader with record sales and triple-digit earnings growth. What started as a small, niche golf company in Southern California has blossomed into a global entity that produces the most innovative and technologically advanced products in the game.

This success stems from the passion and dedication of the brightest and most respected team in golf. Our talented employees never stop looking to improve the way we operate, whether it be product development, manufacturing, marketing, sales or any of the other myriad puzzle pieces that go into making a great company. Due in large part to their conviction and devotion, our employees played an integral part in building the momentum we forged in 2007.

Many elements came together for the Company to have such a banner year, most notably the enthusiastic acceptance of our extensive product line by golfers worldwide. Our Woods business, driven by patented Fusion Technology, had a major impact. The launch of the highly anticipated FT-i and FT-5 Drivers proved to be an instant hit with both professional and amateur golfers alike. Our Irons continued their long streak of dominance, staying No. 1 in U.S. market share for the 11th consecutive year, fueled mainly by the extremely popular X-20 line. Odyssey remained the #1 Putter in Golf, and was able to increase its market leading share by nearly 3 points.



NET SALES IN MILLIONS

Good news also came from the Top-Flite business. We began 2007 with a plan to stabilize and begin growing this brand, and I'm happy to report that all the hard work and effort is beginning to pay off. After many years of declining revenues and market share, Top-Flite's core business reversed course and grew by 2%. We gained distribution in more than 900 new accounts, and as a testament to the performance of Dimple in Dimple aerodynamics, Time magazine named the D2 Golf Ball one of its "Inventions of the Year." With this year's introduction of the Gamer and Freak golf balls, the brand and its "Never Lay Up" attitude is on track to begin regaining its position as a leading player in the value category.

Overall, we were very pleased with our financial results in 2007. Our net sales increased 10% to \$1.125 billion and fully diluted earnings per share increased 138% to \$.81. Our gross margin initiatives we announced in 2006 are also paying dividends, as gross margins increased from 39% of net sales in 2006 to 44% in 2007. This dramatic improvement was largely the result of more than \$30 million in savings from process improvements initiated in 2006, and we are committed to delivering additional savings in 2008 and beyond.

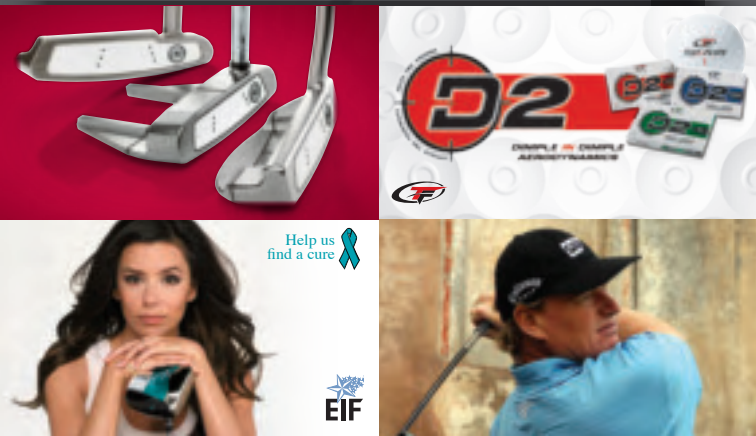
This year, Callaway Golf once again is at the forefront of innovation with the introduction of I-MIX Technology, which capitalizes on a recent rule change on club adjustability. This system gives golfers the ability to quickly and easily customize their driver clubhead and shaft to the weather conditions and/or style of golf course. With more than 1,600 combinations available, I-MIX easily

outdistances the systems of our competitors so golfers seeking the latest and greatest technology can find the ideal setups for their game.

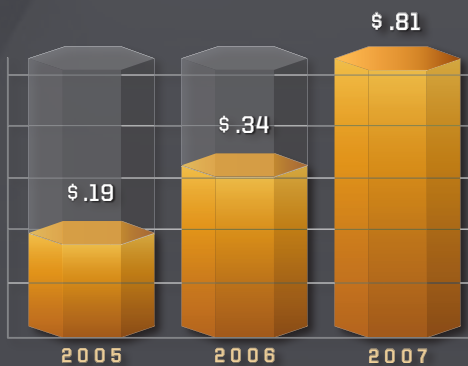
In golf balls, the new Tour i Series is generating serious buzz on Tour and in golf shops around the country. The Tour i and Tour ix and their 4-Piece Inertia Technology are the most advanced golf balls we've ever developed. Callaway Golf ball usage on Tour is up more than 40 percent compared to 2007, further validating our excitement about this new product. In fact, four of the six players occupying the top 3 spots in the men's and women's World Golf Rankings play Callaway Golf balls. Obviously, no other manufacturer can make that claim.

The professional tours provide us with some of our most valuable visibility and we were thrilled when the opportunity presented itself to add the highly respected and admired Ernie Els to our Tour Staff. His beautiful swing, worldwide appeal and major championship pedigree were a welcome addition to our already stellar roster of talent, and since switching to Callaway Golf equipment he has risen to No. 3 in the world rankings. Phil Mickelson solidified his position as the No. 2 player in the world by winning The Players Championship, the PGA Tour's unofficial 5th major, as well as the Deutsche Bank Championship during the inaugural FedEx Cup Playoffs.

Morgan Pressel became the youngest player in LPGA history to win a major title when she captured the Kraft Nabisco Championship. And arguably the greatest women's player of all-time, Annika Sorenstam, has started the



Help us find a cure



EARNINGS PER SHARE

2008 season with a win in Hawaii, continuing her march toward the record for most career victories. Our overall staff strength has never been better with the signing of several up-and-coming players to our PGA Tour and European Tour staffs and we're looking forward to watching all of them compete this year.

But our Tour professionals represent just one part of our extensive plan to reach out to the public. In addition to our traditional print and TV advertising, we are exploring ways to take advantage of untraditional marketing media designed to educate and excite golfers of all ages and abilities about our brands and innovative products. Our website, callawaygolf.com, is one of the most highly visited sites among all golf manufacturers and the weekly television show, "The Approach with Callaway Golf" is one of The Golf Channel's most popular programs.

In late 2007, we established ourselves as an industry leader in cause-related marketing. The Callaway Golf Foundation joined forces with the Entertainment Industry Foundation, one of North America's pre-eminent fund-raising organizations, to build an awareness campaign for ovarian cancer research. Our public service announcements featuring TV star Eva Longoria, along with the inaugural Callaway Golf Foundation Challenge celebrity pro-am golf tournament, have helped raise more than \$1 million to fund treatment and find a cure for the disease while emphasizing Callaway Golf's commitment to women. We are focused on achieving a leadership position in the fast-growing women's market and have implemented a comprehensive promotional and public relations program,

PERFORMANCE MOMENTUM

along with a new line of golf equipment designed specifically for women, to help get us there.

Another focus will be continuing to expand our international reach. In 2007, international sales represented approximately 47% of revenue and 53% of profits. With our commitment to growing our business both at home and abroad, we one day expect to generate the majority of our business from international markets – including Eastern Europe, China and Latin America. With the help of a new integrated, global view of the business, we can develop innovative products, programs and marketing vehicles that are globally efficient and locally relevant.

We've begun the process of expanding our reach beyond the traditional golf business, as well. We want to be viewed not only as a premier golf company, but also as a premier consumer products company in the active leisure segment. This is a subtle, yet important distinction, especially as we begin to expand the appeal of golf to untapped audiences and new geographies. This focus presents us with a fresh growth opportunity and competitive marketing advantage.

While we are confident that our new product introductions will be met with widespread approval by golfers around the world, this year will not be without its challenges. In light of uncertain economic forecasts, it's important to remember that we are not the same Company we were just a few short years ago. We entered this year with strong Brand momentum, our supply chain is much improved with greater flexibility to changes in the marketplace, nearly half of

our business originates internationally, and our balance sheet is strong with no long-term debt. However, we are proactively addressing these uncertainties by developing plans that will let us adapt quickly and efficiently to changing market conditions, allowing us to remain competitive and profitable.

Looking toward 2009 and beyond, the cutting edge products in our pipeline are poised to allow us to expand our leadership within the industry. The spirit of technological innovation and continuous improvement instilled by Ely Callaway is alive and well.

Over the last quarter century, our brand has carved a place in the hearts and minds of golfers everywhere. Most importantly, Callaway Golf has stayed true to its philosophy of producing innovative products that help make every golfer a better golfer.

I'd like to express my sincere thanks to our employees, our customers, our consumers and you, our shareholders, for your contributions to an outstanding year and for your continued support. Here's to the next great 25 years at Callaway Golf.



George Fellows
President and Chief Executive Officer
March 17, 2008



George Fellows

President, Chief Executive Officer and Director

BOARD OF DIRECTORS

Samuel H. Armacost

Chairman, SRI International

Ronald S. Beard

Chairman and Lead Independent Director
Partner, Zeughauser Group LLC; Retired Former
Partner, Gibson Dunn & Crutcher LLP

John C. Cushman, III

Chairman, Cushman & Wakefield, Inc.

Yotaro Kobayashi

Chief Corporate Advisor and Former Chairman,
Fuji Xerox Co., Ltd.

Richard L. Rosenfield

Co-Founder, Co-Chairman of the Board,
Co-Chief Executive Officer and
Co-President, California Pizza Kitchen, Inc.

Anthony S. Thornley

Retired Former President and
Chief Operating Officer,
QUALCOMM Incorporated

SENIOR MANAGEMENT

Christopher O. Carroll

Senior Vice President, Human Resources

Jeffrey M. Colton

Senior Vice President,
Research and Development

Bradley J. Holiday

Senior Executive Vice President
and Chief Financial Officer

William F. Knees

Senior Vice President, Marketing

David A. Laverty

Senior Vice President, Operations

Steven C. McCracken

Senior Executive Vice President,
Chief Administrative Officer and Secretary

Michele M. Szyal

Vice President, Public Relations

Joseph Urzetta

Senior Vice President, U.S. Sales

Thomas Yang

Senior Vice President, International

CORPORATE DATA

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Costa Mesa, CA 92626

Transfer Agent and Registrar

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TDD for Hearing Impaired: 800.231.5469
Foreign Shareholders: 201.680.6578
TDD Foreign Shareholders: 201.680.6610
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Independent Counsel

Gibson, Dunn & Crutcher LLP

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Irvine, CA 92612

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760.931.1771
invrelations@callawaygolf.com

MEETING AND INFORMATION

The 2008 Annual Meeting of Shareholders

Tuesday, May 20, 2008

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Carlsbad, CA 92008
760.931.1771

For more information
visit the company's websites:

callawaygolf.com
odysseygolf.com
topflite.com
benhogan.com
callawaygolfpreowned.com
tradeintradeup.com
shop.callawaygolf.com

FORM 10-K

CALLAWAY GOLF COMPANY

2007 ANNUAL REPORT

For the fiscal year ended December 31, 2007

CERTIFICATIONS

In June 2007, the Company filed with the New York Stock Exchange the Annual CEO Certification required under Section 303A.12(a) of the NYSE's Listed Company Manual regarding the Company's compliance with the NYSE's corporate governance listing standards. In February 2008, the Company filed with the Securities and Exchange Commission the certifications of the Company's Chief Executive Officer and Chief Financial Officer required under Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 as Exhibits 31.1, 31.2 and 32.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

FORWARD - LOOKING INFORMATION

Statements made in the letter to shareholders that relate to future plans, events, financial results or performance, including statements relating to future gross margin improvements and market acceptance of new products, are forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. These statements are based upon current goals, estimates, information and expectations. Actual results may differ materially from those anticipated as a result of certain risks and uncertainties, including delays, difficulties, changed strategies, or unanticipated factors affecting the implementation of the Company's gross margin improvement initiatives, as well as the general risks and uncertainties applicable to the Company and its business. For details concerning these and other risks and uncertainties, see Part I, Item 1A, "Risk Factors" contained in the following Annual Report on Form 10-K, as well as the Company's other reports on Forms 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 update forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2007

or

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

For the transition period from

to

Commission file number 1-10962

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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange on which registered

Common Stock, \$.01 par value per share

New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of June 29, 2007, the aggregate market value of the Registrant's Common Stock held by nonaffiliates of the Registrant was \$1,227,008,320 based on the closing sales price of the Registrant's Common Stock as reported on the New York Stock Exchange. Such amount was calculated by excluding all shares held by directors and executive officers, shares held in treasury, and shares held by the Company's grantor stock trust without conceding that any of the excluded parties are "affiliates" of the Registrant for purposes of the federal securities laws.

As of January 31, 2008, the number of shares of the Registrant's Common Stock outstanding was 66,279,762, and there were no shares of the Registrant's Preferred Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference from the Registrant's Definitive Proxy Statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the Registrant's 2008 Annual Meeting of Shareholders, which is scheduled to be held on May 20, 2008. Such Definitive Proxy Statement will be filed with the Securities and Exchange Commission not later than 120 days after the conclusion of the Registrant's fiscal year ended December 31, 2007.

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 dividends, cash flows and liquidity, as well as estimated unrecognized compensation expense, projected capital expenditures, and future 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 if the information on which those estimates was based ultimately proves to be incorrect or as a result of certain risks and uncertainties, including delays, difficulties, changed strategies, or unanticipated factors including those affecting the implementation of the Company's gross margin initiatives, as well as the general risks and uncertainties applicable to the Company and its business. For details concerning these and other risks and uncertainties, see Part I, Item IA, "Risk Factors" 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 update 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 distributing 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 Better Game By Design—A Passion For Excellence—Apex—Ben Hogan—BH—Big Bertha—Black Series—Callaway—Callaway Collection—Callaway Golf—Callaway Golf Drysport—Chev—Chevron Device—Complete—Demonstrably Superior and Pleasingly Different—Dimple-in-Dimple—Dual Force—ERC—Explosive Distance—Amazing Soft Feel—Flying Lady—Ft-i—FTi-brid—FT-3—FT-5—Freak-Fusion—Game Series—Gems—Great Big Bertha—Heavenwood—Hogan—HX—HX Hot—Hx Hot Bite—HX Pearl—HX Tour—Hyper X-IMIX—Little Ben—Marksman—Molitor—Number One Putter in Golf—Odyssey—OptiFit-ORG.14—Rossie—S2H2—Sabertooth—SRT—SenSert—Speed Slot—Squareway—Steelhead—Strata—Stronomic—Sure-Out—TF design—Tech Series—Top-Flite—Top-Flite D2—Top-Flite XL—Tour Authentic—Tour Deep—Tour i—Tour iX—Trade In! Trade Up!—TriBall—Tru Bore—Tunite—VFT—War Bird—Warbird—WarmSport—White Hot—White Hot Tour—White Hot XG—White Steel—Windsport—World's Friendliest—X-20—X-20 Tour—X460—XL 3000—XJ Series—XL Extreme—X-Forged—X Hot—X-Series—X-Sole—X-SPANN—Xtra Traction Technology—X-Tour—XTT—Xtra Width Technology—XWT.*

CALLAWAY GOLF COMPANY

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PART I

Item 1. *Business*

Callaway Golf Company (the “Company” or “Callaway Golf”) was incorporated in California in 1982 and reincorporated in Delaware on July 1, 1999. In 1997, the Company acquired substantially all of the assets of Odyssey Sports, Inc., which manufactured and marketed the Odyssey brand of putters and wedges. In 1998, the Company began a reorganization of its international operations by acquiring the distribution rights in certain key international markets. As a result, during 1998 through 2001, the Company acquired distribution rights and substantially all of the assets from its distributors in Japan, France, Belgium, Norway, Denmark, Germany, Japan, Ireland, Spain, Canada, Korea and Australia. In 2000, the Company entered the golf ball business with the release of its first golf ball product. In 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 “Top-Flite Acquisition”). Beginning in 2001, the Company and its participating retailers partnered with FrogTrader, Inc. to develop the Trade In! Trade Up! program. In 2004, the Company acquired all of the issued and outstanding shares of stock of FrogTrader, Inc. (which subsequently changed its name to Callaway Golf Interactive, Inc.). The Company acquired FrogTrader to stimulate purchases of new clubs by growing its Trade In! Trade Up! program and to enable the Company to better manage the distribution of pre-owned golf clubs. The Company currently has the following wholly-owned operating subsidiaries: Callaway Golf Sales Company, Callaway Golf Ball Operations, Inc. (f/k/a The Top-Flite Golf Company), Callaway Golf Interactive, Inc., Callaway Golf Europe Ltd., Callaway Golf K.K., Callaway Golf Korea Ltd., Callaway Golf Canada Ltd., Callaway Golf South Pacific PTY Ltd., and Callaway Golf (Shanghai) Trading Company, Ltd.

The Company, together with its subsidiaries, designs, manufactures and sells high quality golf clubs (drivers, fairway woods, hybrids, irons, wedges and putters) and golf balls. The Company also sells golf accessories such as golf bags, golf gloves, golf headwear, golf footwear, golf towels and golf umbrellas. The Company generally sells its products to golf retailers (including pro shops at golf courses as well as off-course retailers), sporting goods retailers and mass merchants, directly and through its wholly-owned subsidiaries, and to third party distributors. The Company also sells pre-owned golf products through its website, www.callawaygolfpreowned.com. In addition, in November of 2006, the Company launched an online store, where consumers can place an order for Callaway Golf, Top-Flite, Ben Hogan and Odyssey products through its website Shop.CallawayGolf.com and have the order fulfilled by a local participating retailer or in certain circumstances, by the Company. The Company’s products are sold in the United States and in over 100 countries around the world. The Company’s products are designed for the enjoyment of both amateur and professional golfers. Golfers generally purchase the Company’s products on the basis of performance, ease of use, brand recognition and appearance. In addition, the Company licenses its trademarks and service marks in exchange for a royalty fee to third parties for use on products such as golf apparel, watches, rangefinders, practice aids, travel gear and eyewear. The Company’s business is seasonal and as a result approximately two-thirds of its sales and most, if not all, of its profitability occur during the first half of its fiscal year (see below “Certain Factors Affecting Callaway Golf Company” contained in Item 1A).

Financial Information about Segments and Geographic Areas

Information regarding the Company’s segments and geographic areas in which the Company operates is contained in Note 15 to the Company’s Consolidated Financial Statements for the years ended December 31, 2007, 2006, and 2005 (“Consolidated Financial Statements”), which note is incorporated herein by this reference and is included as part of Item 8. “Financial Statements and Supplementary Data.”

Products

The Company designs, manufactures and sells high quality golf clubs and golf balls and also sells golf footwear and accessories. The Company designs its products to be technologically-advanced and in this regard invests a considerable amount in research and development each year. The Company's products are designed for golfers of all skill levels, both amateur and professional.

The following table sets forth the contribution to net sales attributable to the principal product groups for the periods indicated:

	Year Ended December 31,					
	2007		2006		2005	
	(In millions)					
Drivers and fairway woods	\$ 305.9	27%	\$ 266.5	26%	\$241.3	24%
Irons	309.6	28%	288.0	28%	316.5	32%
Putters	109.1	10%	102.7	10%	109.3	11%
Golf balls	213.1	19%	214.8	21%	214.7	22%
Accessories and other	186.9	17%	145.9	15%	116.3	12%
Net sales	<u>\$1,124.6</u>	<u>100%</u>	<u>\$1,017.9</u>	<u>100%</u>	<u>\$998.1</u>	<u>100%</u>

For a discussion regarding the changes in net sales for each product group from 2007 to 2006 and from 2006 to 2005, see below, "Management's Discussion and Analysis of Financial Condition and Results of Operations—Results of Operations" contained in Item 7.

The Company's current principal products by product group are described below:

Drivers and Fairway Woods. This product category includes sales of the Company's drivers, fairway woods and hybrid products, which are sold under the Callaway Golf, Top-Flite and Ben Hogan brands. These products are generally made of metal (either titanium or steel) or a combination of metal and a composite material. The Company's products compete at various price levels in the drivers and fairway woods category. In general, composite/metal drivers, fairway woods and hybrids sell at higher price points than titanium drivers and fairway woods, and titanium products sell at higher price points than steel products. The Company's drivers, fairway woods and hybrid products are available in a variety of lofts, shafts and other specifications to accommodate the preferences and skill levels of all golfers. All of the Company's current drivers, fairway woods and hybrid products conform to the current rules of the United States Golf Association (the "USGA") or the Royal and Ancient Golf Club of St. Andrews (the "R&A"), as applicable to the markets in which the products are intended to be sold.

Irons. This product category includes sales of the Company's irons and wedges, which are sold under the Callaway Golf, Top-Flite and Ben Hogan brands. The Company's irons are generally made of metal (either titanium, steel or special alloy) or a composite material (a combination of metal and polymer materials). The Company's products compete at various price levels in the irons category. In general, the Company's composite metal irons and titanium irons sell at higher price points than its steel irons. The Company's irons are available in a variety of lofts, shafts and other specifications to accommodate the preferences and skill levels of all golfers. All of the Company's current iron products conform to the current rules of the USGA and the R&A.

Putters. This product category includes sales of the Company's putters, which are sold under the Odyssey, Callaway Golf, Top-Flite and Ben Hogan brands. The Company's products compete at multiple price levels in the putters category. The Company's putters are available in a variety of styles, shafts and other specifications to accommodate the preferences and skill levels of all golfers. All of the Company's current putter products conform to the current rules of the USGA and the R&A.

Golf Balls. This product category includes sales of the Company's golf balls, which are primarily sold under the Callaway Golf and Top-Flite brands. The Company's golf balls are generally either a 2-piece golf ball (consisting of a core and cover) or a multi-layer golf ball (consisting of two or more components in addition to the cover). The Company's golf ball products include covers that incorporate a traditional dimple pattern as well as covers that incorporate innovative designs, including the Company's proprietary HEX Aerodynamics (i.e., a series of hexagons and pentagons separated by tubular ridges), dimple-in-dimple and deep dimple technologies. The Company's products compete at all price levels in the golf ball category. In general, the Company's multi-layer golf balls sell at higher price points than its 2-piece golf balls. All of the Company's current golf ball products conform to the current rules of the USGA and the R&A.

Accessories and Other. This product category includes sales of golf bags, footwear, recreational club sets, gloves, headwear, towels, umbrellas, and other accessories, as well as sales of pre-owned products through Callaway Golf Interactive, Inc. Additionally, this product category includes royalties from licensing of the Company's trademarks and service marks on products such as golf and life style apparel, watches, travel gear, rangefinders, practice aids and eyewear.

Product Design and Development

Product design at the Company is a result of the integrated efforts of its brand management, research and development, manufacturing and sales departments, all of which work together to generate new ideas for golf equipment. The Company has not limited itself in its research efforts by trying to duplicate designs that are traditional or conventional and believes it has created a work environment in which new ideas are valued and explored. In 2007, 2006 and 2005 the Company invested \$32.0 million, \$26.8 million and \$27.0 million, respectively, in research and development. The Company intends to continue to invest substantial amounts in its research and development activities in connection with its development of new golf club and golf ball products.

The Company has the ability to create and modify product designs by using computer aided design ("CAD") software, computer aided manufacturing ("CAM") software and computer numerical control milling equipment. CAD software enables designers to develop computer models of new product designs. CAM software is then used by engineers to translate the digital output from CAD computer models so that physical prototypes can be produced. Further, the Company utilizes a variety of testing equipment and computer software, including a golf robot, launch monitors, a proprietary virtual test center, a proprietary performance analysis system, an indoor test range and other methods to develop and test its products. Through the use of these technologies, the Company has been able to accelerate and make more efficient the design, development and testing of new golf clubs and golf balls.

For certain risks associated with product design and development, see below, "Certain Factors Affecting Callaway Golf Company" contained in Item 1A.

Manufacturing

Golf Clubs

The Company's drivers, fairway woods, hybrids, irons, wedges and putters are assembled primarily at the Company's facilities in Carlsbad, California. A portion of these products are also assembled outside of the United States. The Company's products are assembled using components obtained from suppliers both internationally and within the United States. Significant progress has been made in automating certain facets of the manufacturing process during the last few years and continued emphasis will be placed on automated manufacturing by the Company. However, the overall golf club assembly process remains fairly labor intensive, and requires extensive global supply chain coordination.

Golf Balls

Prior to the Top-Flite acquisition in September 2003, Callaway Golf manufactured golf balls in its Carlsbad, California facility and Top-Flite manufactured golf balls primarily in its Chicopee, Massachusetts and Gloversville, New York facilities. Following the Top-Flite acquisition, the Company began consolidating all golf ball manufacturing operations. The consolidation allowed the Company to eliminate redundant infrastructure and overhead while improving functionality. As a result of the consolidation, most of the Company's golf ball products are now manufactured at the Chicopee and Gloversville facilities. In October 2006, the Company entered into a supply agreement to have a limited portion of its golf ball products manufactured overseas beginning in 2007. See Note 3 to the Consolidated Financial Statements. Overall, although a significant amount of labor is still used in the golf ball manufacturing process, the golf ball manufacturing process is much more automated than the golf club assembly process.

For certain risks associated with golf club and golf ball manufacturing, see below, "Certain Factors Affecting Callaway Golf Company" contained in Item 1A.

Sales and Marketing

Sales in the United States

Approximately 53% of the Company's net sales were derived from sales within the United States in 2007 and 56% in both 2006 and 2005. The Company primarily sells to both on- and off-course golf retailers and sporting goods retailers who sell quality golf products and provide a level of customer service appropriate for the sale of such products. The Company also sells certain products to mass merchants. On a consolidated basis, no one customer that distributes golf clubs or golf balls in the United States accounted for more than 3% of the Company's consolidated revenues in 2007 and 2006 and 4% in 2005. On a segment basis, the golf ball customer base is much more concentrated than the golf club customer base. In 2007, the top five golf ball customers accounted for approximately 20% of the Company's total consolidated 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.

Sales of the Company's products in the United States are made and supported by full-time regional field representatives and in-house sales and customer service representatives. Most of the Company's geographic territories are covered by both a field representative and a dedicated in-house sales representative who work together to initiate and maintain relationships with customers through frequent telephone calls and in-person visits. In addition to these sales representatives, the Company also has dedicated in-house customer service representatives.

In addition, other dedicated sales representatives provide service to corporate customers who want their corporate logo imprinted on the Company's golf balls, putters or golf bags. The Company imprints the logos on the majority of these corporate products, thereby retaining control over the quality of the process and final product. The Company also pays a commission to certain on-and off-course professionals and retailers with whom it has a relationship for corporate sales that originate through such professionals and retailers.

The Company also has a separate team of club fitting specialists who focus on the Company's custom club sales. Custom club sales are generated primarily from the utilization of the Company's club fitting programs such as performance centers as well as other, iron and wood fitting carts, and a vehicle with club building capacity. In addition, during 2007, the Company introduced the Callaway Golf OptiFit System, which expands on the capabilities of the OptiFit Driver System that was launched in 2006 to now include irons in addition to drivers. The OptiFit System is a custom fitting system that enables golfers to experiment at participating on and off-course retail stores with an extensive variety of clubhead and shaft combinations in order to find the driver or set of irons that fits their personal specifications. The OptiFit System equips retailers and pros with a compact, hi-tech fitting tool that can quickly identify the precise clubhead and shaft combination for each golfer's individual swing, thereby dramatically improving the process in which consumers select a new driver or set of

irons. Club fittings are performed by golf professionals who are specifically trained to fit golfers of all abilities into custom-fitted clubs. The Company believes that offering golfers the opportunity to increase performance with custom club specifications increases sales and promotes brand loyalty.

The Company maintains various sales programs including a Preferred Retailer Program. The Preferred Retailer Program offers longer payment terms during the initial sell in period, as well as potential rebates and discounts, for participating retailers in exchange for providing certain benefits to the Company, including the maintenance of agreed upon inventory levels, prime product placement and retailer staff training.

Sales Outside of the United States

Approximately 47% of the Company's net sales were derived from sales for distribution outside of the United States in 2007 and 44% in both 2006 and 2005. The Company does business (either directly or through its subsidiaries and distributors) in more than 100 countries around the world. The Company's management believes that controlling the distribution of its products in certain major markets in the world has been and will continue to be an important element in the future growth and success of the Company.

The majority of the Company's international sales are made through its wholly-owned subsidiaries located in Europe, Japan, Canada, Korea and Australia. In addition to sales through its subsidiaries, the Company also sells through distributors in over 60 foreign countries, including Singapore, China, Taiwan, the Philippines, South Africa, Argentina and various countries in South America. Prices of golf clubs and balls for sales by distributors outside of the United States generally reflect an export pricing discount to compensate international distributors for selling and distribution costs. A change in the Company's relationship with significant distributors could negatively impact the volume of the Company's international sales.

The Company's sales programs in foreign countries are specifically designed based upon local laws and competitive conditions. Some of the sales programs utilized include the custom club fitting experiences and the Preferred Retailer Program or variations of those programs employed in the United States as described above.

Conducting business outside of the United States subjects the Company to increased risks inherent in international business. See below, "Certain Factors Affecting Callaway Golf Company" contained in Item 1A.

Sales of Pre-Owned and Outlet Golf Clubs

The Company sells certified pre-owned Callaway Golf products through its websites, www.callawaygolfpreowned.com and www.callawaygolfoutlet.com. The Company generally acquires the pre-owned products through the Company's Trade In! Trade Up! program. The website for this program is www.tradeintradeup.com. The Trade In! Trade Up! program gives golfers the opportunity to trade in their used Callaway Golf clubs and certain competitor golf clubs at authorized Callaway Golf retailers or through the Callaway Golf Pre-Owned website for credit toward the purchase of new or pre-owned Callaway Golf equipment.

On-Line Store

In November of 2006, the Company announced Shop.CallawayGolf.com, an alliance between Callaway Golf and its network of authorized U.S. retailers that links consumers and golf retailers by allowing the consumer to place an order through Callaway Golf's website and have it fulfilled by a local participating retailer, or by the Company. This website is also accessible via the Company's main website, www.CallawayGolf.com. The website offers the full line of official Callaway Golf, Top-Flite, Ben Hogan and Odyssey products, including drivers, fairway woods, hybrids, irons, golf balls, footwear, eyewear, apparel and accessories.

Advertising and Promotion

Within the United States, the Company has focused its advertising efforts mainly on a combination of printed advertisements in national magazines, such as *Golf Magazine*, *Sports Illustrated* and *Golf Digest*, and television commercials, primarily on The Golf Channel and on network television during golf telecasts, as well as web-based advertising. Advertising of the Company's products outside of the United States is generally handled by the Company's subsidiaries and is consistent with U.S. strategies.

In addition, the Company establishes relationships with professional golfers in order to promote the Company's products. The Company has entered into endorsement arrangements with members of the various professional golf tours to promote the Company's golf club and golf ball products. For certain risks associated with such endorsements, see below, "Certain Factors Affecting Callaway Golf Company" contained in Item 1A.

Competition

The golf club markets in which the Company competes are highly competitive, and are served by a number of well-established and well-financed companies with recognized brand names, as well as new companies with popular products. With respect to drivers, fairway woods and irons, the Company's major competitors are TaylorMade, Titleist, Cobra, Cleveland (Srixon), Ping, Mizuno, Bridgestone, MacGregor and Nike. For putters, the Company's major competitors are Ping, Titleist and TaylorMade. In addition, the Company also competes with Dunlop, Bridgestone and PRGR among others in Japan and throughout Asia. The Company believes that it is the leader, or one of the leaders, in every golf club market in which it competes.

The golf ball business is also highly competitive. There are a number of well-established and well-financed competitors, including Acushnet (Titleist and Pinnacle brands), Sumitomo Rubber Industries (Dunlop and Srixon brands), Bridgestone (Bridgestone and Precept brands), Nike, TaylorMade (Maxfli brand) and others. These competitors compete for market share in the golf ball business, with Acushnet having a market share of over 50% of the golf ball business in the United States. The Company's golf ball products have been well received by both professional and amateur golfers alike. The Company's golf ball products continue to receive a significant degree of usage on the major professional golf tours and maintained the number two position on the PGA tour in 2007. In addition, the Company's golf ball products remained number two in U.S. dollar market share in 2007.

For both golf clubs and golf balls, the Company generally competes on the basis of technology, quality, performance, customer service and price. In order to gauge the effectiveness of the Company's response to such factors, its management receives and evaluates Company-generated market research for U.S. and foreign markets, as well as periodic public and customized market research for U.S. markets from *Golf Datatech*. For risks relating to competition, see below, "Certain Factors Affecting Callaway Golf Company" contained in Item 1A.

Environmental Matters

The Company's operations are subject to federal, state and local environmental laws and regulations that impose limitations on the discharge of pollutants into the environment and establish standards for the handling, generation, emission, release, discharge, treatment, storage and disposal of certain materials, substances and wastes and the remediation of environmental contaminants ("Environmental Laws"). In the ordinary course of its manufacturing processes, the Company uses paints, chemical solvents and other materials, and generates waste by-products, that are subject to these Environmental Laws. In addition, in connection with the Top-Flite Acquisition, the Company assumed certain monitoring and remediation obligations at the manufacturing facility in Chicopee, Massachusetts.

The Company adheres to all applicable Environmental Laws and takes action as necessary to comply with these laws. The Company maintains an environmental and safety program and employs two full-time environmental engineers at its Carlsbad, California facility and a director of environmental, health and safety matters at its Chicopee, Massachusetts facility to manage the program. The environmental and safety program includes obtaining environmental permits as required, capturing and appropriately disposing of any waste by-products, tracking hazardous waste generation and disposal, air emissions, safety situations, material safety data sheet management, storm water management and recycling, and auditing and reporting on its compliance.

In addition, the facility in Chicopee was a charter member in the U.S. Environmental Protection Agency's National Performance Track program. This program recognizes facilities that have demonstrated a commitment to superior environmental performance and have a good record of compliance with environmental regulations. The National Environmental Performance Track was developed by the Environmental Protection Agency to reward companies who do more than environmental regulations require.

Historically, the costs of environmental compliance have not had a material adverse effect upon the Company's business. Furthermore, the Company does not believe that the monitoring and remedial obligations it assumed in connection with the Top-Flite Acquisition will have a material adverse effect upon the Company's business. The Company believes that its operations are in substantial compliance with all applicable Environmental Laws.

Intellectual Property

The Company is the owner of approximately 2,800 U.S. and foreign trademark registrations and over 2,100 U.S. and foreign patents relating to the Company's products, product designs, manufacturing processes and research and development concepts. Other patent and trademark applications are pending and await registration. In addition, the Company owns various other protectable rights under copyright, trade dress and other statutory and common laws. The Company's intellectual property rights are very important to the Company and the Company seeks to protect such rights through the registration of trademarks and utility and design patents, the maintenance of trade secrets and the creation of trade dress. When necessary and appropriate, the Company enforces its rights through litigation. Information regarding current litigation matters in connection with intellectual property is contained in Item 3 "Legal Proceedings" below and in Note 14 to the Company's Consolidated Financial Statements, "Commitments and Contingencies: Legal Matters."

The Company's patents are generally in effect for up to 20 years from the date of the filing of the patent application. The Company's trademarks are generally valid as long as they are in use and their registrations are properly maintained and have not been found to become generic. See below, "Certain Factors Affecting Callaway Golf Company" contained in Item 1A.

Licensing

The Company from time to time, in exchange for a royalty fee, licenses its trademarks and service marks to third parties for use on products such as golf apparel, watches, travel gear, rangefinders, practice aids and eyewear. The Company has current licensing arrangements with (i) Ashworth, Inc. for a complete line of men's and women's apparel for distribution in the United States, Canada, Europe and South Africa, (ii) Sanei International Co., Ltd. for a complete line of men's and women's apparel for distribution in Japan, Korea, China and other Asian Pacific countries, and (iii) Playcorp Pty. Ltd. for a complete line of men's and women's apparel for distribution in Australia and New Zealand.

In addition to apparel, the Company has also licensed its trademarks to, among others, (i) Fossil, Inc. for a line of watches and clocks, (ii) TRG Accessories, LLC for a collection primarily consisting of travel gear, (iii) Global Wireless Entertainment, Inc. for the creation of golf-related software and applications for wireless handheld devices and platforms, (iv) MicroVision Optical, Inc. for eyewear, (v) Nikon Vision Co., Ltd.

for rangefinders and (vi) IZZO Golf for practice aids. Prior to April 2006, the Company had a licensing arrangement with Tour Golf Group, Inc. (“TGG”) for a line of Callaway Golf footwear. In April 2006, the licensing arrangement was terminated and the Company acquired certain assets of TGG. The Company currently designs and sells its own Callaway Golf footwear line.

Employees

During 2005, in connection with the 2005 Restructuring Initiatives, the Company announced the elimination of approximately 500 positions worldwide, including full-time and part-time employees, temporary employees and open positions. Most of these positions were eliminated prior to December 31, 2005 and the remainder of the planned eliminations were completed during 2006. As of December 31, 2007, the Company and its subsidiaries had approximately 3,000 full-time and part-time employees. In addition, the Company employs temporary employees as the business requires.

Historically, Callaway Golf employees have not been represented by unions. The golf ball manufacturing employees in Chicopee, Massachusetts, however, are unionized. Shortly after the Top-Flite Acquisition was consummated the Company negotiated a new collective bargaining agreement with the union in Chicopee which is scheduled to expire on September 30, 2008. In addition, in connection with the Top-Flite Acquisition, certain of the Company’s production employees in Canada and Australia are also unionized. As of December 31, 2007, the Company had approximately 530 employees covered under the collective bargaining agreement. The Company considers its employee relations to be good.

Access to SEC Filings through Company Website

Interested readers can access the Company’s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the “Exchange Act”) through the Investor Relations section of the Company’s website at www.callawaygolf.com. These reports can be accessed free of charge from the Company’s website as soon as reasonably practicable after the Company electronically files such materials with, or furnishes them to, the Securities and Exchange Commission. In addition, the Company’s Corporate Governance Guidelines, Code of Conduct and the written charters of the committees of the Board of Directors are available in the Corporate Governance portion of the Investor Relations section of the Company’s website and are available in print to any shareholder who requests a copy. The information contained on the Company’s website shall not be deemed to be incorporated into this report.

Item 1A. Risk Factors

Certain Factors Affecting Callaway Golf Company

The financial statements contained in this report and the related discussions 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.

Successfully managing the frequent introduction of new products that satisfy changing consumer preferences is very important to the Company's success.

The Company's main products, like those of its competitors, generally have life cycles of two years or less, with sales occurring at a much higher rate in the first year than in the second. Factors driving these short product life cycles include the rapid introduction of competitive products and quickly changing consumer preferences. In this marketplace, a substantial portion of the Company's annual revenues is generated each year by products that are in their first year of life.

These marketplace conditions raise a number of issues that the Company must successfully manage. For example, the Company must properly anticipate consumer preferences or its new products will not achieve sufficient market success to compensate for the usual decline in sales experienced by products already in the market. Second, the Company's R&D and supply chain groups face constant pressures to design, develop, source and supply new products—many of which incorporate new or otherwise untested technology, suppliers or inputs. Third, for new products to generate equivalent or greater revenues than their predecessors, they must either maintain the same or higher sales levels with the same or higher pricing, or exceed the performance of their predecessors in one or both of those areas. Fourth, the relatively short window of opportunity for launching and selling new products requires great expertise in forecasting demand and assuring that supplies are ready and delivered during the critical selling periods. Finally, the rapid changeover in products creates a need to monitor and manage the close out of obsolete products both at retail and in the Company's own inventory.

Should the Company not successfully manage all of the risk factors associated with this rapidly moving marketplace, the Company's sales and earnings may be adversely affected.

A reduction in discretionary consumer spending could reduce sales of the Company's products.

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. Discretionary spending is also affected by many other factors, including general business conditions, interest rates, the availability of consumer credit, taxation and consumer confidence in future economic conditions. Purchases of the Company's products could decline during periods when disposable income is lower, or during periods of actual or perceived unfavorable economic conditions. Any significant decline in general economic conditions or uncertainties regarding future economic prospects that adversely affect discretionary consumer spending, whether in the United States or in the Company's international markets (which represent almost half of the Company's total sales), could result in reduced sales of the Company's products.

A reduction in the number of rounds of golf played or in the number of golf participants could adversely affect the Company's sales.

The Company generates substantially all of its revenues from the sale of golf related products, including golf clubs, golf balls and golf accessories. The demand for golf related products, generally, and golf balls in particular, is directly related to the number of golf participants and the number of rounds of golf being played by these participants. If golf participation or the number of rounds of golf played decreases, sales of the Company's products may be adversely affected. In the future, the overall dollar volume of the market for golf-related products may not grow or may decline.

In addition, the demand for golf products is also directly related to the popularity of magazines, cable channels and other media dedicated to golf, television coverage of golf tournaments and attendance at golf events. The Company depends on the exposure of its products through advertising and the media or at golf tournaments and events. Any significant reduction in television coverage of, or attendance at, golf tournaments and events or any significant reduction in the popularity of golf magazines or golf channels, could reduce the visibility of the Company's brand and could adversely affect the Company's sales.

The Company may have limited opportunities for future growth in sales of golf clubs and golf balls.

In order for the Company to significantly grow its sales of golf clubs or golf balls, the Company must either increase its share of the market for golf clubs or balls, or the market for golf clubs or balls must grow. The Company already has a significant share of worldwide sales of golf clubs and golf balls. Therefore, opportunities for additional market share may be limited. Furthermore, the Company does not believe there has been any material increase in the number of golfers worldwide in over five years. The Company also believes that overall dollar volume of the worldwide market for golf equipment sales has not experienced substantial growth in the past several years. In the future, the overall dollar volume of worldwide sales of golf clubs or golf balls may not grow or may decline.

If the Company inaccurately forecasts demand for its products, it may manufacture either insufficient or excess quantities, which, in either case, could adversely affect its financial performance.

The Company plans its manufacturing capacity based upon the forecasted demand for its products. The nature of the Company's business makes it difficult to quickly adjust its manufacturing capacity if actual demand for its products exceeds or is less than forecasted demand. If actual demand for its products exceeds the forecasted demand, the Company may not be able to produce sufficient quantities of new products in time to fulfill actual demand, which could limit the Company's sales and adversely affect its financial performance. On the other hand, if actual demand is less than the forecasted demand for its products, the Company could produce excess quantities, resulting in excess inventories and related obsolescence charges that could adversely affect the Company's financial performance.

The Company depends on single-source or a limited number of suppliers for some of its products, and the loss of any of these suppliers could harm its business.

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. If current suppliers are unable to deliver clubheads, shafts or other components, or if the Company is required to transition to other suppliers, the Company could experience significant production delays or disruption to its business. The Company also depends on a single or a limited number of suppliers for the materials it uses to make its golf balls. Many of these 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, the Company may not be able to find adequate alternative suppliers at a reasonable cost or without significant disruption to its business.

A significant disruption in the operations of the Company's golf club assembly facilities in Carlsbad, California or its golf ball manufacturing facilities in Chicopee, Massachusetts could have a material adverse effect on the Company's sales, profitability and results of operations.

A substantial majority of the Company's golf club products are assembled at and shipped from its facilities in Carlsbad, California. A large majority of the Company's golf ball products are manufactured at and shipped from its facilities in Chicopee, Massachusetts. Any natural disaster or other significant disruption to the operation of these facilities could substantially disrupt the Company's global supply chain coordination for the relevant golf club or golf ball business segment, including damage to inventory at the respective facilities. In addition, the Company could incur significantly higher costs and longer lead times associated with fulfilling orders and distributing product. As a result, a significant disruption at either of the Carlsbad, California or Chicopee, Massachusetts, facilities could adversely affect the Company's sales, profitability and results of operations.

If the Company is unable to obtain at reasonable costs materials or electricity necessary for the manufacture of its products its business would be adversely affected.

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 produce 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. In the future, the Company may be unable to obtain its requirements for such materials at a reasonable price or at all. 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's business.

The Company's golf club and golf ball manufacturing facilities use, among other resources, significant quantities of electricity to operate. An interruption in the supply of electricity or a significant increase in the cost of electricity could have a significant adverse effect upon the Company's results of operations.

A disruption in the service or a significant increase in the cost of the Company's primary delivery and shipping services for its products and component parts could have a material adverse effect on the Company's business.

The Company uses United Parcel Service, or UPS, for substantially all ground shipments of products to its U.S. customers. The Company uses air carriers and ship services for most of its international shipments of products. Furthermore, 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. The Company's inbound and outbound shipments are particularly dependent upon air carrier facilities at Los Angeles International Airport and ship service facilities at the Port of Los Angeles (Long Beach). If there were any significant interruption in service by such providers or at other significant airports or shipping ports, the Company may be unable to engage alternative suppliers or to receive or ship goods through alternate sites in order to deliver its products or components in a timely and cost-efficient manner. As a result, the Company could experience manufacturing delays, increased manufacturing and shipping costs, and lost sales as a result of missed delivery deadlines and product demand cycles. Any significant interruption in UPS services, air carrier services or ship services could have a material adverse effect upon the Company's business. Furthermore, if the cost of delivery or shipping services were to increase significantly and the additional costs could not be covered by product pricing, the Company's operating results could be significantly adversely affected.

The Company faces intense competition in each of its markets.

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. New product introductions, price reductions, consignment sales, extended payment terms, "closeouts," including closeouts of products that were recently commercially successful, and significant tour and advertising spending by competitors continue to generate intense market competition. Furthermore, continued downward pressure on pricing in the market for new clubs could have a significant adverse effect on the Company's pre-owned club business as the gap narrows between the cost of a new club and a pre-owned club. Successful marketing activities, discounted pricing, consignment sales, extended payment terms or new product introductions by competitors could negatively impact the Company's future sales.

Golf Balls. The golf ball business is also highly competitive. There are a number of well-established and well-financed competitors, including one competitor with an estimated U.S. market share of approximately 50%. As competition in this business increases, many of these competitors are 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 competitive pressures and increased costs will continue to adversely affect the profitability of the Company's golf ball business.

Accessories. The Company's accessories include golf bags, golf gloves, golf footwear and other items. The Company faces significant competition in every region with respect to each of these product categories. In most cases, the Company is not the market leader with respect to its accessory markets.

The Company's golf ball business has a concentrated customer base. The loss of one or more of the Company's top customers could have a significant negative impact on this business.

On a consolidated basis, no one customer that distributes the Company's golf clubs or golf balls in the United States accounted for more than 3% of the Company's revenue in 2007 and 2006 and 4% in 2005. On a segment basis, the Company's golf ball customer base is much more concentrated than its golf club customer base. In 2007, the top five golf ball customers accounted for approximately 20% of the Company's total golf ball sales in the United States. A loss of one or more of these customers could have a significant adverse effect upon the Company's golf ball sales.

International political instability and terrorist activities may decrease demand for the Company's products and disrupt its business.

The Company's business has been adversely affected in recent years by terrorist activities and armed conflicts, such as the attacks on the World Trade Center and the Pentagon, bombings in London and Spain, incidents of Anthrax poisoning and the military actions in the Middle East, including the war in Iraq. Future similar or threatened events or conflicts could have an adverse effect upon the United States or worldwide economy and could cause decreased demand for the Company's products as consumers' attention and interest are diverted from golf and become focused on issues relating to these events. If such events disrupt 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 would be harmed. Furthermore, such events can negatively impact tourism, which could adversely affect the Company's sales to retailers at resorts and other vacation destinations.

The Company's business could be harmed by the occurrence of natural disasters or pandemic diseases.

The occurrence of a natural disaster, such as an earthquake, fire, flood or hurricane, or the outbreak of a pandemic disease, such as Severe Acute Respiratory Syndrome or the Avian Flu, could significantly adversely affect the Company's business. A natural disaster or 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 also could be negatively affected as consumers in the affected regions restrict their recreational activities and as tourism to those areas declines. If the Company's suppliers experienced a significant disruption in their business as a result of a natural disaster or pandemic disease, the Company's ability to obtain the necessary components to make its products could be significantly adversely affected. In addition, the occurrence of a natural disaster or the outbreak of a pandemic disease generally restricts the travel to and from the affected areas, making it more difficult in general to manage the Company's international operations.

The Company has significant international sales and purchases, and is exposed to currency exchange rate fluctuations.

A significant portion of the Company's purchases and sales are international purchases and sales, and the Company conducts transactions in approximately 12 currencies worldwide. Conducting business in such various currencies exposes the Company to fluctuations in foreign currency exchange rates relative to the U.S. dollar.

The Company's financial results are reported in U.S. dollars. As a result, transactions conducted in foreign currencies must be translated into U.S. dollars for reporting purposes based upon the applicable foreign currency exchange rates. Fluctuations in these foreign currency exchange rates therefore may positively or negatively affect the Company's reported financial results.

The effect of the translation of foreign currencies on the Company's financial results can be significant. The Company therefore engages in certain hedging activities to mitigate over time the impact of the translation of foreign currencies on the Company's financial results. The Company's hedging activities are designed to reduce, but not to eliminate, the effects of 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 also reduce the positive impact of a weaker U.S. dollar. The Company's future financial results could be significantly affected by the value of the U.S. dollar in relation 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.

Foreign currency fluctuations can also affect the prices at which products are sold in the Company's international markets. The Company therefore adjusts its pricing based in part upon fluctuations in foreign currency exchange rates. Significant unanticipated changes in foreign currency exchange rates make it more difficult for the Company to manage pricing in its international markets. If the Company is unable to adjust its pricing in a timely manner to counteract the effects of foreign currency fluctuations, the Company's pricing may not be competitive in the marketplace and the Company's financial results in its international markets could be adversely affected.

The Company's business and therefore operating results are subject to seasonal fluctuations.

The Company's business is subject to 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 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 products by the Company's competitors. Retailers are sometimes reluctant to re-order the Company's products in significant quantity when they already have excess inventory of products of the Company or its 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 the Company's key markets 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. The Company's sales during the fourth quarter are generally significantly less than the other quarters because in many of the Company's principal markets fewer people are playing golf during that time of year due to cold weather. Furthermore, in the past, the Company announced its new product line at the beginning of each calendar year. In recent years, 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 deferments could have a material adverse effect upon sales of the Company's current products or result in close out sales at reduced prices.

The seasonality of the Company's business could exacerbate the adverse effects of unusual or severe weather conditions on the Company's business.

Because of the seasonality of the Company's business, the Company's business can be significantly adversely affected by unusual or severe weather conditions. Unfavorable weather conditions generally result in fewer golf rounds played, which generally results in reduced demand for golf products, generally, and golf balls in particular. Furthermore, catastrophic storms can negatively affect golf rounds played both during the storms and afterward, as storm damaged golf courses are repaired and golfers focus on repairing the damage to their homes, businesses and communities. Consequently, sustained adverse weather conditions, especially during the warm weather months, could materially affect the Company's sales.

Changes in equipment standards under applicable Rules of Golf could adversely affect the Company's business.

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. The Company believes that all of its products conform to both the USGA and R&A rules.

The Company's future products may not satisfy USGA and/or R&A standards or existing USGA and/or R&A standards may 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.

The Company's sales could decline if professional golfers do not endorse or use the Company's products.

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 incentives 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.

If the Company is unable to enforce its intellectual property rights, its reputation and sales could be adversely affected.

The golf club industry, in general, has been characterized by widespread imitation of popular club designs. The Company has an active program of monitoring, investigating and enforcing its proprietary rights against companies and individuals who market or manufacture counterfeits and "knock off" products. The Company asserts its rights against infringers of its copyrights, patents, trademarks, and trade dress. However, these efforts may not be successful in reducing sales of golf products by these infringers. Additionally, other golf club manufacturers may 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. The failure to prevent or limit such infringers or imitators, could adversely affect the Company's reputation and sales.

The Company may become subject to intellectual property suits that could cause it to incur significant costs or pay significant damages or that could prohibit it from selling its products.

An increasing number of the Company's competitors have 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, third parties have claimed or may claim that the Company's products infringe upon their proprietary rights. 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. However, in the future, intellectual property claims could force the Company to alter its existing products or withdraw them from the market or could delay the introduction of new products.

Various patents have been issued to the Company's competitors in the golf ball industry and these competitors may assert that the Company's golf balls infringe their patent or other proprietary rights. If the Company's golf balls are found to infringe third party intellectual property rights, the Company may be unable to obtain a license to use such technology, and it could incur substantial costs to redesign its products or to defend legal actions.

The Company's brands may be damaged by the actions of its licensees.

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. In addition, the Company requires its licensees to abide by certain standards of conduct and the laws and regulations of the jurisdictions in which they do business. However, if a licensee fails to adhere to these requirements, the Company's brands could be damaged. The Company's brands could also be damaged if a licensee becomes insolvent or by any negative publicity concerning a licensee or if the licensee does not maintain good relationships with its customers or consumers, many of which are also the Company's customers and consumers.

Sales of the Company's products by unauthorized retailers or distributors could adversely affect the Company's authorized distribution channels and harm the Company's reputation.

Some of the Company's products find their way to unauthorized 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 the Company's products to unauthorized distributors or an increase in sales returns over historical levels. While the Company has taken some lawful steps to limit commerce of its products in the "gray market" in both the United States and abroad, it has not stopped such commerce.

The Company has significant international operations and is exposed to risks associated with doing business globally.

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 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:

- increased difficulty in protecting the Company's intellectual property rights and trade secrets;
- unexpected government action or changes in legal or regulatory requirements;
- social, economic or political instability;
- the effects of any anti-American sentiments on the Company's brands or sales of the Company's products;
- increased difficulty in ensuring compliance by employees, agents and contractors with the Company's policies as well as with the laws of multiple jurisdictions, including but not limited to the U.S. Foreign Corrupt Practices Act, and local international environmental, health and safety laws, and increasingly complex regulations relating to the conduct of international commerce;
- 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
- increased exposure to interruptions in air carrier or ship services.

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, financial performance and condition.

If the Company's customers and distributors do not pay for their purchases in a timely manner, the Company's financial results would be harmed.

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 uncollectible accounts for some of the Company's significant customers. 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.

The Company relies on increasingly complex information systems for management of its manufacturing, distribution, sales and other functions. If the Company's information systems fail to perform these functions adequately or if the Company experiences an interruption in their operation, its business and results of operations could suffer.

All of the Company's major operations, including manufacturing, distribution, sales and accounting, are dependent upon the Company's complex information systems. The Company's information systems are vulnerable to damage or interruption from:

- earthquake, fire, flood, hurricane and other natural disasters;
- power loss, computer systems failure, Internet and telecommunications or data network failure; and
- hackers, computer viruses, software bugs or glitches.

Any damage or significant disruption in the operation of such systems or the failure of the Company's information systems to perform as expected could disrupt the Company's business, result in decreased sales, increased overhead costs, excess inventory and product shortages and otherwise adversely affect the Company's operations, financial performance and condition.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company and its subsidiaries conduct operations in both owned and leased properties. The Company's principal executive offices and domestic operations are located in Carlsbad, California. The eight buildings utilized in the Company's Carlsbad operations include corporate offices, as well as manufacturing, research and development, warehousing and distribution facilities. These buildings comprise approximately 735,000 square feet of space. The Company owns five of these buildings, representing approximately 492,000 square feet of space. An additional three properties, representing approximately 243,000 square feet of space, are leased and the leases are scheduled to expire between March 2009 and November 2017. The Company is in the process of converting its headquarters building to consolidate its campus into a more efficient layout. The Company also owns a manufacturing plant, warehouse and offices that encompass approximately 869,000 square feet in Chicopee, Massachusetts and a manufacturing plant in Gloversville, New York comprising approximately 70,000 square feet. In addition, the Company owns and leases a number of other properties domestically and internationally, including properties in Australia, Canada, Japan, Korea, the United Kingdom and China. The Company's operations at each of these properties are used to some extent for both the golf club and golf ball businesses. The Company believes that its facilities currently are adequate to meet its requirements.

Item 3. 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. The Company is also active internationally. For example, it has worked with other manufacturers to encourage Chinese government officials to conduct raids of identified counterfeiters, resulting in the seizure and destruction of counterfeit golf clubs. 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 February 9, 2006, the Company filed a complaint in the United States District Court for the District of Delaware, Case No. C.A. 06-91, asserting claims against Acushnet Company for patent infringement. Specifically, Callaway Golf asserted that Acushnet's sale of the Titleist Pro V1 family of golf balls infringes four golf ball patents that Callaway Golf acquired when it acquired the assets of Top-Flite. Callaway Golf is seeking damages and an injunction to prevent future infringement by Acushnet. In its answer to the Complaint, Acushnet responded that the patents at issue are invalid and not infringed by the Pro V1 golf balls. On November 20, 2007, the District Court granted Callaway Golf's motion for summary judgment on a breach of contract claim, holding that Acushnet's initiation of parallel re-examination proceedings, described below, constituted a breach of a pre-existing dispute resolution agreement with Callaway Golf. The Court also rejected various legal challenges by Acushnet as to the validity of the patents, permitting Callaway Golf's claims against Acushnet to proceed to

trial, and ruled that the issues of damages and willfulness would be decided in a second trial between the parties. On the eve of trial, Acushnet stipulated that its Pro V1 golf balls infringe one or more of the nine claims in the four patents asserted by Callaway Golf. As a result of the Court's rulings, and Acushnet's concession as to infringement, only the validity of the patents was tried before a jury commencing on December 5, 2007. On December 14, 2007, after a six day trial, a unanimous jury decided that eight of the nine patent claims asserted by Callaway Golf against Acushnet are valid. The Court entered judgment in favor of Callaway Golf and against Acushnet on December 20, 2007. Callaway Golf has requested that the Court enter a permanent injunction requiring Acushnet to stop production and sale of the Pro V1 golf balls. Acushnet has asked the Court to enter judgment notwithstanding the verdict or, alternatively, for a new trial. Those two motions are pending.

Acushnet also filed petitions for reexamination with the United States Patent and Trademark Office ("PTO") challenging the validity of the patents asserted by Callaway Golf. Although the PTO agreed the petitions for reexamination raised substantial new questions of patentability, and issued a first office action preliminarily rejecting the claims of all four of the patents, the PTO has not made a final and binding determination as to the validity of any of the patents. The interim rulings by the PTO do not void the Court's judgment.

On June 9, 2007, the Company filed a complaint in the United States District Court for the District of Delaware, Case No. C.A. 07-367, asserting claims against Acushnet Company for patent infringement. Callaway Golf asserts that Acushnet's sale of numerous drivers, including but not limited to the King Cobra 454 Comp, King Cobra F Speed, King Cobra HS9 F Speed, King Cobra HS9 M speed, and King Cobra LD F Speed, Titleist 905R, Titleist 905S and Titleist 905T drivers, infringes one or more of Callaway Golf U.S. patents (numbers 6,348,015; 6,478,692; 6,669,579; 6,685,576; and 6,949,032). Callaway Golf is seeking damages and an injunction to prevent future infringement. Acushnet has answered the complaint denying infringement of any valid patent and asserting counterclaims against Callaway Golf. Acushnet asserts that sales of Callaway Golf's FT-i, FT-5, X-460, X-460 Tour, Big Bertha Fusion FT-3 and Big Bertha 460 drivers infringe two patents issued to Acushnet, namely U.S. patent numbers 6,960,142 and 7,041,003. Acushnet seeks damages and an injunction as well. Callaway Golf responded to the counterclaim on August 31, 2007, denying infringement of any valid patent claim. The parties are engaged in preliminary discovery. The trial of this matter is set to commence in the District Court on May 18, 2009.

On August 1, 2007, the Company filed a complaint in the United States District Court for the Eastern District of Texas, Case No. 207CV329, asserting claims of patent infringement against TaylorMade Golf Company, Inc. Specifically, Callaway Golf is asserting that sales of certain TaylorMade irons infringe Callaway Golf's U.S. patent No. 5,704,849. Callaway Golf is seeking damages and an injunction to prevent future infringement. On September 4, 2007, TaylorMade answered the complaint denying infringement.

On August 4, 2007, Callaway Golf filed a complaint in the United States District Court for the Southern District of California, Case No. 07 CV 1424, asserting claims against TaylorMade Golf Company, Inc. for patent infringement and seeking declaratory relief. Specifically, Callaway Golf asserts that TaylorMade's sales of its TP Red and TP Black golf balls infringe Callaway Golf's U.S. Patent Nos. 6,638,185 and 7,160,207, which relate to multi-layer golf balls. Callaway Golf is also seeking declarations of license, invalidity, unenforceability, and/or non-infringement of TaylorMade's U.S. Patent Nos. 6,991,558, 7,198,575, 6,719,644, and 6,547,678. TaylorMade filed an answer and counterclaim asserting non-infringement and/or invalidity of Callaway Golf's golf ball patents. TaylorMade also asserts that certain of Callaway Golf's drivers, including the FT-i, FT-5, and Big Bertha 460 infringe its above-named patents and related patent applications. In addition, Taylor Made is seeking declarations of invalidity, unenforceability, and non-infringement of Callaway Golf's U.S. Patent Nos. 5,704,849, 5,409,229 and 5,605,511, which relate to undercut irons.

On December 14, 2007, Callaway Golf and TaylorMade issued a joint press release announcing a resolution of all pending litigation between the parties. Specifically, the parties announced that they entered into a settlement and patent license agreement under the terms of which each company has specified rights to make products under patents owned by the other. Technologies at issue include high moment of inertia drivers, undercut irons, and golf balls.

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

None.

Executive Officers of the Registrant

Biographical information concerning the Company's executive officers is set forth below.

<u>Name</u>	<u>Age</u>	<u>Position(s) Held</u>
George Fellows	65	President and Chief Executive Officer, Director
Steven C. McCracken	57	Senior Executive Vice President, Chief Administrative Officer and Secretary
Bradley J. Holiday	54	Senior Executive Vice President and Chief Financial Officer
David A. Laverty	50	Senior Vice President, Operations
Thomas Yang	55	Senior Vice President, International

George Fellows is President and Chief Executive Officer of the Company as well as one of its Directors. He has served in such capacities since joining the Company in August 2005. Prior to joining the Company, during the period from 2000 through July 2005, he served as President and Chief Executive Officer of GF Consulting, a management consulting firm, and served as Senior Advisor to Investcorp International, Inc. and J.P. Morgan Partners, LLC. Previously, Mr. Fellows was a member of senior management of Revlon, Inc. from 1993 to 1999, including his terms as President, which commenced in 1995, and Chief Executive Officer, which began in 1997. He is a member of the board of directors of VF Corporation (a global apparel company) and Jack in the Box, Inc. (fast food restaurant chain). Mr. Fellows is also chair of the Audit Committee and a member of the Nominating and Governance Committee of VF Corporation as well as a member of the Finance Committee of Jack in the Box, Inc. Previously, he has served on the boards of directors of Revlon, Inc.; the National Association of Chain Drug Stores; the Cosmetics, Toiletries and Fragrance Association; and has served on the New York Stock Exchange Listed Company Advisory Committee. Mr. Fellows graduated with a B.S. degree from City College of New York, received an MBA from Columbia University and completed the Harvard Advanced Management Program.

Steven C. McCracken is Senior Executive Vice President, Chief Administrative Officer and Secretary of the Company and has served in such capacity since October 2005. He previously served as Senior Executive Vice President, Chief Legal Officer and Secretary from August 2000 until October 2005. He served as Executive Vice President, Licensing and Chief Legal Officer from April 1997 to August 2000. He has served as an Executive Vice President since April 1996 and served as General Counsel from April 1994 to April 1997. He served as Vice President from April 1994 to April 1996. He has served as Secretary since April 1994. Prior to joining the Company, Mr. McCracken was a partner at Gibson, Dunn & Crutcher LLP for 11 years, and had been in the private practice of law for over 18 years. During a portion of that period, he provided legal services to the Company. Mr. McCracken serves on the boards of Pro Kids Golf Academy and Learning Center (First Tee San Diego) and Golf Entertainment International, Inc. (in which the Company has a minority interest investment). Mr. McCracken received a B.A., magna cum laude, from the University of California at Irvine and a J.D. from the University of Virginia.

Bradley J. Holiday is Senior Executive Vice President and Chief Financial Officer of the Company and has served in such capacity since September 2003. Mr. Holiday previously served as Executive Vice President and Chief Financial Officer beginning in August 2000. Before joining the Company, Mr. Holiday served as Vice President—Financial Planning & Analysis for Gateway, Inc. Prior to Gateway, Inc., Mr. Holiday was with Nike, Inc. in various capacities beginning in April 1993, including Chief Financial Officer—Golf Company, where he directed all global financial initiatives and strategic planning for Nike, Inc.'s golf business. Prior to Nike, Inc., Mr. Holiday served in various financial positions with Pizza Hut, Inc. and General Mills, Inc. Mr. Holiday has an M.B.A. in Finance from the University of St. Thomas and a B.S. in Accounting from Iowa State University.

David A. Laverty is Senior Vice President, Operations of the Company and has served in such capacity since August 2006. Prior to joining the Company, Mr. Laverty was a Senior Vice President with Vertis Inc., in Baltimore, Maryland. Previously, until April 2005, he had spent 25 years at Revlon in numerous operations management posts. He has a B.A. in Economics from Temple University.

Thomas Yang is Senior Vice President, International and has served in such capacity since joining the Company in July 2006. Until July 2006, Mr. Yang served as Senior Vice President of Global Consumer Products, International for Starbucks Corporation, a position he held for the last 16 months of the nearly five years he worked for Starbucks. He also previously served in international roles for Coca Cola, Proctor & Gamble and the Clorox Company. Mr. Yang serves on the Diversity Council of Korn/Ferry International (an advisory council to its Board of Directors on diversity matters). He graduated from the University of Colorado with a B.S. in Marketing and has a Masters of International Management from the American Graduate School of International Management (Thunderbird) in Arizona.

Information with respect to the Company's employment agreements with its Chief Executive Officer, Chief Financial Officer and other three most highly compensated executive officers will be contained in the Company's definitive Proxy Statement in connection with the 2008 Annual Meeting of Shareholders. In addition, copies of the employment agreements are included as exhibits to this report.

PART II

Item 5. *Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities*

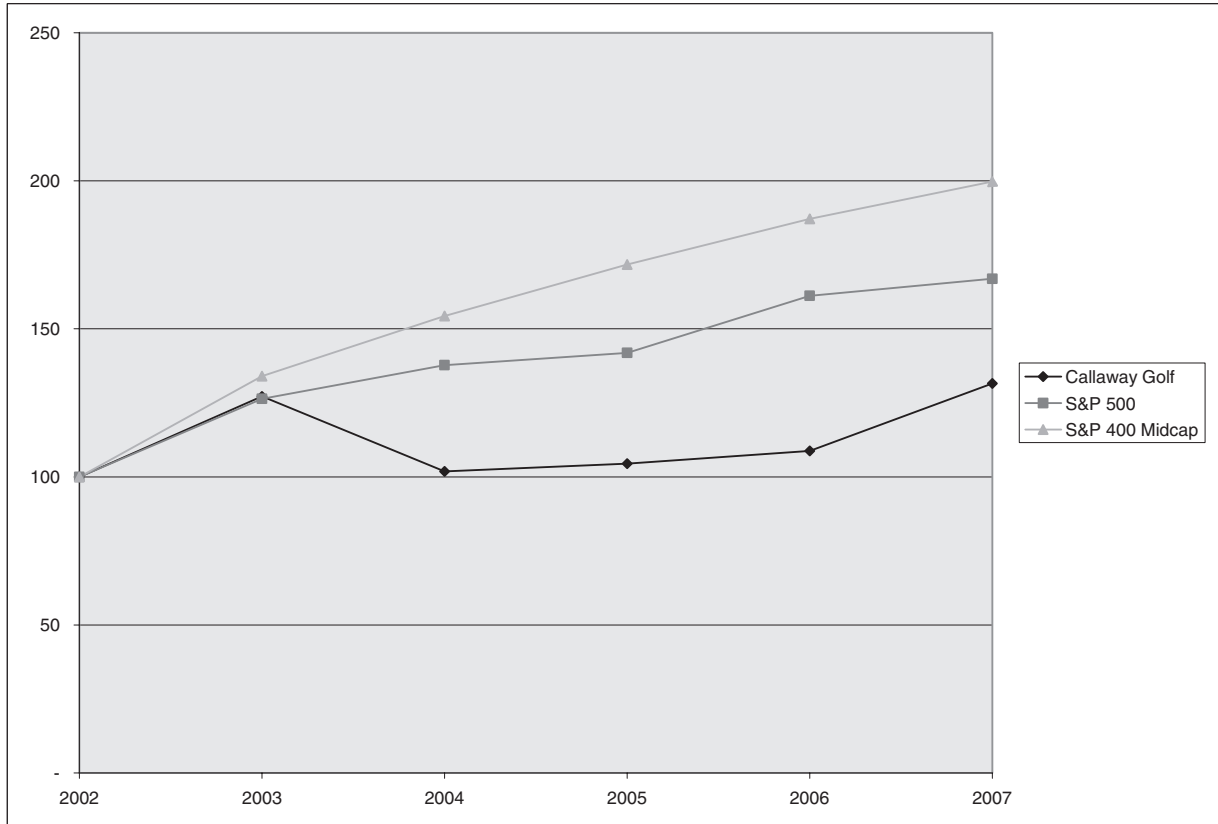
The Company's Common Stock is listed, and principally traded, on the New York Stock Exchange ("NYSE"). The Company's symbol for its Common Stock is "ELY." As of January 31, 2008, the approximate number of holders of record of the Company's Common Stock was 8,800. The following table sets forth the range of high and low per share closing prices of the Company's Common Stock and per share dividends for the periods indicated.

Period:	Year Ended December 31,					
	2007			2006		
	High	Low	Dividend	High	Low	Dividend
First Quarter	\$16.91	\$13.98	\$0.07	\$17.29	\$13.57	\$0.07
Second Quarter	\$18.67	\$16.17	\$0.07	\$17.42	\$12.35	\$0.07
Third Quarter	\$19.26	\$15.62	\$0.07	\$13.73	\$11.49	\$0.07
Fourth Quarter	\$18.07	\$15.27	\$0.07	\$15.23	\$12.26	\$0.07

The Company intends to continue to pay quarterly dividends subject to capital availability and periodic determinations that cash dividends are in the best interests of our stockholders. Future dividends may be affected by, among other items, the Company's views on potential future capital requirements, projected cash flows and needs, and changes to our business model.

PERFORMANCE GRAPH

The following graph presents a comparison of the cumulative total shareholder return since December 31, 2002 of the Company's Common Stock, the Standard & Poor's 500 Index and the Standard & Poor's 400 Midcap Index. The graph assumes an initial investment of \$100 at December 31, 2002 and reinvestment of all dividends.



	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Callaway Golf	100.00	127.17	101.89	104.46	108.76	131.55
S&P 500	100.00	126.38	137.74	141.87	161.20	166.89
S&P 400 Midcap	100.00	134.02	154.34	171.73	187.17	199.70

The Callaway Golf Company index is based upon the closing prices of Callaway Golf Company Common Stock on December 31, 2002, 2003, 2004, 2005, 2006 and 2007 of \$13.25, \$16.85, \$13.50, \$13.84, \$14.41 and \$17.43, respectively.

Securities Authorized for Issuance under Equity Compensation Plans

The following table provides information about the number of stock options and shares underlying Restricted Stock Units (RSUs) and Performance Units outstanding and authorized for issuance under all equity compensation plans of the Company as of December 31, 2007. See Note 11 “Share-Based Employee Compensation” to the Notes of Consolidated Financial Statements for further discussion of the equity plans of the Company.

Equity Compensation Plan Information

Plan Category	Number of Shares to be Issued Upon Exercise of Outstanding Options and Vesting of RSUs and Performance Units	Weighted Average Exercise Price of Outstanding Options ⁽⁵⁾	Number of Shares Remaining Available for Future Issuance
(In thousands, except dollar amounts)			
Equity Compensation Plans Approved by Shareholders (including ESPP) ⁽¹⁾	3,817 ⁽⁴⁾	\$15.81	7,757 ⁽²⁾
Equity Compensation Plans Not Approved by Shareholders ⁽³⁾	<u>2,854</u>	<u>\$17.33</u>	<u>—</u>
Total	<u>6,671</u>	<u>\$16.51</u>	<u>7,757⁽²⁾</u>

- (1) Consists of the following plans: 1991 Stock Incentive Plan, 1996 Stock Option Plan, Non-Employee Directors Stock Option Plan, 2001 Non-Employee Directors Stock Incentive Plan and 2004 Incentive Plan and Employee Stock Purchase Plan. No shares are available for grant under the 1991 Stock Incentive Plan, 1996 Stock Option Plan or Non-Employee Directors Stock Option Plan at December 31, 2007. The 2001 Non-Employee Directors Stock Incentive Plan permits the awards of stock options, restricted stock and restricted stock units. The 2004 Incentive Plan permits the award of stock options, restricted stock, performance units and various other stock-based awards.
- (2) Includes 3,159,835 shares reserved for issuance under the Employee Stock Purchase Plan.
- (3) Consists of the following plans: 1995 Employee Stock Incentive Plan and 1992 Promotion, Marketing and Endorsement Stock Incentive Plan. In connection with shareholder approval of the 2004 Incentive Plan, the Company agreed that no further grants would be made under the 1995 Plan or the Promotion Plan. No grants have been made under the 1995 Plan since May, 2004 or under the Promotion Plan since March 2002.
- (4) Includes 177,669 and 268,385 shares underlying performance units and RSUs, respectively, issuable from the 2004 Incentive Plan, and 39,369 shares underlying RSUs issuable from the 2001 Non-Employee Directors Stock Incentive Plan.
- (5) Does not include shares underlying RSUs and Performance Units, which do not have an exercise price.

Equity Compensation Plans Not Approved By Shareholders

The Company has the following equity compensation plans which were not approved by shareholders: the 1995 Employee Stock Incentive Plan (the “1995 Plan”) and the 1992 Promotion, Marketing and Endorsement Stock Incentive Plan (the “Promotion Plan”). No shares are available for grant under the 1995 Plan or the Promotion Plan at December 31, 2007. For additional information, see Note 11 “Share-Based Employee Compensation” to the Notes to Consolidated Financial Statements.

1995 Plan. Under the 1995 Plan, the Company granted stock options to non-executive officer employees and consultants of the Company. Although the 1995 Plan permitted stock option grants to be made at less than the fair market value of the Company’s Common Stock on the date of grant, the Company’s practice was to generally grant stock options at exercise prices equal to the fair market value of the Company’s Common Stock on the date of grant.

Promotion Plan. Under the Promotion Plan, the Company granted stock options to golf professionals and other endorsers of the Company’s products. Such grants were generally made at prices that were equal to the fair market value of the Company’s Common Stock on the date of grant.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

In June 2007, the Board of Directors authorized a new repurchase program (the “June 2007 repurchase program”) for the Company to repurchase shares of its common stock up to a maximum cost to the Company of \$100.0 million, which would remain in effect until completed or otherwise terminated by the Board of Directors. In November 2007, the Board of Directors authorized a new repurchase program (“the November 2007 repurchase program”) for the Company to repurchase shares of its common stock up to a maximum cost to the Company of \$100.0 million. The November 2007 repurchase program supersedes the June 2007 stock repurchase authorization and will remain in effect until completed or otherwise terminated by the Board of Directors. See Note 10—“Capital Stock” to the Notes to Consolidated Financial Statements.

Under the June 2007 repurchase program, during the three months ended December 31, 2007, the Company repurchased 0.7 million shares of its common stock at a weighted average cost per share of \$16.61 for a total cost of \$11.1 million. As of December 31, 2007, there were no repurchases made under the November 2007 repurchase program and the Company remained authorized to repurchase up to the maximum authorization of \$100.0 million of its common stock under this program.

The following table summarizes the purchases by the Company under its repurchase programs during the fourth quarter of 2007 (in thousands, except per share data):

	Three Months Ended December 31, 2007			
	Total Number of Shares Purchased	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Dollar Value that May Yet Be Purchased Under the Programs
October 1, 2007—October 31, 2007	667	\$16.61	667	\$ 11,104
November 1, 2007—November 30, 2007	—	\$ —	—	\$100,000
December 1, 2007—December 31, 2007	—	\$ —	—	\$100,000
Total	667	\$16.61	667	\$100,000

Item 6. Selected Financial Data

The following statements of operations data and balance sheet data for the five years ended December 31, 2007 were derived from the Company's audited consolidated financial statements. Consolidated balance sheets at December 31, 2007 and 2006 and the related consolidated statements of operations and statements of cash flows for each of the three years in the period ended December 31, 2007 and notes thereto appear elsewhere in this report. The following data should be read in conjunction with the annual consolidated financial statements, related notes and other financial information appearing elsewhere in this report.

	Year Ended December 31,				
	2007	2006	2005	2004 ⁽¹⁾	2003 ⁽²⁾
	(In thousands, except per share data)				
Statement of Operations Data:					
Net sales	\$1,124,591	\$1,017,907	\$998,093	\$934,564	\$814,032
Cost of sales	631,368	619,832	583,679	575,742	445,417
Gross profit	493,223	398,075	414,414	358,822	368,615
Selling, general and administrative expenses	371,020	334,235	370,219	352,967	273,231
Research and development expenses	32,020	26,785	26,989	30,557	29,529
Income (loss) from operations	90,183	37,055	17,206	(24,702)	65,855
Interest and other income (expense), net	3,455	3,364	(390)	1,934	3,550
Interest expense	(5,363)	(5,421)	(2,279)	(945)	(1,522)
Income (loss) before income taxes	88,275	34,998	14,537	(23,713)	67,883
Income tax provision (benefit)	33,688	11,708	1,253	(13,610)	22,360
Net income (loss)	<u>\$ 54,587</u>	<u>\$ 23,290</u>	<u>\$ 13,284</u>	<u>\$ (10,103)</u>	<u>\$ 45,523</u>
Earnings (loss) per common share:					
Basic	\$ 0.82	\$ 0.34	\$ 0.19	\$ (0.15)	\$ 0.69
Diluted	\$ 0.81	\$ 0.34	\$ 0.19	\$ (0.15)	\$ 0.68
Dividends paid per share	\$ 0.28	\$ 0.28	\$ 0.28	\$ 0.28	\$ 0.28

	December 31,				
	2007	2006	2005	2004	2003
	(In thousands)				
Balance Sheet Data:					
Cash and cash equivalents	\$ 49,875	\$ 46,362	\$ 49,481	\$ 31,657	\$ 47,340
Working capital	\$273,033	\$269,745	\$298,385	\$272,934	\$253,302
Total assets	\$856,963	\$845,947	\$764,498	\$735,737	\$748,566
Long-term liabilities	\$ 63,207	\$ 43,388	\$ 28,245	\$ 28,622	\$ 29,023
Total shareholders' equity	\$568,230	\$577,117	\$596,048	\$586,317	\$589,383

- (1) On May 28, 2004, the Company acquired all of the issued and outstanding shares of stock of FrogTrader, Inc. Thus, the Company's financial data includes the FrogTrader, Inc. results of operation commencing May 28, 2004.
- (2) On September 15, 2003 the Company completed the domestic portion of the Top-Flite Acquisition. The settlement of the international assets was effective October 1, 2003. Thus, the Company's financial data includes The Top-Flite Golf Company results of operations in the United States commencing September 15, 2003, and the international operations commencing October 1, 2003.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the Consolidated Financial Statements, the related notes and the "Important Notice to Investors" that appear elsewhere in this report.

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, liabilities, sales and expenses, as well as related disclosures of contingent assets and liabilities. The Company bases its estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances. Actual results may materially differ from these estimates under different assumptions or conditions. On an ongoing basis, the Company reviews its estimates to ensure that the estimates appropriately reflect changes in its business and new information as it becomes available.

Management believes the critical accounting policies discussed below affect its more significant estimates and assumptions used in the preparation of its consolidated financial statements. For a complete discussion of all of the Company's significant accounting policies, see Note 2 to the Consolidated Financial Statements.

Revenue Recognition

Sales are recognized in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements," as products are shipped to customers, net of an allowance for sales returns and accruals for sales programs. The Company records a reserve for anticipated returns through a reduction of sales and cost of sales in the period that the related sales are recorded. Sales returns are estimated based upon historical returns, current economic trends, changes in customer demands and sell-through of products. Historically, the Company's actual sales returns have not been materially different from management's original estimates. The Company does not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions used to calculate the allowance for sales returns. However, if the actual costs of sales returns are significantly different than the recorded estimated allowance, the Company may be exposed to losses or gains that could be material. For example, assuming there had been a 10% increase in the Company's 2007 sales returns, net earnings for the year ended December 31, 2007 would have been reduced by approximately \$2.3 million.

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. The Company's primary sales program "the Preferred Retailer Program" offers longer payment terms during the initial sell in period, as well as potential rebates and discounts, for participating retailers in exchange for providing certain benefits to the Company, including the maintenance of agreed upon inventory levels, prime product placement and retailer staff training. Under this program, qualifying retailers can earn either discounts or rebates based upon the amount of product purchased. Discounts are applied and recorded at the time of sale. For rebates, the Company accrues an estimate of the rebate at the time of sale based on the customer's estimated qualifying current year product purchases. The estimate is based on the historical level of purchases, adjusted for any factors expected to affect the current year purchase levels. The estimated year-end rebate is adjusted quarterly based on actual purchase levels, as necessary. The Preferred Retailer Program is generally short term in nature and the actual costs of the program are known as of the end of the year and paid to customers shortly after year-end. In addition to the Preferred Retailer Program, the Company from time to time offers additional sales program incentive offerings which are also generally short term in nature. Historically the Company's actual costs related to its Preferred Retailer Program and other sales programs have not been materially different than its estimates.

Revenues from gift cards are deferred and recognized when the cards are redeemed. In addition, the Company recognizes revenue from unredeemed gift cards when the likelihood of redemption becomes remote and under circumstances that comply with applicable state escheatment laws, if any. The Company's gift cards have no expiration, therefore, to determine when redemption is remote, the Company analyzes an aging of unredeemed cards (based on the date the card was last used or the activation date if the card has never been used) and compares that information with historical redemption trends. The Company does not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions used to determine the timing of recognition of gift card revenues. However, if the Company is not able to accurately determine when gift card redemption is remote, the Company may be exposed to losses or gains that could be material. The deferred revenue associated with outstanding gift cards increased \$1.8 million to \$4.8 million during the year ended December 31, 2007.

Inventories

Inventories are valued at the lower of cost or fair market value. 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 current inventory levels, sales trends and historical experience as well as management's understanding of market conditions and forecasts of future product demand, all of which are subject to change.

The calculation of the Company's allowance for obsolete or unmarketable inventory requires management to make assumptions and to apply judgment regarding inventory aging, forecasted consumer demand and pricing, regulatory (USGA and R&A) rule changes, the promotional environment and technological obsolescence. The Company does not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions used to calculate the allowance. However, if estimates regarding consumer demand are inaccurate or changes in technology affect demand for certain products in an unforeseen manner, the Company may be exposed to losses that could be material. Historically, there have been no material inventory write-offs for which an allowance had not previously been established. Assuming there had been a 10% increase in the Company's 2007 allowance for obsolete or unmarketable inventory, net earnings for the year ended December 31, 2007 would have been reduced by approximately \$2.0 million.

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, investments, goodwill and other intangible assets) whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. Impairment is assessed when the undiscounted future cash flows estimated to be derived from an asset are less than its carrying amount. Determining whether an impairment has occurred typically requires various estimates and assumptions, including determining the amount of undiscounted cash flows directly related to the potentially impaired asset, the useful life over which cash flows will occur, the timing of the impairment test, and the asset's residual value, if any. The Company uses its best judgment based on current facts and circumstances related to its business when applying these impairment rules. To determine fair value, the Company uses its internal cash flow estimates discounted at an appropriate interest rate, quoted market prices and royalty rates when available and independent appraisals, as appropriate. The Company does not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions used to calculate long-lived asset impairment losses. However, if actual results are not consistent with the Company's estimates and assumptions used in calculating future cash flows and asset fair values, the Company may be exposed to losses that could be material.

Warranty Policy

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 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.

The Company's estimates for calculating the warranty reserve are principally based on assumptions regarding the warranty costs of each club product line over the expected warranty period, where little or no claims experience may exist. Experience has shown that warranty rates can vary between product models, therefore the Company's warranty obligation calculation is based upon long-term historical warranty rates until sufficient data is available. As actual model-specific rates become available, the Company's estimates are modified to ensure that the forecast is within the range of likely outcomes.

Historically, the Company's actual warranty claims have not been materially different from management's original estimated warranty obligation. The Company does not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions used to calculate the warranty obligation. However, if the number of actual warranty claims or the cost of satisfying warranty claims significantly exceeds the estimated warranty reserve, the Company may be exposed to losses that could be material. Assuming there had been a 10% increase in the Company's 2007 warranty obligation, net earnings for the year ended December 31, 2007 would have been reduced by approximately \$1.2 million.

Income Taxes

Current income tax expense or benefit is the amount of income taxes expected to be payable or receivable for the current year. A deferred income tax asset or liability is established for the difference between the tax basis of an asset or liability computed pursuant to FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. 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.

Effective January 1, 2007, the Company was required to adopt and implement the provisions of FIN 48, which requires the Company to accrue for the estimated additional amount of taxes for uncertain tax positions if it is more likely than not that the Company would be required to pay such additional taxes. An uncertain income tax position will not be recognized if it has less than 50% likelihood of being sustained. As a result of the adoption of FIN 48, the Company recognized an increase in the liability for its uncertain tax positions of \$437,000, of which the entire charge was accounted for as a decrease to the beginning balance of retained earnings. The accrual for uncertain tax positions can result in a difference between the estimated benefit recorded in the Company's financial statements and the benefit taken or expected to be taken in the Company's income tax returns. This difference is generally referred to as an "unrecognized tax benefit."

The Company is required to file federal and state income tax returns in the United States and various other income tax returns in foreign jurisdictions. The preparation of these income tax returns requires the Company to interpret the applicable tax laws and regulations in effect in such jurisdictions, which could affect the amount of

tax paid by the Company. The Company, in consultation with its tax advisors, bases its income tax returns on interpretations that are believed to be reasonable under the circumstances. The income tax returns, however, are subject to routine audits by the various federal, state and international taxing authorities in the jurisdictions in which the Company files its income tax returns. As part of these reviews, a taxing authority may disagree with respect to the tax positions taken by the Company. The resolution of any disagreements over the Company's tax positions often involves complex issues and may span multiple years, particularly if litigation is involved. The ultimate resolution of these tax positions is often uncertain until the audit is complete and any disagreements are resolved. As required under applicable accounting rules, the Company therefore accrues an amount for its estimate of additional tax liability, including interest and penalties, for any uncertain tax positions taken or expected to be taken in an income tax return. The Company reviews and updates the accrual for uncertain tax positions as more definitive information becomes available from taxing authorities, completion of tax audits, expiration of statute of limitations, or upon occurrence of other events. Historically, additional taxes paid as a result of the resolution of the Company's uncertain tax positions have not been materially different from the Company's expectations. Information regarding income taxes is contained in Note 13 to the Consolidated Financial Statements.

Share-based Employee Compensation

Beginning in fiscal year 2006, the Company accounts for share-based compensation arrangements in accordance with the provisions of Statement of Financial Accounting Standards No. 123R ("SFAS 123R") "Share-Based Payments," which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated fair values. The Company uses the Black-Scholes option valuation model to estimate the fair value of its stock options at the date of grant. The Black-Scholes option valuation model requires the input of highly subjective assumptions including the Company's expected stock price volatility, the expected dividend yield, the expected life of an option and the number of awards ultimately expected to vest. Changes in subjective input assumptions can materially affect the fair value estimates of an option. Furthermore, the estimated fair value of an option does not necessarily represent the value that will ultimately be realized by an employee. The Company uses historical data to estimate the expected price volatility, the expected dividend yield, the expected option life and the expected forfeiture rate. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. If actual results are not consistent with the Company's assumptions and judgments used in estimating the key assumptions, the Company may be required to increase or decrease compensation expense, which could be material to its results of operations.

In accordance with SFAS 123R, the Company records compensation expense for Restricted Stock Awards based on the estimated fair value of the award on the date of grant. The estimated fair value is determined based on the closing price of the Company's Common Stock on the award date multiplied by the number of awards expected to vest. The number of awards expected to vest is based on the number of awards granted adjusted by estimated forfeiture rates. The total compensation cost is then recognized ratably over the vesting period. If actual forfeiture rates are not consistent with the Company's estimates, the Company may be required to increase or decrease compensation expenses in future periods.

During 2006 the Company granted Performance Units to certain employees under the Company's 2004 Equity Incentive Plan. Performance Units are a form of share-based award in which the number of shares ultimately received depends on the Company's performance against specified performance targets over a three year period. The estimated fair value of the Performance Units is determined based on the closing price of the Company's Common Stock on the grant date multiplied by the expected number of shares to be issued at the end of the performance period. The compensation cost is then amortized on a straight-line basis over the performance period. The Company uses forecasted performance metrics to estimate the number of shares that will ultimately be issued. If actual results are not consistent with the Company's assumptions and judgments used in estimating the forecasted metrics, the Company may be required to increase or decrease compensation expense, which could be material to its results of operations.

Recent Accounting Pronouncements

Information regarding recent accounting pronouncements is contained in Note 2 to the Consolidated Financial Statements, which is incorporated herein by this reference.

Results of Operations

Overview of Business and Seasonality

The Company designs, manufactures and sells high quality golf clubs and golf balls and also sells golf footwear, golf bags and other golf related accessories. The Company designs its products to be technologically-advanced and in this regard invests a considerable amount in research and development each year. The Company's products are designed for golfers of all skill levels, both amateur and professional.

The Company has two operating segments that are organized on the basis of products, which are segregated between golf clubs and golf balls. The golf clubs segment consists primarily of Callaway Golf, Top-Flite and Ben Hogan woods, hybrids, irons, wedges and putters as well as Odyssey putters. This segment also includes other golf-related accessories described above and royalties from licensing of the Company's trademarks and service marks as well as sales of pre-owned golf clubs. The golf balls segment consists primarily of Callaway Golf and Top-Flite golf balls. As discussed below and in Note 15 to the Company's consolidated financial statements, the Company's operating segments exclude a significant amount of corporate and general administrative expenses and other income (expense) not utilized by management in determining segment profitability. While the Company's golf clubs segment has been profitable, the Company's golf balls segment has historically reported annual operating losses for all periods until the current year. The operating results of the Company's golf balls segment includes charges for the applicable periods related to the integration of the Callaway Golf and Top-Flite golf ball operations acquired in September 2003 (the "Top-Flite Integration Initiatives"), charges for the company-wide restructuring initiatives announced in September 2005 (the "2005 Restructuring Initiatives") and charges related to the cost reduction initiatives that target gross margin improvements announced during the fourth quarter of 2006 ("the Gross Margin Improvement Initiatives"). The Company's golf balls segment results of operations have improved significantly from a loss of \$52.7 million in 2003 (including charges of \$24.1 million for the Top-Flite Integration Initiatives) to profitability of \$0.9 million in 2007 (including charges of \$0.3 million and \$3.2 million for the 2005 Restructuring Initiatives and the Gross Margin Improvement Initiatives, respectively). As previously announced, the Company has taken action to address the profitability of its golf ball business, including a re-launch of the Top-Flite brand in 2007, which included among other things the launch of the new D2 golf ball, an updated brand logo as well as an aggressive marketing campaign.

Beginning in November 2006 and continuing throughout 2007, the Company implemented certain Gross Margin Improvement Initiatives. These Gross Margin Improvement Initiatives primarily consisted of process improvements in (i) the procurement of direct materials, including all components used in finished products, (ii) the procurement of indirect goods and services not utilized in finished product such as travel and non-manufacturing temporary labor among others, (iii) the Company's manufacturing and distribution process primarily through the elimination of redundant activities as well as streamlining the process in which the Company's distributes components and finished goods worldwide, and (iv) value engineering and automation, which incorporates strategic capital investments to automate processes and create efficiencies within the Company's operational areas. As a result of these initiatives, as well as certain other factors, the Company's gross margins improved to 44% for the year ended December 31, 2007 from 39% for the same period in 2006. The Company expects to continue implementing these and other Gross Margin Improvement Initiatives in 2008.

In most of the Company's key markets, the game of golf is played primarily on a seasonal basis. Weather conditions generally restrict golf from being played year-round, except in a few small markets, with many of the Company's on-course customers closing for the cold weather months. The Company's business is therefore also subject to seasonal fluctuations. In general, during the first quarter, the Company begins selling its products into the golf retail channel for the new golf season. This initial sell-in generally continues into the second quarter. The Company's second quarter sales are also significantly affected by the amount of re-order business of the products

sold during the first quarter. The Company's third quarter sales are generally dependent on re-order business but are generally less than the second quarter as many retailers begin decreasing their inventory levels in anticipation of the end of the golf season. The Company's fourth quarter sales are generally less than the other quarters due to the end of the golf season in many of the Company's key markets. This seasonality, and therefore quarter to quarter fluctuations, can be affected by many factors, including the timing of new product introductions. In general, however, because of this seasonality, a majority of the Company's sales and most, if not all, of its profitability generally occurs during the first half of the year.

Years Ended December 31, 2007 and 2006

Net sales increased \$106.7 million (10%) to \$1,124.6 million for the year ended December 31, 2007 as compared to \$1,017.9 million for the year ended December 31, 2006. The overall increase in net sales is primarily due to the Company's strong 2007 product line and improvements to the Company's supply chain during the current year, which improvements allowed the Company to make the necessary adjustments to supply the products for the increased demand. On an operating segment basis, net sales increased as result of a \$108.4 million (13%) increase in net sales from the Company's golf clubs segment, offset by a decrease of \$1.7 million (1%) in net sales from the Company's golf balls segment. The Company's net sales by operating segment is set forth below (dollars in millions):

	Years Ended December 31,		Growth (Decline)	
	2007	2006	Dollars	Percent
Net sales				
Golf clubs	\$ 911.5	\$ 803.1	\$108.4	13%
Golf balls	213.1	214.8	(1.7)	(1)%
	<u>\$1,124.6</u>	<u>\$1,017.9</u>	<u>\$106.7</u>	<u>10%</u>

For further discussion of each operating segment's results, see "Golf Club and Golf Ball Segments Results" below.

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

	Years Ended December 31,		Growth (Decline)	
	2007	2006	Dollars	Percent
Net sales:				
United States	\$ 597.6	\$ 566.6	\$ 31.0	5%
Europe	193.3	159.9	33.4	21%
Japan	120.1	105.7	14.4	14%
Rest of Asia	86.1	75.6	10.5	14%
Other foreign countries	127.5	110.1	17.4	16%
	<u>\$1,124.6</u>	<u>\$1,017.9</u>	<u>\$106.7</u>	<u>10%</u>

Net sales in the United States increased \$31.0 million (5%) to \$597.6 million during the year ended December 31, 2007 compared to 2006. The Company's sales in regions outside of the United States increased \$75.7 million (17%) to \$527.0 million during the year ended December 31, 2007 compared to 2006. This increase in U.S. and international sales is attributable to increased sales in all regions primarily due to favorable consumer acceptance of the Company's new products. The Company's net sales were positively affected during 2007 by changes in foreign currency rates, primarily in Europe, Australia, Canada and Korea partially offset by unfavorable foreign currency rate changes in Japan.

For the year ended December 31, 2007, gross profit increased \$95.1 million (24%) to \$493.2 million from \$398.1 million in 2006. Gross profit as a percentage of net sales improved to 44% during the year ended

December 31, 2007 from 39% in the comparable period of 2006. Overall gross margins during 2007 were favorably impacted by increases in average selling prices resulting from a more favorable current year product mix combined with improved manufacturing efficiencies, a decline in freight costs as well as other Gross Margin Improvement Initiatives. Gross profit for the year ended December 31, 2007 was negatively affected by charges of \$8.9 million related to the implementation of the Company's Gross Margin Improvement Initiatives. Gross profit for the year ended December 31, 2006 was negatively affected by charges of \$3.5 million related to the Top-Flite Integration Initiatives, \$1.9 million related to the Gross Margin Improvement Initiatives, as well as \$0.3 million in connection with the Company's 2005 Restructuring Initiatives.

Selling expenses increased \$27.5 million (11%) to \$282.0 million for the year ended December 31, 2007 as compared to \$254.5 million for the year ended December 31, 2006. As a percentage of net sales, selling expense remained constant at 25% for the years ended December 31, 2007 and 2006. The dollar increase was primarily due to a \$14.1 million increase in employee costs primarily related to employee incentive compensation as a result of the Company's improved financial performance in 2007. In addition, advertising and other promotional expenses increased \$8.0 million primarily due to expenditures associated with current year new product introductions as well as the previously announced re-launch of the Top-Flite brand, and depreciation expense increased \$2.2 million as a result of an increase in display and shelving fixtures as well as fitting carts acquired during 2007.

General and administrative expenses increased \$9.4 million (12%) to \$89.1 million for the year ended December 31, 2007 as compared to \$79.7 million for the year ended December 31, 2006. As a percentage of net sales, general and administrative expenses remained constant at 8% for the years ended December 31, 2007 and 2006. The dollar increase was due to a \$7.7 million increase in employee costs primarily related to employee incentive compensation as a result of the Company's improved financial performance, a \$5.2 million increase in corporate legal expense primarily associated with golf ball intellectual property rights litigation and a \$1.8 million increase in professional fees primarily related to consulting services. These increases were partially offset by a \$5.4 million gain recognized in connection with the sale of two buildings in August and December of 2007.

Research and development expenses increased \$5.2 million (19%) to \$32.0 million for the year ended December 31, 2007 as compared to \$26.8 million for the year ended December 31, 2006. As a percentage of net sales, research and development expenses remained constant at 3% for the years ended December 31, 2007 and 2006. The dollar increase was primarily due to a \$3.6 million increase in employee costs primarily related to employee incentive compensation as a result of the Company's improved financial performance combined with an increase in salaries and wages.

Other net expense decreased \$0.2 million (10%) to \$1.9 million for the year ended December 31, 2007 as compared to \$2.1 million for the year ended December 31, 2006. This improvement is primarily a result of a \$0.9 million increase in net interest income primarily due to improved management of cash on hand, partially offset by a decrease of \$0.6 million in other income as a result of a favorable insurance claim recognized in the fourth quarter of 2006.

The effective tax rate for the year ended December 31, 2007 was 38% compared to 33% for the year ended December 31, 2006. The tax rate benefited from net favorable adjustments to previously estimated tax liabilities in the amount of \$1.6 million and \$3.0 million for the years ended December 31, 2007 and 2006, respectively. Additionally, the relative impact of these net favorable adjustments on the effective tax rate was greater in 2006 as a result of lower income before taxes in that year. Historically, the most significant favorable adjustments resulted from the finalization of the Company's prior year U.S. and state income tax returns as well as agreements reached with major jurisdictions on certain issues necessitating a reassessment of the Company's tax exposures for all open tax years, with no individual year being significantly affected.

Net income for 2007 improved 134% to \$54.6 million from net income of \$23.3 million in 2006. The diluted earnings per share improved 138% to \$0.81 per share in 2007 compared to diluted earnings per share of

\$0.34 in 2006. In 2007, net income was positively impacted by after-tax gains of \$3.3 million (\$0.05 per share) that were recognized in connection with the sale of two buildings in August and December of 2007. Net income in 2007 was negatively impacted by after-tax charges of \$5.5 million (\$0.08 per share) related to costs associated with the Company's Gross Margin Improvement Initiatives. Net income in 2006 was negatively impacted by after-tax charges of \$2.5 million (\$0.04 per share) related to the Top-Flite Integration Initiatives, after-tax charges of \$1.9 million (\$0.03 per share) in connection with the Company's 2005 Restructuring Initiatives and after-tax charges of \$1.1 million (\$0.02 per share) related to costs associated with the Gross Margin Improvement Initiatives.

Golf Clubs and Golf Balls Segments Results for the Years Ended December 31, 2007 and 2006

Golf Clubs Segment

Net sales for the golf clubs segment increased \$108.4 million (13%) to \$911.5 million for the year ended December 31, 2007 as compared to \$803.1 million for the year ended December 31, 2006. This increase is primarily attributable to a \$39.4 million (15%) increase in net sales of woods, a \$41.0 million (28%) increase in net sales of accessories and other products and a \$21.6 million (8%) increase in net sales of irons compared to the prior year.

Net sales information for the golf clubs segment by product category is summarized as follows (dollars in millions):

	Years Ended December 31,		Growth (Decline)	
	2007	2006	Dollars	Percent
Net sales:				
Woods	\$305.9	\$266.5	\$ 39.4	15%
Irons	309.6	288.0	21.6	8%
Putters	109.1	102.7	6.4	6%
Accessories and other	186.9	145.9	41.0	28%
	<u>\$911.5</u>	<u>\$803.1</u>	<u>\$108.4</u>	<u>13%</u>

The \$39.4 million (15%) increase in net sales of woods to \$305.9 million for the year ended December 31, 2007 is primarily attributable to an increase in average selling prices partially offset by lower unit volume. The increase in average selling prices is primarily attributable to a favorable shift in product mix as a result of the launch of two premium multi-material drivers, the FT-i and FT-5, and one titanium driver, the Big Bertha 460, which were introduced during the first quarter of 2007. These products sold at higher price points than the prior generation FT-3 driver, which was in the third year of its product lifecycle and the titanium X460 driver, which was introduced during the first quarter of 2006. The decline in unit volume primarily resulted from a decrease in unit volume of older fairway wood products, which were in the second and third years of their product lifecycles, partially offset by an increase in unit volume of the new driver products discussed above.

The \$21.6 million (8%) increase in net sales of irons to \$309.6 million for the year ended December 31, 2007 resulted primarily from higher unit volume combined with an increase in average selling prices. The increase in unit volume is primarily attributable to an increase in sales of X-20 irons products that were launched during the first quarter of 2007 partially offset by a decrease in sales of the Company's older irons products, primarily Big Bertha irons and prior generation X-18 irons, which were in the second and third years of their product lifecycles. The increase in average selling prices is attributable to a more favorable mix of higher priced irons products during 2007 compared to 2006. This shift in product mix primarily resulted from the current year introduction of more premium multi-material irons products compared to the prior year introduction of steel irons products which generally have lower average selling prices.

The \$6.4 million (6%) increase in net sales of putters to \$109.1 million for the year ended December 31, 2007 resulted primarily from an increase in average selling prices offset by lower unit volume. The increase in

average selling prices is attributable to the current year introduction of the White Hot XG and Black Series putter product lines. The decrease in unit volume is primarily due to decreases in sales of the Company's older White Hot, White Steel, Tri-ball and 2-ball SRT putter products, which were in the second and third years of their product lifecycles.

The \$41.0 million (28%) increase in sales of accessories and other products to \$186.9 million is primarily attributable to an increase in sales of Callaway Golf footwear and other accessories (primarily bags and gloves). The increase in sales of Callaway Golf footwear was primarily due to an increase in unit volume as well as the fact that golf footwear was sold primarily through a licensing arrangement until April of 2006 whereas the Company sold golf footwear directly to retailers during the full year in 2007.

Golf Balls Segment

Net sales information for the golf balls segment is summarized as follows (dollars in millions):

	<u>Years Ended December 31,</u>		<u>Growth (Decline)</u>	
	<u>2007</u>	<u>2006</u>	<u>Dollars</u>	<u>Percent</u>
Net sales:				
Golf balls	\$213.1	\$214.8	\$(1.7)	(1)%

The \$1.7 million (1%) decrease in net sales of golf balls to \$213.1 million for the year ended December 31, 2007 is primarily due to a decrease in unit volume of Top-Flite golf balls, partially offset by an increase in unit volume of Callaway Golf balls. The decrease in unit volume for Top-Flite golf balls is primarily due to a planned 30% reduction in product SKUs combined with a decline in sales of the Company's older Top-Flite brand golf ball products that were in the second and third years of their product lifecycles, partially offset by net sales of the D2 golf ball introduced in the current year. The increase in unit volume for the Callaway Golf balls is attributable to favorable consumer acceptance of the Company's current year product introductions, including the new 2007 HX Hot, Big Bertha and Warbird golf ball product lines.

Segment Profitability

Profitability by operating segment is summarized as follows (dollars in millions):

	<u>Years Ended December 31,</u>		<u>Growth (Decline)</u>	
	<u>2007</u>	<u>2006</u>	<u>Dollars</u>	<u>Percent</u>
Income (loss) before provision for income taxes ⁽¹⁾				
Golf clubs	\$151.8	\$101.8	\$50.0	49%
Golf balls	0.9	(6.4)	7.3	114%
	<u>\$152.7⁽¹⁾</u>	<u>\$ 95.4⁽¹⁾</u>	<u>\$57.3</u>	<u>60%</u>

(1) Amounts shown are before the deduction of corporate general and administration expenses and other income (expenses) of \$64.4 million and \$60.4 million for the years ended December 31, 2007 and 2006, respectively, which are not utilized by management in determining segment profitability. For further information on segment reporting see Note 15 to the Consolidated Condensed Financial Statements—"Segment Information" in this Form 10-K.

Pre-tax income (loss) in the Company's golf clubs and golf balls operating segments improved to \$151.8 million and \$0.9 million, respectively, for the year ended December 31, 2007 compared to income of \$101.8 million and a loss of \$6.4 million, respectively, for the same period in 2006. The increase in the golf clubs operating segment pre-tax income is primarily attributable to improved net sales as well as improved gross

margins resulting from a more favorable club product mix due to the current year launch of higher margin driver and irons products. The increase in the golf balls operating segment pre-tax income is primarily due to improved net sales as well as improved gross margins resulting from a shift in product mix toward increased sales of more premium Callaway branded golf balls and the introduction of a higher-priced Top-Flite branded golf ball combined with a decline in sales of lower margin range balls during the year ended December 31, 2007. Additionally, during 2006, the Company recorded a \$3.3 million charge due to a work-in-progress inventory write-down as a result of an annual physical inventory count. Furthermore, both golf clubs and golf balls operating segment margins were favorably impacted by cost reductions resulting from improved manufacturing efficiencies, declines in freight costs and the successful implementation of the Company's Gross Margin Improvement Initiatives during 2007.

As previously mentioned in the overview above, during 2006 the Company incurred charges in connection with the 2005 Restructuring Initiatives and the Top-Flite Integration Initiatives. The Company's income before provision for income taxes for the golf clubs and golf balls operating segments includes the recognition of charges in connection with these initiatives in the amounts of \$3.2 million and \$3.8 million, respectively, for the year ended December 31, 2006. In connection with the Company's Gross Margin Improvement Initiatives announced during the fourth quarter of 2006, the Company's golf clubs and golf balls operating segments absorbed charges of \$5.7 million and \$3.2 million, respectively, during 2007.

Years Ended December 31, 2006 and 2005

Net sales increased 2% to \$1,017.9 million for the year ended December 31, 2006 as compared to \$998.1 million for the year ended December 31, 2005. The overall increase in net sales is primarily due to a 9% increase in sales of the Callaway Golf and Odyssey branded products partially offset by a 31% decline in sales of the Top-Flite and Ben Hogan branded products. The Company is in the process of implementing several initiatives designed to restore the Top-Flite brand. The Company's net sales by operating segment is set forth below (dollars in millions):

	<u>Years Ended December 31,</u>		<u>Growth (Decline)</u>	
	<u>2006</u>	<u>2005</u>	<u>Dollars</u>	<u>Percent</u>
Net sales				
Golf clubs	\$ 803.1	\$783.4	\$19.7	3%
Golf balls	214.8	214.7	0.1	0%
	<u>\$1,017.9</u>	<u>\$998.1</u>	<u>\$19.8</u>	<u>2%</u>

For further discussion of each operating segment's results, see "Golf Club and Golf Ball Segments Results" below.

Net sales information by region is summarized as follows:

	<u>Years Ended December 31,</u>		<u>Growth (Decline)</u>	
	<u>2006</u>	<u>2005</u>	<u>Dollars</u>	<u>Percent</u>
Net Sales:				
United States	\$ 566.6	\$563.0	\$ 3.6	1%
Europe	159.9	166.2	(6.3)	(4)%
Japan	105.7	103.4	2.3	2%
Rest of Asia	75.6	66.9	8.7	13%
Other foreign countries	110.1	98.6	11.5	12%
	<u>\$1,017.9</u>	<u>\$998.1</u>	<u>\$19.8</u>	<u>2%</u>

Net sales in the United States increased \$3.6 million (1%) to \$566.6 million during 2006 compared to 2005. The Company's sales in regions outside of the United States increased \$16.2 million (4%) to \$451.3 million during 2006 compared to 2005. This increase in international sales is primarily attributable to a \$11.0 million increase in sales in Japan and the rest of Asia as well as an increase of \$11.5 million in sales in other foreign countries due to favorable consumer acceptance of the Company's new products launched in those regions late in 2005 and the beginning of 2006. These increases were partially offset by \$6.3 million decrease in sales in Europe, as a result of a general decline in the golf equipment market due to unfavorable weather conditions in that region and the World Cup soccer event, which reduced traffic in golf retail stores, as well as a decline in Top-Flite and Ben Hogan sales. The Company's 2006 net sales were also positively affected by changes in foreign currency rates primarily in Canada and Korea, partially offset by unfavorable changes in Japan and Europe.

For the year ended December 31, 2006, gross profit decreased \$16.3 million to \$398.1 million from \$414.4 million in the comparable period of 2005. Gross profit as a percentage of net sales decreased to 39% in 2006 from 42% in 2005. This decrease is primarily attributable to (i) decreased sales volumes of higher margin premium irons products which were in the second year of their product life cycles, (ii) price reductions on older club and golf ball products, (iii) higher costs associated with manufacturing certain of the Company's new club products that incorporate more complex designs, and (iv) an increase in freight charges, golf ball material costs and utility costs. Additionally, total gross profit for 2006 was negatively affected by charges of \$3.5 million, \$0.3 million and \$1.9 million related to the integration of the Top-Flite operations, the 2005 Restructuring Initiatives and costs associated with the implementation of the Company's gross margin initiatives, respectively, as well as \$0.5 million in employee share-based compensation expense recorded during the period. In 2005, gross profit was negatively affected by charges of \$6.4 million and \$2.1 million, respectively, related to the integration of the Top-Flite operations and the 2005 Restructuring Initiatives.

Selling expenses decreased \$35.6 million (12%) in 2006 to \$254.5 million from \$290.1 million in 2005. As a percentage of sales, selling expenses decreased to 25% in 2006 compared to 29% in 2005. This decrease was primarily due to decreases of \$20.5 million in advertising, tour and other promotional expenses, \$9.7 million in employee costs as well as \$1.1 million in asset disposal losses all associated with the 2005 Restructuring Initiatives implemented during the second half of 2005. In addition, accrued employee incentive compensation expense decreased by \$0.9 million, depreciation and amortization expense decreased by \$1.7 million and share-based compensation expense for non-employees decreased by \$2.7 million, partially offset by an increase of \$1.7 million in share-based compensation for employees as a result of the Company's adoption of SFAS 123R.

General and administrative expenses decreased \$0.4 million (0.5%) in 2006 to \$79.7 million from \$80.1 million in 2005. As a percentage of sales, general and administrative expenses remained consistent at 8% in both 2006 and 2005. The dollar decrease was due primarily to a net decrease of \$1.8 million in employee costs and a decrease of \$0.9 million in asset disposal losses both in connection with the 2005 Restructuring Initiatives. In addition, there were decreases of \$0.9 million in accrued employee incentive compensation expense, \$1.4 million in bad debt expense, \$0.9 million in building expenses, \$1.4 million in consulting and professional fees, \$0.6 million in computer equipment, supplies and telephone charges as well as \$0.9 million in depreciation and amortization expense as a result of assets that became fully depreciated during 2005. These decreases were partially offset by increases of \$6.6 million in employee costs primarily due to share-based compensation expense as a result of the Company's adoption of SFAS 123R and employee relocation expenses recorded during the period as well as \$2.2 million in legal expenses.

Research and development expenses decreased \$0.2 million (1%) in 2006 to \$26.8 million from \$27.0 million in 2005. As a percentage of sales, research and development expenses remained consistent at 3% in both periods. The dollar decrease was primarily due to a decrease in consulting fees partially offset by increases in employee costs and travel expenses.

Other expense, net improved to \$2.1 million in 2006 compared to other expense, net of \$2.7 million in 2005. This decrease in other expense is due to a \$2.7 million improvement in net foreign currency fluctuation gains as

well as a \$0.6 million increase in other income due to an insurance claim recognized in the fourth quarter of 2006. These improvements are partially offset by an increase in interest expense of \$2.7 million due to an increase in average outstanding borrowings under the Company's line of credit during 2006 as compared to 2005.

The income tax provision reflects effective tax rates of 33% and 9% for the years ended December 31, 2006 and 2005, respectively. During 2006 and 2005, the Company's tax rate varied from its statutory rate primarily as a result of recorded net favorable adjustments of \$3.0 million and \$3.6 million, respectively, related to the reassessment and resolution of various tax exposures. The relative impact of these adjustments on the effective tax rates was greater in 2005 as a result of lower income before taxes in that year.

Net income for 2006 increased \$10.0 million (75%) to \$23.3 million from net income of \$13.3 million in 2005. Diluted earnings per share increased to \$0.34 in 2006 compared to diluted earnings per share of \$0.19 in 2005. In 2006, net income was negatively impacted by after-tax charges related to the recognition of share-based compensation expense, the Top-Flite Integration, the 2005 Restructuring Initiatives, and the 2006 Gross Margin Initiatives and in the amounts of \$5.8 million (\$0.08 per share), \$2.5 million (\$0.04 per share), \$1.9 million (\$0.03 per share), and \$1.1 million (\$0.02 per share), respectively. In 2005, net income was negatively impacted by after-tax charges related to the Top-Flite Integration and the 2005 Restructuring Initiatives in the amounts of \$7.7 million (\$0.11 per share) and \$5.2 million (\$0.07 per share), respectively.

Golf Clubs and Golf Balls Segments Results for the Years Ended December 31, 2006 and 2005

Golf Clubs Segment

Net sales for the golf clubs segment increased 3% to \$803.1 million for the year ended December 31, 2006 as compared to \$783.4 million for the year ended December 31, 2005. The overall increase in golf clubs net sales during 2006 was due to a \$29.6 million (26%) increase in net sales of accessories and other, a \$25.2 million (10%) increase in net sales of drivers and fairway woods, partially offset by decreases of \$28.5 million (9%) in net sales of irons and \$6.6 million (6%) in net sales of putters compared to the prior year.

Net sales information for the golf clubs segment by product category is summarized as follows:

	Years Ended December 31,		Growth (Decline)	
	2006	2005	Dollars	Percent
	(\$ in millions)			
Net Sales:				
Driver and fairway woods	\$266.5	\$241.3	\$ 25.2	10%
Irons	288.0	316.5	(28.5)	(9)%
Putters	102.7	109.3	(6.6)	(6)%
Accessories and other	145.9	116.3	29.6	26%
	<u>\$803.1</u>	<u>\$783.4</u>	<u>\$ 19.7</u>	<u>3%</u>

The \$25.2 million (10%) increase in net sales of drivers and fairway woods to \$266.5 million for the year ended December 31, 2006 is primarily due to higher average selling prices as well as an increase in units sold. The increase in average selling prices is primarily attributable to a more favorable mix of higher priced multi-material driver and hybrid products introduced during the current year as well as continued favorable consumer acceptance of the Company's multi-material driver and fairway woods that were launched during the second half of 2005. These increases were partially offset by a reduction in average selling price of the Company's older Ben Hogan and Callaway Golf brand driver and fairway woods products. The increase in units sold is primarily due to the launch of steel fairway woods and multi-material hybrid clubs during 2006 as well as continued favorable consumer acceptance of the Company's 2005 product introductions mentioned above.

The \$28.5 million (9%) decrease in net sales of irons to \$288.0 million for the year ended December 31, 2006 is primarily due to a decline in average selling prices as well as a decrease in units sold during 2006

compared to 2005. The decrease in average selling prices is primarily due to a higher mix of lower priced irons products during 2006 compared to 2005. This shift in product mix primarily resulted from the current year introduction of lower priced steel irons products compared to the prior year introduction of multi-material irons products which generally have higher average selling prices. The decrease in units sold is primarily attributable to the Company offering fewer new irons models in its 2006 product line than its 2005 product line, as well as a decline in sales of the Company's older irons products which were in the second and third years of their product life cycles.

The \$6.6 million (6%) decrease in net sales of putters to \$102.7 million for the year ended December 31, 2006 resulted primarily from supply issues experienced by the Company during the first half of 2006 on the SRT line of putters combined with a reduction in units sold of the Company's older Odyssey White Steel and White Hot putter lines (which were in the second and third years of their product lifecycles, respectively). This decrease was partially offset by the current year introduction of the Odyssey White Hot XG and XG 2-ball, Odyssey White Steel SRT 2-ball and 3-ball and Dual Force 2 putter models. The decrease in net putter sales was further impacted by a decline in average selling prices primarily as a result of a higher mix of lower priced putter products during the year ended December 31, 2006.

The \$29.6 million (26%) increase in net sales of accessories and other products to \$145.9 million for the year ended December 31, 2006 is primarily attributable to an increase in sales of Callaway Golf brand golf bag and accessories and other products as well as an increase in licensing revenue and revenue from the Company's Trade In! Trade Up! pre-owned golf club program. These increases were partially offset by a decrease in sales of Top-Flite and Ben Hogan brand golf bags and accessories and other products

Golf Balls Segment

Net sales information for the golf balls segment is summarized as follows (dollars in millions):

	Years Ended December 31,		Growth (Decline)	
	2006	2005	Dollars	Percent
Net sales:				
Golf balls	\$214.8	\$214.7	\$0.1	0%

The Company's net sales of golf balls remained flat at \$214.8 million for the year ended December 31, 2006 compared to \$214.7 million for the year ended December 31, 2005. Although total net sales remained flat, the Company experienced a decrease in Top-Flite golf ball sales, offset by an increase in sales of Callaway Golf brand golf balls. The decrease in Top-Flite golf ball sales is primarily attributable to a decline in average selling prices resulting from an unfavorable shift in product mix to lower priced golf ball products (including range balls), as well as a reduction in selling prices of certain products related to initiatives to clear Top-Flite golf ball inventory in preparation for the 2007 re-launch of the Top-Flite brand. The increase in Callaway Golf brand golf ball sales is primarily due to the introduction of the Callaway Golf new HX Tour model in the second quarter of 2006 combined with higher sales of the HX Tour 56, which was launched during the third quarter of 2005.

Segment Profitability

Profitability by operating segment is summarized as follows (dollars in millions):

	Years Ended December 31,		Growth (Decline)	
	2006	2005	Dollars	Percent
Income before provision for income taxes ⁽¹⁾				
Golf clubs	\$101.8	\$68.3	\$33.5	49%
Golf balls	(6.4)	(3.6)	(2.8)	(78)%
	<u>\$ 95.4⁽¹⁾</u>	<u>\$64.7⁽¹⁾</u>	<u>\$30.7</u>	<u>47%</u>

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- (1) Amounts shown are before the deduction of corporate general and administration expenses and other income (expenses) of \$60.4 million and \$50.2 million for the years ended December 31, 2006 and 2005, respectively, which are not utilized by management in determining segment profitability. For further information on segment reporting see Note 15 to the Consolidated Condensed Financial Statements—“Segment Information” in this Form 10-K.

Pre-tax income in the Company’s golf clubs operating segment improved to \$101.8 million for the year ended December 31, 2006 compared to \$68.3 million for the same period in 2005. The increase in the golf clubs operating segment pre-tax income is primarily attributable to improved net sales of drivers and fairway woods as well as the Company’s wedge and accessories product categories combined with a decline in operating expenses as a result of the Company’s 2005 restructuring initiatives. These improvements were partially offset by a decline in club gross margins due to an increase in manufacturing costs on new club products that incorporate more complex designs as well as higher unit volumes of lower margin steel iron products sold during 2006.

Pre-tax loss in the Company’s golf balls operating segment declined to a loss of \$6.4 million for the year ended December 31, 2006 compared to a loss of \$3.6 million for the same period in 2005. The decrease in the golf ball operating segment pre-tax income is primarily due a decline in gross profit combined with relatively flat net sales. This decline in gross profit resulted from a reduction in average selling prices of older Top-Flite brand golf ball products, an increase in sales of lower priced, lower margin golf ball products as well as an overall increase in golf ball manufacturing costs. In addition, during 2006, the Company recorded a \$3.3 million charge due to a work-in-progress inventory write-down as a result of an annual physical inventory count. These declines were partially offset by an improvement in operating expenses primarily due to a decline in advertising and other promotional expenses as well as a decrease in employee costs compared to the prior year.

Furthermore, during 2006 the Company incurred charges in connection with the 2005 Restructuring Initiatives and the Top-Flite Integration Initiatives. The Company’s income before provision for income taxes for the golf clubs and golf balls operating segments includes the recognition of charges in connection with these initiatives in the amounts of \$3.2 million and \$3.8 million, respectively, for the year ended December 31, 2006, and \$6.5 million and \$10.4 million, respectively, for the year ended December 31, 2005.

Financial Condition

The Company’s overall financial condition improved during the year ended December 31, 2007. Cash and cash equivalents increased \$3.5 million (8%) to \$49.9 million at December 31, 2007, from \$46.4 million at December 31, 2006. The Company generated positive cash flow from operations of \$152.0 million and an additional \$48.0 million from the issuance of common stock in connection with stock options exercised during the year ended December 31, 2007. The Company used a portion of those funds to repurchase \$114.8 million of Company stock. Additionally, the Company made net payments of \$43.5 million on its credit facility, funded approximately \$32.9 million in capital expenditures and paid dividends of \$18.8 million during the year. Management expects to fund the Company’s future operations from cash provided by its operating activities combined with borrowings from its credit facilities, as deemed necessary.

The Company’s accounts receivable balance fluctuates throughout the year as a result of the general seasonality of the Company’s business. The Company’s accounts receivable balance will generally be at its highest during the first and second quarters and decline significantly during the third and fourth quarters as a result of an increase in cash collections. As of December 31, 2007, the Company’s net accounts receivable decreased \$6.0 million to \$112.1 million from \$118.1 million as of December 31, 2006. The decrease in accounts receivable is primarily attributable to a \$5.5 million decrease in sales during the fourth quarter of 2007 compared to the same quarter of the prior year.

The Company’s inventory balance also fluctuates throughout the year as a result of the general seasonality of the Company’s business. Generally, the Company’s buildup of inventory levels begins during the fourth

quarter and continues heavily into the first quarter as well as into the beginning of the second quarter in order to meet demands during the height of the golf season. Inventory levels start to decline toward the end of the second quarter and are at their lowest during the third quarter. The Company's net inventory decreased \$12.1 million to \$253.0 million as of December 31, 2007 compared to \$265.1 million as of December 31, 2006. This decrease is the result of the Company's inventory reduction initiatives which included a reduction in component lead times as well as the implementation of internal supply chain process improvements during the current year.

Liquidity and Capital Resources

Sources of Liquidity

The Company's principal sources of liquidity are cash flows provided by operations and the Company's credit facilities in effect from time to time. The Company currently expects this to continue. Cash flows from operations combined with borrowings under the Company's credit facilities are affected by the seasonal fluctuations of the golf business as discussed above (see "Overview and Business Seasonality"). Generally, a significant portion of cash outflows from operations are used to purchase inventory. Cash inflows from operations generally begin to increase during the second quarter and peak during the third quarter as a result of collections from customers. As necessary, the Company uses its credit facilities to supplement its cash inflows from operations as well as for other financing and investing activities, including stock repurchases.

The Company's primary line of credit is a \$250.0 million line of credit with Bank of America, N.A. and certain other lenders party to the Company's November 5, 2004 Amended and Restated Credit Agreement.

The Line of Credit provides for revolving loans of up to \$250.0 million, although actual borrowing availability can be effectively limited by the financial covenants contained therein. As of December 31, 2007, the maximum amount that could be borrowed under the Line of Credit was \$250.0 million, of which \$35.0 million was outstanding at December 31, 2007. In addition, the Company had approximately \$1.5 million outstanding at December 31, 2007 under other credit facilities at its foreign subsidiary locations.

Under the Line of Credit, the Company is required to pay certain fees, including an unused commitment fee of between 10.0 to 25.0 basis points per annum of the unused commitment amount, with the exact amount determined based upon the Company's consolidated leverage ratio and trailing four quarters earnings before interest, income taxes, depreciation and amortization, as well as other non-cash expense and income items (EBITDA) (each as defined in the agreement governing the Line of Credit). Outstanding borrowings under the Line of Credit accrue interest, at the Company's election, based upon the Company's consolidated leverage ratio and trailing four quarters' EBITDA of (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, or (ii) the Eurodollar Rate (as defined in the agreement governing the Line of Credit) plus a margin of 50.0 to 125.0 basis points.

The Line of Credit requires the Company to meet certain financial covenants and includes certain other restrictions, including restrictions limiting dividends, stock repurchases, capital expenditures and asset sales. As of December 31, 2007, the Company was in compliance with the covenants and other terms of the Line of Credit, as then applicable.

The total origination fees incurred in connection with the Line of Credit, including fees incurred in connection with the amendments, were \$2.1 million and are being amortized into interest expense over the remaining term of the Line of Credit agreement. Unamortized origination fees were \$1.2 million as of December 31, 2007, of which \$0.3 million was included in prepaid and other current assets and \$0.9 million in other long-term assets in the accompanying consolidated balance sheet.

Share Repurchases

In June 2006, the Company announced that its Board of Directors authorized it to repurchase shares of its common stock in the open market or in private transactions, subject to the Company's assessment of market conditions and buying opportunities, up to a maximum cost to the Company of \$50.0 million, which would

remain in effect until completed or otherwise terminated by the Board of Directors (the “June 2006 repurchase program”). In June 2007, the Board of Directors authorized a new repurchase program (the “June 2007 repurchase program”) for the Company to repurchase shares of its common stock up to a maximum cost to the Company of \$100.0 million, which would remain in effect until completed or otherwise terminated by the Board of Directors. In November 2007, the Board of Directors authorized another new repurchase program (“the November 2007 repurchase program”) for the Company to repurchase shares of its common stock up to a maximum cost to the Company of \$100.0 million. The November 2007 repurchase program supersedes all prior stock repurchase authorizations and will remain in effect until completed or otherwise terminated by the Board of Directors.

As of December 31, 2007, the Company repurchased 1.6 million shares of its common stock under the June 2006 repurchase program at an average cost of per share of \$16.07 for a total cost of \$25.9 million. In addition, the Company repurchased 5.3 million shares of its common stock under the June 2007 repurchase program at an average cost per share of \$16.86 for a total cost of \$88.9 million. As of December 31, 2007, there were no repurchases made under the November 2007 repurchase program and the Company was authorized to repurchase up to the maximum authorization of \$100.0 million of its common stock under this program.

The Company’s repurchases of shares of common stock are recorded at the average cost of the common stock held in treasury and result in a reduction of shareholders’ equity. In November 2007, the Board of Directors authorized the retirement of all common stock held in treasury, which resulted in the retirement of approximately 18.9 million shares at a total cost of \$309.1 million. The retirement also reduced additional paid in capital and common stock by \$308.9 million and \$0.2 million, respectively.

Other Significant Cash and Contractual Obligations

The following table summarizes certain significant cash obligations as of December 31, 2007 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	\$ 36.5	\$ 36.5	\$ —	\$ —	\$ —
Operating leases ⁽¹⁾	27.2	7.7	8.1	4.5	6.9
Unconditional purchase obligations ⁽²⁾	109.4	57.6	49.2	2.5	0.1
Deferred compensation ⁽³⁾	7.8	0.4	0.7	0.3	6.4
Investment commitments ⁽⁴⁾	1.5	1.5	—	—	—
Uncertain tax contingencies ⁽⁵⁾	15.8	3.2	4.7	5.3	2.6
Total⁽⁶⁾	<u>\$198.2</u>	<u>\$106.9</u>	<u>\$62.7</u>	<u>\$12.6</u>	<u>\$16.0</u>

- (1) The Company leases certain warehouse, distribution and office facilities, vehicles and office equipment under operating leases. The amounts presented in this line item represent commitments for minimum lease payments under noncancelable operating leases.
- (2) During the normal course of its business, the Company enters into agreements to purchase goods and services, including purchase commitments for production materials, endorsement agreements with professional golfers and other endorsers, employment and consulting agreements, and intellectual property licensing agreements pursuant to which the Company is required to pay royalty fees. It is not possible to determine the amounts the Company will ultimately be required to pay under these agreements as they are subject to many variables including performance-based bonuses, reductions in payment obligations if designated minimum performance criteria are not achieved, and severance arrangements. The amounts listed approximate minimum purchase obligations, base compensation, and guaranteed minimum royalty payments the Company is obligated to pay under these agreements. The actual amounts paid under some of these agreements may be higher or lower than the amounts included. In the aggregate, the actual amount paid under these obligations is likely to be higher than the amounts listed as a result of the variable nature of

these obligations. In addition, 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 that are undocumented except for an invoice. Such unconditional purchase 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.

- (3) The Company has an unfunded, nonqualified 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 upon 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 \$9.1 million at December 31, 2007. The liability for the deferred compensation is included in long-term liabilities and was \$7.8 million at December 31, 2007.
- (4) The amount is in connection with the Company's investment in Golf Entertainment International Limited. See Note 3 "Investments" to the Consolidated Financial Statements.
- (5) Amount represents total uncertain income tax positions related to the adoption FIN 48, which is comprised of a short-term income tax payable of \$3.2 million and a long-term income tax payable of \$12.6 million. For further discussion see Note 13 to the Consolidated Condensed Financial Statements—"Income Taxes" in this Form 10-K.
- (6) 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, Note 14 "Commitments and Contingencies—Supply of Electricity and Energy Contracts" to the Consolidated Financial Statements.

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 each of its officers and certain other employees providing for severance payments upon the termination of employment. 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 guarantees in the form of two standby letters of credit as security for contingent liabilities under certain workers' compensation insurance policies and as collateral for a loan issued to Golf Entertainment International Limited ("GEI"). 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. Except for the letter of credit in connection with the Company's investment in GEI, (see Note 3 "Investments" to the Consolidated Financial Statements), the fair value of indemnities, commitments and guarantees that the Company issued during the fiscal year ended December 31, 2007 was not material to the Company's financial position, results of operations or cash flows.

In addition to the 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 Note 14 to the Company's Consolidated Financial Statements.

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 Line of Credit, will be sufficient to finance current operating requirements, planned capital expenditures, contractual obligations and commercial commitments, for at least the next 12 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 above, "Certain Factors Affecting Callaway Golf Company" contained in Item 1A).

Capital Resources

The Company does not currently have any material commitments for capital expenditures. The Company expects to have capital expenditures of approximately \$50 to \$55 million during the subsequent 12 months ended December 31, 2008. Of this amount, approximately \$15 million will be used in support of the Company's building improvement and consolidation projects. The remaining amount will be used for capital expenditures in support of the Company's ongoing operating requirements.

Off-Balance Sheet Arrangements

During the fourth quarter of 2006, the Company made an investment in Golf Entertainment International Limited ("GEI"), the owner and operator of TopGolf entertainment centers. In connection with this investment, the Company acquired Preferred Shares of GEI for approximately \$10.0 million. The Company accounts for this investment under the cost method in accordance with the provisions of APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" and reflected the investment balance in other long-term assets in the consolidated condensed balance sheet as of December 31, 2007 and 2006 included in this Form 10-K. In February 2008, the Company and another GEI shareholder entered into an arrangement to provide collateral in the form of a letter of credit in the amount of \$8.0 million for a loan that was issued to a subsidiary of GEI. The Company is currently responsible for \$5.5 million of the total guaranteed amount. This letter of credit will expire one year from the date of issuance.

In addition, at December 31, 2007, the Company had total outstanding commitments on non-cancelable operating leases of approximately \$27.3 million related to certain warehouse, distribution and office facilities, vehicles as well as office equipment. Lease terms range from 1 to 10 years expiring at various dates through November 2017, with options to renew at varying terms.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The Company uses derivative financial instruments for hedging purposes to limit its exposure to changes in foreign currency exchange rates. Transactions involving these financial instruments are with creditworthy 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 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 (see Note 8 to the Company's Consolidated Condensed Financial Statements) that could impact the Company's results of operations. The Company's risk management strategy includes the use of derivative financial instruments, including forwards and purchase 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, Australian Dollar and Chinese Renminbi. 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 European currencies, 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 12 months from their inception.

At December 31, 2007, 2006 and 2005, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$31.1 million, \$32.5 million and \$35.6 million, respectively. At December 31, 2007, 2006 and 2005, there were no foreign exchange contracts designated as cash flow hedges.

As part of the Company's risk management procedure, a sensitivity analysis model is used to measure the 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 sensitivity analysis model quantifies the estimated potential effect of unfavorable movements of 10% in foreign currencies to which the Company was exposed at December 31, 2007 through its derivative financial instruments. The estimated maximum one-day loss from the Company's foreign currency derivative financial instruments, calculated using the sensitivity analysis model described above is \$3.3 million at December 31, 2007. 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 \$3.3 million at December 31, 2007 and would impact earnings. 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. 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.

Interest Rate Fluctuations

The Company is exposed to interest rate risk from its Line of Credit (see Note 7 to the Company's Consolidated Condensed Financial Statements). Outstanding borrowings accrue interest at the Company's election, based upon the Company's consolidated leverage ratio and trailing four quarters' EBITDA, of (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, or (ii) the Eurodollar Rate (as defined in the agreement governing the Line of Credit) plus a margin of 50.0 to 125.0 basis points.

As part of the Company's risk management procedures, a sensitivity analysis was performed to determine the impact of unfavorable changes in interest rates on the Company's cash flows. The sensitivity analysis quantified that the estimated potential cash flows impact would be approximately \$0.5 million in additional interest expense if interest rates were to increase by 10% over a twelve month period.

Item 8. Financial Statements and Supplementary Data

The Company's consolidated financial statements as of December 31, 2007 and 2006 and for each of the three years in the period ended December 31, 2007, together with the reports of our independent registered public accounting firm, are included in this Annual Report on Form 10-K on pages F-1 through F-36.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures. 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, as of December 31, 2007, of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under 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 were effective as of December 31, 2007.

Management's Report on Internal Control over Financial Reporting. The Company's management is responsible for establishing and maintaining effective internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act). Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in its report entitled *Internal Control—Integrated Framework*. Based on that assessment, management believes that, as of December 31, 2007, the Company's internal control over financial reporting was effective based on the COSO criteria.

Changes in Internal Control over Financial Reporting. During the year ended December 31, 2007, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2007 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in its report which is included herein.

Item 9B. Other Information

None.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Callaway Golf Company
Carlsbad, CA

We have audited the internal control over financial reporting of Callaway Golf Company and its subsidiaries (the “Company”) as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company’s internal control over financial reporting is a process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedules as of and for the year ended December 31, 2007, of the Company and our report dated February 28, 2008, expressed an unqualified opinion on those financial statements and financial statement schedules and included an explanatory paragraph regarding the Company’s adoption of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* in 2007.

/s/ DELOITTE & TOUCHE LLP
Costa Mesa, California
February 28, 2008

PART III

Item 10. *Directors, Executive Officers and Corporate Governance*

Certain information concerning the Company's executive officers is included under the caption "Executive Officers of the Registrant" following Part I, Item 4 of this Form 10-K. The other information required by Item 10 will be included in the Company's definitive Proxy Statement under the captions "Board of Directors and Corporate Governance" and "Section 16(a) Beneficial Ownership Reporting Compliance," to be filed with the Commission within 120 days after the end of fiscal year 2007 pursuant to Regulation 14A, which information is incorporated herein by this reference.

Item 11. *Executive Compensation*

The Company maintains employee benefit plans and programs in which its executive officers are participants. Copies of certain of these plans and programs are set forth or incorporated by reference as Exhibits to this report. Information required by Item 11 will be included in the Company's definitive Proxy Statement under the captions "Compensation of Executive Officers and Directors," "Compensation Discussion and Analysis," "Report of the Compensation and Management Succession Committee" and "Board of Directors and Corporate Governance," to be filed with the Commission within 120 days after the end of fiscal year 2007 pursuant to Regulation 14A, which information is incorporated herein by this reference.

Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters*

The information required by Item 12 will be included in Item 5 of this report and the Company's definitive Proxy Statement under the caption "Beneficial Ownership of the Company's Securities," to be filed with the Commission within 120 days after the end of fiscal year 2007 pursuant to Regulation 14A, which information is incorporated herein by this reference.

Item 13. *Certain Relationships, Related Transactions and Director Independence*

The information required by Item 13 will be included in the Company's definitive Proxy Statement under the caption "Compensation of Executive Officers and Directors—Compensation Committee Interlocks and Insider Participation", "Certain Relationships and Transactions with Related Persons," and "Board of Directors and Corporate Governance" to be filed with the Commission within 120 days after the end of fiscal year 2007 pursuant to Regulation 14A, which information is incorporated herein by this reference.

Item 14. *Principal Accountant Fees and Services*

The information included in Item 14 will be included in the Company's definitive Proxy Statement under the caption "Information Concerning Independent Registered Public Accounting Firm" to be filed with the Commission within 120 days after the end of fiscal year 2007 pursuant to Regulation 14A, which information is incorporated herein by this reference.

PART IV

Item 15. *Exhibits and Financial Statement Schedules*

(a) *Documents filed as part of this report:*

1. *Financial Statements.* The following consolidated financial statements of Callaway Golf Company and its subsidiaries required to be filed pursuant to Part II, Item 8 of this Form 10-K, are included in this Annual Report on Form 10-K on pages F-1 through F-36:

Consolidated Balance Sheets as of December 31, 2007 and 2006;

Consolidated Statements of Operations for the years ended December 31, 2007, 2006 and 2005;

Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005;

Consolidated Statements of Shareholders' Equity and Comprehensive Income for the years ended December 31, 2007, 2006 and 2005;

Notes to Consolidated Financial Statements; and

Report of Independent Registered Public Accounting Firm.

2. *Financial Statement Schedule.* The following consolidated financial statement schedule of Callaway Golf Company and its subsidiaries required to be filed pursuant to Part IV, Item 15 of this Form 10-K, is included in this Annual Report on Form 10-K on page S-1:

Schedule II—Consolidated Valuation and Qualifying Accounts; and

All other schedules are omitted because they are not applicable or the required information is shown in the Consolidated Financial Statements or notes thereto.

3. *Exhibits.*

A copy of any of the following exhibits will be furnished to any beneficial owner of the Company's Common Stock, or any person from whom the Company solicits a proxy, upon written request and payment of the Company's reasonable expenses in furnishing any such exhibit. All such requests should be directed to the Company's Investor Relations Department at Callaway Golf Company, 2180 Rutherford Road, Carlsbad, CA 92008.

- 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 Fourth Amended and Restated Bylaws, as amended and restated as of February 21, 2008, incorporated herein by this reference to Exhibit 3.2 to the Company's Current Report on Form 8-K, as filed with the Commission on February 27, 2008 (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, 1994 (file no. 33-77024).

Executive Compensation Contracts/Plans

- 10.1 Executive Officer Employment Agreement, entered into as of July 29, 2005, between the Company and George Fellows, incorporated herein by this reference in Exhibit 10.55 to the Company's Current Report on Form 8-K, as filed with the Commission on August 4, 2005 (file no. 1-10962).

- 10.2 Callaway Golf Company First Amendment to Chief Executive Officer Employment Agreement, effective as of April 19, 2007, by and between Callaway Golf Company and George Fellows, incorporated herein by this reference to Exhibit 10.47 to the Company's Quarterly Report on Form 10-K, as filed with the Commission on May 4, 2007 (file no. 1-10962).
- 10.3 Restricted Stock Grant Agreement, effective as of August 1, 2005, between the Company and George Fellows, incorporated herein by this reference to Exhibit 10.58 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, as filed with the Commission on October 27, 2005 (file no. 1-10962).
- 10.4 Notice of Grant of Stock Option and Option Agreement, effective as of August 1, 2005, between the Company and George Fellows, incorporated herein by this reference to Exhibit 10.59 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, as filed with the Commission on October 27, 2005 (file no. 1-10962).
- 10.5 Executive Officer Employment Agreement, entered into as of December 20, 2005, between the Company and Steven C. McCracken, incorporated herein by this reference to Exhibit 10.60 to the Company's Current Report on Form 8-K, as filed with the Commission on December 22, 2005 (file no. 1-10962).
- 10.6 First Amendment to Officer Employment Agreement, effective as of April 1, 2007, by and between the Company and Steven C. McCracken, incorporated herein by this reference to Exhibit 10.43 to the Company's Current Report on Form 8-K, as filed with the Commission on April 5, 2007 (file no. 1-10962).
- 10.7 Executive Officer Employment Agreement, entered into as of December 20, 2005, between the Company and Bradley J. Holiday, incorporated herein by this reference to Exhibit 10.61 to the Company's Current Report on Form 8-K, as filed with the Commission on December 22, 2005 (file no. 1-10962).
- 10.8 First Amendment to Officer Employment Agreement, effective as of April 1, 2007, by and between the Company and Bradley J. Holiday, incorporated herein by this reference to Exhibit 10.44 to the Company's Current Report on Form 8-K, as filed with the Commission on April 5, 2007 (file no. 1-10962).
- 10.9 Officer Employment Agreement, effective as of April 1, 2007, by and between the Company and Thomas Yang, incorporated herein by this reference to Exhibit 10.46 to the Company's Current Report on Form 8-K, as filed with the Commission on April 5, 2007 (file no. 1-10962).
- 10.10 Officer Employment Agreement, effective as of April 1, 2007, by and between the Company and David A. Lavery, incorporated herein by this reference to Exhibit 10.45 to the Company's Current Report on Form 8-K, as filed with the Commission on April 5, 2007 (file no. 1-10962).
- 10.11 Form of Notice of Grant of Stock Option and Option Agreement, incorporated herein by this reference to Exhibit 10.61 to the Company's Current Report on Form 8-K, as filed with the Commission on January 22, 2007 (file no. 1-10962).
- 10.12 Form of Restricted Stock Unit Grant, incorporated herein by this reference to Exhibit 10.62 to the Company's Current Report on Form 8-K, as filed with the Commission on January 22, 2007 (file no. 1-10962).
- 10.13 Form of Performance Unit Grant, incorporated herein by this reference to Exhibit 10.63 to the Company's Current Report on Form 8-K, as filed with the Commission on January 22, 2007 (file no. 1-10962).

- 10.14 Form of Notice of Grant of Stock Option and Option Agreement for Non-Employee Directors, incorporated herein by this reference to Exhibit 10.25 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004, as filed with the Commission on March 10, 2005 (file no. 1-10962).
- 10.15 Form of Non-Employee Director Restricted Stock Unit Grant Agreement, incorporated herein by this reference to Exhibit 10.14 to the Company's Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the Commission on March 1, 2007 (file no. 1-10962).
- 10.16 Callaway Golf Company 2004 Equity Incentive Plan, incorporated herein by this reference to Exhibit B to the Company's definitive Proxy Statement on Schedule 14A filed with the Commission on April 20, 2004 (file no. 1-10962).
- 10.17 Callaway Golf Company 2001 Non-Employee Directors Stock Incentive Plan (Amended and Restated Effective as of June 6, 2006), incorporated herein by this reference to Exhibit 10.57 to the Company's Current Report on Form 8-K, as filed with the Commission on June 9, 2006 (file no. 1-10962).
- 10.18 Callaway Golf Company Non-Employee Directors Stock Option Plan (As Amended and Restated August 15, 2000), incorporated herein by this reference to Exhibit 10.25 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).
- 10.19 Callaway Golf Company 1996 Stock Option Plan (As Amended and Restated May 3, 2000), incorporated herein by this reference to Exhibit 10.23 to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2000, as filed with the Commission on August 14, 2000 (file no. 1-10962).
- 10.20 Callaway Golf Company 1995 Employee Stock Incentive Plan (As Amended and Restated November 7, 2001), incorporated herein by this reference to Exhibit 10.22 to the Company's Annual Report on Form 10-K for the year ended December 31, 2002, as filed with the Commission on March 17, 2003 (file no. 1-10962).
- 10.21 Callaway Golf Company 1991 Stock Incentive Plan (as Amended and Restated August 15, 2000), incorporated herein by this reference to Exhibit 10.24 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).
- 10.22 2005 Callaway Golf Company Executive Deferred Compensation Plan (Master Plan Document), incorporated herein by this reference to Exhibit 10.30 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Commission on February 27, 2006 (file no. 1-10962).
- 10.23 Callaway Golf Company Executive Deferred Compensation Plan, as amended and restated, effective May 6, 2002, incorporated herein by this reference to Exhibit 10.23 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004, as filed with the Commission on March 10, 2005 (file no. 1-10962).
- 10.24 Trust Agreement for the Callaway Golf Company Executive Deferred Compensation Plans, incorporated herein by this reference to Exhibit 10.32 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Commission on February 27, 2006 (file no. 1-10962).
- 10.25 Callaway Golf Company Employee Stock Purchase Plan (as Amended and Restated Effective as of February 1, 2006), incorporated herein by this reference to Exhibit 10.33 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Commission on February 27, 2006 (file no. 1-10962).

- 10.26 Callaway Golf Company Amended and Restated 2004 Incentive Plan (Amended and Restated effective as of June 5, 2007), incorporated herein by this reference to Exhibit A to the Company's annual proxy statement on Schedule 14A, as filed with the Securities and Exchange Commission on April 23, 2007 (file no. 1-10962).
- 10.27 Callaway Golf Company 2008 Senior Management Incentive Program, incorporated herein by this reference to Exhibit 10.48 to the Company's Current Report on Form 8-K, as filed with the Commission on January 18, 2008 (file no. 1-10962).
- 10.28 Indemnification Agreement, dated April 7, 2004, between the Company and Anthony S. Thornley, incorporated herein by this reference to Exhibit 10.34 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004, as filed with the Commission on March 10, 2005 (file no. 1-10962).
- 10.29 Indemnification Agreement, dated as of April 21, 2003, between the Company and Samuel H. Armacost, incorporated herein by this reference to Exhibit 10.57 the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, as filed with the Commission on August 7, 2003 (file no. 1-10962).
- 10.30 Indemnification Agreement, dated as of April 21, 2003, between the Company and John C. Cushman, III, incorporated herein by this reference to Exhibit 10.58 the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, as filed with the Commission on August 7, 2003 (file no. 1-10962).
- 10.31 Indemnification Agreement, effective June 7, 2001, between the Company and Ronald S. Beard, incorporated herein by this reference to Exhibit 10.28 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001, as filed with the Commission on November 14, 2001 (file no. 1-10962).
- 10.32 Indemnification Agreement, dated July 1, 1999, between the Company and Yotaro Kobayashi, incorporated herein by this reference to Exhibit 10.30 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999, as filed with the Commission on August 16, 1999 (file no. 1-10962).
- 10.33 Indemnification Agreement, dated July 1, 1999, between the Company and Richard L. Rosenfield, incorporated herein by this reference to Exhibit 10.32 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999, as filed with the Commission on August 16, 1999 (file no. 1-10962).

Other Contracts

- 10.34 Fourth Amendment to Amended and Restated Credit Agreement dated as of January 28, 2008 by and among Callaway Golf Company, Bank of America, N.A. (as Administrative Agent, Swing Line Lender and L/C Issuer) and certain other lenders named therein, incorporated herein by this reference to Exhibit 10.49 to the Company's Current Report on Form 8-K, as filed with the Commission on February 1, 2008 (file no. 1-10962).
- 10.35 Third Amendment to Amended and Restated Credit Agreement dated as of February 15, 2007 by and among Callaway Golf Company, Bank of America, N.A. (as Administrative Agent, Swing Line Lender and L/C Issuer), and certain other lenders named therein, incorporated herein by this reference to Exhibit 10.64 to the Company's Current Report on Form 8-K, dated as of February 15, 2007, as filed with the Commission on February 21, 2007 (file no. 1-10962).

- 10.36 Second Amendment to Amended and Restated Credit Agreement dated as of January 23, 2006 between the Company, Bank of America, N.A. as Administrative Agent, Swing Line Lender and L/C Issuer, and the other lenders party to the Amended and Restated Credit Agreement dated November 5, 2004, incorporated herein by this reference to Exhibit 10.60 to the Company's Current Report on Form 8-K, dated as of January 23, 2006, as filed with the Commission on January 27, 2006 (file no. 1-10962).
- 10.37 First Amendment to Amended and Restated Credit Agreement, dated as of March 31, 2005, between the Company, Bank of America, N.A. as Administrative Agent, Swing Line Lender and L/C Issuer, and the other lenders party to the Amended and Restated Credit Agreement dated November 5, 2004, incorporated herein by this reference to Exhibit 10.54 to the Company's Current Report on Form 8-K, dated as of March 31, 2005, as filed with the Commission on April 6, 2005 (file no. 1-10962).
- 10.38 Amended and Restated Credit Agreement, dated as of November 5, 2004, between the Company and Bank of America, N.A. as Administrative Agent, Swing Line Lender and L/C Issuer, Banc of America Securities LLC, as Sole Lead Manager and Sole Book Manager, and the other lenders party to the Amended and Restated Credit Agreement, incorporated herein by this reference to Exhibit 10.48 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, as filed with the Commission on November 9, 2004 (file no. 1-10962).
- 10.39 Master Energy Purchase and Sale Agreement and related Confirmation letter, each entered into as of April 12, 2001, between the Company and Enron Energy Services, Inc., incorporated herein by this reference to Exhibit 10.34 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001, as filed with the Commission on August 14, 2001 (file no. 1-10962).
- 10.40 Amendment No. 3 to Trust Agreement, effective as of November 1, 2005, by the Company with the consent of Union Bank of California, N.A., incorporated herein by this reference to Exhibit 10.47 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Commission on February 27, 2006 (file no. 1-10962).
- 10.41 Amendment No. 2 to Trust Agreement, effective as of October 21, 2004, by the Company with the consent of Arrowhead Trust Incorporated, incorporated herein by this reference to Exhibit 10.50 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004, as filed with the Commission on March 10, 2005 (file no. 1-10962).
- 10.42 Amendment No. 1 to Trust Agreement, effective as of June 29, 2001, by the Company with the consent of Arrowhead Trust Incorporated, incorporated herein by this reference to Exhibit 10.46 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).
- 10.43 Assignment and Assumption Agreement, effective as of January 1, 2006, among the Company, Arrowhead Trust Incorporated and Union Bank of California, N.A., incorporated herein by this reference to Exhibit 10.50 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Commission on February 27, 2006 (file no. 1-10962).
- 10.44 Assignment and Assumption Agreement, effective as of April 24, 2000, among the Company, Sanwa Bank California and Arrowhead Trust Incorporated, incorporated herein by reference to Exhibit 10.47 to the Company's Annual Report on Form 10-K for the year ended December 31, 2000, as filed with the Commission on March 30, 2001 (file no. 1-10962).
- 10.45 Trust Agreement, dated July 14, 1995, between the Company and Sanwa Bank California, as Trustee, for the benefit of participating employees, incorporated herein by this reference to Exhibit 10.45 to the corresponding exhibit to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1995, as filed with the Commission on November 14, 1995 (file no. 1-10962).
- 21.1 List of Subsidiaries.†

- 23.1 Consent of Deloitte & Touche LLP.†
- 24.1 Form of Limited Power of Attorney.†
- 31.1 Certification of George Fellows 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 of George Fellows and Bradley J. Holiday pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.†

† Included in this Report

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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/ GEORGE FELLOWS
George Fellows
President and Chief Executive Officer

Date: February 28, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and as of the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Dated as of</u>
Principal Executive Officer:		
/s/ GEORGE FELLOWS George Fellows	President and Chief Executive Officer, Director	February 28, 2008
Principal Financial Officer and Principal Accounting Officer:		
/s/ BRADLEY J. HOLIDAY Bradley J. Holiday	Senior Executive Vice President and Chief Financial Officer	February 28, 2008
Directors:		
* Samuel H. Armacost	Director	February 28, 2008
* Ronald S. Beard	Chairman of the Board	February 28, 2008
* John C. Cushman, III	Director	February 28, 2008
* Yotaro Kobayashi	Director	February 28, 2008
* Richard L. Rosenfield	Director	February 28, 2008
* Anthony S. Thornley	Director	February 28, 2008
*By: /s/ BRADLEY J. HOLIDAY		
Bradley J. Holiday Attorney-in-fact		

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, George Fellows, certify that:

1. I have reviewed this annual report on Form 10-K 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(s) 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15(d)-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) 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
 - (d) 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(s) 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/ GEORGE FELLOWS

George Fellows
President and Chief Executive Officer

Date: February 28, 2008

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Bradley J. Holiday, certify that:

1. I have reviewed this annual report on Form 10-K 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(s) 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15(d)-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) 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
 - (d) 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(s) 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

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

Date: February 28, 2008

**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 Annual Report of the Company on Form 10-K for the year ended December 31, 2007, as filed with the Securities and Exchange Commission (the “10-K Report”), that:

(1) the 10-K 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-K 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 February 28, 2008.

/s/ GEORGE FELLOWS

George Fellows
President and Chief Executive Officer

/s/ BRADLEY J. HOLIDAY

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Callaway Golf Company
Carlsbad, CA

We have audited the accompanying consolidated balance sheets of Callaway Golf Company and subsidiaries (the “Company”) as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2007. Our audits also included the financial statement schedules listed in the Index at Item 15. These consolidated financial statements and financial statement schedules are the responsibility of the Company’s management. Our responsibility is to express an opinion on the basic consolidated financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such basic consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedules, when considered in relation to the consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

As discussed in Note 13 to the consolidated financial statements, the Company adopted the provisions of Financial Accounting Standards Board Interpretation FIN No. 48, *Accounting for Uncertainty in Income Taxes* in 2007.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2008, expressed an unqualified opinion on the Company’s internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Costa Mesa, California

February 28, 2008

CALLAWAY GOLF COMPANY
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	December 31,	
	2007	2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 49,875	\$ 46,362
Accounts receivable, net	112,064	118,133
Inventories, net	253,001	265,110
Deferred taxes	42,219	32,813
Income taxes receivable	9,232	9,094
Other current assets	30,190	21,688
Total current assets	496,581	493,200
Property, plant and equipment, net	128,036	131,224
Intangible assets, net	140,985	144,326
Goodwill	32,060	30,833
Deferred taxes	18,885	18,821
Other assets	40,416	27,543
	\$856,963	\$ 845,947
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$130,410	\$ 111,360
Accrued employee compensation and benefits	44,245	18,731
Accrued warranty expense	12,386	13,364
Credit facilities	36,507	80,000
Total current liabilities	223,548	223,455
Long-term liabilities:		
Deferred taxes	21,252	16,256
Energy derivative valuation account	19,922	19,922
Income tax payable	13,833	—
Deferred compensation and other	8,200	7,210
Minority interest in consolidated subsidiary	1,978	1,987
Commitments and contingencies (Note 14)		
Shareholders' equity:		
Preferred Stock, \$.01 par value, 3,000,000 shares authorized, none issued and outstanding at December 31, 2007 and 2006	—	—
Common Stock, \$.01 par value, 240,000,000 shares authorized, 66,281,693 shares and 85,096,782 shares issued at December 31, 2007 and 2006, respectively	663	851
Additional paid-in capital	111,953	402,628
Unearned compensation	(2,158)	(3,566)
Retained earnings	470,469	435,074
Accumulated other comprehensive income	18,904	11,135
Less: Grantor Stock Trust held at market value, 1,813,010 shares and 5,184,601 shares at December 31, 2007 and 2006, respectively	(31,601)	(74,710)
Less: Common Stock held in treasury, at cost, 0 shares and 11,957,968 shares at December 31, 2007 and 2006, respectively	—	(194,295)
Total shareholders' equity	568,230	577,117
	\$856,963	\$ 845,947

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

CALLAWAY GOLF COMPANY
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Year Ended December 31,					
	2007		2006		2005	
Net sales	\$1,124,591	100%	\$1,017,907	100%	\$998,093	100%
Cost of sales	631,368	56%	619,832	61%	583,679	58%
Gross profit	493,223	44%	398,075	39%	414,414	42%
Selling expenses	281,960	25%	254,526	25%	290,074	29%
General and administrative expenses	89,060	8%	79,709	8%	80,145	8%
Research and development expenses	32,020	3%	26,785	3%	26,989	3%
Total operating expenses	403,040	36%	361,020	35%	397,208	40%
Income from operations	90,183	8%	37,055	4%	17,206	2%
Interest and other income (expense), net	3,455		3,364		(390)	
Interest expense	(5,363)		(5,421)		(2,279)	
Income before income taxes	88,275	8%	34,998	3%	14,537	1%
Provision for income taxes	33,688		11,708		1,253	
Net income	<u>\$ 54,587</u>	5%	<u>\$ 23,290</u>	2%	<u>\$ 13,284</u>	1%
Earnings per common share:						
Basic	\$ 0.82		\$ 0.34		\$ 0.19	
Diluted	\$ 0.81		\$ 0.34		\$ 0.19	
Common equivalent shares:						
Basic	66,371		67,732		68,646	
Diluted	67,484		68,503		69,239	

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

CALLAWAY GOLF COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended December 31,		
	2007	2006	2005
Cash flows from operating activities:			
Net income	\$ 54,587	\$ 23,290	\$ 13,284
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	35,326	32,274	38,260
Noncash compensation	10,851	11,921	6,527
(Gain) loss on disposal of long-lived assets	(4,731)	1,135	4,031
Deferred taxes	9,047	673	(3,906)
Tax benefit from exercise of stock options	—	—	2,408
Changes in assets and liabilities, net of effects from acquisitions:			
Accounts receivable, net	12,478	(12,128)	2,296
Inventories, net	17,292	(16,842)	(65,595)
Other assets	(7,410)	(4,475)	7,583
Accounts payable and accrued expenses	10,341	(4,525)	32,423
Accrued employee compensation and benefits	25,158	(6,376)	5,121
Accrued warranty expense	(978)	98	1,224
Income taxes receivable and payable	(10,573)	(6,936)	26,676
Other liabilities	594	(1,128)	(351)
Net cash provided by operating activities	<u>151,982</u>	<u>16,981</u>	<u>69,981</u>
Cash flows from investing activities:			
Capital expenditures	(32,930)	(32,453)	(33,942)
Proceeds from sale of capital assets	11,460	469	1,363
Investment in golf related ventures	(3,698)	(10,008)	—
Acquisitions, net of cash acquired	—	374	—
Net cash used in investing activities	<u>(25,168)</u>	<u>(41,618)</u>	<u>(32,579)</u>
Cash flows from financing activities:			
Issuance of common stock	48,035	9,606	14,812
Acquisition of treasury stock	(114,795)	(52,872)	(39)
Dividends paid, net	(18,755)	(19,212)	(19,557)
Proceeds from (payments on) credit facilities, net	(43,493)	80,000	(13,000)
Tax benefit from exercise of stock options	6,031	884	—
Other financing activities	(9)	1,971	(44)
Net cash provided by (used in) financing activities	<u>(122,986)</u>	<u>20,377</u>	<u>(17,828)</u>
Effect of exchange rate changes on cash and cash equivalents	(315)	1,141	(1,750)
Net increase (decrease) in cash and cash equivalents	3,513	(3,119)	17,824
Cash and cash equivalents at beginning of year	46,362	49,481	31,657
Cash and cash equivalents at end of year	<u>\$ 49,875</u>	<u>\$ 46,362</u>	<u>\$ 49,481</u>
Supplemental disclosures:			
Cash paid for interest and fees	\$ (5,633)	\$ (4,502)	\$ (2,096)
Cash paid for income taxes	\$ (38,292)	\$ (18,859)	\$ (24,837)

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

CALLAWAY GOLF COMPANY
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
AND COMPREHENSIVE INCOME
(In thousands)

	Common Stock		Additional Paid-in Capital	Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Grantor Stock Trust	Treasury Stock		Total	Comprehensive Income
	Shares	Amount						Shares	Amount		
Balance, December 31, 2004	84,786	\$ 848	\$ 387,950	\$ (12,562)	\$437,269	\$11,081	\$ (96,885)	(8,498)	\$ (141,384)	\$586,317	\$ (1,912)
Exercise of stock options	5	—	(1,452)	—	—	—	12,349	—	—	10,897	—
Tax benefit from exercise of stock options	—	—	2,408	—	—	—	—	—	—	2,408	—
Issuance of Restricted Common Stock	160	2	2,387	(2,389)	—	—	—	—	—	—	—
Acquisition of Treasury Stock	—	—	—	—	—	—	—	(3)	(39)	(39)	—
Compensatory stock and stock options	—	—	590	5,937	—	—	—	—	—	6,527	—
Employee stock purchase plan	—	—	(1,432)	—	—	—	5,347	—	—	3,915	—
Cash dividends	—	—	—	—	(19,557)	—	—	—	—	(19,557)	—
Adjustment of Grantor Stock Trust shares to market value	—	—	3,225	—	—	—	(3,225)	—	—	—	—
Equity adjustment from foreign currency translation	—	—	—	—	—	(5,724)	—	—	—	(5,724)	\$ (5,724)
Unrealized loss on cash flow hedges, net of tax	—	—	—	—	—	(1,980)	—	—	—	(1,980)	(1,980)
Net income	—	—	—	—	13,284	—	—	—	—	13,284	13,284
Balance, December 31, 2005	84,951	\$ 850	\$ 393,676	\$ (9,014)	\$430,996	\$ 3,377	\$ (82,414)	(8,501)	\$ (141,423)	\$596,048	\$ 5,580
Adoption of SFAS 123R	—	—	(2,382)	2,382	—	—	—	—	—	—	—
Exercise of stock options	—	—	(1,053)	—	—	—	7,134	—	—	6,081	—
Tax benefit from exercise of stock options	—	—	578	—	—	—	—	—	—	578	—
Issuance of Restricted Common Stock	146	1	(1)	—	—	—	—	—	—	—	—
Acquisition of Treasury Stock	—	—	—	—	—	—	—	(3,457)	(52,872)	(52,872)	—
Compensatory stock and stock options	—	—	8,855	3,066	—	—	—	—	—	11,921	—
Employee stock purchase plan	—	—	(533)	—	—	—	4,058	—	—	3,525	—
Cash dividends	—	—	—	—	(19,212)	—	—	—	—	(19,212)	—
Adjustment of Grantor Stock Trust shares to market value	—	—	3,488	—	—	—	(3,488)	—	—	—	—
Equity adjustment from foreign currency translation	—	—	—	—	—	7,758	—	—	—	7,758	\$ 7,758
Net income	—	—	—	—	23,290	—	—	—	—	23,290	23,290
Balance, December 31, 2006	85,097	\$ 851	\$ 402,628	\$ (3,566)	\$435,074	\$11,135	\$ (74,710)	(11,958)	\$ (194,295)	\$577,117	\$31,048
Adoption of FIN 48	—	—	—	—	(437)	—	—	—	—	—	(437)
Exercise of stock options	51	—	(6,370)	—	—	—	51,604	—	—	45,234	—
Tax benefit from exercise of stock options	—	—	3,858	—	—	—	—	—	—	3,858	—
Acquisition of Treasury Stock	—	—	—	—	—	—	—	(6,883)	(114,795)	(114,795)	—
Retirement of Treasury Stock	(18,841)	(188)	(308,902)	—	—	—	—	18,841	309,090	—	—
Compensatory stock and stock options	(25)	—	9,443	1,408	—	—	—	—	—	10,851	—
Employee stock purchase plan	—	—	(474)	—	—	—	3,275	—	—	2,801	—
Cash dividends	—	—	—	—	(18,755)	—	—	—	—	(18,755)	—
Adjustment of Grantor Stock Trust shares to market value	—	—	11,770	—	—	—	(11,770)	—	—	—	—
Equity adjustment from foreign currency translation	—	—	—	—	—	7,769	—	—	—	7,769	\$ 7,769
Net income	—	—	—	—	54,587	—	—	—	—	54,587	54,587
Balance, December 31, 2007	66,282	\$ 663	\$ 111,953	\$ (2,158)	\$470,469	\$18,904	\$ (31,601)	—	\$ —	\$568,230	\$62,356

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

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company

Callaway Golf Company (“Callaway Golf” or the “Company”), a Delaware corporation, together with its subsidiaries, designs, manufactures and sells high quality golf clubs (drivers, fairway woods, hybrids, irons, wedges and putters) and golf balls. The Company also sells golf accessories such as footwear, golf bags, golf gloves, golf headwear, golf towels and golf umbrellas. The Company generally sells its products to golf retailers (including pro shops at golf courses and off course retailers), sporting goods retailers and mass merchants, directly and through its wholly owned subsidiaries, and to third party distributors in the United States and in over 100 countries around the world. The Company also sells pre-owned Callaway Golf products through its website, www.callawaygolfpreowned.com. In addition, the Company licenses its name for apparel, watches, travel gear, eyewear and other golf accessories.

Note 2. Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Callaway Golf Company and its domestic and foreign subsidiaries. All material intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (“GAAP”) requires management 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. Examples of such estimates include provisions for warranty, uncollectible accounts receivable, inventory obsolescence, sales returns, tax contingencies, market value estimates of derivative instruments, estimates on the valuation of share-based awards and recoverability of long-lived assets. Actual results may materially differ from these estimates. On an ongoing basis, the Company reviews its estimates to ensure that these estimates appropriately reflect changes in its business or as new information becomes available.

Revenue Recognition

Sales are recognized in accordance with Staff Accounting Bulletin No. 104, “Revenue Recognition in Financial Statements,” as products are shipped to customers, net of an allowance for sales returns and sales programs. The criteria for recognition of revenue is met when persuasive evidence that an arrangement exists and both title and risk of loss have passed to the customer, the price is fixed or determinable and collectability is reasonably assured. 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.

Amounts billed to customers for shipping and handling are included in net sales and costs incurred related to shipping and handling are included in cost of sales.

Royalty income is recorded as underlying product sales occur, subject to certain minimums, in accordance with the related licensing arrangements (see Note 16).

Warranty Policy

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 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. The following table provides a reconciliation of the activity related to the Company's reserve for warranty expense:

	Year Ended December 31,		
	2007	2006	2005
	(In thousands)		
Beginning balance	\$ 13,364	\$ 13,267	\$12,043
Provision	10,504	11,696	10,965
Claims paid/costs incurred	(11,482)	(11,599)	(9,741)
Ending balance	<u>\$ 12,386</u>	<u>\$ 13,364</u>	<u>\$13,267</u>

Fair Value of Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, trade receivables and payables, forward foreign currency exchange contracts (see Note 8) and its financing arrangements (see Note 7). The carrying amounts of these instruments approximate fair value because of their short-term maturities and variable interest rates.

Advertising Costs

The Company advertises primarily through television and print media. The Company's policy is to expense advertising costs, including production costs, as incurred. Advertising expenses for 2007, 2006 and 2005 were \$52,203,000, \$47,599,000 and \$60,404,000, respectively.

Research and Development Costs

Research and development costs are expensed as incurred. Research and development costs for 2007, 2006 and 2005 were \$32,020,000, \$26,785,000 and \$26,989,000, respectively.

Foreign Currency Translation and Transactions

The Company's foreign subsidiaries utilize their local currency as their functional currency. The accounts of these foreign subsidiaries have been translated into United States dollars using the current exchange rate at the balance sheet date for assets and liabilities and at the average exchange rate for the period for revenues and expenses. Cumulative translation gains or losses are recorded as accumulated other comprehensive income in shareholders' equity. Gains or losses resulting from transactions that are made in a currency different from the functional currency are recognized in earnings as they occur or, for hedging contracts, when the underlying hedged transaction affects earnings. The Company recorded net foreign currency transaction gains of \$158,000 and \$251,000 in 2007 and 2006, respectively, and a net foreign currency transaction loss of \$2,441,000 in 2005, in interest and other income, net.

Derivatives and Hedging

The Company enters into derivative financial instrument contracts only for hedging purposes and accounts for them in accordance with Statement of Financial Accounting Standard ("SFAS") No. 133 "Accounting for Derivative Instruments and Hedging Activities," and its amendments SFAS No. 137, "Accounting for Derivative

Instruments and Hedging Activities-Deferral of the Effective Date of SFAS No. 133,” SFAS No. 138, “Accounting for Certain Derivative Instruments and Certain Hedging Activities” and SFAS No. 149, “Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities.” The purpose of these derivative instruments is to minimize the variability of cash flows associated with the anticipated transactions being hedged. As changes in foreign currency rates impact the United States dollar value of anticipated transactions, the fair value of the forward contracts also changes, offsetting foreign currency rate fluctuations. Changes in the fair value of derivatives are recorded each period in income or other comprehensive income, depending on whether the derivatives are designated as hedges and, if so, the types and effectiveness of hedges. Additional information about the Company’s use of derivative instruments is presented in Note 8.

Cash and Cash Equivalents

Cash equivalents are highly liquid investments purchased with original maturities of three months or less.

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 uncollectible 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, all of which are subject to change. Actual uncollected amounts have been consistent with the Company’s expectations.

Inventories

Inventories are valued at the lower of cost or fair market value. 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 current inventory levels, sales trends and historical experience as well as management’s understanding of market conditions and forecasts of future product demand, all of which are subject to change. Actual inventory charges have been consistent with the Company’s expectations.

Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over estimated useful lives as follows:

Buildings and improvements	10-30 years
Machinery and equipment	5-15 years
Furniture, computers and equipment	3-5 years
Production molds	2 years

Normal repairs and maintenance costs are expensed as incurred. Expenditures that materially increase values, change capacities or extend useful lives are capitalized. The related costs and accumulated depreciation of disposed assets are eliminated and any resulting gain or loss on disposition is included in net income. Construction in-process consists primarily of machinery and equipment that have not yet been placed into service, unfinished molds as well as in-process internally developed software.

In accordance with American Institute of Certified Public Accountants Statement of Position 98-1, “Accounting for the Costs of Computer Software Developed or Obtained for Internal Use,” the Company capitalizes certain costs incurred in connection with developing or obtaining internal use software. Costs incurred in the preliminary project stage are expensed. All direct external costs incurred to develop internal-use software during the development stage are capitalized and amortized using the straight-line method over the remaining estimated useful lives. Costs such as maintenance and training are expensed as incurred.

In connection with the consolidation of Callaway Golf and Top-Flite golf club and golf ball manufacturing and research and development operations, the Company disposed of certain long-lived assets. As a result, the Company reduced the carrying value of its golf ball assets and therefore incurred pre-tax charges to earnings of \$44,711,000 in the aggregate, of which \$1,122,000 and \$5,290,000 were incurred during 2006 and 2005, respectively. There were no charges recognized in connection with the consolidation of Callaway Golf and Top-Flite during 2007.

Long-Lived Assets

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the Company assesses potential impairments of its long-lived assets whenever events or changes in circumstances indicate that the asset's carrying value may not be recoverable. An impairment loss would be recognized when the carrying amount of a long-lived asset or asset group is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset or asset group is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or asset group.

Goodwill and Intangible Assets

Goodwill and intangible assets consist of goodwill, trade names, trademarks, service marks, trade dress, patents and other intangible assets acquired during the acquisition of Odyssey Sports, Inc., the Top-Flite assets, FrogTrader, Inc., the Tour Golf Group assets and certain foreign distributors.

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill and intangible assets with indefinite lives are not amortized but instead are measured for impairment at least annually, or when events indicate that an impairment exists. The Company calculates impairment as the excess of the carrying value of its indefinite-lived intangible assets over their estimated fair value. If the carrying value exceeds the estimate of fair value a write-down is recorded.

Intangible assets that are determined to have definite lives are amortized over their estimated useful lives and are measured for impairment only when events or circumstances indicate the carrying value may be impaired in accordance with SFAS No. 144 discussed above. See Note 6 for further discussion of the Company's goodwill and intangible assets.

Investments

The Company determines the appropriate classification of its investments at the time of acquisition 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. Other investments that do not have readily determinable fair values 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 interest and other income, net.

The Company monitors investments for impairment in accordance with APB 18 and Emerging Issues Task Force No. 03-1 "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments." See Note 3 for further discussion of the Company's investments.

Share-Based Employee Compensation

Beginning in fiscal year 2006, the Company accounts for share-based compensation arrangements in accordance with the provisions of Statement of Financial Accounting Standards No. 123R ("SFAS 123R") "Share-Based Payment," which requires the measurement and recognition of compensation expense for all share-

based payment awards to employees and directors based on estimated fair values. The Company uses the Black-Scholes option valuation model to estimate the fair value of its stock options at the date of grant. The Black-Scholes option valuation model requires the input of subjective assumptions to calculate the value of stock options. The Company uses historical data among other information to estimate the expected price volatility, option life, dividend yield and forfeiture rate. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. The total compensation is recognized on a straight-line basis over the vesting period.

In accordance with SFAS 123R, the Company records compensation expense for Restricted Stock Awards and Restricted Stock Units based on the estimated fair value of the award on the date of grant. The estimated fair value is determined based on the closing price of the Company's Common Stock on the award date multiplied by the number of awards expected to vest. The number of awards expected to vest is based on the number of awards granted adjusted by estimated forfeiture rates. The total compensation cost is then recognized on a straight-line basis over the vesting period.

During 2006, the Company granted Performance Share Units to certain employees under the Company's 2004 Equity Incentive Plan. Performance Share Units are a form of share-based award in which the number of shares ultimately received depends on the Company's performance against specified performance targets over a three year period from the date of grant. The estimated fair value of the Performance Share Units is determined based on the closing price of the Company's Common Stock on the award date multiplied by the expected number of shares to be issued at the end of the performance period. The compensation cost is then amortized on a straight-line basis over the performance period. The Company uses forecasted performance metrics to estimate the number of Performance Share Units to be issued as well as approval from the Compensation and Management Succession Committee. The Company's performance against the specified performance targets is reviewed quarterly.

Income Taxes

Current income tax expense or benefit is the amount of income taxes expected to be payable or receivable for the current year. A deferred income tax asset or liability is established for the difference between the tax basis of an asset or liability computed pursuant to FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Deferred income tax expense or benefit is the net change during the year in the deferred income tax asset or liability.

Effective January 1, 2007, the Company was required to adopt and implement the provisions of FIN 48, which requires the Company to accrue for the estimated additional amount of taxes for uncertain tax positions if it is more likely than not that the Company would be required to pay such additional taxes. An uncertain income tax position will not be recognized if it has less than 50% likelihood of being sustained. As a result of the adoption of FIN 48, the Company recognized an increase in the liability for its uncertain tax positions of \$437,000, of which the entire charge was accounted for as a decrease to the beginning balance of retained earnings. The accrual for uncertain tax positions can result in a difference between the estimated benefit recorded in the Company's financial statements and the benefit taken or expected to be taken in the Company's income tax returns. This difference is generally referred to as an "unrecognized tax benefit."

Deferred taxes have not been provided on the cumulative undistributed earnings of foreign subsidiaries since such amounts are expected to be reinvested indefinitely. 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 (see Note 13).

Interest and Other Income, Net

Interest and other income, net primarily includes gains and losses on foreign currency transactions, interest income and gains and losses on investments to fund the deferred compensation plan. The components of interest and other income, net are as follows:

	Year Ended December 31,		
	2007	2006	2005
	(In thousands)		
Foreign currency gains (losses)	\$ 158	\$ 251	\$(2,441)
Interest income	2,202	1,329	900
Gains on deferred compensation plan assets	496	272	100
Other	599	1,512	1,051
	<u>\$3,455</u>	<u>\$3,364</u>	<u>\$ (390)</u>

Other Accumulated Comprehensive Income

Components of comprehensive income are reported in the financial statements in the period in which they are recognized. The components of comprehensive income for the Company include net income, unrealized gains on cash flow hedges and foreign currency translation adjustments. Since the Company has met the indefinite reversal criteria, it does not accrue income taxes on foreign currency translation adjustments. During 2007 and 2006, no gains or losses were reclassified to earnings as a result of the discontinuance of cash flow hedges. The total equity adjustment from foreign currency translation included in accumulated other comprehensive income was \$18,904,000 and \$11,135,000 as of December 31, 2007 and 2006, respectively.

Segment Information

The Company's operating segments are organized on the basis of products and consist of Golf Clubs and Golf Balls. The Golf Clubs segment consists primarily of Callaway Golf, Top-Flite and Ben Hogan woods, hybrids, irons, wedges and putters as well as Odyssey putters, pre-owned clubs, other golf-related accessories and royalty and other income. 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. The Company also discloses information about geographic areas. This information is presented in Note 15.

Diversification of Credit Risk

The Company's financial instruments that are subject to concentrations of credit risk consist primarily of cash equivalents, trade receivables and foreign currency contracts.

The Company historically invests its excess cash in money market accounts and short-term U.S. Government securities and has established guidelines relative to diversification and maturities in an effort to maintain safety and liquidity. These guidelines are periodically reviewed and modified to take advantage of trends in yields and interest rates.

The Company operates in the golf equipment industry and primarily sells its products to golf equipment retailers (including pro shops at golf courses and off course retailers), sporting goods retailers and mass merchants, 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. The Company maintains reserves for estimated credit losses, which it considers adequate to cover any such losses. Managing customer-related credit risk is more difficult in regions outside of the United States. During 2007, 2006 and 2005, approximately 47%, 44% and 44%, respectively, of the Company's net sales were made in regions outside of the United States. An adverse change in either economic

conditions abroad or in the Company's relationship with significant foreign retailers could significantly increase the Company's credit risk related to its international operations.

From time to time, the Company enters into foreign currency exchange contracts and put or call options for the purpose of hedging foreign exchange rate exposures on existing or anticipated transactions. In the event of a failure to honor one of these contracts by one of the banks with which the Company has contracted, management believes any loss would be limited to the exchange rate differential from the time the contract was made until the time it was settled.

Recent Accounting Pronouncements

On December 4, 2007 the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), "Business Combinations" (FAS 141 (R)) and No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 (FAS 160)". FAS 141(R) will change how business acquisitions are accounted for and FAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. FAS 141(R) and FAS 160 are effective for fiscal years beginning on or after December 15, 2008 (January 1, 2009 for the Company). The adoption of FAS 141(R) and FAS 160 are not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). This new standard provides guidance for using fair value to measure assets and liabilities and information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. This framework is intended to provide increased consistency in how fair value determinations are made under various existing accounting standards which permit, or in some cases require, estimates of fair market value. SFAS 157 also expands financial statement disclosure requirements about a company's use of fair value measurements, including the effect of such measures on earnings. The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007. Based on the Company's evaluation of SFAS 157, the adoption of this standard will not have a material impact on its consolidated financial position and results of operations.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statements No. 115" ("SFAS 159"). SFAS 159 allows the irrevocable election of fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities and other items on an instrument-by-instrument basis. Changes in fair value would be reflected in earnings as they occur. The objective of SFAS 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 is effective as of the beginning of the first fiscal year beginning after November 15, 2007. The implementation of this standard will not have a material impact on the Company's consolidated financial position and results of operations.

In June 2007, the FASB ratified EITF 06-11 "Accounting for the Income Tax Benefits of Dividends on Share-Based Payment Awards" ("EITF 06-11"). EITF 06-11 provides that tax benefits associated with dividends on share-based payment awards be recorded as a component of additional paid-in capital. EITF 06-11 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007. The implementation of this standard will not have a material impact on the Company's consolidated financial position and results of operations.

Note 3. Investments

Investment in Golf Entertainment International Limited Company

During the fourth quarter of 2006, the Company made an investment in Golf Entertainment International Limited ("GEI"), the owner and operator of TopGolf entertainment centers. In connection with this investment,

the Company acquired Preferred Shares of GEI for approximately \$10,000,000. The Company accounts for this investment under the cost method in accordance with the provisions of APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" and reflected the investment balance in other long-term assets in the accompanying consolidated condensed balance sheet as of December 31, 2007 and 2006.

In addition, the Company and GEI entered into a Preferred Partner Agreement under which the Company is granted preferred signage rights, the option to supply golf balls for the TopGolf driving ranges, rights as the preferred supplier of golf products used or offered for use at TopGolf facilities at prices no less than those paid by the Company's customers, preferred retail positioning in the TopGolf retail stores, access to consumer information obtained by TopGolf, and other rights incidental to those listed.

In August 2007, the Company and other GEI shareholders entered into a loan agreement with GEI to provide funding to GEI for certain capital projects as well as operational needs. In December 2007, the Company and other GEI shareholders entered into a second loan agreement with GEI to supplement GEI's cash flows from operations as a result of the seasonal fluctuations of the business. Both loan agreements extend to all shareholders of GEI, whereby each shareholder may participate by funding up to an amount agreed upon by GEI. As of December 31, 2007, the Company funded a combined total of \$3,698,000 under both loan agreements, which includes accrued interest. The loan agreements provide for the option, at the Company's discretion, to convert up to 100 percent of the amount drawn by GEI, including accrued interest, into convertible preferred shares. In connection with the loans, the Company has received underwriting fees and will receive annual interest at market rates on loaned amounts. The Company is conditionally committed to fund an additional \$1,500,000 under the second loan agreement during 2008 if called upon by GEI and if not otherwise funded by other shareholders.

In February 2008, the Company and another GEI shareholder entered into an arrangement to provide collateral in the form of a letter of credit in the amount of \$8,000,000 for a loan that was issued to a subsidiary of GEI. The Company is currently responsible for \$5,500,000 of the total guaranteed amount. This letter of credit will expire one year from the date of issuance. In connection with the letter of credit, the Company received underwriting fees and warrants to purchase GEI's preferred stock, at a discounted price, at a future date.

The Company currently has no intention of exercising the warrants in connection with the letter of credit as well as converting the amount funded to GEI into preferred shares.

Investment in Qingdao Suntech Sporting Goods Limited Company

In October 2006, the Company entered into a Golf Ball Manufacturing and Supply Agreement with Qingdao Suntech Sporting Goods Limited Company ("Suntech"), where Suntech manufactures and supplies certain golf balls solely for and to the Company. Suntech is a wholly owned subsidiary of Suntech Mauritius Limited Company ("Mauritius"). In connection with the agreement, the Company provides Suntech with golf ball raw materials, packing materials, molds, tooling, as well as manufacturing equipment in order to carry out the manufacturing and supply obligations set forth in the agreement. Suntech provides the personnel as well as the facilities to effectively perform these manufacturing and supply obligations. Due to the nature of the arrangement, as well as the controlling influence the Company has in the Suntech operations, the Company is required to consolidate the financial results of Suntech in its consolidated condensed financial statements as of December 31, 2007 and 2006, in accordance with the provisions of FASB Interpretation No. 46, "Consolidation of Variable Interest Entities."

In addition, the Company entered into a loan agreement which provides that the Company will make certain loans to Mauritius to provide working capital for Suntech. As of December 31, 2007, the Company has loaned Mauritius a total of \$3,200,000 and has completed its obligations under the loan agreement.

Note 4. Restructuring and Integration Initiatives

In September 2005, the Company began the implementation of several company-wide restructuring initiatives designed to improve the Company's business processes and reduce the Company's overall expenses (the "2005 Restructuring Initiatives"). The 2005 Restructuring Initiatives include, among other things, the

consolidation of the Callaway Golf, Odyssey, Top-Flite and Ben Hogan selling functions, as well as the elimination or reduction of other operating expenses. The 2005 Restructuring Initiatives and estimated charges for such initiatives are in addition to the previously reported integration of the Callaway Golf and Top-Flite operations and the charges for such integration.

In connection with the 2005 Restructuring Initiatives, the Company committed to staff reductions that involved the elimination of approximately 500 positions worldwide, including full-time and part-time employees, temporary staffing and open positions. In the aggregate, the Company recorded charges to pre-tax earnings of \$12,243,000 in connection with the 2005 Restructuring Initiatives. Of this amount, approximately \$896,000, \$3,023,000 and \$8,324,000 were incurred in 2007, 2006 and 2005, respectively.

The activity and liability balances recorded as part of the 2005 Restructuring Initiatives were as follows (in thousands):

	<u>Workforce Reductions</u>	<u>Facility and Other</u>	<u>Total</u>
Charges to cost and expense	\$ 7,119	\$ 1,205	\$ 8,324
Non-cash items	—	(1,024)	(1,024)
Cash payments	<u>(3,682)</u>	<u>(181)</u>	<u>(3,863)</u>
Restructuring balance, December 31, 2005	3,437	—	3,437
Charges to cost and expense	2,507	516	3,023
Non-cash items	—	(216)	(216)
Cash payments	<u>(3,798)</u>	<u>(300)</u>	<u>(4,098)</u>
Restructuring balance, December 31, 2006	2,146	—	2,146
Charges to cost and expense	260	636	896
Non-cash items	—	—	—
Cash payments	<u>(2,157)</u>	<u>(636)</u>	<u>(2,793)</u>
Restructuring balance, December 31, 2007	<u>\$ 249</u>	<u>\$ —</u>	<u>\$ 249</u>

The Company has incurred in the aggregate approximately \$69,032,000 of non-cash charges for the acceleration of depreciation on certain golf ball manufacturing equipment and cash charges related to severance and facility consolidations in connection with the Company's full integration of the Callaway Golf ball manufacturing with the Top-Flite golf ball manufacturing at the Chicopee, Massachusetts and Gloversville, New York locations (the "Top-Flite Integration Initiatives"). The Company recorded charges to pre-tax earnings of \$4,039,000 and \$12,413,000 during 2006 and 2005, respectively. There were no charges incurred during 2007.

The activity and liability balances recorded as part of the Top-Flite Integration Initiatives were as follows (in thousands):

	<u>Workforce Reductions</u>	<u>Facility and Other</u>	<u>Total</u>
Integration balance, December 31, 2004	\$ 554	\$ —	\$ 554
Charges to cost and expense	1,241	11,172	12,413
Non-cash payments	—	(7,011)	(7,011)
Cash payments	<u>(1,795)</u>	<u>(2,572)</u>	<u>(4,367)</u>
Integration balance, December 31, 2005	—	1,589	1,589
Charges to cost and expense	—	4,039	4,039
Non-cash payments	—	(1,456)	(1,456)
Cash payments	<u>—</u>	<u>(2,583)</u>	<u>(2,583)</u>
Integration balance, December 31, 2006	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

Note 5. Selected Financial Statement Information

	December 31,	
	2007	2006
(In thousands)		
Accounts receivable, net:		
Trade accounts receivable	\$ 120,054	\$ 126,672
Allowance for doubtful accounts	(7,990)	(8,539)
	<u>\$ 112,064</u>	<u>\$ 118,133</u>
Inventories, net:		
Raw materials	\$ 82,185	\$ 85,798
Work-in-process	1,932	4,195
Finished goods	168,884	175,117
	<u>\$ 253,001</u>	<u>\$ 265,110</u>
Property, plant and equipment, net:		
Land	\$ 11,609	\$ 12,815
Buildings and improvements	85,245	91,477
Machinery and equipment	143,994	135,573
Furniture, computers and equipment	112,079	113,982
Production molds	41,511	38,523
Construction-in-process	10,368	11,157
	404,806	403,527
Accumulated depreciation	(276,770)	(272,303)
	<u>\$ 128,036</u>	<u>\$ 131,224</u>
Accounts payable and accrued expenses:		
Accounts payable	\$ 33,019	\$ 40,947
Accrued expenses	97,391	70,413
	<u>\$ 130,410</u>	<u>\$ 111,360</u>
Accrued employee compensation and benefits:		
Accrued payroll and taxes	\$ 31,882	\$ 7,927
Accrued vacation and sick pay	10,752	9,600
Accrued commissions	1,611	1,204
	<u>\$ 44,245</u>	<u>\$ 18,731</u>

Note 6. Goodwill and Intangible Assets

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," the Company's goodwill and certain intangible assets are not amortized, but are subject to an annual impairment test. The following sets forth the intangible assets by major asset class:

	Useful Life (Years)	December 31, 2007			December 31, 2006		
		Gross	Accumulated Amortization	Net Book Value	Gross	Accumulated Amortization	Net Book Value
(In thousands)							
Non-Amortizing:							
Trade name, trademark and trade dress	NA	\$121,794	\$ —	\$121,794	\$121,794	\$ —	\$121,794
Amortizing:							
Patents	3-16	36,459	18,288	18,171	36,459	15,471	20,988
Other	1-9	2,853	1,833	1,020	2,853	1,309	1,544
Total intangible assets		<u>\$161,106</u>	<u>\$20,121</u>	<u>\$140,985</u>	<u>\$161,106</u>	<u>\$16,780</u>	<u>\$144,326</u>

Aggregate amortization expense on intangible assets was approximately \$3,341,000, \$3,301,000 and \$3,045,000 for the years ended December 31, 2007, 2006 and 2005, respectively. Amortization expense related to intangible assets at December 31, 2007 in each of the next five fiscal years and beyond is expected to be incurred as follows (in thousands):

2008	\$ 3,158
2009	2,978
2010	2,838
2011	2,587
2012	2,158
Thereafter	<u>5,472</u>
	<u>\$19,191</u>

In accordance with SFAS No. 142, the Company has completed its annual impairment tests and fair value analysis for goodwill and other non-amortizing intangible assets held throughout the year. There were no impairments and no loss was recorded during the year ended December 31, 2007. There were no additions to goodwill during the year ended December 31, 2007 and goodwill additions during the year ended December 31, 2006 consisted approximately of \$307,000 in connection with the FrogTrader acquisition. In addition, the goodwill balances held in foreign currencies as of December 31, 2007 and 2006 include favorable foreign currency translation adjustments of \$1,227,000 and \$1,458,000, respectively.

Note 7. Financing Arrangements

The Company’s principal sources of liquidity are cash flows provided by operations and the Company’s credit facilities in effect from time to time. The Company currently expects this to continue. The Company’s primary line of credit is a \$250,000,000 line of credit with Bank of America, N.A. and certain other lenders party to the Company’s November 5, 2004 Amended and Restated Credit Agreement.

The Line of Credit provides for revolving loans of up to \$250,000,000, although actual borrowing availability can be effectively limited by the financial covenants contained therein. As of December 31, 2007, the maximum amount that could be borrowed under the Line of Credit was \$250,000,000, of which \$35,000,000 was outstanding at December 31, 2007. In addition, the Company had approximately \$1,507,000 outstanding at December 31, 2007 under other credit facilities.

Under the Line of Credit, the Company is required to pay certain fees, including an unused commitment fee of between 10.0 to 25.0 basis points per annum of the unused commitment amount, with the exact amount determined based upon the Company’s consolidated leverage ratio and trailing four quarters’ earnings before interest, income taxes, depreciation and amortization, as well as other non-cash expense and income items (EBITDA) (each as defined in the agreement governing the Line of Credit). Outstanding borrowings under the Line of Credit accrue interest, at the Company’s election, based upon the Company’s consolidated leverage ratio and trailing four quarters’ EBITDA of (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America’s prime rate, or (ii) the Eurodollar Rate (as defined in the agreement governing the Line of Credit) plus a margin of 50.0 to 125.0 basis points.

The Line of Credit requires the Company to meet certain financial covenants and includes certain other restrictions, including restrictions limiting dividends, stock repurchases, capital expenditures and asset sales. As of December 31, 2007, the Company was in compliance with the covenants and other terms of the Line of Credit, as then applicable.

The total origination fees incurred in connection with the Line of Credit, including fees incurred in connection with the amendments, were \$2,130,000 and are being amortized into interest expense over the remaining term of the Line of Credit agreement. Unamortized origination fees were \$1,183,000 as of December 31, 2007, of which \$282,000 was included in prepaid and other current assets and \$901,000 in other long-term assets in the accompanying consolidated condensed balance sheet.

Note 8. Derivatives and Hedging

The Company from time to time uses derivative financial instruments to manage its exposure to foreign currency exchange rates. The derivative instruments are accounted for pursuant to SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS Nos. 138 and 149, "Accounting for Certain Derivative Instruments and Certain Hedging Activities" and SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments." 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 from time to time 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 may 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 which may include derivatives that do not meet the criteria for hedge accounting. The Company does not enter into foreign exchange contracts for speculative purposes. Hedging contracts mature within twelve months from their inception.

At December 31, 2007, 2006 and 2005, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$31,095,000, \$32,470,000 and \$35,624,000, 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 with changes in fair value recorded in the statement of operations. At December 31, 2007, the fair values of foreign currency-related derivatives were recorded as current liabilities of \$421,000. At December 31, 2006, the fair values of foreign currency-related derivatives were recorded as current assets of \$219,000 and current liabilities of \$58,000. The gains and losses on foreign currency contracts used to manage balance sheet exposures are recognized as a component of other income (expense) in the same year as the remeasurement gain and loss of the related foreign currency denominated assets and liabilities and thus generally offset these gains and losses. During 2007 and 2006, the Company recorded net losses of \$5,979,000 and \$2,064,000, respectively, and during 2005, a net gain of \$4,222,000, due to net realized and unrealized gains and losses on contracts used to manage balance sheet exposures that do not qualify for hedge accounting. These net realized and unrealized contractual gains and losses are used by the Company to offset actual foreign currency transactional net gains of \$6,137,000 and 2,315,000 as of December 31, 2007 and 2006, respectively, and transactional net losses of \$6,663,000 as of December 31, 2005. At December 31, 2007, 2006 and 2005, there were no foreign exchange contracts designated as cash flow hedges.

Note 9. Earnings per Common Share

Basic earnings per common share is calculated by dividing net income for the period by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income for the period by the sum of the weighted-average number of common shares outstanding during the period, plus the number of potentially dilutive common shares (“dilutive securities”) that were outstanding during the period. Dilutive securities include options granted pursuant to the Company’s stock option plans, potential shares related to the Employee Stock Purchase Plan and Restricted Stock grants to employees and non-employees (see Note 11). Dilutive securities related to the Callaway Golf Company Grantor Stock Trust and the Company’s stock option plans are included in the calculation of diluted earnings per common share using the treasury stock method. Under the treasury stock method, the dilutive securities related to the Callaway Golf Company Grantor Stock Trust do not have any impact upon the diluted earnings per common share. Dilutive securities related to the Employee Stock Purchase Plan are calculated by dividing the average withholdings during the period by 85% of the market value at the end of the period.

The schedule below summarizes the elements included in the calculation of basic and diluted earnings per common share for the years ended December 31, 2007, 2006 and 2005.

	<u>Year Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(In thousands, except per share data)		
Net income	<u>\$54,587</u>	<u>\$23,290</u>	<u>\$13,284</u>
Weighted-average shares outstanding:			
Weighted-average shares outstanding—Basic	66,371	67,732	68,646
Dilutive securities	<u>1,113</u>	<u>771</u>	<u>593</u>
Weighted-average shares outstanding—Diluted	<u>67,484</u>	<u>68,503</u>	<u>69,239</u>
Earnings per common share:			
Basic	\$ 0.82	\$ 0.34	\$ 0.19
Diluted	\$ 0.81	\$ 0.34	\$ 0.19

Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Options with an exercise price in excess of the average market value of the Company’s Common Stock during the period have been excluded from the calculation as their effect would be antidilutive. Additionally, potentially dilutive securities are excluded from the computation of earnings per share in periods in which a net loss is reported as their effect would be antidilutive. Thus, weighted-average shares outstanding—Diluted is the same as weighted-average shares outstanding—Basic in periods when a net loss is reported. For the years ended December 31, 2007, 2006 and 2005, options outstanding totaling approximately 2,856,000, 6,447,000 and 7,816,000 shares, respectively, were excluded from the calculations of earnings per common share, as their effect would have been antidilutive.

Note 10. Capital Stock

Common Stock and Preferred Stock

The Company has an authorized capital of 243,000,000 shares, \$0.01 par value, of which 240,000,000 shares are designated Common Stock, and 3,000,000 shares are designated Preferred Stock. Of the Preferred Stock, 240,000 shares are designated Series A Junior Participating Preferred Stock. The remaining shares of Preferred Stock are undesignated as to series, rights, preferences, privileges or restrictions.

The holders of Common Stock are entitled to one vote for each share of Common Stock on all matters submitted to a vote of the Company’s shareholders. Although to date no shares of Series A Junior Participating Preferred Stock have been issued, if such shares were issued, each share of Series A Junior Participating

Preferred Stock would entitle the holder thereof to 1,000 votes on all matters submitted to a vote of the shareholders of the Company. The holders of Series A Junior Participating Preferred Stock and the holders of Common Stock shall generally vote together as one class on all matters submitted to a vote of the Company's shareholders. Shareholders entitled to vote for the election of directors are entitled to vote cumulatively for one or more nominees.

Treasury Stock

In June 2006, the Company announced that its Board of Directors authorized it to repurchase shares of its common stock in the open market or in private transactions, subject to the Company's assessment of market conditions and buying opportunities, up to a maximum cost to the Company of \$50,000,000, which would remain in effect until completed or otherwise terminated by the Board of Directors (the "June 2006 repurchase program"). In June 2007, the Board of Directors authorized a new repurchase program (the "June 2007 repurchase program") for the Company to repurchase shares of its common stock up to a maximum cost to the Company of \$100,000,000, which would remain in effect until completed or otherwise terminated by the Board of Directors. In November 2007, the Board of Directors authorized a new repurchase program ("the November 2007 repurchase program") for the Company to repurchase shares of its common stock up to a maximum cost to the Company of \$100,000,000. The November 2007 repurchase program supersedes all prior stock repurchase authorizations and will remain in effect until completed or otherwise terminated by the Board of Directors.

During 2007, the Company repurchased 6,883,000 shares of its common stock under the June 2006 and June 2007 repurchase programs at an average cost per share of \$16.68 for a total cost of \$114,795,000. As of December 31, 2007, there were no repurchases made under the November 2007 repurchase program and the Company was authorized to repurchase up to the maximum authorization of \$100,000,000 of its common stock under this program.

The Company's repurchases of shares of common stock are recorded at the average cost of the common stock held in treasury and result in a reduction of shareholders' equity. In November 2007, the Board of Directors authorized the retirement of all common stock held in treasury, which resulted in the retirement of approximately 18,841,000 shares at a total cost of \$309,090,000. The retirement also reduced additional paid in capital and common stock by \$308,902,000 million and \$188,000, respectively.

Grantor Stock Trust

In July 1995, the Company established the Callaway Golf Company Grantor Stock Trust (the "GST") for the purpose of funding the Company's obligations with respect to one or more of the Company's nonqualified or qualified employee benefit plans. The GST shares are used primarily for the settlement of employee equity-based awards, including stock option exercises and employee stock plan purchases. The existence of the GST will have no impact upon the amount of benefits or compensation that will be paid under the Company's employee benefit plans. The GST acquires, holds and distributes shares of the Company's Common Stock in accordance with the terms of the trust. Shares held by the GST are voted in accordance with voting directions from eligible employees of the Company as specified in the GST.

In conjunction with the formation of the GST, the Company issued 4,000,000 shares of newly issued Common Stock to the GST in exchange for a promissory note in the amount of \$60,575,000 (\$15.14 per share). In December 1995, the Company issued an additional 1,300,000 shares of newly issued Common Stock to the GST in exchange for a promissory note in the amount of \$26,263,000 (\$20.20 per share). In July 2001, the Company issued 5,837,000 shares of Common Stock held in treasury to the GST in exchange for a promissory note in the amount of \$90,282,000 (\$15.47 per share). The issuance of these shares to the GST had no net impact on shareholders' equity.

For financial reporting purposes, the GST is consolidated with the Company. The value of shares owned by the GST are accounted for as a reduction to shareholders' equity until used in connection with the settlement of employee stock option exercises, employee stock plan purchases or other awards. Each period, the shares owned by the GST are valued at the closing market price, with corresponding changes in the GST balance reflected in additional paid-in capital. The issuance of shares by the GST is accounted for by reducing the GST and additional paid-in capital accounts proportionately as the shares are released. The GST does not impact the determination or amount of compensation expense for the benefit plans being settled. The GST shares do not have any impact on the Company's earnings per share until they are used in connection with the settlement of employee stock option exercises, employee stock plan purchases or other awards.

The following table presents shares released from the GST for the settlement of employee stock option exercises and employee stock plan purchases for the years ended December 31, 2007, 2006 and 2005:

	<u>Year Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(In thousands)		
Employee stock option exercises	3,170	468	853
Employee stock plan purchases	<u>201</u>	<u>303</u>	<u>369</u>
Total shares released from the GST	<u>3,371</u>	<u>771</u>	<u>1,222</u>

Note 11. Share-Based Employee Compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R ("SFAS 123R"), "Share-Based Payment," which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated fair values. The Company adopted SFAS 123R using the modified prospective transition method. Under this transition method, compensation expense for all share-based awards outstanding as of the adoption date is based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. The valuation provisions of SFAS 123R apply to new share-based awards granted on or after January 1, 2006.

On November 10, 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. FAS 123R-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards." The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of share-based compensation pursuant to SFAS 123R. The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool ("APIC Pool") related to the tax effects of employee share-based compensation, and to determine the subsequent impact on the APIC Pool and Consolidated Statements of Cash Flows of the tax effects of employee and director share-based awards that were outstanding upon adoption of SFAS 123R.

Stock Plans

As of December 31, 2007, the Company had the following two shareholder approved stock plans under which shares were available for equity-based awards: the Callaway Golf Company Amended and Restated 2004 Incentive Plan (the "2004 Plan") and the 2001 Non-Employee Directors Stock Incentive Plan (the "2001 Directors Plan"). The 2004 Plan permits the granting of stock options, stock appreciation rights, restricted stock/units, performance share units and other equity-based awards to the Company's officers, employees, consultants and certain other non-employees who provide services to the Company. All grants under the 2004 Plan are discretionary, although no participant may receive awards in any one year in excess of 1,000,000 shares. The 2001 Directors Plan permits the granting of stock options, restricted stock and restricted stock units. Directors receive an initial equity award grant not to exceed 20,000 shares upon their initial appointment to the Board and thereafter an annual grant not to exceed 10,000 shares upon being re-elected at each annual meeting of shareholders. On June 5, 2007, the Company's shareholders approved certain amendments to the 2004 Plan and an increase in the number of shares available for issuance by an additional 4,250,000 to a total of 12,250,000. The maximum number of shares issuable over the term of the 2001 Directors Plan is 500,000 shares.

The following table presents shares authorized, available for future grant and outstanding under each of the Company's plans as of December 31, 2007:

	<u>Authorized</u>	<u>Available</u> (In thousands)	<u>Outstanding⁽¹⁾</u>
1991 Stock Incentive Plan	10,000	—	75
Promotion, Marketing and Endorsement Stock Incentive Plan	3,560	—	570
1995 Employee Stock Incentive Plan	10,800	—	2,284
1996 Stock Option Plan	9,000	—	622
2001 Directors Plan	500	254	233
2004 Plan	12,250	4,343	2,783
Employee Stock Purchase Plan	6,000	3,160	—
Non-Employee Directors Stock Option Plan	840	—	104
Total	<u>52,950</u>	<u>7,757</u>	<u>6,671</u>

(1) Outstanding shares do not include issued Restricted Stock awards that are subject to forfeitures.

Stock Options

All stock option grants made under the 2004 Plan and the 2001 Directors Plan are made at exercise prices no less than the Company's closing stock price on the date of grant. Outstanding stock options generally vest over a three year period from the grant date and generally expire up to 10 years after the grant date. The Company recorded \$4,241,000 and \$6,122,000 of compensation expense relating to outstanding stock options as of December 31, 2007 and 2006, respectively. The Company was not required to record compensation expense relating to outstanding options prior to the adoption date of SFAS 123R on January 1, 2006.

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The model uses various assumptions, including a risk-free interest rate, the expected term of the options, the expected stock price volatility over the expected term of the options, and the expected dividend yield. Compensation expense for employee stock options is recognized ratably over the vesting term and is reduced by an estimate for pre-vesting forfeitures, which is based on the Company's historical forfeitures of unvested options and awards. For the years ended December 31, 2007 and 2006, the average estimated pre-vesting forfeiture rate used was 3.9% and 5.6%, respectively. The table below summarizes the average fair value assumptions used in the valuation of stock options granted during the years ended December 31, 2007, 2006 and 2005.

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Dividend yield	2.0%	2.0%	2.0%
Expected volatility	37.4%	39.5%	42.4%
Risk-free interest rate	4.7%	4.7%	4.2%
Expected life	3.1 years	3.2 years	3.6 years

The dividend yield is based upon a three-year historical average. The expected volatility is based on the historical volatility, among other factors, of the Company's stock. The risk free interest rate is based on the U.S. Treasury yield curve at the date of grant with maturity dates approximately equal to the expected term of the options at the date of the grant. The expected life of the Company's options is based on evaluations of historical and expected future employee exercise behavior. The valuation model applied in this calculation utilizes highly

subjective assumptions that could potentially change over time. Changes in the subjective input assumptions can materially affect the fair value estimates of an option. Furthermore, the estimated fair value of an option does not necessarily represent the value that will ultimately be realized by the employee holding the option.

The following table summarizes the Company's stock option activities for the year ended December 31, 2007 (in thousands, except price per share and contractual term):

<u>Options</u>	<u>Number of Shares</u>	<u>Weighted-Average Exercise Price Per Share</u>	<u>Weighted-Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at January 1, 2007	9,279	\$16.84		
Granted	915	\$14.51		
Exercised	(3,220)	\$14.05		
Forfeited	(72)	\$14.22		
Expired	<u>(716)</u>	<u>\$29.52</u>		
Outstanding at December 31, 2007	6,186	\$16.51	5.33	\$10,687
Vested and expected to vest in the future at December 31, 2007	6,049	\$16.56	5.26	\$10,257
Exercisable at December 31, 2007	4,505	\$17.35	4.23	\$ 5,366

The weighted-average grant-date fair value of options granted during the years ended December 31, 2007, 2006 and 2005 was \$3.93, \$4.54 and \$4.13 per share, respectively. The total intrinsic value for options exercised during the years ended December 31, 2007, 2006 and 2005 was \$11,248,000, \$1,344,000 and \$1,998,000, respectively.

Cash received from the exercise of stock options for the years ended December 31, 2007, 2006 and 2005 was approximately \$45,234,000, \$6,081,000 and \$10,897,000, respectively. The Company settles the exercise of stock options through the Callaway Golf Company Grantor Stock Trust (see Note 10—Capital Stock). The actual tax benefit realized for the tax deductions from option exercises for the years ended December 31, 2007, 2006 and 2005 totaled approximately \$3,858,000, \$578,000 and \$2,408,000, respectively.

Restricted Stock, Restricted Stock Units and Performance Units

All Restricted Stock, Restricted Stock Units and Performance Share Units awarded under the 2004 Plan and the 2001 Directors Plan are recorded at the Company's closing stock price on the date of grant. Restricted Stock awards and Restricted Stock Units generally cliff-vest over a period of three years. Performance Share Units generally cliff-vest at the end of a three year performance period. Performance Share Units are a form of stock-based award in which the number of shares ultimately received depends on the Company's performance against specified financial performance metrics over a three year period. At the end of the performance period, the number of shares of stock issued will be determined based upon the Company's performance against those metrics.

The Company recorded \$1,327,000, \$1,448,000, and \$611,000 of compensation expense relating to Restricted Stock awards as of December 31, 2007, 2006 and 2005, respectively. In connection with shares underlying Restricted Stock Units and Performance Share Units, the Company recorded \$1,241,000 and \$326,000, respectively, as of December 31, 2007 and \$156,000 and \$333,000, respectively, as of December 31, 2006. The Company did not award Restricted Stock Units or Performance Units during 2005.

The table below summarizes the total number of Restricted Stock shares and shares underlying Restricted Stock Units and Performance Share Units granted to certain employee participants and directors during the years ended December 31, 2007, 2006 and 2005, as well as the related weighted average grant date fair value for each type of award (number of shares are in thousands).

	# of Shares Granted			Weighted Average Grant-Date Fair Value		
	2007	2006	2005	2007	2006	2005
Restricted Stock Awards	—	166	160	\$ —	\$14.91	\$14.93
Restricted Stock Units	260	52	—	\$14.76	\$14.37	\$ —
Performance Units	—	154	—	\$ —	\$14.90	\$ —

The fair value of nonvested Restricted Stock awards, Restricted Stock Units and Performance Share Units (collectively “nonvested shares”) is determined based on the closing trading price of the Company’s Common Stock on the grant date. A summary of the Company’s nonvested share activity for the year ended December 31, 2007 is as follows (in thousands, except fair value amounts):

<u>Restricted Stock, Restricted Stock Units and Performance Units</u>	<u>Shares</u>	<u>Weighted- Average Grant-Date Fair Value</u>
Nonvested at January 1, 2007	1,086	\$12.42
Granted	260	\$14.76
Vested	(208)	\$10.67
Forfeited	(35)	\$14.95
Nonvested at December 31, 2007 ⁽¹⁾	<u>1,103</u>	\$13.22

(1) Total unvested shares as of December 31, 2007 include 683,000 Restricted Stock shares, 118,000 shares underlying Performance Share Units and 302,000 shares underlying Restricted Stock Units.

At December 31, 2007, there was \$7,284,000 of total unrecognized compensation expense related to nonvested shares granted to both employees and non-employees under the Company’s share-based payment plans, of which \$6,796,000 relates to Restricted Stock awards and Restricted Stock Units and \$489,000 relates to Performance Share Units. That cost is expected to be recognized over a weighted-average period of 1.6 years. The amount of unrecognized compensation expense noted above does not necessarily represent the amount that will ultimately be realized by the Company in its Statement of Operations. Prior to the adoption of SFAS 123R on January 1, 2006, unrecognized compensation expense related to nonvested shares of Restricted Stock awards granted to employees was recorded as unearned share-based compensation in shareholder’s equity. As of January 1, 2006, as part of the adoption of SFAS 123R, \$2,382,000 of unrecognized compensation expense was reclassified as a component of additional paid-in capital.

Employee Stock Purchase Plan

On February 1, 2006, the Company amended and restated the Callaway Golf Company Employee Stock Purchase Plan (the “Plan”) to eliminate the look-back provision. Under the amended and restated plan, participating employees authorize the Company to withhold compensation and to use the withheld amounts to purchase shares of the Company’s common stock at 85% of the closing price on the last day of each six month offering period. During 2007, 2006 and 2005 approximately 201,000, 303,000 and 369,000 shares, respectively, of the Company’s Common Stock were purchased under the Plan on behalf of participating employees. As of December 31, 2007, there were 3,160,000 shares reserved for future issuance under the Plan. In connection with the Plan, the Company recorded \$496,000 and \$597,000 of compensation expense for the years ended December 31, 2007 and 2006, respectively. The Company was not required to record compensation expense in connection with the Plan in 2005.

Employee Share-Based Compensation Expense

The table below summarizes the amounts recognized in the financial statements for the years ended December 31, 2007, 2006 and 2005 for share-based compensation related to employees and directors. Prior to the adoption of SFAS 123R, the Company recorded share-based compensation expense related to Restricted Stock awards. Amounts are in thousands, except for per share data.

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Cost of sales	\$ 490	\$ 484	\$ —
Operating expenses	7,141	8,172	611
Total cost of employee share-based compensation included in income, before income tax	7,631	8,656	611
Amount of income tax recognized in earnings	<u>(2,320)</u>	<u>(2,813)</u>	<u>(232)</u>
Amount charged against net income	<u>\$ 5,311</u>	<u>\$ 5,843</u>	<u>\$ 379</u>
Impact on net income per common share:			
Basic	\$ (0.08)	\$ (0.08)	\$(0.01)
Diluted	\$ (0.08)	\$ (0.08)	\$(0.01)

During 2006, the Company accelerated the vesting of certain share-based awards as a result of employee terminations. In connection with the accelerations, the Company recognized additional expense in the amount of \$1,330,000 before income taxes. In addition, the Company recorded expense of \$3,221,000, \$3,261,000 and \$5,917,000 for Restricted Stock awards granted to certain non-employees for the years ended December 31, 2007, 2006 and 2005, respectively. There were no amounts relating to employee share-based compensation capitalized in inventory during the years 2007, 2006 and 2005.

Note 12. Employee Benefit Plans

The Company has a voluntary deferred compensation plan under Section 401(k) of the Internal Revenue Code (the “401(k) Plan”) for all employees who satisfy the age and service requirements under the 401(k) Plan. Each participant may elect to contribute up to 25% of annual compensation, up to the maximum permitted under federal law, and the Company is obligated to contribute annually an amount equal to 100% of the participant’s contribution up to 6% of that participant’s annual compensation. The portion of the participant’s account attributable to elective deferral contributions and rollover contributions are 100% vested and nonforfeitable. Participants vest in employer matching and profit sharing contributions at a rate of 25% per year, becoming fully vested after the completion of four years of service. Employees contributed \$9,200,000, \$9,235,000 and \$8,925,000 to the 401(k) Plan in 2007, 2006 and 2005, respectively. In accordance with the provisions of the 401(k) Plan, the Company matched employee contributions in the amount of \$6,379,000, \$6,307,000 and \$6,156,000 during 2007, 2006 and 2005, respectively. Additionally, the Company can make discretionary contributions based on the profitability of the Company. For the years ended December 31, 2007, 2006 and 2005 there were no discretionary contributions.

The Company also has an unfunded, nonqualified 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 upon 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 \$9,103,000 and \$8,607,000 at December 31, 2007 and 2006, respectively. The liability for the deferred compensation is included in long-term liabilities and was \$7,790,000 and \$7,210,000 at December 31, 2007, and 2006, respectively. For the years ended December 31, 2007 and 2006, the total participant deferrals were \$1,609,000 and \$1,974,000, respectively.

Note 13. Income Taxes

The Company's income (loss) before income tax provision was subject to taxes in the following jurisdictions for the following periods (in thousands):

	Year Ended December 31,		
	2007	2006	2005
United States	\$69,481	\$18,455	\$(5,685)
Foreign	18,794	16,543	20,222
	<u>\$88,275</u>	<u>\$34,998</u>	<u>\$14,537</u>

The provision for income taxes is as follows (in thousands):

	Year Ended December 31,		
	2007	2006	2005
Current tax provision (benefit):			
Federal	\$25,127	\$ 2,986	\$(3,652)
State	4,061	1,085	(1,087)
Foreign	2,790	6,050	7,905
Deferred tax expense (benefit):			
Federal	(2,288)	645	(1,789)
State	(675)	289	459
Foreign	4,673	653	(583)
Income tax provision	<u>\$33,688</u>	<u>\$11,708</u>	<u>\$ 1,253</u>

During 2007, 2006, and 2005, tax cash benefits related to the exercise or vesting of stock-based awards were \$6,031,000, \$884,000 and \$2,408,000, respectively. Such benefits were recorded as a reduction of income taxes payable with a corresponding increase in additional paid-in capital or a decrease to deferred tax assets in connection with compensation cost previously recognized in income.

Deferred tax assets and liabilities are classified as current or noncurrent according to the classification of the related asset or liability. Significant components of the Company's deferred tax assets and liabilities as of December 31, 2007 and 2006 are as follows (in thousands):

	December 31,	
	2007	2006
Deferred tax assets:		
Reserves and allowances	\$ 18,476	\$17,574
Compensation and benefits	16,060	6,963
Effect of inventory overhead adjustment	4,398	5,221
Compensatory stock options and rights	5,836	5,480
Revenue recognition	2,080	2,032
Long-lived asset impairment	—	631
Operating loss carryforwards	1,705	1,357
Tax credit carryforwards	3,633	3,605
Energy derivative	8,305	8,177
Other	44	745
Total deferred tax assets	<u>60,537</u>	<u>51,785</u>
Valuation allowance for deferred tax assets	<u>(4,702)</u>	<u>(4,083)</u>
Deferred tax assets, net of valuation allowance	55,835	47,702
Deferred tax liabilities:		
State taxes, net of federal income tax benefit	(3,094)	(3,162)
Prepaid expenses	(1,707)	(2,373)
Depreciation and amortization	(11,182)	(6,789)
Net deferred tax assets	<u>\$ 39,852</u>	<u>\$35,378</u>

The current year change in net deferred taxes of \$4,474,000 is comprised of a net deferred benefit of \$6,184,000 recorded as of January 1, 2007 as a component of the cumulative effect of the FIN 48 accounting method change offset by a net deferred expense of \$1,710,000 recorded through current income tax expense for the year ended December 31, 2007.

Of the total tax credit carryforwards of \$3,667,000 at December 31, 2007, the Company has state investment tax credits of \$952,000 which expire at various dates through 2010 and \$1,638,000 that generally do not expire, foreign tax credit carryforwards of \$30,000 which expire at various dates through 2009, and state research and development credit carryforwards of \$30,000 which expire at various dates through 2022 and \$1,017,000 that generally do not expire. Of the \$1,705,000 of operating loss carryforwards, \$1,283,000 relates to state loss carryforwards that expire in 2008 through 2010, \$194,000 relates to foreign loss carryforwards that will expire in 2012 and \$228,000 relates to loss carryforwards that do not expire.

The Company maintains a valuation allowance to reduce certain deferred tax assets to amounts that are not, in management's estimation, more likely than not to be realized. This allowance primarily relates to the uncertainty of realizing certain state tax credit carryforwards, state operating loss carryforwards, and a portion of other deferred tax assets. Of the \$4,702,000 valuation allowance at December 31, 2007, \$660,000 is related to certain Top-Flite deferred tax assets existing at the time of the acquisition. In the future, if the Company determines that the realization of these Top-Flite deferred tax assets is more likely than not, the reversal of the related valuation allowance will reduce goodwill instead of the provision for income taxes. Based on management's assessment, it is more likely than not that the net deferred tax assets will be realized through future earnings.

A reconciliation of income taxes computed by applying the statutory U.S. income tax rate to the Company's income before income taxes to the income tax provision is as follows (in thousands):

	<u>Year Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Amounts computed at statutory U.S. tax rate	\$30,896	\$12,246	\$ 5,088
State income taxes, net of U.S. tax benefit	3,282	1,219	(369)
State tax credits, net of U.S. tax benefit	(761)	(326)	(418)
Federal research tax credits	(500)	(51)	(20)
Expenses with no tax benefit	807	1,289	634
Share based compensation	432	555	—
Domestic manufacturing tax benefits	(735)	(181)	—
Extra-territorial income exclusion benefit	—	(263)	(189)
Effect of foreign rate changes	164	—	—
Change in deferred tax valuation allowance	619	90	274
Reversal of previously accrued taxes	(1,620)	(2,983)	(3,564)
Accrual for interest and income taxes related to uncertain tax positions	967	—	—
Other	137	113	(183)
Income tax provision	<u>\$33,688</u>	<u>\$11,708</u>	<u>\$ 1,253</u>

In 2007, 2006 and 2005, the tax rate benefited from net favorable adjustments to previously estimated tax liabilities in the amount of \$1,620,000, \$2,983,000 and \$3,564,000, respectively. The most significant favorable adjustments in each year related to adjustments resulting from the finalization of the Company's prior year U.S. and state income tax returns as well as agreements reached with the Internal Revenue Service ("IRS") and other major jurisdictions on certain issues necessitating a reassessment of the Company's tax exposures for all open tax years, with no individual year being significantly affected.

Effective January 1, 2007, the Company was required to adopt and implement the provisions of FIN 48, which requires the Company to accrue for the estimated additional amount of taxes for uncertain tax positions if it is more likely than not that the Company would be required to pay such additional taxes. An uncertain income

tax position will not be recognized if it has less than 50% likelihood of being sustained. As a result of the adoption of FIN 48, the Company recognized an increase in the liability for its uncertain tax positions of \$437,000, of which the entire charge was accounted for as a decrease to the beginning balance of retained earnings. The accrual for uncertain tax positions can result in a difference between the estimated benefit recorded in the Company's financial statements and the benefit taken or expected to be taken in the Company's income tax returns. This difference is generally referred to as an "unrecognized tax benefit."

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

Balance at January 1, 2007	\$ 23,632
Additions based on tax positions related to the current year	2,122
Additions for tax positions of prior years	666
Reductions for tax positions of prior years—Other	(1,063)
Reductions for tax positions of prior years—Bilateral Advanced Pricing Agreement between US and Japan	(8,239)
Settlements	(258)
Expiration of the statute of limitations for the assessment of taxes	(10)
Balance at December 31, 2007	<u>\$ 16,850</u>

As of December 31, 2007, the liability for income taxes associated with uncertain tax benefits was \$16,850,000 and can be reduced by \$8,143,000 of offsetting tax benefits associated with the correlative effects of potential transfer pricing adjustments which was recorded as a long-term income tax receivable as well as \$884,000 of tax benefits associated with state income taxes and other timing adjustments which are recorded as deferred income taxes pursuant to FIN 48. The net amount of \$7,823,000, if recognized, would affect the Company's financial statements and favorably affect the Company's effective income tax rate.

The Company does expect changes in the amount of unrecognized tax benefits in the next 12 months; however, the Company does not expect the change to have a material impact on its results of operations or its financial position.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense. For the year ended December 31, 2007 the Company recognized approximately \$474,000 of interest and penalties in the provision for income taxes. As of December 31, 2007, and 2006, the Company had accrued \$1,524,000 and \$1,050,000, respectively, (before income tax benefit) for the payment of interest and penalties.

The Internal Revenue Service field examination of tax years 2001 through 2003 is complete and certain issues are pending before IRS Appeals. It is reasonably possible that resolution can be reached by December 31, 2008. Any possible settlement could increase/(decrease) earnings but is not expected to be significant. Audit outcomes and the timing of audit settlements are subject to significant uncertainty.

The Company or one of its subsidiaries files income tax returns in the US federal jurisdiction and various states and foreign jurisdictions. The Company is generally no longer subject to income tax examinations by tax authorities in its major jurisdictions as follows:

<u>Tax Jurisdiction</u>	<u>Years No Longer Subject to Audit</u>
U.S. federal	2000 and prior
California (U.S.)	2000 and prior
Massachusetts (U.S.)	2003 and prior
Australia	2002 and prior
Canada	2002 and prior
Japan	2003 and prior
Korea	2001 and prior
United Kingdom	2001 and prior

As of December 31, 2007, the Company did not provide for United States income taxes or foreign withholding taxes on a cumulative total of \$64,502,000 of undistributed earnings from certain non-U.S. subsidiaries that will be permanently reinvested outside the United States. Upon remittance, certain foreign countries impose withholding taxes that are then available, subject to certain limitations, for use as credits against the Company's U.S. tax liability, if any. It is not practicable to estimate the amount of the deferred tax liability on such unremitted earnings. Should the Company repatriate foreign earnings, the Company would have to adjust the income tax provision in the period management determined that the Company would repatriate earnings.

Cash amounts paid during 2007 for income taxes, net of refunds received, was \$38,292,000.

Note 14. 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. The Company is also active internationally. For example, it has worked with other manufacturers to encourage Chinese government officials to conduct raids of identified counterfeiters, resulting in the seizure and destruction of counterfeit golf clubs. 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 February 9, 2006, the Company filed a complaint in the United States District Court for the District of Delaware, Case No. C.A. 06-91, asserting claims against Acushnet Company for patent infringement. Specifically, Callaway Golf asserted that Acushnet's sale of the Titleist Pro V1 family of golf balls infringes four golf ball patents that Callaway Golf acquired when it acquired the assets of Top-Flite. Callaway Golf is seeking damages and an injunction to prevent future infringement by Acushnet. In its answer to the Complaint, Acushnet responded that the patents at issue are invalid and not infringed by the Pro V1 golf balls. On November 20, 2007,

the District Court granted Callaway Golf's motion for summary judgment on a breach of contract claim, holding that Acushnet's initiation of parallel re-examination proceedings, described below, constituted a breach of a pre-existing dispute resolution agreement with Callaway Golf. The Court also rejected various legal challenges by Acushnet as to the validity of the patents, permitting Callaway Golf's claims against Acushnet to proceed to trial, and ruled that the issues of damages and willfulness would be decided in a second trial between the parties. On the eve of trial, Acushnet stipulated that its Pro V1 golf balls infringe one or more of the nine claims in the four patents asserted by Callaway Golf. As a result of the Court's rulings, and Acushnet's concession as to infringement, only the validity of the patents was tried before a jury commencing on December 5, 2007. On December 14, 2007, after a six day trial, a unanimous jury decided that eight of the nine patent claims asserted by Callaway Golf against Acushnet are valid. The Court entered judgment in favor of Callaway Golf and against Acushnet on December 20, 2007. Callaway Golf has requested that the Court enter a permanent injunction requiring Acushnet to stop production and sale of the Pro V1 golf balls. Acushnet has asked the Court to enter judgment notwithstanding the verdict or, alternatively, for a new trial. Those two motions are pending.

Acushnet also filed petitions for reexamination with the United States Patent and Trademark Office ("PTO") challenging the validity of the patents asserted by Callaway Golf. Although the PTO agreed the petitions for reexamination raised substantial new questions of patentability, and issued a first office action preliminarily rejecting the claims of all four of the patents, the PTO has not made a final and binding determination as to the validity of any of the patents. The interim rulings by the PTO do not void the Court's judgment.

On June 9, 2007, the Company filed a complaint in the United States District Court for the District of Delaware, Case No. C.A. 07-367, asserting claims against Acushnet Company for patent infringement. Callaway Golf asserts that Acushnet's sale of numerous drivers, including but not limited to the King Cobra 454 Comp, King Cobra F Speed, King Cobra HS9 F Speed, King Cobra HS9 M speed, and King Cobra LD F Speed, Titleist 905R, Titleist 905S and Titleist 905T drivers, infringes one or more of Callaway Golf U.S. patents (numbers 6,348,015; 6,478,692; 6,669,579; 6,685,576; and 6,949,032). Callaway Golf is seeking damages and an injunction to prevent future infringement. Acushnet has answered the complaint denying infringement of any valid patent and asserting counterclaims against Callaway Golf. Acushnet asserts that sales of Callaway Golf's FT-i, FT-5, X-460, X-460 Tour, Big Bertha Fusion FT-3 and Big Bertha 460 drivers infringe two patents issued to Acushnet, namely U.S. patent numbers 6,960,142 and 7,041,003. Acushnet seeks damages and an injunction as well. Callaway Golf responded to the counterclaim on August 31, 2007, denying infringement of any valid patent claim. The parties are engaged in preliminary discovery. The trial of this matter is set to commence in the District Court on May 18, 2009.

On August 1, 2007, the Company filed a complaint in the United States District Court for the Eastern District of Texas, Case No. 207CV329, asserting claims of patent infringement against TaylorMade Golf Company, Inc. Specifically, Callaway Golf is asserting that sales of certain TaylorMade irons infringe Callaway Golf's U.S. patent No. 5,704,849. Callaway Golf is seeking damages and an injunction to prevent future infringement. On September 4, 2007, TaylorMade answered the complaint denying infringement.

On August 4, 2007, Callaway Golf filed a complaint in the United States District Court for the Southern District of California, Case No. 07 CV 1424, asserting claims against TaylorMade Golf Company, Inc. for patent infringement and seeking declaratory relief. Specifically, Callaway Golf asserts that TaylorMade's sales of its TP Red and TP Black golf balls infringe Callaway Golf's U.S. Patent Nos. 6,638,185 and 7,160,207, which relate to multi-layer golf balls. Callaway Golf is also seeking declarations of license, invalidity, unenforceability, and/or non-infringement of TaylorMade's U.S. Patent Nos. 6,991,558, 7,198,575, 6,719,644, and 6,547,678. TaylorMade filed an answer and counterclaim asserting non-infringement and/or invalidity of Callaway Golf's golf ball patents. TaylorMade also asserts that certain of Callaway Golf's drivers, including the FT-i, FT-5, and Big Bertha 460 infringe its above-named patents and related patent applications. In addition, Taylor Made is seeking declarations of invalidity, unenforceability, and non-infringement of Callaway Golf's U.S. Patent Nos. 5,704,849, 5,409,229 and 5,605,511, which relate to undercut irons.

On December 14, 2007, Callaway Golf and TaylorMade issued a joint press release announcing a resolution of all pending litigation between the parties. Specifically, the parties announced that they entered into a settlement and

patent license agreement under the terms of which each company has specified rights to make products under patents owned by the other. Technologies at issue include high moment of inertia drivers, undercut irons, and golf balls.

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. 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 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.

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 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 \$19,922,000.

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 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 valuation adjustments for changes in electricity rates.

The Company continues to reflect on its balance sheet the derivative valuation account of \$19,922,000, subject to quarterly review in accordance with applicable law and accounting regulations, including 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 December 31, 2007, 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 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.

Lease Commitments

The Company leases certain warehouse, distribution and office facilities, vehicles as well as office equipment under operating leases and certain computer and telecommunication equipment under capital leases. Lease terms range from 1 to 10 years expiring at various dates through November 2017, with options to renew at varying terms. Commitments for minimum lease payments under non-cancelable operating leases as of December 31, 2007 are as follows (in thousands):

2008	\$ 7,721
2009	4,783
2010	3,295
2011	2,637
2012	1,895
Thereafter	6,925
	<u>\$27,256</u>

Rent expense for the years ended December 31, 2007, 2006 and 2005 was \$9,818,000, \$7,807,000 and \$7,737,000, respectively.

Unconditional Purchase Obligations

During the normal course of its business, the Company enters into agreements to purchase goods and services, including purchase commitments for production materials, endorsement agreements with professional golfers and other endorsers, employment and consulting agreements, and intellectual property licensing agreements pursuant to which the Company is required to pay royalty fees. It is not possible to determine the amounts the Company will ultimately be required to pay under these agreements as they are subject to many variables including performance-based bonuses, reductions in payment obligations if designated minimum performance criteria are not achieved, and severance arrangements. As of December 31, 2007, the Company has entered into many of these contractual agreements with terms ranging from one to seven years. The minimum obligation that the Company is required to pay under these agreements is \$109,445,000 over the next seven years. In addition, 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 that are undocumented except for an invoice. Such unconditional purchase 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 total. Future purchase commitments as of December 31, 2007 are as follows (in thousands):

2008	\$ 57,595
2009	30,315
2010	12,677
2011	6,211
2012	2,522
Thereafter	<u>125</u>
	<u>\$109,445</u>

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 each of its officers and certain other employees providing for severance payments upon the termination of employment. 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 guarantees in the form of two standby letters of credit as security for contingent liabilities under certain workers' compensation insurance policies and as collateral for a loan issued to Golf Entertainment International Limited ("GEI"). 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. Except for the letter of credit in connection with the Company's investment in GEI, (see Note 3 "Investments"), the fair value of indemnities, commitments and guarantees that the Company issued during 2005 through 2007 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 payment of certain severance benefits, including salary continuation, upon the termination of employment following a change in control.

Note 15. 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, hybrids, irons, wedges and putters as well as Odyssey putters, other golf-related accessories and royalties from licensing of the Company's trademarks and service marks. 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.

	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(In thousands)		
Net sales			
Golf Clubs	\$ 911,527	\$ 803,124	\$783,398
Golf Balls	213,064	214,783	214,695
	<u>\$1,124,591</u>	<u>\$1,017,907</u>	<u>\$998,093</u>
Income (loss) before tax			
Golf Clubs	\$ 151,759	\$ 101,837	\$ 68,327
Golf Balls	902	(6,396)	(3,612)
Reconciling items ⁽¹⁾	(64,386)	(60,443)	(50,178)
	<u>\$ 88,275</u>	<u>\$ 34,998</u>	<u>\$ 14,537</u>
Identifiable assets ⁽²⁾			
Golf Clubs	\$ 413,352	\$ 419,212	\$390,153
Golf Balls	140,730	152,282	154,355
Reconciling items ⁽²⁾	302,881	274,453	219,990
	<u>\$ 856,963</u>	<u>\$ 845,947</u>	<u>\$764,498</u>
Goodwill			
Golf Clubs	\$ 32,060	\$ 30,833	\$ 29,068
Golf Balls	—	—	—
	<u>\$ 32,060</u>	<u>\$ 30,833</u>	<u>\$ 29,068</u>
Depreciation and amortization			
Golf Clubs	\$ 23,975	\$ 21,045	\$ 25,935
Golf Balls	11,351	11,229	12,325
	<u>\$ 35,326</u>	<u>\$ 32,274</u>	<u>\$ 38,260</u>

(1) Represents corporate general and administrative expenses and other income (expense) not utilized by management in determining segment profitability.

(2) Identifiable assets are comprised of net inventory, certain property, plant and equipment, intangible assets and goodwill. Reconciling items represent unallocated corporate assets not segregated between the two segments.

The Company's net sales by product category are as follows:

	Year Ended December 31,		
	2007	2006	2005
	(In thousands)		
Net sales			
Drivers and Fairway Woods	\$ 305,880	\$ 266,478	\$241,329
Irons	309,594	287,960	316,501
Putters	109,068	102,714	109,309
Golf Balls	213,064	214,783	214,695
Accessories and Other	186,985	145,972	116,259
	<u>\$1,124,591</u>	<u>\$1,017,907</u>	<u>\$998,093</u>

The Company markets its products in the United States and internationally, with its principal international markets being Japan and Europe. The tables below contain information about the geographical areas in which the Company operates. Revenues are attributed to the location to which the product was shipped. Long-lived assets are based on location of domicile.

	Sales	Long-Lived Assets
	(In thousands)	
2007		
United States	\$ 597,569	\$271,780
Europe	193,336	9,549
Japan	120,148	2,132
Rest of Asia	86,133	5,317
Other foreign countries	127,405	12,303
	<u>\$1,124,591</u>	<u>\$301,081</u>
2006		
United States	\$ 566,600	\$279,879
Europe	159,886	9,406
Japan	105,705	1,871
Rest of Asia	75,569	4,518
Other foreign countries	110,147	10,709
	<u>\$1,017,907</u>	<u>\$306,383</u>
2005		
United States	\$ 563,040	\$277,572
Europe	166,177	9,243
Japan	103,389	1,928
Rest of Asia	66,890	4,178
Other foreign countries	98,597	10,009
	<u>\$ 998,093</u>	<u>\$302,930</u>

Note 16. Licensing Arrangements

The Company from time to time, in exchange for a royalty fee, licenses its trademarks and service marks to third parties for use on products such as golf apparel, watches, travel gear, rangefinders and eyewear. The Company has current licensing arrangements with (i) Ashworth, Inc. for a complete line of men's and women's apparel for distribution in the United States, Canada, Europe and South Africa, (ii) Sanei International Co., Ltd. for a complete line of men's and women's apparel for distribution in Japan, Korea, China and other Asian Pacific

countries, and (iii) Playcorp Pty. Ltd. for a complete line of men's and women's apparel for distribution in Australia and New Zealand.

In addition to apparel, the Company has also licensed its trademarks to, among others, (i) Fossil, Inc. for a line of Callaway Golf watches and clocks, (ii) TRG Accessories, LLC for a collection primarily consisting of travel gear, (iii) Global Wireless Entertainment, Inc. for the creation of golf-related software and applications for wireless handheld devices and platforms, (iv) MicroVision Optical, Inc. for eyewear and (v) Nikon Vision Co., Ltd. for rangefinders. Prior to April, 2006, the Company had a licensing arrangement with Tour Golf Group, Inc. ("TGG") for a line of Callaway Golf footwear. In April 2006, the licensing arrangement was terminated and the Company acquired certain assets of TGG. The Company currently designs and sells the Callaway Golf footwear line. The Company recognized royalty income under its various licensing agreements of \$8,672,000, \$8,292,000 and \$7,080,000 during 2007, 2006 and 2005, respectively.

Note 17. Transactions with Related Parties

In December 2006, the Company purchased the primary residence from one of its recently hired officers at a cost of \$545,000. The purchase was pursuant to the Company's home purchase procedures as referenced in the officer's Employment Agreement. The purchase price was determined based upon two independent appraisals. During December 2006, the Company was marketing the home and accounted for the home as a long-lived asset held for sale classified as other assets. In January 2007, this residence was sold and the Company recorded a net loss of \$22,500.

In connection with the terms of a former chief executive officer's separation from the Company, the Company purchased his primary residence at a cost of \$1,715,000. The purchase price was determined based upon two independent appraisals. In 2005, this residence was sold and the Company recorded a gain of \$6,000.

The Callaway Golf Company Foundation (the "Foundation") oversees and administers charitable giving for the Company and makes grants to carefully selected organizations. Officers of the Company also serve as directors of the Foundation and the Company's employees provide accounting and administrative services for the Foundation. During 2007, 2006 and 2005, the Company did not contribute to the Foundation.

Note 18. Summarized Quarterly Data (Unaudited)

	Fiscal Year 2007 Quarters				
	1st	2nd	3rd	4th	Total
	(In thousands, except per share data)				
Net sales	\$334,607	\$380,017	\$235,549	\$174,418	\$1,124,591
Gross profit	\$160,721	\$175,125	\$ 94,006	\$ 63,371	\$ 493,223
Net income (loss)	\$ 32,836	\$ 36,639	\$ 1,269	\$ (16,157)	\$ 54,587
Earnings (loss) per common share ⁽¹⁾					
Basic	\$ 0.49	\$ 0.54	\$ 0.02	\$ (0.25)	\$ 0.82
Diluted	\$ 0.48	\$ 0.53	\$ 0.02	\$ (0.25)	\$ 0.81
	Fiscal Year 2006 Quarters				
	1st	2nd	3rd	4th	Total
Net sales	\$302,445	\$341,815	\$193,763	\$179,884	\$1,017,907
Gross profit	\$131,512	\$140,086	\$ 67,705	\$ 58,772	\$ 398,075
Net income (loss)	\$ 22,861	\$ 22,539	\$ (11,916)	\$ (10,194)	\$ 23,290
Earnings (loss) per common share ⁽¹⁾					
Basic	\$ 0.33	\$ 0.33	\$ (0.18)	\$ (0.15)	\$ 0.34
Diluted	\$ 0.33	\$ 0.33	\$ (0.18)	\$ (0.15)	\$ 0.34

(1) Earnings per share is computed individually for each of the quarters presented; therefore, the sum of the quarterly earnings per share may not necessarily equal the total for the year.

CALLAWAY GOLF COMPANY
CONSOLIDATED VALUATION AND QUALIFYING ACCOUNTS
For the Years Ended December 31, 2007, 2006 and 2005

<u>Date</u>	<u>Allowance for Sales Returns</u>	<u>Warranty Reserves</u>	<u>Allowance for Doubtful Accounts</u>	<u>Reserve for Obsolete Inventory</u>
	(In thousands)			
Balance, December 31, 2004	\$ 7,913	\$ 12,043	\$ 7,370	\$13,601
Provision	21,274	10,965	3,221	8,507
Write-off, disposals, costs and other, net	<u>(22,720)</u>	<u>(9,741)</u>	<u>(2,187)</u>	<u>(5,430)</u>
Balance, December 31, 2005	\$ 6,467	\$ 13,267	\$ 8,404	\$16,678
Provision	19,124	11,696	1,823	9,015
Write-off, disposals, costs and other, net	<u>(19,682)</u>	<u>(11,599)</u>	<u>(1,688)</u>	<u>(8,378)</u>
Balance, December 31, 2006	\$ 5,909	\$ 13,364	\$ 8,539	\$17,315
Provision	22,457	10,504	1,519	12,182
Write-off, disposals, costs and other, net	<u>(22,670)</u>	<u>(11,482)</u>	<u>(2,068)</u>	<u>(9,368)</u>
Balance, December 31, 2007	<u>\$ 5,696</u>	<u>\$ 12,386</u>	<u>\$ 7,990</u>	<u>\$20,129</u>



