
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2005

OR

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

For the transition period _____ 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)

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

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

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

The number of shares outstanding of the Registrant's Common Stock, \$.01 par value, as of September 30, 2005 was 76,449,883.

[Table of Contents](#)

Important Notice to Investors: Statements made in this report that relate to future plans, events, liquidity, financial results or performance including statements relating to future cash flows and liquidity, as well as estimated integration and restructuring charges, 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 as a result of certain risks and uncertainties, including delays, difficulties, changed strategies, or unanticipated factors affecting the implementation of the restructuring 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 “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Certain Factors Affecting Callaway Golf Company” contained in this report, as well as the Company’s other reports on Forms 10-K, 10-Q and 8-K subsequently filed with the Securities and Exchange Commission from time to time. Investors are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to 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 Passion For Excellence — Apex — Apex Edge — Apex Tour — Baby Ben — Ben Hogan — BH — BH-5 — Big Ben — Big Bertha — C design — C455 — CBI — CS-3 — CTU 30 — Callaway — Callaway Golf — Callaway Hickory Stick — Carnoustie — Chevron Device — Complete — Dawn Patrol — Daytripper — Demonstrably Superior and Pleasingly Different — Deuce — DFX — Distance Yourself — Divine Nine — Dual Force — Dual Zone — Edge CFT — Ely Would — ERC — Ever Grip — Explosive Distance. Amazing Soft Feel — Flying Lady — FT-3 — FTX — Fusion — Game Enjoyment System — Gems — GES — Ginty — Great Big Bertha — Hawk Eye — Heavenwood — Hogan — HX — I-Trax — Legacy — Legend — Little Ben — Little Bertha — Long & Soft — Molitor — Number One Putter in Golf — Odyssey — Pure Distance — RCH — Riviera — Rossie — Rule 35 — S2H2 — STS — SenSert — Speed Slot — Solitaire — Steelhead — Strata — Stronomic — Sure-Out — Switch..Lower Your Scores — T design — The Hawk — The Longest Balls — The Most Played Name in Golf — TL Distance — TL Tour — Top-Flite — Top-Flite Infinity — Top-Flite Tour — Top-Flite XL — Tour Ace — Tour Blue — Tour Deep — Tour Premier — Tour Professional — Tour Straight — Tour Ultimate — Trade In! Trade Up! — TriForce — TriHot — Trilateral — Tru Bore — Tunité — VFT — Warbird — Where They Don’t Play Golf, They Don’t Play Top-Flite — White Hot — White Steel — World’s Friendliest — X-12 — X-14 — X-16 — X-18 — XL 3000 — X-SPANN — X-Tour — XWT*

[Table of Contents](#)

CALLAWAY GOLF COMPANY

INDEX

[PART I. FINANCIAL INFORMATION](#)

Item 1.	Financial Statements (Unaudited)	4
	Consolidated Condensed Balance Sheets as of September 30, 2005 and December 31, 2004	4
	Consolidated Condensed Statements of Operations for the three and nine months ended September 30, 2005 and 2004	5
	Consolidated Condensed Statements of Cash Flows for the nine months ended September 30, 2005 and 2004	6
	Consolidated Condensed Statement of Shareholders' Equity for the nine months ended September 30, 2005	7
	Notes to Consolidated Condensed Financial Statements	8
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	22
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	42
Item 4.	Controls and Procedures	44

[PART II. OTHER INFORMATION](#)

Item 1.	Legal Proceedings	45
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	46
Item 3.	Defaults Upon Senior Securities	47
Item 4.	Submission of Matters to a Vote of Security Holders	47
Item 5.	Other Information	47
Item 6.	Exhibits	48

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	September 30, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 54,596	\$ 31,657
Accounts receivable, net	141,522	105,153
Inventories, net	211,163	181,230
Deferred taxes	36,249	32,959
Income taxes receivable	—	28,697
Other current assets	16,142	14,036
	<u>459,672</u>	<u>393,732</u>
Total current assets	459,672	393,732
Property, plant and equipment, net	130,525	135,865
Intangible assets, net	146,873	149,168
Goodwill	29,273	30,468
Deferred taxes	6,690	9,837
Other assets	16,247	16,667
	<u>\$ 789,280</u>	<u>\$ 735,737</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 94,452	\$ 75,501
Accrued employee compensation and benefits	26,044	20,215
Accrued warranty expense	13,773	12,043
Line of credit	—	13,000
Capital leases, current portion	11	39
Income taxes payable	9,836	—
	<u>144,116</u>	<u>120,798</u>
Total current liabilities	144,116	120,798
Long-term liabilities:		
Deferred compensation	8,148	8,674
Energy derivative valuation account	19,922	19,922
Capital leases, net of current portion	15	26
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Preferred Stock, \$.01 par value, 3,000,000 shares authorized, none issued and outstanding at September 30, 2005 and December 31, 2004	—	—
Common Stock, \$.01 par value, 240,000,000 shares authorized, 84,950,694 and 84,785,694 issued at September 30, 2005 and December 31, 2004, respectively	850	848
Additional paid-in capital	400,850	387,950
Unearned compensation	(10,808)	(12,562)
Retained earnings	454,595	437,269
Accumulated other comprehensive income	4,283	11,081
Less: Grantor Stock Trust held at market value, 6,048,248 shares and 7,176,678 shares at September 30, 2005 and December 31, 2004, respectively	(91,268)	(96,885)
	<u>758,502</u>	<u>727,701</u>
Less: Common Stock held in treasury, at cost, 8,500,811 and 8,497,667 shares at September 30, 2005 and December 31, 2004, respectively	(141,423)	(141,384)
	<u>617,079</u>	<u>586,317</u>
Total shareholders' equity	617,079	586,317
	<u>\$ 789,280</u>	<u>\$ 735,737</u>

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

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2005		2004		2005		2004	
Net sales	\$ 220,611	100%	\$ 128,457	100%	\$ 843,600	100%	\$ 790,151	100%
Cost of sales	133,713	61%	102,386	80%	477,363	57%	470,053	59%
Gross profit	86,898	39%	26,071	20%	366,237	43%	320,098	41%
Operating expenses:								
Selling expense	69,744	32%	58,300	45%	236,129	28%	203,991	26%
General and administrative expense	19,531	9%	23,219	18%	59,855	7%	67,914	9%
Research and development expense	7,116	3%	7,855	6%	20,439	2%	23,523	3%
Total operating expenses	96,391	44%	89,374	70%	316,423	38%	295,428	37%
Income (loss) from operations	(9,493)	(4)%	(63,303)	(49)%	49,814	6%	24,670	3%
Other income (expense), net	735		1,091		(2,252)		(230)	
Income (loss) before income taxes	(8,758)	(4)%	(62,212)	(48)%	47,562	6%	24,440	3%
Provision for (benefit from) income taxes	(3,954)		(26,317)		15,614		6,075	
Net income (loss)	\$ (4,804)	(2)%	\$ (35,895)	(28)%	\$ 31,948	4%	\$ 18,365	2%
Earnings (loss) per common share:								
Basic	\$ (0.07)		\$ (0.53)		\$ 0.47		\$ 0.27	
Diluted	\$ (0.07)		\$ (0.53)		\$ 0.46		\$ 0.27	
Weighted-average shares outstanding:								
Basic	68,849		67,847		68,436		67,641	
Diluted	68,849		67,847		69,028		68,235	
Dividends declared per share	\$ 0.07		\$ 0.07		\$ 0.21		\$ 0.21	

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

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

	Nine Months Ended September 30,	
	2005	2004
Cash flows from operating activities:		
Net income	\$ 31,948	\$ 18,365
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	30,942	39,027
Non-cash compensation	5,733	101
Loss on disposal of long-lived assets	1,109	4,270
Tax benefit from exercise of stock options	951	1,882
Net non-cash foreign currency hedging gains	—	1,723
Deferred taxes	(2,110)	12,254
Changes in assets and liabilities:		
Accounts receivable, net	(40,369)	(13,710)
Inventories, net	(34,030)	26,111
Income tax receivable	38,554	(39,234)
Other assets	(1,762)	4,238
Accounts payable and accrued expenses	20,545	(9,286)
Accrued employee compensation and benefits	6,210	334
Accrued warranty expense	1,730	(51)
Deferred compensation	(526)	108
Net cash provided by operating activities	58,925	46,132
Cash flows from investing activities:		
Capital expenditures	(25,721)	(16,065)
Business acquisitions, net of cash acquired	—	(9,204)
Proceeds from sale of capital assets	71	415
Net cash used in investing activities	(25,650)	(24,854)
Cash flows from financing activities:		
Proceeds from line of credit	265,600	—
Payments on line of credit	(278,600)	—
Issuance of Common Stock	13,589	18,649
Dividends paid, net	(9,706)	(14,232)
Acquisition of Treasury Stock	(39)	(6,298)
Payments on financing arrangements	(39)	—
Net cash used in financing activities	(9,195)	(1,881)
Effect of exchange rate changes on cash and cash equivalents	(1,141)	781
Net increase in cash and cash equivalents	22,939	20,178
Cash and cash equivalents at beginning of period	31,657	47,340
Cash and cash equivalents at end of period	\$ 54,596	\$ 67,518
Non-cash financing activities:		
Dividends payable at period end	\$ 4,916	\$ —
Liabilities assumed in connection with acquisition	\$ —	\$ 4,380
Issuance of restricted stock	\$ 117	\$ 800

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

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

	Common Stock		Additional Paid-in Capital	Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Income	Grantor Stock Trust	Treasury Stock		Total
	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
Exercise of stock options	5	—	(1,311)	—	—	—	10,985	—	—	9,674
Tax benefit from exercise of stock options	—	—	951	—	—	—	—	—	—	951
Issuance of Restricted Common Stock	160	2	2,387	(2,272)	—	—	—	—	—	117
Compensatory Stock and Stock Options	—	—	1,590	4,026	—	—	—	—	—	5,616
Acquisition of Treasury Stock	—	—	—	—	—	—	—	(3)	(39)	(39)
Employee stock purchase plan	—	—	(1,432)	—	—	—	5,347	—	—	3,915
Cash dividends declared	—	—	—	—	(14,622)	—	—	—	—	(14,622)
Adjustment of Grantor Stock Trust shares to market value	—	—	10,715	—	—	—	(10,715)	—	—	—
Equity adjustment from foreign currency translation	—	—	—	—	—	(4,818)	—	—	—	(4,818)
Unrealized gain loss cash flow hedges, net of tax	—	—	—	—	—	(1,980)	—	—	—	(1,980)
Net income	—	—	—	—	31,948	—	—	—	—	31,948
Balance, September 30, 2005	84,951	\$ 850	\$400,850	\$ (10,808)	\$454,595	\$ 4,283	\$ (91,268)	(8,501)	\$ (141,423)	\$617,079

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

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated condensed financial statements have been prepared by Callaway Golf Company (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 filed with the Securities and Exchange Commission. These consolidated condensed financial statements, in the opinion of management, include all adjustments necessary for the fair presentation of the financial position, results of operations and cash flows for the periods and dates presented. Interim operating results are not necessarily indicative of operating results for the full year.

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

2. Restructuring 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 integration of the Callaway Golf, Odyssey, Top-Flite and Ben Hogan selling functions, the complete consolidation of all golf ball manufacturing at the Top-Flite locations in Massachusetts and New York, and the elimination or reduction of other operating expenses. The Company expects to incur charges in the approximate aggregate amount of \$12,000,000 in 2005 and 2006 related to the implementation of the 2005 Restructuring Initiatives, including approximately \$11,000,000 for employee termination benefits, as discussed below. 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 will involve the elimination of approximately 500 positions worldwide, including full-time and part-time employees, temporary staffing and open positions. The Company expects that most of the employee terminations will be completed by December 31, 2005 and that all such employee terminations will be completed by December 31, 2006. Terminated employees will receive termination benefits for a specified period.

In connection with the 2005 Restructuring Initiatives, the Company recorded charges for the third quarter of 2005 in the amount of \$6,244,000 for employee termination benefits. The Company expects to incur additional charges of approximately \$6,000,000 during the remainder of 2005 and 2006 related to the 2005 Restructuring Initiatives.

3. Stock-Based Employee Compensation

The Company accounts for its stock-based employee compensation plans using the recognition and measurement principles (intrinsic value method) of Accounting Principles Board ("APB") Opinion No. 25,

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

“Accounting for Stock Issued to Employees,” and related interpretations. All employee stock-option awards granted during the period were granted with an exercise price equal to the market value of the underlying common stock on the effective date of grant and no compensation cost is reflected in net income for those awards. For the three and nine months ended September 30, 2005, the Company recorded compensation expense of \$1,776,000 and \$5,733,000, respectively, as a result of restricted stock awards granted to employees and professional endorsers of the Company. During the three and nine months ended September 30, 2004, the Company recorded compensation expense of \$99,000 as a result of restricted stock awards granted in 1998 to certain employees of the Company. The following table illustrates what net income and earnings per share would have been had the Company applied the fair value-based recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, “Accounting for Stock-Based Compensation,” in measuring stock-based employee compensation expense (in thousands, except per data share):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income:				
Net income (loss), as reported	\$(4,804)	\$(35,895)	\$31,948	\$18,365
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects	93	57	232	57
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,297)	(3,087)	(3,780)	(7,933)
Pro forma net income (loss)	\$(6,008)	\$(38,925)	\$28,400	\$10,489
Earnings (loss) per common share:				
Basic — as reported	\$ (0.07)	\$ (0.53)	\$ 0.47	\$ 0.27
Basic — pro forma	\$ (0.09)	\$ (0.57)	\$ 0.41	\$ 0.16
Diluted — as reported	\$ (0.07)	\$ (0.53)	\$ 0.46	\$ 0.27
Diluted — pro forma	\$ (0.09)	\$ (0.57)	\$ 0.41	\$ 0.15

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Dividend yield	2.0%	1.9%	1.9%	1.9%
Expected volatility	43.4%	42.1%	43.5%	42.1%
Risk free interest rates	4.7%	2.8%	3.6%	2.8%
Expected lives	3.6 years	3.3 years	3.7 years	3.3 years

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. The Company’s employee stock options, however, have characteristics significantly different from those of traded options. For example, employee stock options are generally subject to vesting restrictions and are generally not transferable. In addition, option

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

valuation models require the input of highly subjective assumptions including the expected stock price volatility and the expected life of an option. 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.

During 2005 and 2004, the Company granted 160,000 and 1,053,000 shares, respectively, of Restricted Common Stock, which are restricted as to sale or transfer until vesting. The net compensation expense related to these shares is recognized ratably over the vesting period, based on the market value of the stock on the measurement date.

4. Inventories

Inventories are summarized below (in thousands):

	September 30, 2005	December 31, 2004
Raw materials	\$ 95,005	\$ 73,558
Work-in-process	8,606	6,768
Finished goods	125,974	114,505
	<u>229,585</u>	<u>194,831</u>
Reserve for excess and obsolescence	(18,422)	(13,601)
Total inventories, net	<u>\$ 211,163</u>	<u>\$ 181,230</u>

5. Goodwill and Intangible Assets

The Company accounts for its goodwill and other non-amortizing intangible assets using SFAS No. 142, "Goodwill and Other Intangible Assets." Under SFAS No. 142, the Company's goodwill and certain intangible assets are not amortized throughout the period, but are subject to an annual impairment test. The following sets forth the intangible assets by major asset class (in thousands):

	Useful Life (Years)	September 30, 2005			December 31, 2004		
		Gross	Accumulated Amortization	Net Book Value	Gross	Accumulated Amortization	Net Book Value
Non-amortizing:							
Trade name, trademark and trade dress		\$ 121,794	\$ —	\$ 121,794	\$ 121,794	\$ —	\$ 121,794
Amortizing:							
Patents	3-16	34,046	10,552	23,494	35,307	9,787	25,520
Other	1-9	2,335	750	1,585	3,080	1,226	1,854
Total intangible assets		<u>\$ 158,175</u>	<u>\$ 11,302</u>	<u>\$ 146,873</u>	<u>\$ 160,181</u>	<u>\$ 11,013</u>	<u>\$ 149,168</u>

Intangible assets with definite lives are amortized using the straight-line method over periods ranging from 1-16 years. During the three months ended September 30, 2005 and 2004, aggregate amortization expense was approximately \$766,000 and \$705,000, respectively. During the nine months ended September 30, 2005 and

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

2004, aggregate amortization expense was approximately \$2,295,000 and \$2,470,000, respectively. Amortization expense related to intangible assets at September 30, 2005 in each of the next five fiscal years and beyond is expected to be incurred as follows (in thousands):

Remainder of 2005	\$ 690
2006	2,979
2007	2,990
2008	2,955
2009	2,766
2010	2,687
Thereafter	10,012
	<hr/>
	\$25,079
	<hr/>

Changes in goodwill during the three and nine months ended September 30, 2005 were due to foreign currency fluctuations.

6. Financing Arrangements

The Company's credit facility, which is scheduled to expire on November 5, 2009, provides for a revolving line of credit from Bank of America, N.A. and certain other lenders ("the Line of Credit"). The Line of Credit provides for revolving loans of up to \$250,000,000 (with the possible expansion of the Line of Credit to \$300,000,000 upon the satisfaction of certain conditions and the agreement of the lenders). Actual borrowing availability under the Line of Credit is effectively limited by the financial covenants set forth in the agreement governing the Line of Credit. The maximum available amount that could be borrowed under the Line of Credit at September 30, 2005 is approximately \$247,000,000. However, at September 30, 2005, the Company had no balance outstanding under the Line of Credit other than \$1,700,000 of issued Letters of Credit.

Under the Line of Credit, the Company is required to pay certain fees, including an unused commitment fee equal to 17.5 to 35.0 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 income taxes, depreciation and amortization ("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, at (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, and in either case, plus a margin of 00.0 to 75.0 basis points or (ii) the Eurodollar Rate (as defined in the agreement governing the Line of Credit) plus a margin of 75.0 to 200.0 basis points. The Company has agreed that repayment of amounts under the Line of Credit will be guaranteed by certain of the Company's domestic subsidiaries and will be secured by substantially all of the assets of the Company and guarantor subsidiaries. The collateral (other than 65% of the stock of the Company's foreign subsidiaries) could be released upon the satisfaction of certain financial conditions.

The agreement governing the Line of Credit requires the Company to maintain certain financial covenants, including a maximum leverage ratio, a minimum asset coverage ratio, a maximum capitalization ratio, a minimum interest coverage ratio and a minimum consolidated EBITDA. The agreement also includes certain other restrictions, including restrictions limiting additional indebtedness, dividends, stock repurchases, transactions with affiliates, capital expenditures, asset sales, acquisitions, mergers, liens and encumbrances and other restrictions. Additionally, the agreement contains other provisions, including affirmative covenants, representations and warranties and events of default. As of September 30, 2005, the Company was in compliance with the covenants and the terms of the Line of Credit agreement.

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The total origination fees incurred in connection with the Line of Credit were \$1,263,000 and are being amortized into interest expense over five years (the term of the Line of Credit agreement). The unamortized origination fees were \$1,032,000 as of September 30, 2005 and have been included in other assets in the accompanying consolidated balance sheet.

7. Product Warranty

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Beginning balance	\$13,232	\$13,468	\$12,043	\$12,627
Provision	3,284	2,123	9,278	9,270
Claims paid/costs incurred	(2,743)	(3,014)	(7,548)	(9,320)
Ending balance	<u>\$13,773</u>	<u>\$12,577</u>	<u>\$13,773</u>	<u>\$12,577</u>

8. Earnings Per Share

A reconciliation of the weighted-average shares used in the basic and diluted earnings per common share computations for the three and nine months ended September 30, 2005 and 2004 is presented below (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Weighted-average shares outstanding:				
Weighted-average shares outstanding — Basic	68,849	67,847	68,436	67,641
Dilutive securities	—	—	592	594
Weighted-average shares outstanding — Diluted	<u>68,849</u>	<u>67,847</u>	<u>69,028</u>	<u>68,235</u>

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 shares 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 in which a loss is reported. For the three months ended September 30, 2005 and 2004, options outstanding totaling 7,442,000 and 13,049,000 shares, respectively, were excluded from the calculations, as their effect would have been antidilutive. For the nine months ended September 30, 2005 and 2004, options outstanding totaling 8,320,000 and 9,634,000 shares, respectively, were excluded from the calculations, as their effect would have been antidilutive.

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

9. Commitments and Contingencies

Tax Matters

The Company is required to file federal and state tax returns in the United States and various other tax returns in foreign jurisdictions. The preparation of these 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 tax returns on interpretations that are believed to be reasonable under the circumstances. The tax returns, however, are subject to routine reviews by the various taxing authorities in the jurisdictions in which the Company files its returns. As part of these reviews, a taxing authority may disagree with respect to the interpretations the Company used to calculate its tax liability and therefore require the Company to pay additional taxes. As required under applicable accounting rules, the Company accrues an amount for its estimate of probable additional tax liability that it could incur as a result of the ultimate resolution of disagreements with the various taxing authorities. The Company believes that the tax contingency accrual is adequate to cover any such additional tax liability. The tax contingency accrual is recorded as a component of the Company's net income taxes payable/receivable balance, which the Company reviews and updates over time as more definitive information becomes available from taxing authorities, completion of tax audits or upon occurrence of other events. During the three and nine months ended September 30, 2005, the Company recorded net favorable adjustments of approximately \$1,100,000 and \$2,900,000, respectively, related to previously estimated tax liabilities as a result of its assessment and resolution of various tax exposures during 2005.

Legal Matters

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

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

In the fall of 1999, the Company adopted a unilateral sales policy called the "New Product Introduction Policy" ("NPPI"). The NPPI sets forth the basis on which the Company chooses to do business with its customers with respect to the introduction of new products. The NPPI has been the subject of several legal challenges. Currently pending cases, described below, include *Lundsford v. Callaway Golf*, Case No. 2001-24-IV, pending in Tennessee state court ("Lundsford I"); *Foulston v. Callaway Golf*, Case No. 02C3607, pending in Kansas state court; *Murray v. Callaway Golf Sales Company*, Case No. 3:04CV274-H, pending in the United States District Court for the Western District of North Carolina; and *Lundsford v. Callaway Golf*, Civil Action No. 3:04-cv-442, pending in the United States District Court for the Eastern District of Tennessee ("Lundsford II"). An adverse

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

resolution of the NPIP cases could have a significant adverse effect upon the Company's results of operations, cash flows and financial position.

Lundsford I was filed on April 6, 2001, and seeks to assert a putative class action by plaintiff on behalf of himself and on behalf of consumers in Tennessee and Kansas who purchased select Callaway Golf products covered by the NPIP on or after March 30, 2000. Plaintiff asserts violations of Tennessee and Kansas antitrust and consumer protection laws and is seeking damages, restitution and punitive damages. The court has not made any determination that the case may proceed in the form of a class action. In light of the subsequently filed Lundsford II case, the parties agreed to stay Lundsford I and to dismiss it without prejudice once the federal court proceedings in Lundsford II are underway. Subsequent to this agreement, plaintiff moved to reactivate Lundsford I and that motion is currently pending. No hearing date has been set on that motion.

In Foulston, filed on November 4, 2002, plaintiff seeks to assert an alleged class action on behalf of Kansas consumers who purchased Callaway Golf products covered by the NPIP and seeks damages and restitution for the alleged class under Kansas law. The trial court in Foulston stayed the case in light of Lundsford I. The Foulston court has not made any determination that the case may proceed in the form of a class action.

The complaint in Murray was filed on May 14, 2004, alleging that a retail golf business was damaged by the alleged refusal of Callaway Golf Sales Company to sell certain products after the store violated the NPIP, and by the failure to permit plaintiff to sell Callaway Golf products on the Internet. The proprietor seeks compensatory and punitive damages associated with the failure of his retail operation. Callaway Golf removed the case to the United States District Court for the Western District of North Carolina, and has answered the complaint denying liability. The parties are currently engaged in discovery and motion practice, and a trial date in December 2005 has been set by the court.

Lundsford II was filed on September 28, 2004 and the complaint asserts that the NPIP constitutes an unlawful resale price agreement and an attempt to monopolize golf club sales prohibited by federal antitrust law. The complaint also alleges a violation of the state antitrust laws of Tennessee, Kansas, South Carolina and Oklahoma. Lundsford II seeks to assert a nationwide class action consisting of all persons who purchased Callaway Golf clubs subject to the NPIP on or after March 30, 2000. Plaintiff seeks treble damages under the federal antitrust laws, compensatory damages under state law, and an injunction. The Lundsford II court determined on July 20, 2005 that the case may not proceed in the form of a class action. The court also denied plaintiff's motion for summary judgment. On September 22, 2005, the United States Court of Appeals for the Sixth Circuit denied plaintiff's request to file an interim appeal of the class certification issue. The plaintiff's request to the district court for permission to appeal the adverse ruling on the summary judgment ruling is pending. Trial has been set for the summer of 2006. The parties are engaged in discovery and motion practice.

On October 3, 2001, the Company filed suit in the United States District Court for the District of Delaware, Civil Action No. 01-669, against Dunlop Slazenger Group Americas, Inc., d/b/a Maxfli ("Maxfli"), for infringement of a golf ball aerodynamics patent owned by the Company, U.S. Patent No. 6,213,898 (the "Aerodynamics Patent"). The Company later amended its complaint to add a claim that Maxfli engaged in false advertising by claiming that its A10 golf balls were the "longest ball on tour." Maxfli answered the complaint denying patent infringement and false advertising, and also filed a counterclaim asserting that former Maxfli employees hired by the Company had disclosed confidential Maxfli trade secrets to the Company, and that the Company had used that information to enter the golf ball business. In the counterclaim, Maxfli sought compensatory damages of \$30,000,000; punitive damages equal to two times the compensatory damages; prejudgment interest; attorneys' fees; a declaratory judgment; and injunctive relief. On November 12, 2003,

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

pursuant to an agreement between the Company and Maxfli, the court dismissed the Company's claim for infringement of the Aerodynamics Patent. On May 13, 2004, the Court granted the Company's motion for summary judgment, eliminating a portion of Maxfli's counterclaim and reducing Maxfli's compensatory damages claim from approximately \$30,000,000 to \$18,500,000. The case was tried to a jury beginning on August 2, 2004. On August 12, 2004, the jury returned a verdict of \$2,200,000 in favor of the Company based upon its finding that Maxfli willfully engaged in false advertising. The jury also rejected Maxfli's counterclaim that the Company used any Maxfli trade secrets. Maxfli filed post-trial motions seeking to set aside the verdict and/or obtain a new trial. In post-trial motions, Callaway Golf is seeking attorneys' fees and prejudgment interest on its successful false advertising claim, while Maxfli is seeking attorneys' fees on the dismissal of the patent infringement claims filed by Callaway Golf. On August 25, 2005, the district court issued an opinion and order ruling on all post trial motions. The district court rejected Maxfli's motion for a new trial on the trade secret claim, and its request for attorneys' fees. Similarly, the court denied Callaway Golf's request for attorneys' fees and prejudgment interest. The court, however, granted Maxfli's request to reduce the jury's damages award to Callaway Golf from \$2,000,000 to \$1,100,000. Thereafter the parties resolved the matter on terms that are confidential. Settlement documentation has been executed by the parties, thereby concluding the matter.

The Company and its subsidiaries, incident to their business activities, are parties to a number of legal proceedings, lawsuits and other claims, including the matters specifically noted above. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. Consequently, management is unable to estimate the ultimate aggregate amount of monetary liability, amounts which may be covered by insurance, or the financial impact with respect to these matters. Except as discussed above with regard to the cases challenging the NPIP, 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

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

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 periodic review, in accordance with SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities."

The Company believes the Enron Contract has been terminated, and as of September 30, 2005, EESI has not asserted any claim against the Company. There can be no assurance, however, that EESI or another party will not assert a future claim against the Company or that a bankruptcy court or arbitrator will not ultimately nullify the Company's termination of the Enron Contract. No provision has been made for contingencies or obligations, if any, under the Enron Contract beyond November 30, 2001.

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Unconditional Purchase Obligations

During the normal course of 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 September 30, 2005, 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 \$113,653,000 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 September 30, 2005 are as follows:

	(In thousands)
2005	\$ 42,492
2006	28,019
2007	20,885
2008	17,231
2009	4,126
Thereafter	900
	<hr/>
	\$ 113,653

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 a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain workers' compensation insurance policies. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation on the maximum amount of future payments the Company could be obligated to make. Historically, costs incurred to settle claims related to indemnities have not been material to the Company's financial position, results of operations or cash flows. In addition, the Company believes the likelihood is remote that material payments will be required under the commitments and guarantees described above. The fair value of indemnities, commitments and guarantees that the Company issued during the three and nine months ended September 30, 2005 was not material to the Company's financial position, results of operations or cash flows.

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Employment Contracts

The Company has entered into employment contracts with each of the Company's officers. These contracts generally provide for severance benefits, including salary continuation, if employment is terminated by the Company for convenience or by the officer for substantial cause. In addition, in order to assure that the officers would continue to provide independent leadership consistent with the Company's best interests in the event of an actual or threatened change in control of the Company, the contracts also generally provide for certain protections in the event of such a change in control. These protections include the extension of employment contracts and the payment of certain severance benefits, including salary continuation, upon the termination of employment following a change in control. The Company is also obligated in most, but not all cases, to reimburse such officers for the amount of any excise taxes associated with such benefits.

10. Segment Information

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net sales				
Golf Clubs	\$ 170,227	\$ 87,329	\$ 663,424	\$ 602,396
Golf Balls	50,384	41,128	180,176	187,755
	<u>\$ 220,611</u>	<u>\$ 128,457</u>	<u>\$ 843,600</u>	<u>\$ 790,151</u>
Income (loss) before provision for income taxes(1)				
Golf Clubs(2)	\$ 8,685	\$ (50,118)	\$ 82,429	\$ 59,582
Golf Balls(3)	(7,700)	(5,173)	43	(3,064)
Reconciling items(4)	(9,743)	(6,921)	(34,910)	(32,078)
	<u>\$ (8,758)</u>	<u>\$ (62,212)</u>	<u>\$ 47,562</u>	<u>\$ 24,440</u>
Additions to long-lived assets				
Golf Clubs	\$ 2,868	\$ 3,518	\$ 12,614	\$ 9,631
Golf Balls	3,797	4,808	13,107	6,434
	<u>\$ 6,665</u>	<u>\$ 8,326</u>	<u>\$ 25,721</u>	<u>\$ 16,065</u>

- (1) Prior period amounts have been reclassified to conform with current period presentations as a result of changes in the current year allocation methods for certain selling, general and administrative and research and development expenses.
- (2) The Company's 2005 and 2004 income before provision for income taxes for Golf Clubs includes the recognition of integration charges in the amounts of approximately \$3,295,000 and \$1,883,000 for the three months ended September 30, 2005 and 2004, respectively, and \$4,665,000 and \$4,475,000 for the nine

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

months ended September 30, 2005 and 2004, respectively, related to the integration of the Callaway Golf and Top-Flite operations.

- (3) The Company's 2005 and 2004 income before provision for income taxes for Golf Balls includes the recognition of integration charges in the amounts of approximately \$3,747,000 and \$4,429,000 for the three months ended September 30, 2005 and 2004, respectively, and \$8,115,000 and \$13,387,000 for the nine months ended September 30, 2005 and 2004, respectively, related to the integration of the Callaway Golf and Top-Flite operations.
- (4) Represents corporate general and administrative expenses and other income (expense) not utilized by management in determining segment profitability. For the three months ended September 30, 2005, the reconciling items include the recognition of non-allocated integration and restructuring charges in the amounts of approximately \$247,000 and \$1,188,000, respectively. For the nine months ended September 30, 2005, the reconciling items include the recognition of non-allocated integration and restructuring charges in the amounts of approximately \$1,156,000 and \$1,188,000, respectively. For the three and nine months ended September 30, 2004, the reconciling items include the recognition of non-allocated integration charges of approximately \$1,156,000 and \$5,402,000, respectively.

11. Derivatives and Hedging

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

Foreign Currency Exchange Contracts

The Company 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 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 September 30, 2005 and 2004, the notional amounts of the Company's foreign exchange contracts were approximately \$70,154,000 and \$33,530,000, 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 September 30, 2005, the fair values of foreign currency-related derivatives were recorded as current assets of \$1,310,000 and current liabilities of \$824,000.

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

As of September 30, 2005 and 2004, there were no foreign exchange contracts designated as cash flow hedges. For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is initially recorded in accumulated other comprehensive income as a separate component of shareholders' equity and subsequently reclassified into earnings in the period during which the hedged transaction is recognized.

The ineffective portion of the gain or loss for derivative instruments that are designated and qualify as cash flow hedges is immediately reported as a component of other income (expense). For foreign currency contracts designated as cash flow hedges, hedge effectiveness is measured using the spot rate. Changes in the spot-forward differential are excluded from the test of hedging effectiveness and are recorded currently in earnings as a component of other income (expense). During the three and nine months ended September 30, 2005, no gain or loss was recorded as a result of changes in the spot-forward differential. During the three and nine months ended September 30, 2004, the Company recorded no gain or loss and a net loss of \$103,000, respectively, as a result of changes in the spot-forward differential. Assessments of hedge effectiveness are performed using the dollar offset method and applying a hedge effectiveness ratio between 80% and 125%. Given that both the hedged item and the hedging instrument are evaluated using the same spot rate, the Company anticipates the hedges to be highly effective. The effectiveness of each derivative is assessed quarterly.

At September 30, 2005 and 2004, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$70,154,000 and \$33,530,000, respectively. 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 period as the remeasurement gain and loss of the related foreign currency denominated assets and liabilities and thus offset these gains and losses. During the three months ended September 30, 2005 and 2004, the Company recorded net losses of \$363,000 and \$915,000, respectively, due to net realized and unrealized gains and losses on contracts used to manage balance sheet exposures that do not qualify for hedge accounting. During the nine months ended September 30, 2005 and 2004, the Company recorded a net gain of \$3,212,000 and a net loss of \$282,000, respectively, due to net realized and unrealized gains and losses on contracts used to hedge balance sheet exposures.

12. Comprehensive Income

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss)	\$(4,804)	\$(35,895)	\$31,948	\$18,365
Other comprehensive income:				
Foreign currency translation	(222)	1,152	(4,818)	(16)
Net unrealized gain (loss) on cash flow hedges, net of tax	(919)	470	(1,980)	3,781
Comprehensive income (loss)	\$(5,945)	\$(34,273)	\$25,150	\$22,130

CALLAWAY GOLF COMPANY
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

13. Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, “Accounting Changes and Error Corrections” (“SFAS 154”), which replaces APB Opinion No. 120, “Accounting Changes,” and SFAS No. 3, “Reporting Accounting Changes in Interim Financial Statements.” SFAS 154 changes the requirements for accounting and reporting a change in accounting principle, and applies to all voluntary changes in accounting principles, as well as changes required by an accounting pronouncement in the unusual instance it does not include specific transition provisions. Specifically, SFAS 154 requires retrospective application to prior periods’ financial statements, unless it is impracticable to determine the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the effects of the change, the new accounting principle must be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and a corresponding adjustment must be made to the opening balance of retained earnings for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of the change, the new principle must be applied as if it were adopted prospectively from the earliest date practicable. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. SFAS 154 does not change the transition provisions of any existing pronouncements. As of September 30, 2005, the Company has evaluated the impact of SFAS 154 and does not expect the adoption of this Statement to have a significant impact on its consolidated statement of income or financial condition. The Company will apply SFAS 154 in future periods, when applicable.

In December 2004, the FASB issued SFAS No. 123 (revised 2004) (“SFAS 123R”), “Share-Based Payment.” This statement replaces SFAS No. 123, “Accounting for Stock-Based Compensation,” and supersedes APB Opinion No. 25, “Accounting for Stock Issued to Employees.” SFAS 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise’s equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123R eliminates the ability to account for share-based compensation transactions using the intrinsic value method under APB Opinion No. 25, “Accounting for Stock Issued to Employees,” and generally would require instead that such transactions be accounted for using a fair-value-based method. The Company is currently evaluating SFAS 123R to determine which fair-value-based model and transitional provision it will follow upon adoption. SFAS 123R will be effective for the Company beginning in its first quarter of fiscal 2006. Although the Company will continue to evaluate the application of SFAS 123R, management expects adoption to have a material impact on its reported results of operations in amounts that are currently undeterminable.

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

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

Overview

The Company's sales continued to improve during the third quarter of 2005 as compared to the same period in 2004, primarily due to favorable consumer acceptance of the Company's products as well as new products launched during the quarter. Sales for the third quarter of 2005 increased 72% as compared to the third quarter of 2004, contributing to record sales for the first nine months of 2005. In addition, sales in the third quarter of 2004 were adversely affected by the Company's pricing discount programs implemented in mid-2004 to stimulate retail sales of certain of its products.

The Company's earnings for the third quarter of 2005 improved significantly to a loss of \$0.07 per diluted share compared to a loss of \$0.53 per diluted share for the third quarter of 2004. Despite this earnings improvement, the Company's earnings continue to be hampered by gross margin pressures and high operating expenses. As a result, on September 29, 2005, the Company announced the implementation of several company-wide initiatives designed to improve the Company's business processes and reduce the Company's overall expenses (the "2005 Restructuring Initiatives"). The cost of implementing these initiatives is expected to result in pre-tax charges of approximately \$12.0 million, \$6.2 million of which was recorded in the third quarter of 2005 and the balance of which is expected to be recorded in the fourth quarter of 2005 and in 2006. The Company is also in the process of undertaking other business improvement initiatives, including the review of manufacturing processes, automation opportunities and sourcing strategies in an effort to further improve its gross margins.

The 2005 Restructuring Initiatives are in addition to the previously reported integration charges associated with the integration of the Callaway Golf and Top-Flite operations ("Top-Flite Integration"). The Top-Flite Integration is nearing completion and all of the Company's golf balls are being manufactured at the Top-Flite facilities. During the nine months ended September 30, 2005, the Company recorded charges of \$9.3 million associated with the Top-Flite Integration. To date, the Company has recorded charges of \$62 million associated with the Top-Flite Integration. The Company expects to record additional charges of approximately \$4 million during the remainder of 2005 and early 2006 as it completes the integration.

The Company's sales in the fourth quarter are generally less than the other quarters because in many of the Company's key markets fewer people are playing golf due to cold weather. Also during the fourth quarter, the Company begins preparing for the start of the new golf season. These preparations include building of inventory for the new golf season. The Company expects to increase the amount of inventory that it has on hand as it enters the new golf season to avoid some of the supply shortages it experienced during 2005 with certain of its products.

Results of Operations

Three-Month Periods Ended September 30, 2005 and 2004

Net sales increased \$92.1 million (72%) to \$220.6 million for the three months ended September 30, 2005 as compared to \$128.5 million for the comparable period in the prior year. The overall increase in net sales was primarily due to a \$48.6 million (339%) increase in sales of woods, a \$24.0 million (66%) increase in sales of irons, a \$9.2 million (22%) increase in sales of golf balls, a \$6.8 million (44%) increase in sales of putters and a \$3.5 million (17%) increase in sales of accessories and other products. The overall increase in net sales during the quarter is generally attributable to favorable consumer acceptance of the Company's products as well as new product launches during the third quarter.

[Table of Contents](#)

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

	Three Months Ended September 30,		Growth/(Decline)	
	2005	2004	Dollars	Percent
Net sales:				
Woods	\$ 62.9	\$ 14.3	\$ 48.6	339%
Irons	60.3	36.3	24.0	66%
Putters	22.4	15.6	6.8	44%
Golf balls	50.4	41.2	9.2	22%
Accessories and other	24.6	21.1	3.5	17%
	<u>\$ 220.6</u>	<u>\$ 128.5</u>	<u>\$ 92.1</u>	<u>72%</u>

The \$48.6 million (339%) increase in net sales of woods to \$62.9 million for the three months ended September 30, 2005 is primarily attributable to an increase in sales volumes as well as to higher average selling prices in the third quarter of 2005 compared to the same period in the prior year. The increase in sales volumes is primarily due to the launch of a premium driver in the third quarter of 2005 as well as favorable consumer acceptance of the Company's current driver, fairway woods and hybrid products. The increase in average selling prices is primarily attributable to a more favorable mix of higher priced products and a reduction in pricing discount programs in the third quarter of 2005 compared to the same period in the prior year.

The \$24.0 million (66%) increase in net sales of irons to \$60.3 million for the three months ended September 30, 2005 resulted from higher sales volumes as well as higher average selling prices in the third quarter of 2005 compared to the same period in the prior year. The higher sales volume is primarily attributable to the Company offering more new irons models in its 2005 product line than its 2004 product line, including multi-material irons products which were not introduced until the fourth quarter of 2004. The increase in average selling prices is due to a shift in product mix to higher priced multi-material and steel irons products. These sales increases were partially offset by a decrease in sales of the Company's older irons products which were in the second and third years of their product life cycles.

The \$6.8 million (44%) increase in net sales of putters to \$22.4 million for the three months ended September 30, 2005 resulted from increased sales volumes as well as higher average selling prices in the third quarter of 2005 compared to the same period in the prior year. This increase in putter sales is primarily attributable to the current year introduction of the Odyssey White Steel putter models. These increases were partially offset by a decline in sales of older putter models.

The \$9.2 million (22%) increase in net sales of golf balls to \$50.4 million for the three months ended September 30, 2005 resulted from an increase in sales volumes as well as higher average selling prices in the third quarter of 2005 compared to the same period in the prior year. The increase in sales volumes is primarily attributable to an increase in Callaway Golf ball sales volumes partially offset by a decrease in Top-Flite golf ball sales volumes. The increase in average selling prices is due to a favorable shift in product mix to higher priced golf ball models.

The \$3.5 million (17%) increase in sales of accessories and other products to \$24.6 million is primarily attributable to an increase in royalty revenue from licensed merchandise and an increase in sales of Callaway Golf and Odyssey golf bags slightly offset by a decrease in sales of other accessories.

[Table of Contents](#)

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

	Three Months Ended September 30,		Growth/(Decline)	
	2005	2004	Dollars	Percent
Net sales:				
United States	\$ 119.1	\$ 71.4	\$ 47.7	67%
Europe	36.4	21.9	14.5	67%
Japan	25.7	10.1	15.6	154%
Rest of Asia	18.9	9.9	9.0	91%
Other foreign countries	20.5	15.2	5.3	35%
	<u>\$ 220.6</u>	<u>\$ 128.5</u>	<u>\$ 92.1</u>	<u>72%</u>

Net sales in the United States increased \$47.7 million (67%) to \$119.1 million during the third quarter of 2005 compared to the same period in the prior year. The Company's sales in regions outside of the United States increased \$44.4 million (78%) to \$101.5 million during the third quarter of 2005 compared to the same quarter in 2004. The overall increase in the United States and regions outside the United States is primarily attributable to favorable consumer acceptance of the Company's products as well as new product launches during the third quarter of 2005.

For the third quarter of 2005, gross profit increased \$60.8 million to \$86.9 million from \$26.1 million in the third quarter of 2004. Gross profit as a percentage of net sales increased to 39% in the third quarter of 2005 from 20% in the comparable period of 2004. This increase reflects an increase in gross profit as a percent of net sales in both the golf club and golf ball segments. These increases are primarily attributable to improved average selling prices (due to the Company having significantly less product discounting issues in 2005 compared to 2004) as well as a more favorable mix of products in the third quarter of 2005 compared to the prior year. This increase in gross profit was partially offset by charges of \$2.1 million related to the 2005 Restructuring Initiatives and \$1.2 million related to the integration of the Callaway Golf and Top-Flite operations. In the third quarter of 2004, gross profit was negatively affected by charges of \$4.8 million related to the integration of the Top-Flite operations.

Selling expenses increased \$11.4 million (20%) to \$69.7 million in the third quarter of 2005 as compared to \$58.3 million in the same period of 2004. As a percentage of sales, selling expenses decreased to 32% in the third quarter of 2005 from 45% in the third quarter of 2004. This dollar increase was primarily due to increases in tour and promotional expense of \$6.4 million and employee costs of \$2.8 million in the third quarter of 2005 compared to the same quarter in the prior year. The increase in tour and promotional expenses is primarily due to costs associated with brand investment, the timing of marketing expenses in support of new product launches and expenses associated with favorable tour player performance. The increase in employee costs is primarily attributable to charges of \$2.6 million related to employee termination benefits in connection with the 2005 Restructuring Initiatives.

General and administrative expenses decreased \$3.7 million (16%) in the third quarter of 2005 to \$19.5 million from \$23.2 million in the third quarter of 2004. As a percentage of sales, general and administrative expenses decreased to 9% in the third quarter of 2005 from 18% in the third quarter of 2004. The dollar decrease was primarily due to a decrease in employee costs as well as a decrease in legal expense. The decrease in employee costs was partially offset by charges of \$1.2 million related to employee termination benefits in connection with the 2005 Restructuring Initiatives.

Research and development expenses decreased \$0.8 million (9%) in the third quarter of 2005 to \$7.1 million from \$7.9 million in the comparable period of 2004. As a percentage of sales, research and development expenses decreased to 3% in the third quarter of 2005 from 6% in the comparable period of 2004. The dollar decrease was primarily due to lower employee costs in the third quarter of 2005 compared to the same period in the prior year.

[Table of Contents](#)

Other income decreased \$0.4 million in the third quarter of 2005 to \$0.7 million as compared to other income of \$1.1 million in the comparable period of 2004. The decrease in other income is primarily attributable to \$0.3 million of increased interest expense.

The income tax benefits reflect quarterly tax rates of 45% and 42% for the quarter ended September 30, 2005 and 2004, respectively. This increase in tax benefit as a percent of income (loss) before taxes is primarily attributable to net favorable adjustments of \$1.1 million during the third quarter of 2005 related to the reversal of previously estimated tax liabilities as a result of tax proceedings held during the quarter, and the receipt of a state refund claim in connection with research and development tax credits.

The net loss for the three months ended September 30, 2005 improved 87% to \$4.8 million from a net loss of \$35.9 million in the comparable period of 2004. The diluted loss per share improved to \$0.07 per share in the third quarter of 2005 compared to a loss of \$0.53 per share in the third quarter of 2004. Net income (loss) was negatively impacted by after-tax charges related to the 2005 Restructuring Initiatives and the integration of the Callaway Golf and Top-Flite operations in the amounts of \$3.9 million (\$0.06 per share) and \$1.4 million (\$0.02 per share), respectively, in the third quarter of 2005. Net income (loss) for the third quarter of 2004 was negatively impacted by after-tax charges related to the integration of the Callaway Golf and Top-Flite operations in the amount of \$4.4 million (\$0.07 per share).

Nine-Month Periods Ended September 30, 2005 and 2004

Net sales increased 7% to \$843.6 million for the nine months ended September 30, 2005 as compared to \$790.2 million for the comparable period in the prior year. The overall increase in net sales is primarily due to a \$60.1 million (27%) increase in sales of irons, combined with a \$6.5 million (8%) increase in the sale of putters and a \$10.1 million (12%) increase in sales of accessories and other products in the nine months ended September 30, 2005 as compared to the nine months ended September 30, 2004. These increases were partially offset by a \$15.7 million (7%) decrease in the sale of woods combined with a \$7.6 million (4%) decrease in the sale of golf balls. The overall increase in net sales during the first nine months of 2005 is generally attributable to favorable consumer acceptance of the Company's products.

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

	Nine Months Ended September 30,		Growth (Decline)	
	2005	2004	Dollars	Percent
Net sales:				
Woods	\$ 197.9	\$ 213.6	\$ (15.7)	(7)%
Irons	279.9	219.8	60.1	27%
Putters	88.2	81.7	6.5	8%
Golf balls	180.2	187.8	(7.6)	(4)%
Accessories and other	97.4	87.3	10.1	12%
	<u>\$ 843.6</u>	<u>\$ 790.2</u>	<u>\$ 53.4</u>	<u>7%</u>

The \$15.7 million (7%) decrease in net sales of woods to \$197.9 million for the nine months ended September 30, 2005 resulted from lower average selling prices on relatively flat sales volumes in 2005 compared to the same period in the prior year. The majority of this decrease in sales related to a decline in sales of the Company's multi-material driver products, steel fairway woods products and titanium fairway woods products, all of which were expected as the Company's products generally sell better in their first year after introduction and 2005 is the second year in the life cycle of these products. These decreases were partially offset by sales of the Company's new 2005 products, including new multi-material woods.

The \$60.1 million (27%) increase in net sales of irons to \$279.9 million for the nine months ended September 30, 2005 resulted from higher sales volumes as well as higher average selling prices in the first nine

[Table of Contents](#)

months of 2005 compared to the same period in the prior year. The increase in sales volumes is primarily attributable to the Company offering more new irons models in its 2005 product line than its 2004 product line, including multi-material irons products which were not introduced until the fourth quarter of 2004. The increase in average selling prices is due to a shift in product mix to higher priced multi-material and steel irons products. These sales increases were partially offset by a decrease in the Company's older irons products which were in the second and third years of their product life cycles.

The \$6.5 million (8%) increase in net sales of putters to \$88.2 million is attributable to the current year introduction of the Odyssey White Steel and Callaway Golf I-Trax putter models partially offset by decreased sales of the Company's older putter models which were in the second and third year of their product lifecycles.

The \$7.6 million (4%) decrease in net sales of golf balls to \$180.2 million resulted from decreased Top-Flite golf ball sales partially offset by an increase in Callaway Golf ball sales. The decrease in Top-Flite golf ball sales resulted from lower sales volumes and lower average selling prices. The decrease is due in part to the planned reduction in the number of Top-Flite golf ball models in the 2005 product line as a result of the Company's discontinuance of certain less profitable golf ball models. The increase in Callaway golf ball sales is primarily due to the expansion of the Callaway Golf ball product line as the result of the successful launch of two new Callaway Golf ball models during 2005.

The \$10.1 million (12%) increase in sales of accessories and other products to \$97.4 million is primarily attributable to an increase in sales of Top-Flite and Ben Hogan bags, gloves and other accessories combined with an increase in royalty revenue from licensed merchandise slightly offset by decreased sales of Callaway Golf bags and other accessories.

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

	Nine Months Ended September 30,		Growth (Decline)	
	2005	2004	Dollars	Percent
Net sales:				
United States	\$ 485.6	\$ 460.4	\$ 25.2	5%
Europe	144.1	146.9	(2.8)	(2)%
Japan	80.9	58.4	22.5	39%
Rest of Asia	52.6	43.1	9.5	22%
Other foreign countries	80.4	81.4	(1.0)	(1)%
	<u>\$ 843.6</u>	<u>\$ 790.2</u>	<u>\$ 53.4</u>	<u>7%</u>

Net sales in the United States increased \$25.2 million (5%) to \$485.6 million during the first nine months of 2005 compared to the same period in the prior year. In addition, the Company's sales in regions outside of the United States increased \$28.2 million (9%) to \$358.0 million during the first nine months of 2005 compared to the same period in 2004. The overall increase in international sales is primarily attributable to a \$22.5 million (39%) increase in sales in Japan combined with an \$8.5 million (7%) increase in sales in other foreign countries partially offset by a \$2.8 million (2%) decrease in sales in Europe. The decrease in sales in Europe was primarily attributable to the Company's failure to supply sufficient product to satisfy demand in that region during the first half of 2005 which was tempered by the increase in sales experienced during the third quarter of 2005. The Company's net sales were also positively affected by changes in foreign currency rates. See below, "Certain Factors Affecting Callaway Golf Company — Foreign Currency Risk."

For the nine months ended September 30, 2005, gross profit increased \$46.1 million to \$366.2 million from \$320.1 million in the comparable period of 2004. Gross profit as a percentage of net sales increased to 43% of net sales in the first nine months of 2005 from 41% in the comparable period of 2004. This increase reflects an increase in gross profit as a percent of net sales in both the golf club and golf ball segments. The overall increase

[Table of Contents](#)

in the gross profit as a percent of sales is primarily attributable to improved average club selling prices (due to the Company having significantly less product discounting issues in 2005 compared to 2004), favorable foreign currency exchange rate fluctuations and a more favorable mix of golf ball products in the first nine months of 2005 compared to the same period in the prior year. This increase in gross profit was partially offset by charges of \$5.6 million related to the integration of the Callaway Golf and Top-Flite operations and \$2.1 million related to the 2005 Restructuring Initiatives. In 2004, gross profit was negatively affected by charges of \$14.2 million related to the integration of the Callaway Golf and Top-Flite operations.

Selling expenses increased \$32.1 million (16%) in the first nine months of 2005 to \$236.1 million from \$204.0 million in the comparable period of 2004, and were 28% and 26% of net sales, respectively. This increase was primarily due to increases in advertising expense of \$8.2 million and tour and promotional expense of \$18.5 million in the first nine months of 2005 compared to the same period in the prior year. These increases were primarily due to costs associated with brand investment, increased marketing expenses in support of new product launches and expenses associated with favorable tour player performance.

General and administrative expenses decreased \$8.1 million (12%) in the first nine months of 2005 to \$59.9 million from \$67.9 million in the comparable period of 2004. As a percentage of sales, general and administrative expenses decreased to 7% in the first nine months of 2005 from 9% in the comparable period of 2004. This decrease was primarily due to a decline in employee costs of \$5.1 million as a result of a reduction in workforce during the first nine months of 2005 and a decrease in legal expense of \$5.0 million. The decrease in employee costs was partially offset by charges of \$1.2 million related to employee termination benefits in connection with the 2005 Restructuring Initiatives.

Research and development expenses decreased \$3.1 million (13%) in the first nine months of 2005 to \$20.4 million from \$23.5 million in the comparable period of 2004. As a percentage of sales, research and development expenses were 2% and 3% of net sales, respectively. The dollar decrease was primarily due to lower employee costs.

Other expense increased to \$2.3 million in the first nine months of 2005 compared to other expense of \$0.2 million in the comparable period of 2004. The \$2.1 million increase in other expense is primarily attributable to an increase of \$1.3 million in interest expense due to an increase in the average outstanding borrowings under the Company's line of credit in 2005 compared to the same period of the prior year. Additionally, net foreign currency losses increased \$1.3 million in the first nine months of 2005 compared to the same period in the prior year.

The income tax provisions reflect tax rates of 33% and 25% for the period ended September 30, 2005 and 2004, respectively. During the first nine months of 2005 and 2004, the Company recorded net favorable adjustments of \$2.9 million related to the reassessment and resolution of various tax exposures. The increase in income taxes as a percent of income before taxes was due to the fact that the 2004 adjustments had a larger impact on the income tax rate resulting from lower income before income taxes for the first nine months of 2004 compared to the first nine months of 2005. The final annual effective tax rate cannot be determined until the end of the fiscal year and the actual rate could differ from our current estimate.

Net income for the first nine months of 2005 increased \$13.6 million (74%) to \$31.9 million from \$18.4 million in the comparable period in 2004. Diluted earnings per share increased to \$0.46 for the first nine months of 2005 compared to \$0.27 in the comparable period in 2004. Net income was negatively impacted by after-tax charges related to the 2005 Restructuring Initiatives and the integration of the Callaway Golf and Top-Flite operations in the amounts of \$3.9 million (\$0.06 per share) and \$5.8 million (\$0.08 per share), respectively, in the first nine months of 2005. Net income for the first nine months of 2004 was negatively impacted by after-tax charges related to the integration of the Callaway Golf and Top-Flite operations in the amount of \$14.3 million (\$0.20 per share).

Financial Condition

Cash and cash equivalents increased \$22.9 million (72%) to \$54.6 million at September 30, 2005, from \$31.7 million at December 31, 2004. The increase in cash primarily resulted from cash provided by operating activities of \$58.9 million offset by cash used in investing activities of \$25.7 million and cash used in financing activities of \$9.2 million. Cash flows provided by operating activities for the nine months ended September 30, 2005, reflect net income of \$31.9 million, adjusted for depreciation and amortization of \$30.9 million, a \$20.5 million increase in accounts payable and accrued expenses, a \$38.6 million decrease in income taxes receivable, and a \$6.2 million increase in accrued employee compensation benefits. These cash inflows were partially offset by a \$40.4 million increase in net accounts receivable and a \$34.0 million increase in net inventories. Cash flows used in investing activities reflects capital expenditures of \$25.7 million during the first nine months of 2005. Cash flows used in financing activities are primarily attributable to an increase in net payment on the Company's line of credit in the amount of \$13.0 million partially offset by the issuance of common stock under employee benefit plans during the period. Additionally, during the nine months ended September 30, 2005, the Company declared three dividends totaling \$14.6 million in the aggregate. Of this amount, \$9.7 million was paid to shareholders and \$4.9 million was payable as of September 30, 2005.

As of September 30, 2005, the Company's net accounts receivable increased \$36.3 million to \$141.5 million from \$105.2 million at December 31, 2004. The increase in accounts receivable is the result of the general seasonality of the Company's business as compared to the fourth quarter of 2004. The Company's net accounts receivable increased \$26.7 million at September 30, 2005 as compared to the Company's net accounts receivable at September 30, 2004. This increase is primarily attributable to the increase in net sales, partially offset by more favorable collection terms in 2005 compared to the prior year. The Company's days sales outstanding ("DSO") were 59 days at September 30, 2005, compared to 67 days at December 31, 2004, and 81 days at September 30, 2004.

As of September 30, 2005, the Company's net inventory increased \$30.0 million to \$211.2 million from \$181.2 million at December 31, 2004. The Company's net inventory increased \$49.7 million as of September 30, 2005 as compared to the Company's net inventory as of September 30, 2004. This increase in inventory reflects additional products in the Company's 2005 product line and lower inventory in 2004 due to product compensation programs implemented in 2004 to stimulate retail sales. In addition, in 2005 the Company implemented a new supply chain methodology that had the unintended effect of limiting the Company's visibility of incoming products, resulting in additional inventory of a few current product lines. The Company has corrected these supply chain issues and believes the quality of inventory is good and that it will sell through normal channels. The Company expects additional increases in inventory during the fourth quarter of 2005 as it builds other new products for the 2006 golf season.

As of September 30, 2005, the Company's net property, plant and equipment decreased \$5.4 million to \$130.5 million from \$135.9 million at December 31, 2004. This decrease is primarily due to depreciation of \$28.6 million during the first nine months of 2005, partially offset by additions of \$25.7 million during the same period.

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. The Company's credit facility, which is scheduled to expire on November 5, 2009, provides for a revolving line of credit from Bank of America, N.A. and certain other lenders ("the Line of Credit"). The Line of Credit provides for revolving loans of up to \$250.0 million (with the possible expansion of the Line of Credit to \$300.0 million upon the satisfaction of certain conditions and the agreement of the lenders). Actual borrowing availability under the Line of Credit is effectively limited by the financial covenants set forth in the agreement governing the Line of Credit. At September 30, 2005, the maximum available amount that could be borrowed under the Line of Credit was approximately \$247.0 million. However, the Company had no balance outstanding under the Line of Credit other than \$1.7 million of issued Letters of Credit.

[Table of Contents](#)

Under the Line of Credit, the Company is required to pay certain fees, including an unused commitment fee equal to 17.5 to 35.0 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 income taxes, depreciation and amortization ("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, at (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, and in either case, plus a margin of 00.0 to 75.0 basis points or (ii) the Eurodollar Rate (as defined in the agreement governing the Line of Credit) plus a margin of 75.0 to 200.0 basis points. The Company has agreed that repayment of amounts under the Line of Credit will be guaranteed by certain of the Company's domestic subsidiaries and will be secured by substantially all of the assets of the Company and guarantor subsidiaries. The collateral (other than 65% of the stock of the Company's foreign subsidiaries) could be released upon the satisfaction of certain financial conditions.

The agreement governing the Line of Credit requires the Company to maintain certain financial covenants, including a maximum leverage ratio, a minimum asset coverage ratio, a maximum capitalization ratio, a minimum interest coverage ratio and a minimum consolidated EBITDA. The agreement also includes certain other restrictions, including restrictions limiting additional indebtedness, dividends, stock repurchases, transactions with affiliates, capital expenditures, asset sales, acquisitions, mergers, liens and encumbrances and other restrictions. Additionally, the agreement contains other provisions, including affirmative covenants, representations and warranties and events of default. As of September 30, 2005, the Company was in compliance with the covenants and the terms of the Line of Credit agreement.

The total origination fees incurred in connection with the Line of Credit were \$1.3 million and are being amortized into interest expense over five years (the term of the Line of Credit agreement). The unamortized origination fees were \$1.0 million as of September 30, 2005 and have been included in other assets in the accompanying consolidated balance sheet.

Share Repurchases

In May 2002, the Company announced that its Board of Directors authorized it to repurchase its Common Stock in the open market or in private transactions, subject to the Company's assessment of market conditions and buying opportunities from time to time, up to a maximum cost to the Company of \$50.0 million. During the third quarter of 2005, the Company did not repurchase any of its shares under the May 2002 authorization. (See Part II, Item 2. Unregistered Sales of Equity Securities and Use of Proceeds).

As of September 30, 2005, the Company is authorized to repurchase up to \$7.9 million of its Common Stock under the repurchase program announced in May 2002. The Company's repurchases of shares of Common Stock are recorded at cost in Common Stock held in treasury and result in a reduction of shareholders' equity.

Other Significant Cash and Contractual Obligations

The following table summarizes certain significant cash and contractual obligations as of September 30, 2005 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	\$ —	\$ —	\$ —	\$ —	\$ —
Operating leases(1)	12.4	5.1	5.4	1.2	0.7
Capital leases(2)	—	—	—	—	—
Unconditional purchase obligations(3)	113.6	42.5	48.9	21.3	0.9
Deferred compensation(4)	8.2	0.9	0.7	0.6	6.0
Total(5)	\$134.2	\$ 48.5	\$ 55.0	\$ 23.1	\$ 7.6

Table of Contents

- (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 non-cancelable operating leases.
- (2) The amounts presented in this line item represent commitments for minimum lease payments under non-cancelable capital leases.
- (3) During the normal course of 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 one year and are settled by cash payments upon delivery of goods and services and are not reflected in this line item.
- (4) The Company has an unfunded, non-qualified deferred compensation plan. The plan allows officers, certain other employees and directors of the Company to defer all or part of their compensation, to be paid to the participants or their designated beneficiaries after retirement, death or separation from the Company. To support the deferred compensation plan, the Company has elected to purchase Company-owned life insurance. The cash surrender value of the Company-owned insurance related to deferred compensation is included in other assets and was \$9.9 million at September 30, 2005.
- (5) During the third quarter of 2001, the Company entered into a derivative commodity instrument to manage electricity costs in the volatile California energy market. The contract was originally effective through May 2006. During the fourth quarter of 2001, the Company notified the energy supplier that, among other things, the energy supplier was in default of the energy supply contract and that based upon such default, and for other reasons, the Company was terminating the energy supply contract. The Company continues to reflect the \$19.9 million derivative valuation account on its balance sheet, subject to periodic review, in accordance with SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." The \$19.9 million represents unrealized losses resulting from changes in the estimated fair value of the contract and does not represent contractual cash obligations. The Company believes the energy supply contract has been terminated, and therefore, the Company does not have any further cash obligations under the contract. Accordingly, the energy derivative valuation account is not included in the table. There can be no assurance, however, that a party will not assert a future claim against the Company or that a bankruptcy court or arbitrator will not ultimately nullify the Company's termination of the contract. No provision has been made for contingencies or obligations, if any, under the contract beyond November 2001. See Note 9 — "Supply of Electricity and Energy Contracts."

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 several employees providing for severance payments upon the occurrence of certain

[Table of Contents](#)

prescribed events. The Company also has several consulting agreements that provide for payment of nominal fees upon the issuance of patents and/or the commercialization of research results. The Company has also issued a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain workers' compensation insurance policies. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation on the maximum amount of future payments the Company could be obligated to make. Historically, costs incurred to settle claims related to indemnities have not been material to the Company's financial position, results of operations or cash flows. In addition, the Company believes the likelihood is remote that material payments will be required under the commitments and guarantees described above. The fair value of indemnities, commitments and guarantees that the Company issued during the three and nine months ended September 30, 2005 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 below "Part II, Item 1 — Legal Proceedings."

Sufficiency of Liquidity

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

Capital Resources

The Company does not currently have any material commitments for capital expenditures. The Company expects to have capital expenditures of approximately \$30 to \$35 million for the year ended December 31, 2005.

Off-Balance-Sheet Arrangements

The Company does not currently have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance-sheet arrangements or other contractually narrow or limited purposes.

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 of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may materially differ from these estimates under different assumptions or conditions. On an on-going basis, the Company reviews its estimates to ensure that the estimates appropriately reflect changes in its business or as new information becomes available.

[Table of Contents](#)

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

Revenue Recognition

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

Allowance for Doubtful Accounts

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

Inventories

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

Long-Lived Assets

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

Warranty

The Company has a stated two-year warranty policy for its Callaway Golf clubs, although the Company's historical practice has been to honor warranty claims well after the two-year stated warranty period. The Company's policy is to accrue the estimated cost of satisfying future warranty claims at the time the sale is recorded. In estimating its future warranty obligations, the Company considers various relevant factors, including

[Table of Contents](#)

the Company's stated warranty policies and practices, the historical frequency of claims, and the cost to replace or repair its products under warranty. If the number of actual warranty claims or the cost of satisfying warranty claims significantly exceeds the estimated warranty reserve, the Company's cost of sales, gross profit and net income would be significantly adversely affected.

Income Taxes

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

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.

Market Acceptance of Products

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

New Product Introduction and Product Cyclicity

The Company believes that the introduction of new, innovative golf clubs and golf balls is important to its future success. A major portion of the Company's revenues is generated by products that are less than two years

old. The Company faces certain risks associated with such a strategy. For example, in the golf industry, new models and basic design changes in golf equipment are frequently met with consumer rejection. In addition, prior successful designs have been rendered obsolete within a relatively short period of time as new products are introduced into the marketplace. Further, any new products that retail at a lower price than prior products may negatively impact the Company's revenues unless unit sales increase. The rapid introduction of new golf club or golf ball products by the Company has resulted in closeouts of existing inventories at both the wholesale and retail levels. Such closeouts have resulted in reduced margins on the sale of older products, as well as reduced sales of new products, given the availability of older products at lower prices.

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

Manufacturing Capacity

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, this could result in less than optimum capacity usage and/or in excess inventories and related obsolescence charges that could adversely affect the Company's financial performance.

Dependence on Certain Suppliers and Materials

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

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

[Table of Contents](#)

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

Dependence on Energy Resources

The Company’s golf club and golf ball manufacturing facilities in California use, among other resources, significant quantities of electricity to operate. In 2001, some companies in California, including the Company, experienced periods of blackouts during which electricity was not available. If the Company were to experience such blackouts again, there is no assurance that it would be able to obtain alternative power supplies at reasonable prices. 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.

Competition

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

Golf Balls. The golf ball business is also highly competitive. 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.

On a consolidated basis, no one customer that distributes the Company’s golf clubs or balls in the United States accounted for more than 3% and 4% of the Company’s revenue during the first nine months ended September 30, 2005 and 2004, respectively. On a segment basis, the Company’s golf ball customer base is much more concentrated than its golf club customer base. In the first nine months of 2005, the top five golf ball customers accounted for approximately 16% of the Company’s total golf ball sales. A loss of one or more of these customers could have a significant adverse effect upon the Company’s golf ball sales.

Adverse Global Economic Conditions

The Company sells golf clubs, golf balls and golf accessories. These products are recreational in nature and are therefore discretionary purchases for consumers. Consumers are generally more willing to make discretionary purchases of golf products during favorable economic conditions and when consumers are feeling confident and

[Table of Contents](#)

prosperous. Adverse economic conditions in the United States or in the Company's international markets (which represent almost half of the Company's total sales), or a decrease in prosperity among consumers, or even a decrease in consumer confidence as a result of anticipated adverse economic conditions, could cause consumers to forgo or to postpone purchasing new golf products, which could have a material adverse effect upon the Company.

Terrorist Activity and Armed Conflict

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

Natural Disasters and Pandemic Diseases

The occurrence of a natural disaster, such as an earthquake or hurricane, or the outbreak of a pandemic disease, such as Severe Acute Respiratory Syndrome ("SARS") or the Avian Flu, could significantly adversely affect the Company's business. A 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 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.

Foreign Currency Risk

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

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 reduce, but do not 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 they also reduce the positive impact of a weaker U.S. dollar. For the effect of the Company's hedging activities during the current reporting periods, see below

[Table of Contents](#)

“Quantitative and Qualitative Disclosures about Market Risk.” 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.

In addition, 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.

Growth Opportunities

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 golf club sales and the Company’s golf ball products achieved the number two retail market share in 2004. Therefore, opportunities for additional market share may be limited. The Company does not believe there has been any material increase in the number of golfers worldwide in over four years. Furthermore, the Company believes that overall worldwide golf club sales have generally not experienced substantial growth in the past several years. There is no assurance that the overall dollar volume of worldwide golf club or ball sales will grow, or that it will not decline, in the future.

Seasonality and Adverse Weather Conditions

In addition to the effects of product cycles described above, the Company’s business is also subject to the effects of seasonal fluctuations. The Company’s first quarter sales generally represent the Company’s sell-in to the golf retail channel of its golf club products for the new golf season. Orders for many of these sales are received during the fourth quarter of the prior year. The Company’s second and third quarter sales generally represent re-order business for golf clubs. Sales of golf clubs during the second and third quarters are significantly affected not only by the sell-through of the Company’s products that were sold into the channel during the first quarter but also by the sell-through of the products of the Company’s competitors. Retailers are sometimes reluctant to re-order the Company’s products in significant quantity when they already have excess inventory of the Company’s or its competitors’ products. The Company’s sales 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 general in many of the Company’s principal markets less people are playing golf during that time of year due to cold weather. Furthermore, it previously was the Company’s practice to announce its new product line at the beginning of each calendar year. 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 deferrals could have a material adverse effect upon sales of the Company’s current products and/or result in close out sales at reduced prices.

Because of these seasonal trends, the Company’s business can be significantly adversely affected by unusual or severe weather conditions. Unfavorable weather conditions generally result in less golf rounds played, which generally results in less demand for golf clubs and golf balls. Furthermore, catastrophic storms can negatively affect golf rounds played not only during the storms but also for a significant period of time afterward as storm

[Table of Contents](#)

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.

Conformance with the Rules of Golf

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

The Rules of Golf as published by the R&A and the USGA are virtually the same except with respect to the regulation of "driving clubs." The R&A rules currently permit driver clubheads with greater flexibility (as measured by a specific test) than are permitted under the USGA rules. As a result, in jurisdictions where the R&A rules are followed, the Company (like many of its competitors) has marketed and sold drivers that conform to the R&A rules but not the USGA rules (the "Plus Drivers"). In those jurisdictions where the USGA rules are followed, the Company markets and sells its standard drivers that conform to both the R&A and the USGA rules. All of the Company's other products are believed to conform to both the USGA and R&A rules.

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

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

Golf Professional Endorsements

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

The Company believes that professional usage of its golf clubs and golf balls contributes to retail sales. The Company therefore spends a significant amount of money to secure professional usage of its products. Many other companies, however, also aggressively seek the patronage of these professionals and offer many inducements, including significant cash rewards and specially designed products. There is a great deal of competition to secure the representation of tour professionals. As a result, it is becoming increasingly difficult

[Table of Contents](#)

and more expensive to attract and retain such tour professionals. The inducements offered by other companies could result in a decrease in usage of the Company's products by professional golfers or limit the Company's ability to attract other tour professionals. A decline in the level of professional usage of the Company's products could have a material adverse effect on the Company's sales and business.

Intellectual Property and Proprietary Rights

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

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

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

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

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

Brand Licensing

The Company licenses its trademarks to third party licensees who produce, market and sell their products bearing the Company's trademarks. The Company chooses its licensees carefully and imposes upon such

[Table of Contents](#)

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 brand could be damaged by the use or misuse of the Company's trademarks in connection with its licensees' products.

Product Returns

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

The Company monitors the level and nature of any golf club breakage and, where appropriate, seeks to incorporate design and production changes to assure its customers of the highest quality available in the market. Significant increases in the incidence of breakage or other product problems may adversely affect the Company's sales and image with golfers. The Company believes that it has adequate reserves for warranty claims. If the Company were to experience an unusually high incidence of breakage or other warranty problems in excess of these reserves, the Company's financial results would be adversely affected. See above, "Critical Accounting Policies and Estimates — Warranty."

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

"Gray Market" Distribution

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

International Risks

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

As a result of this international business, the Company is exposed to increased risks inherent in conducting business outside of the United States. In addition to foreign currency risks, these risks include (i) increased

[Table of Contents](#)

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

Credit Risk

The Company primarily sells its products to golf equipment retailers directly and through wholly owned domestic and foreign subsidiaries, and to foreign distributors. The Company performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral from these customers. Historically, the Company's bad debt expense has been low. However, a downturn in the retail golf equipment market could result in increased delinquent or 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.

Information Systems

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

Change in Accounting Rules

The Company currently and historically has accounted for its stock-based compensation under Accounting Principles Board Opinion No. 25 ("APB No. 25"). Under APB No. 25, the Company is not required to record compensation expense for equity-based awards granted to employees. The Financial Accounting Standards Board recently issued SFAS No. 123R, which requires the Company to begin recording compensation expense for such awards based upon the fair value of such awards for the first fiscal year beginning after January 1, 2006. Such non-cash compensation expense is anticipated to have a significant adverse effect upon the Company's reported earnings.

Although the Company has historically provided in the notes to its financial statements pro forma earnings information showing what the Company's results would have been had the Company been recording compensation expense for such awards, the amount of such expense was not reflected in its financial results. Consequently, when the Company begins recording such compensation expense in 2006, the period over period comparisons will be significantly affected by the inclusion of such expense in 2006 and the absence of such expense from 2005 and prior periods. If investors do not appropriately consider these changes in accounting rules, the price at which the Company's stock is traded could be significantly adversely affected. Had this

[Table of Contents](#)

accounting standard been in effect during the nine months ended September 30, 2005, the Company's net income and diluted earnings per share would have decreased by \$3.5 million and \$0.05, respectively. The Company will incur additional expense during 2006 related to new awards granted during the remainder of 2005 and 2006 that cannot yet be quantified. The Company is in the process of determining how the guidance regarding valuing share-based compensation as prescribed in FAS 123R will be applied to valuing share-based awards granted after the effective date and the impact that the recognition of compensation expense related to such awards will have on its financial statements.

Analyst Guidance, Media Reports and Market Volatility

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

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

The Company may from time to time provide investors with estimates of anticipated revenues and earnings per share. If the Company provides such estimates, they will be based upon the information available and management's expectations at the time such estimates are made and actual results could differ materially. See "Important Notice to Investors" on the inside cover of this report.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company uses derivative financial instruments for hedging purposes to limit its exposure to changes in foreign exchange rates. Transactions involving these financial instruments are with credit worthy firms. The use of these instruments exposes the Company to market and credit risk which may at times be concentrated with certain counterparties, although counterparty nonperformance is not anticipated. The Company is also exposed to interest rate risk from its credit facility.

Foreign Currency Fluctuations

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

[Table of Contents](#)

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

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

As of September 30, 2005 and 2004, the notional amounts of the Company's foreign exchange contracts were approximately \$70.2 million and \$33.5 million, respectively. The Company estimates the fair values of derivatives based on quoted market prices or pricing models using current market rates, and records all derivatives on the balance sheet at fair value. At September 30, 2005, the fair value of foreign currency-related derivatives was recorded as current assets of \$1.3 million and current liabilities of \$0.8 million.

As of September 30, 2005 and 2004, there were no foreign exchange contracts designated as cash flow hedges. For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is initially recorded in accumulated other comprehensive income as a separate component of shareholders' equity and subsequently reclassified into earnings in the period during which the hedged transaction is recognized.

The ineffective portion of the gain or loss for derivative instruments that are designated and qualify as cash flow hedges is immediately reported as a component of other income (expense), net. For foreign currency contracts designated as cash flow hedges, hedge effectiveness is measured using the spot rate. Changes in the spot-forward differential are excluded from the test of hedging effectiveness and are recorded currently in earnings as a component of other income (expense), net. During the three and nine months ended September 30, 2005, no gain or loss was recorded as a result of changes in the spot-forward differential. During the nine months ended September 30, 2004, the Company recorded a net loss of \$0.1 million, as a result of changes in the spot-forward differential. Assessments of hedge effectiveness are performed using the dollar offset method and applying a hedge effectiveness ratio between 80% and 125%. Given that both the hedged item and the hedging instrument are evaluated using the same spot rate, the Company anticipates the hedges to be highly effective. The effectiveness of each derivative is assessed quarterly.

At September 30, 2005 and 2004, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$70.2 million and \$33.5 million, respectively. The gains and losses on foreign currency contracts used to hedge balance sheet exposures are recognized as a component of other income (expense), net in the same period as the remeasurement gain and loss of the related foreign currency denominated assets and liabilities and thus offset these gains and losses. During the three

[Table of Contents](#)

months ended September 30, 2005 and 2004, the Company recorded a net loss of \$0.4 million and a net loss of \$0.9 million, respectively, due to net realized and unrealized gains and losses on contracts used to hedge balance sheet exposures. During the nine months ended September 30, 2005 and 2004, the Company recorded a net gain of \$3.2 million and a net loss of \$0.3 million respectively, on contracts used to hedge balance sheet exposures.

Sensitivity analysis is the measurement of potential loss in future earnings of market sensitive instruments resulting from one or more selected hypothetical changes in interest rates or foreign currency values. The Company used a sensitivity analysis model to quantify the estimated potential effect of unfavorable movements of 10% in foreign currencies to which the Company was exposed at September 30, 2005 through its derivative financial instruments.

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

The estimated maximum one-day loss from the Company's foreign-currency derivative financial instruments, calculated using the sensitivity analysis model described above, is \$7.3 million at September 30, 2005. 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 \$7.3 million at September 30, 2005 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.

Interest Rate Fluctuations

Additionally, the Company is exposed to interest rate risk from its Line of Credit (see Note 6 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 of EBITDA, at (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, and in either case less a margin of 00.0 to 75.0 basis points or (ii) the Eurodollar Rate (as such term is defined in the agreement governing the Line of Credit) plus a margin of 75.0 to 200.0 basis points.

Note 6 to the Company's Consolidated Condensed Financial Statements outlines the principal amounts, if any, and other terms required to evaluate the expected cash flows and sensitivity to interest rate changes.

Item 4. Controls and Procedures

Disclosure Controls and Procedures. As of September 30, 2005, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information required to be included in the Company's periodic filings with the Securities and Exchange Commission.

Changes in Internal Control over Financial Reporting. During the quarter ended September 30, 2005, there were no changes in the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

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

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

In the fall of 1999, the Company adopted a unilateral sales policy called the "New Product Introduction Policy" ("NPIP"). The NPIP sets forth the terms on which the Company chooses to do business with its customers with respect to the introduction of new products. The NPIP has been the subject of several legal challenges. Currently pending cases, described below, include *Lundsford v. Callaway Golf*, Case No. 2001-24-IV, pending in Tennessee state court ("Lundsford I"); *Foulston v. Callaway Golf*, Case No. 02C3607, pending in Kansas state court; *Murray v. Callaway Golf Sales Company*, Case No. 3:04CV274-H, pending in the United States District Court for the Western District of North Carolina; and *Lundsford v. Callaway Golf*, Civil Action No. 3:04-cv-442, pending in the United States District Court for the Eastern District of Tennessee ("Lundsford II"). An adverse resolution of the NPIP cases could have a significant adverse effect upon the Company's results of operations, cash flows and financial position.

Lundsford I was filed on April 6, 2001, and seeks to assert a putative class action by plaintiff on behalf of himself and on behalf of consumers in Tennessee and Kansas who purchased select Callaway Golf products covered by the NPIP on or after March 30, 2000. Plaintiff asserts violations of Tennessee and Kansas antitrust and consumer protection laws and is seeking damages, restitution and punitive damages. The court has not made any determination that the case may proceed in the form of a class action. In light of the subsequently filed *Lundsford II* case, the parties agreed to stay *Lundsford I* and to dismiss it without prejudice once the federal court proceedings in *Lundsford II* are underway. Subsequent to this agreement, plaintiff moved to reactivate *Lundsford I* and that motion is currently pending. No hearing date has been set on that motion.

In *Foulston*, filed on November 4, 2002, plaintiff seeks to assert an alleged class action on behalf of Kansas consumers who purchased Callaway Golf products covered by the NPIP and seeks damages and restitution for the alleged class under Kansas law. The trial court in *Foulston* stayed the case in light of *Lundsford I*. The *Foulston* court has not made any determination that the case may proceed in the form of a class action.

The complaint in *Murray* was filed on May 14, 2004, alleging that a retail golf business was damaged by the alleged refusal of Callaway Golf Sales Company to sell certain products after the store violated the NPIP, and by the failure to permit plaintiff to sell Callaway Golf products on the Internet. The proprietor seeks compensatory and punitive damages associated with the failure of his retail operation. Callaway Golf removed the case to the United States District Court for the Western District of North Carolina, and has answered the complaint denying liability. The parties are currently engaged in discovery and motion practice and a trial date in December 2005 has been set by the court.

[Table of Contents](#)

Lundsford II was filed on September 28, 2004 and the complaint asserts that the NPIP constitutes an unlawful resale price agreement and an attempt to monopolize golf club sales prohibited by federal antitrust law. The complaint also alleges a violation of the state antitrust laws of Tennessee, Kansas, South Carolina and Oklahoma. Lundsford II seeks to assert a nationwide class action consisting of all persons who purchased Callaway Golf clubs subject to the NPIP on or after March 30, 2000. Plaintiff seeks treble damages under the federal antitrust laws, compensatory damages under state law, and an injunction. The Lundsford II court determined on July 20, 2005 that the case may not proceed in the form of a class action. The court also denied plaintiff's motion for summary judgment. On September 22, 2005, the United States Court of Appeals for the Sixth Circuit denied plaintiff's request to file an interim appeal of the class certification issue. The plaintiff's request to the district court for permission to appeal the adverse ruling on the summary judgment ruling is pending. Trial has been set for the summer of 2006. The parties are engaged in discovery and motion practice.

On October 3, 2001, the Company filed suit in the United States District Court for the District of Delaware, Civil Action No. 01-669, against Dunlop Slazenger Group Americas, Inc., d/b/a Maxfli ("Maxfli"), for infringement of a golf ball aerodynamics patent owned by the Company, U.S. Patent No. 6,213,898 (the "Aerodynamics Patent"). The Company later amended its complaint to add a claim that Maxfli engaged in false advertising by claiming that its A10 golf balls were the "longest ball on tour." Maxfli answered the complaint denying patent infringement and false advertising, and also filed a counterclaim asserting that former Maxfli employees hired by the Company had disclosed confidential Maxfli trade secrets to the Company, and that the Company had used that information to enter the golf ball business. In the counterclaim, Maxfli sought compensatory damages of \$30,000,000; punitive damages equal to two times the compensatory damages; prejudgment interest; attorneys' fees; a declaratory judgment; and injunctive relief. On November 12, 2003, pursuant to an agreement between the Company and Maxfli, the court dismissed the Company's claim for infringement of the Aerodynamics Patent. On May 13, 2004, the Court granted the Company's motion for summary judgment, eliminating a portion of Maxfli's counterclaim and reducing Maxfli's compensatory damages claim from approximately \$30,000,000 to \$18,500,000. The case was tried to a jury beginning on August 2, 2004. On August 12, 2004, the jury returned a verdict of \$2,200,000 in favor of the Company based upon its finding that Maxfli willfully engaged in false advertising. The jury also rejected Maxfli's counterclaim that the Company used any Maxfli trade secrets. Maxfli filed post-trial motions seeking to set aside the verdict and/or obtain a new trial. In post-trial motions, Callaway Golf is seeking attorneys' fees and prejudgment interest on its successful false advertising claim, while Maxfli is seeking attorneys' fees on the dismissal of the patent infringement claims filed by Callaway Golf. On August 25, 2005, the district court issued an opinion and order ruling on all post trial motions. The district court rejected Maxfli's motion for a new trial on the trade secret claim, and its request for attorneys' fees. Similarly, the court denied Callaway Golf's request for attorneys' fees and prejudgment interest. The court, however, granted Maxfli's request to reduce the jury's damages award to Callaway Golf from \$2.2 million to \$1.1 million. Thereafter the parties resolved the matter on terms that are confidential. Settlement documentation has been executed by the parties thereby concluding the matter.

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

Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds*

In May 2002, the Company announced that its Board of Directors authorized it to repurchase its Common Stock in the open market or in private transactions, subject to the Company's assessment of market conditions and buying opportunities from time to time, up to a maximum cost to the Company of \$50.0 million. During the

[Table of Contents](#)

third quarter of 2005, the Company did not repurchase any of its shares under the May 2002 authorization. During the nine months ended September 30, 2005, the Company reacquired 3,000 shares of its Common Stock through the withholding of shares in satisfaction of employee tax obligations in connection with the vesting of employee restricted stock awards.

As of September 30, 2005, the Company is authorized to repurchase up to \$7.9 million of its Common Stock under the repurchase program announced in May 2002. The Company's repurchases of shares of Common Stock are recorded at cost in Common Stock held in treasury and result in a reduction of shareholders' equity.

Item 3. *Defaults upon Senior Securities*

None

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

None

Item 5. *Other Information*

None

[Table of Contents](#)

Item 6. Exhibits

- 3.1 Certificate of Incorporation, incorporated herein by this reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, as filed with the Securities and Exchange Commission ("Commission") on July 1, 1999 (file no. 1-10962).
- 3.2 Third Amended and Restated Bylaws, as amended and restated as of December 3, 2003, incorporated herein by this reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the Commission on March 15, 2004 (file no. 1-10962).
- 4.1 Dividend Reinvestment and Stock Purchase Plan, incorporated herein by this reference to the Prospectus in the Company's Registration Statement on Form S-3, as filed with the Commission on March 29, 1994 (file no. 33-77024).
- 10.58 Restricted Stock Grant agreement, effective August 1, 2005, between the Company and George Fellows.†
- 10.59 Notice of Grant of Stock Option and Option Agreement, effective August 1, 2005, between the Company and George Fellows.†
- 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 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 with this Report.

SIGNATURES

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

CALLAWAY GOLF COMPANY

By: _____ /s/ BRADLEY J. HOLIDAY

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

Date: October 27, 2005

EXHIBIT INDEX

<u>Exhibit</u>	<u>Description</u>
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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.

Callaway Golf Company
Restricted Stock Grant

<i>Recipient:</i>	George Fellows
<i>Effective Grant Date:</i>	August 1, 2005
<i>Number of Shares:</i>	160,000 shares
<i>Plan:</i>	2004 Equity Incentive Plan

CALLAWAY GOLF COMPANY, a Delaware corporation (the “**Company**”), has elected to grant to you, the Recipient named above, an award of stock subject to the restrictions and on the terms and conditions set forth below. Terms not otherwise defined in this Restricted Stock Grant will have the meanings ascribed to them in the Plan identified above (the “**Plan**”).

1. **Governing Plan.** The Recipient hereby acknowledges receipt of a copy of the Plan and a Prospectus for the Plan (the “**Plan Prospectus**”). This Restricted Stock Grant is subject in all respects to the applicable provisions of the Plan, which are incorporated herein by this reference. In the case of any conflict between the provisions of the Plan and this Restricted Stock Grant, the provisions of the Plan will control.
2. **Grant of Restricted Stock.** Effective as of the Effective Grant Date identified above, the Company has granted and issued to the Recipient the Number of Shares of the Company’s Common Stock identified above (the “**Restricted Stock**”), subject to the terms, conditions and restrictions set forth in this Restricted Stock Grant.
3. **Restrictions on the Granted Stock.** The Restricted Stock is subject to the following restrictions:
 - (a) **No Transfer.** The shares of Restricted Stock may not be sold, assigned, transferred, pledged, hypothecated or otherwise disposed of or encumbered until the restrictions set forth in this paragraph lapse or expire as provided in paragraph 4, and any additional requirements or restrictions contained in this Restricted Stock Grant have been satisfied, terminated or waived by the Company in writing.
 - (b) **Cancellation of Unvested Shares.** In the event Recipient ceases to be an employee of the Company or its subsidiary for any reason before the restrictions set forth in this paragraph have lapsed or expired as provided in paragraph 4, the Company will cancel and void all shares of Restricted Stock for which such restrictions have not lapsed or expired (i.e. unvested shares); *provided, however*, that the Board of Directors or its designee may, in its discretion, determine not to cancel and void all or part of such unvested shares, in which case the Board of Directors or designee may impose whatever conditions it considers appropriate on any shares that are not cancelled or voided.
 - (c) **Certificate.** The certificate(s) representing the Restricted Stock will remain in the physical custody of the Company or its designated agent until the restrictions set forth in this paragraph lapse or expire as provided in paragraph 4, and any additional requirements or restrictions contained in this Restricted Stock Grant have been satisfied, terminated or expressly waived by the Company in writing. Notwithstanding the foregoing, the Company may elect to maintain the shares in book-entry form with its transfer agent unless and until the Company is required to deliver the certificates hereunder.
 - (d) **Restrictive Legend.** The certificate(s) representing the Restricted Stock may bear a legend making reference to any restrictions (or other terms and conditions) imposed by this Restricted Stock Grant as the Company deems necessary or appropriate to enforce such restrictions (or other terms and conditions).

4. **Lapse of Restrictions.** The restrictions imposed under paragraph 3 will lapse and expire, and the shares of Restricted Stock will vest, in accordance with the following:

- (a) **Vesting Schedule.** Subject to earlier cancellation, and subject to the accelerated vesting provisions, if any, set forth in any employment agreement between Recipient and the Company or its subsidiary, as the same may be amended, modified, extended or renewed from time to time, the restrictions imposed under paragraph 3 will lapse and be removed with respect to the number of shares of Restricted Stock set forth below in accordance with the vesting schedule set forth below (the “**Vesting Schedule**”):

<u>Number of Shares</u>	<u>Date Restrictions Lapse</u>
160,000 shares	December 31, 2008

The Board of Directors or its designee, however, may, in its discretion, accelerate the Vesting Schedule (in which case, the Board of Directors or designee may impose whatever conditions it considers appropriate on the accelerated portion). In addition, the restrictions imposed under paragraph 3 will automatically lapse and be removed immediately prior to any Change in Control, if the Recipient is an employee of the Company or its subsidiary at that time, provided, however, that the Board of Directors, or appropriate committee thereof, in its sole discretion, may provide that such restrictions do not automatically lapse immediately prior to any such Change in Control, and instead provide that the Restricted Stock shall continue under the same terms and conditions or shall continue under the same terms and conditions with respect to shares of a successor company that may be issued in exchange or settlement of such Restricted Stock in connection with a Change in Control. For purposes hereof, “Change in Control” shall have the meaning set forth in Exhibit A attached hereto.

- (b) **Payment of Taxes.** Upon the lapse of the restrictions in accordance with the foregoing, Recipient must pay in the form of a check or cash or other cash equivalents to the Company such amount as the Company determines it is required to withhold under applicable laws as a result of the lapse of such restrictions; provided that Recipient may satisfy such withholding obligation by authorizing the Company to withhold from the shares for which such restrictions have lapsed that number of shares having an aggregate Fair Market Value (as defined in the Plan), determined as of the date the withholding tax obligation arises, equal to the amount of the total withholding tax obligation; provided, however, that, the number of shares so withheld shall not have an aggregate Fair Market Value in excess of the minimum required withholding obligation.
- (c) **Release of Certificate.** As soon as practicable after the lapse and removal of the restrictions applicable to all or any portion of the Restricted Stock as provided in this paragraph, the Company will release (or cause to be issued) certificate(s) representing such Restricted Stock to the Recipient, provided that the Recipient has paid to the Company, by cash or check or by any other method permitted by paragraph 4(b), an amount sufficient to satisfy any taxes or other amounts required by any governmental authority to be withheld and paid over to such authority for the Recipient’s account, or otherwise made arrangements satisfactory to the Company for the payment of such amounts through withholding or otherwise.

5. **Voting and Other Rights.** Notwithstanding anything to the contrary in the foregoing, during the period prior to the lapse and removal of the restrictions set forth in paragraph 3, except as otherwise provided herein, the Recipient will have all of the rights of a shareholder with respect to all of the Restricted Stock, including without limitation the right to vote the Restricted Stock and the right to receive all dividends or other distributions with respect to the Restricted Stock. In connection with the payment of such dividends or other distributions, the Company will be entitled to deduct any taxes or other amounts required by any governmental authority to be withheld and paid over to such authority for the Recipient's account.
6. **Section 83(b) Election.** The Recipient will be entitled to make an election pursuant to Section 83(b) of the Internal Revenue Code, or comparable provisions of any state tax law, to include in the Recipient's gross income the amount by which the fair market value of the Restricted Stock the Recipient acquires exceeds the consideration paid for such shares *only if*, prior to making any such election, the Recipient (a) timely notifies the Company in writing of the Recipient's intention to make such election by delivering to the Company a copy of a fully-executed Section 83(b) Election Form approved by the Company and (b) pays to the Company an amount sufficient to satisfy any taxes or other amounts required by any governmental authority to be withheld or paid over to such authority for the Recipient's account, or otherwise makes arrangements satisfactory to the Company for the payment of such amounts through withholding or otherwise. **Recipient hereby acknowledges that (i) the foregoing does not set forth all the requirements for effecting a valid 83(b) election, (ii) that Recipient will need to take additional action, including making certain filings with the Internal Revenue Service to make a valid 83(b) election and (iii) that the Company has no responsibility for ensuring that Recipient satisfies the requirements for a valid 83(b) election.**
7. **Taxable Event.** The Recipient acknowledges that the Restricted Stock will have significant tax consequences to the Recipient and Recipient is hereby advised to consult with Recipient's own tax advisors concerning such tax consequences. A general description of the U.S. federal income tax consequences related to restricted stock awards is set forth in the Plan Prospectus.
8. **Governing Law.** This Restricted Stock Grant will be governed by and construed in accordance with the laws of the State of Delaware and applicable federal law.

IN WITNESS WHEREOF, the Company and Recipient have executed this Restricted Stock Grant effective as of the Effective Grant Date.

CALLAWAY GOLF COMPANY

RECIPIENT

By: /s/ Ronald S. Beard
Ronald S. Beard, Chairman

/s/ George Fellows
George Fellows

EXHIBIT A

A “Change in Control” means the following and shall be deemed to occur if any of the following events occurs:

(a) Any person, entity or group, within the meaning of Section 13(d) or 14(d) of the Securities Exchange Act of 1934 (the “Exchange Act”) but excluding the Company and its subsidiaries and any employee benefit or stock ownership plan of the Company or its subsidiaries and also excluding an underwriter or underwriting syndicate that has acquired the Company’s securities solely in connection with a public offering thereof (such person, entity or group being referred to herein as a “Person”) becomes the beneficial owner (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of 30% or more of either the then outstanding shares of Common Stock or the combined voting power of the Company’s then outstanding securities entitled to vote generally in the election of directors; or

(b) Individuals who, as of the effective date hereof, constitute the Board of Directors of the Company (the “Incumbent Board”) cease for any reason to constitute at least a majority of the Board of Directors of the Company, provided that any individual who becomes a director after the effective date hereof whose election, or nomination for election by the Company’s shareholders, is approved by a vote of at least a majority of the directors then comprising the Incumbent Board shall be considered to be a member of the Incumbent Board unless that individual was nominated or elected by any Person having the power to exercise, through beneficial ownership, voting agreement and/or proxy, 20% or more of either the outstanding shares of Common Stock or the combined voting power of the Company’s then outstanding voting securities entitled to vote generally in the election of directors, in which case that individual shall not be considered to be a member of the Incumbent Board unless such individual’s election or nomination for election by the Company’s shareholders is approved by a vote of at least two-thirds of the directors then comprising the Incumbent Board; or

(c) Consummation by the Company of the sale, lease, exchange or other disposition (in one transaction or a series of related transactions) by the Company of all or substantially all of the Company’s assets or a reorganization or merger or consolidation of the Company with any other person, entity or corporation, other than

(i) a reorganization or merger or consolidation that would result in the voting securities of the Company outstanding immediately prior thereto (or, in the case of a reorganization or merger or consolidation that is preceded or accomplished by an acquisition or series of related acquisitions by any Person, by tender or exchange offer or otherwise, of voting securities representing 5% or more of the combined voting power of all securities of the Company, immediately prior to such acquisition or the first acquisition in such series of acquisitions) continuing to represent, either by remaining outstanding or by being converted into voting securities of another entity, more than 50% of the combined voting power of the voting securities of the Company or such other entity outstanding immediately after such reorganization or merger or consolidation (or series of related transactions involving such a reorganization or merger or consolidation), or

(ii) a reorganization or merger or consolidation effected to implement a recapitalization or reincorporation of the Company (or similar transaction) that does not result in a material change in beneficial ownership of the voting securities of the Company or its successor; or

(d) Approval by the shareholders of the Company or an order by a court of competent jurisdiction of a plan of complete liquidation or dissolution of the Company.

**NOTICE OF GRANT OF STOCK
OPTION AND OPTION AGREEMENT**

**CALLAWAY GOLF COMPANY
ID: 95-3797580
2180 RUTHERFORD ROAD
CARLSBAD, CA 92008**

GEORGE FELLOWS

PLAN: 2004 EQUITY INCENTIVE PLAN

1. Grant of Option. Effective August 1, 2005 (“Effective Date”), you have been granted a Non-qualified Stock Option (“Option”) to buy shares of Callaway Golf Company (the “Company”) common stock upon the following terms:

SHARES	EXERCISE PRICE	SCHEDULED VESTING DATE	SCHEDULED EXPIRATION DATE
133,334	\$ 14.93	August 1, 2006	August 1, 2015
133,333	\$ 14.93	August 1, 2007	August 1, 2015
133,333	\$ 14.93	August 1, 2008	August 1, 2015

The Option is granted to you pursuant to the terms and conditions of this Notice of Grant of Stock Option and Option Agreement (this “Agreement”), and the Company’s 2004 Equity Incentive Plan (as amended and restated from time to time, the “Plan”), the provisions of which Plan are by this reference incorporated in this Agreement. In the event of any conflict between the provisions of the Plan and the provisions of this Agreement, the provisions of the Plan shall be controlling. The Company has provided you with a copy of the Plan.

The exercise price must be paid in the form of cash, unless otherwise determined by the Board of Directors or Committee administering the plan (“Committee”) in their sole discretion. Upon exercise of the Option, you must pay in the form of a check or cash or other cash equivalents to the Company any such additional amount as the Company determines that it is required to withhold under applicable laws in respect of such exercise; provided that you may satisfy such withholding obligation by authorizing the Company to withhold from the shares otherwise issuable to you upon the exercise of the Option that number of shares having an aggregate Fair Market Value (as defined in the Plan), determined as of the date the withholding tax obligation arises, equal to the amount of the total withholding tax obligation; provided, however, that, the number of shares so withheld shall not have an aggregate Fair Market Value in excess of the minimum required withholding.

2. Vesting. Subject to Section 3 (Term and Termination) and Section 4 (Cancellation, Forfeiture and Rescission) of this Agreement, and subject to the accelerated vesting provisions, if any, set forth in any employment agreement between you and the Company or its subsidiary, as the same may be amended, modified, extended or renewed from time to time, the Option shall vest in accordance with the vesting schedule set forth above. The Committee may in its discretion accelerate the vesting schedule (in which case it may impose whatever conditions it considers appropriate on the accelerated portion). In addition, the entire Option shall vest and become exercisable immediately prior to any Change in Control, if you are an employee of the Company or its subsidiary at that time, provided, however, that the Board of Directors, or appropriate committee thereof, in its sole discretion, may provide that such Option does not vest and become exercisable immediately prior to any such Change in Control, and instead provide that the Option shall be assumed or that an equivalent option or right shall be substituted by a successor company, in which case the amount and price of such assumed or substituted option shall be determined by adjusting the amount and price of the Option consistent with the terms of the transaction giving rise to the Change in Control. For purposes hereof, “Change in Control” shall have the meaning set forth in **Exhibit A** attached hereto.

3. Term and Termination. Subject to Section 4 (Cancellation, Forfeiture and Rescission) hereof, the Option shall expire on the earlier of (i) the scheduled expiration date set forth above or (ii) in the case of an Option that has vested, one (1) year from the date on which you cease to be an employee or consultant of the Company or its subsidiary for any reason including death. Subject to Section 2 (Vesting), if you cease for any reason to be an employee of the Company or its subsidiary, that portion of the Option which has not yet vested shall be terminated.

4. Cancellation, Forfeiture and Rescission.

(a) If during your employment or during any period thereafter that you are receiving Special Severance from the Company, you directly or indirectly disclose or misuse any confidential information or trade secrets of the Company then:

(1) any unexercised portion of the Option is automatically cancelled as of the date you first committed the act or acts described above (the "Cancellation Date"); and

(2) any exercise of all or any portion of the Option exercised on or after the Cancellation Date or during the "Look-Back Period" preceding the Cancellation Date shall be rescinded, and you shall be required to pay to the Company, within ten days of receiving written notice from the Company, the amount of any gain realized as the result of any such rescinded exercise (the "Option Gain").

The Company shall notify you in writing of any such rescission within two years of any such exercise. If you are still an employee on the Cancellation Date, the "Look-Back Period" is ninety days. If you are no longer an employee on the Cancellation Date, the "Look-Back Period" is the longer of ninety days or the number of days elapsed from the date of termination of your employment to the Cancellation Date. For purposes of this Agreement, an "indirect" use of the Company's confidential information or trade secrets shall be presumed to have occurred if you take a comparable position with a competitor in which case you shall have the burden of proving that no use or disclosure of confidential information or trade secrets occurred or will occur. For purposes of this Agreement, and in the absence of proof of actual gain on the date of exercise, "Option Gain" shall mean the New York Stock Exchange closing price on the date of exercise minus the exercise price of the Option, multiplied by the number of shares you purchased upon the exercise, without regard to any subsequent market price decrease or increase.

(b) In lieu of paying to the Company any Option Gain required to be paid to Company pursuant to this Section 4, you may return to the Company the number of shares purchased upon exercise of the Option. You hereby agree that the Company may set off against any amount the Company may now or hereafter owe you the amount of any Option Gain required to be paid by you to Company under this Section 4. This Section 4 does not limit any other legal or equitable remedy available to the Company. As a condition of each exercise of all or any portion of the Option, you will be required to certify to the Company on a form of notice of exercise acceptable to the Company that you have not committed any of the acts described in paragraph (a) above.

You acknowledge that you have read each provision of this Section 4 and have had an opportunity to ask questions with respect to this Section. You acknowledge that you understand that the Company is granting the Option subject to the terms of this Section 4.

_____ (Optionee)

5. Severability. The provisions of this Agreement shall be deemed to be severable and the invalidity or unenforceability of any provision shall not affect the validity or enforceability of the other provisions hereof. If any provision of this Agreement, or the application thereof to any person or any circumstance, is held to be invalid or unenforceable under present or future laws effective during the term of this Agreement, such provision shall be fully severed, and in lieu thereof there shall automatically be added as part of this Agreement a suitable and equitable provision in order to carry out, so far as may be valid and enforceable, the intent and purpose of such invalid or unenforceable provision.

6. Governing Law. This Agreement shall be governed by and construed in accordance with the internal laws of the State of Delaware and applicable federal law.

7. Arbitration.

(a) **You and the Company agree that any dispute, controversy or claim arising hereunder or in any way related to this Agreement, its interpretation, enforceability, or applicability, that cannot be resolved by mutual agreement of the parties shall be submitted to binding arbitration. You and the Company also agree that arbitration is the parties' only recourse for such claims and hereby waive the right to pursue such claims in any other forum, unless otherwise provided by law. Any court action involving a dispute which is not subject to arbitration shall be stayed pending arbitration of arbitrable disputes.**

(b) **You and the Company agree that the arbitrator shall have the authority to issue provisional relief. You and the Company further agree that each has the right to apply to a court for a provisional remedy in connection with an arbitrable dispute so as to prevent the arbitration from being rendered ineffective.**

(c) Any demand for arbitration shall be in writing and must be communicated to the other party prior to the expiration of the applicable statute of limitations.

(d) The arbitration shall be conducted pursuant to the procedural rules stated in the National Rules for Resolution of Employment Disputes of the American Arbitration Association (“AAA”). The arbitration shall be conducted in San Diego by a former or retired judge or attorney with at least 10 years experience in employment-related disputes, or a non-attorney with like experience in the area of dispute, who shall have the power to hear motions, control discovery, conduct hearings and otherwise do all that is necessary to resolve the matter. You and the Company must mutually agree on the arbitrator. If the parties cannot agree on the arbitrator after their best efforts, an arbitrator from the American Arbitration Association will be selected pursuant to the American Arbitration Association National Rules for Resolution of Employment Disputes. The Company shall pay the costs of the arbitrator’s fees.

(e) The arbitration will be decided upon a written decision of the arbitrator stating the essential findings and conclusions upon which the award is based. The arbitrator shall have the authority to award damages, if any, to the extent that they are available under applicable law(s). The arbitration award shall be final and binding, and may be entered as a judgment in any court having competent jurisdiction. Either party may seek review pursuant to the Federal Arbitration Act.

(f) It is expressly understood that the parties have chosen arbitration to avoid the burdens, costs and publicity of a court proceeding, and the arbitrator is expected to handle all aspects of the matter, including discovery and any hearings, in such a way as to minimize the expense, time, burden and publicity of the process, while assuring a fair and just result. The arbitrator shall allow reasonable discovery, but shall control the amount and scope of discovery.

(g) The provisions of this Section 7 shall survive the expiration or termination of the Agreement, and shall be binding upon the parties.

THE PARTIES HAVE READ SECTION 7 AND IRREVOCABLY AGREE TO ARBITRATE ANY DISPUTE IDENTIFIED ABOVE.

_____ (Optionee)

IN WITNESS WHEREOF, the undersigned have executed this Agreement as of the Effective Date.

CALLAWAY GOLF COMPANY

George Fellows

By: /s/ Ronald S. Beard
Ronald S. Beard
Chairman

/s/ George Fellows

EXHIBIT A

A “Change in Control” means the following and shall be deemed to occur if any of the following events occurs:

(a) Any person, entity or group, within the meaning of Section 13(d) or 14(d) of the Securities Exchange Act of 1934 (the “Exchange Act”) but excluding the Company and its subsidiaries and any employee benefit or stock ownership plan of the Company or its subsidiaries and also excluding an underwriter or underwriting syndicate that has acquired the Company’s securities solely in connection with a public offering thereof (such person, entity or group being referred to herein as a “Person”) becomes the beneficial owner (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of 30% or more of either the then outstanding shares of Common Stock or the combined voting power of the Company’s then outstanding securities entitled to vote generally in the election of directors; or

(b) Individuals who, as of the effective date hereof, constitute the Board of Directors of the Company (the “Incumbent Board”) cease for any reason to constitute at least a majority of the Board of Directors of the Company, provided that any individual who becomes a director after the effective date hereof whose election, or nomination for election by the Company’s shareholders, is approved by a vote of at least a majority of the directors then comprising the Incumbent Board shall be considered to be a member of the Incumbent Board unless that individual was nominated or elected by any Person having the power to exercise, through beneficial ownership, voting agreement and/or proxy, 20% or more of either the outstanding shares of Common Stock or the combined voting power of the Company’s then outstanding voting securities entitled to vote generally in the election of directors, in which case that individual shall not be considered to be a member of the Incumbent Board unless such individual’s election or nomination for election by the Company’s shareholders is approved by a vote of at least two-thirds of the directors then comprising the Incumbent Board; or

(c) Consummation by the Company of the sale, lease, exchange or other disposition (in one transaction or a series of related transactions) by the Company of all or substantially all of the Company’s assets or a reorganization or merger or consolidation of the Company with any other person, entity or corporation, other than

(i) a reorganization or merger or consolidation that would result in the voting securities of the Company outstanding immediately prior thereto (or, in the case of a reorganization or merger or consolidation that is preceded or accomplished by an acquisition or series of related acquisitions by any Person, by tender or exchange offer or otherwise, of voting securities representing 5% or more of the combined voting power of all securities of the Company, immediately prior to such acquisition or the first acquisition in such series of acquisitions) continuing to represent, either by remaining outstanding or by being converted into voting securities of another entity, more than 50% of the combined voting power of the voting securities of the Company or such other entity outstanding immediately after such reorganization or merger or consolidation (or series of related transactions involving such a reorganization or merger or consolidation), or

(ii) a reorganization or merger or consolidation effected to implement a recapitalization or reincorporation of the Company (or similar transaction) that does not result in a material change in beneficial ownership of the voting securities of the Company or its successor; or

(d) Approval by the shareholders of the Company or an order by a court of competent jurisdiction of a plan of complete liquidation or dissolution of the Company.

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, George Fellows, certify that:

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

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

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

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

Dated: October 27, 2005

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

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Bradley J. Holiday, certify that:

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

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

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

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

Dated: October 27, 2005

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

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

Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, each of the undersigned officers of Callaway Golf Company, a Delaware corporation (the "Company"), does hereby certify with respect to the Quarterly Report of the Company on Form 10-Q for the quarterly period ended September 30, 2005, as filed with the Securities and Exchange Commission (the "10-Q Report"), that:

- (1) the 10-Q Report fully complies with the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the 10-Q Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

The undersigned have executed this Certification effective as of October 27, 2005.

/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

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