
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 June 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

The number of shares outstanding of the Registrant's Common Stock, \$.01 par value, as of July 31, 2005 was 76,288,633.

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 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. 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 — CB1 — 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*

CALLAWAY GOLF COMPANY

INDEX

PART I. FINANCIAL INFORMATION

Item 1.	Financial Statements (Unaudited)	
	Consolidated Condensed Balance Sheets as of June 30, 2005 and December 31, 2004	1
	Consolidated Condensed Statements of Operations for the three and six months ended June 30, 2005 and 2004	2
	Consolidated Condensed Statements of Cash Flows for the six months ended June 30, 2005 and 2004	3
	Consolidated Condensed Statement of Shareholders’ Equity for the six months ended June 30, 2005	4
	Notes to Consolidated Condensed Financial Statements	5
Item 2.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	37
Item 4.	Controls and Procedures	39

PART II. OTHER INFORMATION

Item 1.	Legal Proceedings	39
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	42
Item 3.	Defaults Upon Senior Securities	42
Item 4.	Submission of Matters to a Vote of Security Holders	42
Item 5.	Other Information	43
Item 6.	Exhibits	43
EXHIBIT 10.56		
EXHIBIT 10.57		
EXHIBIT 31.1		
EXHIBIT 31.2		
EXHIBIT 32.1		

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	June 30, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 42,656	\$ 31,657
Accounts receivable, net	238,253	105,153
Inventories, net	193,361	181,230
Deferred taxes	36,644	32,959
Income taxes receivable	1,083	28,697
Other current assets	13,555	14,036
Total current assets	525,552	393,732
Property, plant and equipment, net	132,070	135,865
Intangible assets, net	147,638	149,168
Goodwill	29,272	30,468
Deferred taxes	6,234	9,837
Other assets	16,447	16,667
	<u>\$ 857,213</u>	<u>\$ 735,737</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 122,105	\$ 75,501
Accrued employee compensation and benefits	28,706	20,215
Accrued warranty expense	13,232	12,043
Line of credit	50,000	13,000
Capital leases, current portion	17	39
Total current liabilities	214,060	120,798
Long-term liabilities:		
Deferred compensation	7,760	8,674
Energy derivative valuation account	19,922	19,922
Capital leases, net of current portion	18	26
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Preferred Stock, \$.01 par value, 3,000,000 shares authorized, none issued and outstanding at June 30, 2005 and December 31, 2004	—	—
Common Stock, \$.01 par value, 240,000,000 shares authorized, 84,789,444 and 84,785,694 issued at June 30, 2005 and December 31, 2004, respectively	848	848
Additional paid-in capital	402,177	387,950
Unearned compensation	(10,535)	(12,562)
Retained earnings	464,315	437,269
Accumulated other comprehensive income	5,424	11,081
Less: Grantor Stock Trust held at market value, 6,827,793 shares and 7,176,678 shares at June 30, 2005 and December 31, 2004, respectively	(105,353)	(96,885)
	756,876	727,701
Less: Common Stock held in treasury, at cost, 8,500,811 and 8,497,667 shares at June 30, 2005 and December 31, 2004, respectively	(141,423)	(141,384)
Total shareholders' equity	615,453	586,317
	<u>\$ 857,213</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 June 30,				Six Months Ended June 30,			
	2005		2004		2005		2004	
Net sales	\$ 323,132	100%	\$ 297,908	100%	\$ 622,989	100%	\$ 661,694	100%
Cost of sales	176,399	55%	170,072	57%	343,650	55%	367,667	56%
Gross profit	146,733	45%	127,836	43%	279,339	45%	294,027	44%
Operating expenses:								
Selling expense	90,640	28%	74,496	25%	166,385	27%	145,691	22%
General and administrative expense	21,239	7%	21,834	7%	40,324	6%	44,695	7%
Research and development expense	7,083	2%	7,559	3%	13,323	2%	15,668	2%
Total operating expenses	118,962	37%	103,889	35%	220,032	35%	206,054	31%
Income from operations	27,771	9%	23,947	8%	59,307	10%	87,973	13%
Other expense, net	(1,806)		(1,592)		(2,987)		(1,321)	
Income before income taxes	25,965	8%	22,355	8%	56,320	9%	86,652	13%
Provision for income taxes	7,573		8,640		19,568		32,392	
Net income	<u>\$ 18,392</u>	6%	<u>\$ 13,715</u>	5%	<u>\$ 36,752</u>	6%	<u>\$ 54,260</u>	8%
Earnings per common share:								
Basic	\$ 0.27		\$ 0.20		\$ 0.54		\$ 0.80	
Diluted	\$ 0.27		\$ 0.20		\$ 0.54		\$ 0.79	
Weighted-average shares outstanding:								
Basic	68,270		67,788		68,226		67,536	
Diluted	68,660		68,368		68,643		68,367	
Dividends declared per share	\$ 0.07		\$ 0.07		\$ 0.14		\$ 0.14	

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

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

	Six Months Ended June 30,	
	2005	2004
Cash flows from operating activities:		
Net income	\$ 36,752	\$ 54,260
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	22,659	26,320
Non-cash compensation	3,957	2
Loss on disposal of long-lived assets	856	1,619
Tax benefit from exercise of stock options	269	1,832
Net non-cash foreign currency hedging gains	—	1,552
Deferred taxes	(1,184)	5,972
Changes in assets and liabilities:		
Accounts receivable, net	(137,015)	(160,441)
Inventories, net	(15,815)	32,298
Income tax receivable	27,635	(3,520)
Other assets	183	1,418
Accounts payable and accrued expenses	48,505	13,520
Accrued employee compensation and benefits	8,864	4,980
Accrued warranty expense	1,189	841
Deferred compensation	(914)	(98)
Net cash used in operating activities	<u>(4,059)</u>	<u>(19,445)</u>
Cash flows from investing activities:		
Capital expenditures	(19,056)	(7,739)
Business acquisitions, net of cash acquired	—	(9,215)
Proceeds from sale of capital assets	20	366
Net cash used in investing activities	<u>(19,036)</u>	<u>(16,588)</u>
Cash flows from financing activities:		
Net proceeds from line of credit	37,000	20,000
Issuance of Common Stock	3,560	16,691
Dividends paid, net	(4,853)	(4,728)
Acquisition of Treasury Stock	(39)	(6,298)
Payments on financing arrangements	(22)	(301)
Net cash provided by financing activities	<u>35,646</u>	<u>25,364</u>
Effect of exchange rate changes on cash and cash equivalents	<u>(1,552)</u>	<u>(926)</u>
Net increase (decrease) in cash and cash equivalents	10,999	(11,595)
Cash and cash equivalents at beginning of period	31,657	47,340
Cash and cash equivalents at end of period	<u>\$ 42,656</u>	<u>\$ 35,745</u>
Non-cash financing activities:		
Dividends payable	\$ 4,853	\$ 4,745
Issuance of restricted stock	—	\$ 800

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

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

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Unearned Compensation</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Grantor Stock Trust</u>	<u>Treasury Stock</u>		<u>Total</u>
	<u>Shares</u>	<u>Amount</u>						<u>Shares</u>	<u>Amount</u>	
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	3	—	(286)	—	—	—	2,042	—	—	1,756
Tax benefit from exercise of stock options	—	—	269	—	—	—	—	—	—	269
Compensatory Stock and Stock Options	—	—	1,930	2,027	—	—	—	—	—	3,957
Acquisition of Treasury Stock	—	—	—	—	—	—	—	(3)	(39)	(39)
Employee stock purchase plan	—	—	(584)	—	—	—	2,388	—	—	1,804
Cash dividends declared	—	—	—	—	(9,706)	—	—	—	—	(9,706)
Adjustment of Grantor Stock Trust shares to market value	—	—	12,898	—	—	—	(12,898)	—	—	—
Equity adjustment from foreign currency translation	—	—	—	—	—	(4,596)	—	—	—	(4,596)
Unrealized gain on cash flow hedges, net of tax	—	—	—	—	—	(1,061)	—	—	—	(1,061)
Net income	—	—	—	—	36,752	—	—	—	—	36,752
Balance, June 30, 2005	<u>84,789</u>	<u>\$ 848</u>	<u>\$ 402,177</u>	<u>\$ (10,535)</u>	<u>\$ 464,315</u>	<u>\$ 5,424</u>	<u>\$ (105,353)</u>	<u>(8,501)</u>	<u>\$ (141,423)</u>	<u>\$ 615,453</u>

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. 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, “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 date of grant and no compensation cost is reflected in net income for those awards. For the six months ended June 30, 2005, the Company recorded compensation expense of \$3,957,000 as a result of restricted stock awards granted in 2004 to employees and professional endorsers of the Company. During the six months ended June 30, 2004, the Company recorded compensation expense of \$2,000 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 SFAS No. 123, “Accounting for Stock-Based Compensation,” in measuring stock-based employee compensation expense (in thousands, except per data share):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income:				
Net income, as reported	\$ 18,392	\$ 13,715	\$ 36,752	\$ 54,260
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	82	—	139	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,295)	(2,566)	(2,483)	(4,846)
Pro forma net income	<u>\$ 17,179</u>	<u>\$ 11,149</u>	<u>\$ 34,408</u>	<u>\$ 49,414</u>
Earnings per common share:				
Basic — as reported	\$ 0.27	\$ 0.20	\$ 0.54	\$ 0.80
Basic — pro forma	\$ 0.25	\$ 0.16	\$ 0.50	\$ 0.73
Diluted — as reported	\$ 0.27	\$ 0.20	\$ 0.54	\$ 0.79
Diluted — pro forma	\$ 0.25	\$ 0.16	\$ 0.50	\$ 0.72

CALLAWAY GOLF COMPANY

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Dividend yield	2.0%	1.8%	2.0%	1.8%
Expected volatility	42.4%	42.2%	42.4%	42.2%
Risk free interest rates	3.7%	3.4%	3.3%	3.4%
Expected lives	4 years	4 years	4 years	4 years

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

During 2004, the Company granted 1,000,000 shares 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 difference between the exercise price and market value of the stock on the measurement date.

3. Inventories

Inventories are summarized below (in thousands):

	June 30, 2005	December 31, 2004
Raw materials	\$ 82,881	\$ 73,558
Work-in-process	7,520	6,768
Finished goods	116,769	114,505
	207,170	194,831
Reserve for excess and obsolescence	(13,809)	(13,601)
Total inventories, net	\$ 193,361	\$ 181,230

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)
(Unaudited)**4. 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)	June 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	9,877	24,169	35,307	9,787	25,520
Other	1-9	2,335	660	1,675	3,080	1,226	1,854
Total intangible assets		<u>\$ 158,175</u>	<u>\$ 10,537</u>	<u>\$ 147,638</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 June 30, 2005 and 2004, aggregate amortization expense was approximately \$765,000 and \$742,000, respectively. During the six months ended June 30, 2005 and 2004, aggregate amortization expense was approximately \$1,530,000 and \$1,765,000, respectively. Amortization expense related to intangible assets at June 30, 2005 in each of the next five fiscal years and beyond is expected to be incurred as follows (in thousands):

Remainder of 2005	\$ 1,384
2006	2,979
2007	2,990
2008	2,955
2009	2,766
2010	2,687
Thereafter	10,083
	<u>\$ 25,844</u>

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

5. 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 current maximum amount that could be borrowed under the Line of Credit is approximately \$200,000,000 and of that amount, the Company had \$50,000,000 outstanding and Letters of Credit issued of \$1,700,000.

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

CALLAWAY GOLF COMPANY

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

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 June 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 \$1,263,000 and are being amortized into interest expense over five years (the term of the Line of Credit agreement). The unamortized origination fees were \$1,095,000 as of June 30, 2005 and have been included in other assets in the accompanying consolidated balance sheet.

6. Product Warranty

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Beginning balance	\$ 12,902	\$ 13,891	\$ 12,043	\$ 12,627
Provision	3,061	3,015	5,994	7,147
Claims paid/costs incurred	(2,731)	(3,438)	(4,805)	(6,306)
Ending balance	<u>\$ 13,232</u>	<u>\$ 13,468</u>	<u>\$ 13,232</u>	<u>\$ 13,468</u>

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS — (Continued)
(Unaudited)**7. Earnings Per Share**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Weighted-average shares outstanding:				
Weighted-average shares outstanding — Basic	68,270	67,788	68,226	67,536
Dilutive securities	390	580	417	831
Weighted-average shares outstanding — Diluted	<u>68,660</u>	<u>68,368</u>	<u>68,643</u>	<u>68,367</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. For the three months ended June 30, 2005 and 2004, options outstanding totaling 12,244,000 and 9,610,000 shares, respectively, were excluded from the calculations, as their effect would have been antidilutive. For the six months ended June 30, 2005 and 2004, options outstanding totaling 11,009,000 and 6,637,000 shares, respectively, were excluded from the calculations, as their effect would have been antidilutive.

8. Income Taxes

The Company has studied the impact of the one-time favorable foreign dividend provision enacted on October 22, 2004 as part of the American Jobs Creation Act of 2004, and has no plans at this time to repatriate earnings of its foreign subsidiaries pursuant to the one-time dividend provision provided by the act.

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 quarter ended June 30, 2005, the Company recorded a net favorable adjustment of approximately \$1,600,000 related to previously estimated tax liabilities as a result of its assessment and resolution of various tax exposures during the second quarter of 2005.

CALLAWAY GOLF COMPANY

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

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" ("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.

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

CALLAWAY GOLF COMPANY

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

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 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 has not made a determination that the case may proceed in the form of a class action. The parties are engaged in discovery and motion practice. Plaintiff has moved for summary judgment and to certify the case as a nationwide class action. On July 13, 2005 the court denied the plaintiff's motion for summary judgment. On July 20, 2005, the court denied plaintiff's motion to certify the case as a nationwide class action.

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. It is expected that if Maxfli is ultimately unsuccessful with its post-trial motions, it will appeal the verdict. If Maxfli is successful with its post-trial motions, or an appeal of the verdict, and Maxfli's counterclaims are ultimately resolved in Maxfli's favor, such matters could have a significant adverse effect upon the Company's results of operations, cash flows and financial position.

On December 14, 2004, Callaway Golf Sales Company was served with a complaint captioned York v. Callaway Golf Sales Company, filed in the Circuit Court for Dade County, Florida, Case No. 04-25625 CA 11, asserting a purported class action on behalf of all consumers who purchased allegedly defective HX Red golf balls with cracked covers. The complaint contains causes of action for strict liability, breach of implied and express warranties, and violation of the Magnuson-Moss Consumer Product Warranty Act. On January 12, 2005, Callaway Golf removed the case to the United States District Court for the Southern District of Florida. Plaintiff subsequently dismissed his federal claim, and two of his state court claims, and the case was remanded to the Circuit Court for Dade County, Florida. Thereafter, plaintiff dismissed the complaint without prejudice, terminating the matter.

CALLAWAY GOLF COMPANY

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

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

Supply of Electricity and Energy Contracts

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

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

Because the Enron Contract provided for the Company to purchase an amount of energy in excess of what it expected to be able to use in its operations, the Company accounted for the Enron Contract as a derivative instrument in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." The Enron Contract did not qualify for hedge accounting under SFAS No. 133. Therefore, the Company recognized changes in the estimated fair value of the Enron Contract currently in earnings. The estimated fair value of the Enron Contract was based upon present value determination of the net differential between the contract price for electricity and the estimated future market prices for electricity as applied to the remaining amount of unpurchased electricity under the Enron Contract. Through September 30, 2001, the Company had recorded unrealized pre-tax losses of \$19,922,000.

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

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

As a result of the Company's notice of termination to EESI, and certain other automatic termination provisions under the Enron Contract, the Company believes that the Enron Contract has been terminated. As a result, the Company adjusted the estimated value of the Enron Contract through the date of termination, at

CALLAWAY GOLF COMPANY

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

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 June 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.

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 June 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 \$125,105,000 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 June 30, 2005 are as follows:

	(In thousands)
2005	\$ 29,408
2006	34,236
2007	24,544
2008	19,514
2009	16,503
Thereafter	900
	<u>\$ 125,105</u>

Other Contingent Contractual Obligations

During its normal course of business, the Company has made certain indemnities, commitments and guarantees under which it may be required to make payments in relation to certain transactions. These include (i) intellectual property indemnities to the Company's customers and licensees in connection with the use, sale and/or license of Company products, (ii) indemnities to various lessors in connection with facility leases for certain claims arising from such facilities or leases, (iii) indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct of the Company and (iv) indemnities involving the accuracy of representations and warranties in certain contracts. In addition, the Company has made contractual commitments to each of its officers and certain other employees providing for severance

CALLAWAY GOLF COMPANY

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

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 six months ended June 30, 2005 was not material to the Company's financial position, results of operations or cash flows.

Employment Contracts

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

CALLAWAY GOLF COMPANY

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net sales				
Golf clubs	\$ 252,373	\$ 223,377	\$ 493,197	\$ 515,067
Golf balls	70,759	74,531	129,792	146,627
	<u>\$ 323,132</u>	<u>\$ 297,908</u>	<u>\$ 622,989</u>	<u>\$ 661,694</u>
Income before provision for income taxes ⁽¹⁾				
Golf clubs ⁽²⁾	\$ 33,365	\$ 32,659	\$ 73,744	\$ 111,502
Golf balls ⁽³⁾	6,018	3,756	7,744	2,109
Reconciling items ⁽⁴⁾	(13,418)	(14,060)	(25,168)	(26,959)
	<u>\$ 25,965</u>	<u>\$ 22,355</u>	<u>\$ 56,320</u>	<u>\$ 86,652</u>
Additions to long-lived assets				
Golf clubs	\$ 5,857	\$ 3,395	\$ 9,746	\$ 5,330
Golf balls	3,001	1,722	9,310	2,409
	<u>\$ 8,858</u>	<u>\$ 5,117</u>	<u>\$ 19,056</u>	<u>\$ 7,739</u>

- (1) Prior period amounts have been reclassified to conform with current period presentations.
- (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 \$1,248,000 and \$2,413,000 for the three months ended June 30, 2005 and 2004, respectively, and \$1,370,000 and \$2,593,000 for the six months ended June 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 \$1,365,000 and \$5,420,000 for the three months ended June 30, 2005 and 2004, respectively, and \$4,368,000 and \$8,958,000 for the six months ended June 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. The reconciling items include the recognition of non-allocated integration charges in the amounts of approximately \$647,000 and \$2,855,000 for the three months ended June 30, 2005 and 2004, respectively, and \$7,087,000 and \$15,796,000 for the six months ended June 30, 2005 and 2004, respectively, related to the integration of the Callaway Golf and Top-Flite operations.

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

CALLAWAY GOLF COMPANY

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

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 June 30, 2005 and 2004, the notional amounts of the Company's foreign exchange contracts were approximately \$78,808,000 and \$85,005,000, 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 June 30, 2005, the fair values of foreign currency-related derivatives were recorded as current assets of \$1,906,000 and current liabilities of \$81,000.

As of June 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 six months ended June 30, 2005, no gain or loss was recorded as a result of changes in the spot-forward differential. During the three and six months ended June 30, 2004, the Company recorded a net loss of \$77,000 and \$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 June 30, 2005 and 2004, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$78,808,000 and \$85,005,000, respectively. The gains and losses on foreign currency contracts used to manage balance sheet exposures are recognized as a

CALLAWAY GOLF COMPANY

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

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 June 30, 2005 and 2004, the Company recorded net gains of \$2,850,000 and \$1,143,000, 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 six months ended June 30, 2005 and 2004, the Company recorded net gains of \$3,576,000 and \$633,000, 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 June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income	\$ 18,392	\$ 13,715	\$ 36,752	\$ 54,260
Other comprehensive income:				
Foreign currency translation	(3,024)	(1,694)	(4,596)	(1,168)
Net unrealized gain (loss) on cash flow hedges, net of tax	—	392	(1,061)	3,311
Comprehensive income	<u>\$ 15,368</u>	<u>\$ 12,413</u>	<u>\$ 31,095</u>	<u>\$ 56,403</u>

13. Recent Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" (Statement 154), which replaces APB Opinion No. 120, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." This statement 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, the Statement 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. This Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. This Statement does not change the transition provisions of any existing pronouncements. As of June 30, 2005, the Company has evaluated the impact of Statement 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 Statement 154 in future periods, when applicable.

CALLAWAY GOLF COMPANY

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

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 No. 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 No. 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 No. 123R to determine which fair-value-based model and transitional provision it will follow upon adoption. SFAS No. 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 No. 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

Overall, the Company's sales improved during the second quarter of 2005 compared to the second quarter of 2004. The Company's products were generally well-received at retail and demand for the Company's products was strong with demand exceeding the Company's ability to supply some products. Despite record second quarter sales, the Company's second quarter earnings were tempered by increased operating expenses related to brand investment and the timing of marketing expenses in support of second and third quarter product launches in 2005.

The Company's third quarter business generally represents re-orders of products that sold during the first half of the year, although during the third quarter of 2005 the Company is launching some new products, including the Big Bertha Fusion FT-3 Driver, the Big Bertha Fusion Fairway Woods and the HX Tour 56 golf balls. One of the Company's challenges for the third quarter will be the management of the supply and inventory of products in order to capture re-orders of the Company's current products before the demand for such products dissipates as the end of the golf season approaches in some of the Company's markets. The Company's success in the third quarter will also depend upon the success of the sell-in of the new products being launched in the third quarter. Despite these challenges, the Company anticipates significant improvement in its third quarter sales and earnings as compared to the same period in 2004.

Results of Operations**Three-Month Periods Ended June 30, 2005 and 2004**

Net sales increased \$25.2 million (8%) to \$323.1 million for the three months ended June 30, 2005 as compared to \$297.9 million for the comparable period in the prior year. The overall increase in net sales was primarily due to a \$24.7 million (28%) increase in sales of irons, combined with a \$5.4 million (17%) increase in sales of accessories and other products and a \$4.7 million (16%) increase in sales of putters. These increases were offset by a \$5.9 million (8%) decrease in sales of woods and a \$3.7 million (5%) decrease in sales of golf balls. The overall increase in net sales during the quarter is generally attributable to favorable consumer acceptance of the Company's products. This increase in net sales was tempered by supply constraints during the quarter.

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

	Three Months Ended June 30,		Growth/(Decline)	
	2005	2004	Dollars	Percent
Net sales:				
Woods	\$ 69.6	\$ 75.5	\$ (5.9)	(8)%
Irons	111.7	87.0	24.7	28%
Putters	33.9	29.2	4.7	16%
Golf balls	70.8	74.5	(3.7)	(5)%
Accessories and other	37.1	31.7	5.4	17%
	<u>\$ 323.1</u>	<u>\$ 297.9</u>	<u>\$ 25.2</u>	<u>8%</u>

The \$5.9 million (8%) decrease in net sales of woods to \$69.6 million for the three months ended June 30, 2005 is primarily attributable to lower average selling prices partially offset by an increase in sales volumes in the second quarter of 2005 compared to the same period in the prior year. The decrease in average selling prices is primarily attributable to the absence of a super premium driver model in the 2005 product line

[Table of Contents](#)

as well as a higher mix of lower priced products in the second quarter of 2005. The increase in sales volumes is primarily attributable to the introduction of hybrid clubs during the current year partially offset by a decrease in sales volumes of fairway woods and drivers.

The \$24.7 million (28%) increase in net sales of irons to \$111.7 million for the three months ended June 30, 2005 resulted from higher sales volumes as well as higher average selling prices in the second quarter of 2005 compared to the same period in the prior year. The higher sales volume is primarily attributable to the Company having more new irons models in its 2005 product line than its 2004 product line, including multi-material irons products which were not introduced until 2005. 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 steel irons products which were in the second and third years of their product life cycles.

The \$4.7 million (16%) increase in net sales of putters to \$33.9 million for the three months ended June 30, 2005 resulted from increased sales volumes, partially offset by lower average selling prices in the second 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 and Callaway Golf I-Trax Putter models. These increases were partially offset by a decline in sales of older putter models.

The \$3.7 million (5%) decrease in net sales of golf balls to \$70.8 million for the three months ended June 30, 2005 resulted from a decrease in Top-Flite sales volumes and lower average selling prices partially offset by an increase in Callaway Golf ball sales volumes. The decrease in sales of Top-Flite golf balls was primarily due to a planned reduction in the number of golf ball models in the 2005 product line as a result of the Company's discontinuance of certain less profitable golf ball models.

The \$5.4 million (17%) increase in sales of accessories and other products to \$37.1 million is primarily attributable to an increase in sales of Callaway Golf and Odyssey golf bags and royalty revenue from licensed merchandise slightly offset by decreases in sales of other accessories.

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

	Three Months Ended June 30,		Growth/(Decline)	
	2005	2004	Dollars	Percent
Net sales:				
United States	\$ 181.5	\$ 171.3	\$ 10.2	6%
Europe	56.5	57.8	(1.3)	(2)%
Japan	30.2	16.6	13.6	82%
Rest of Asia	19.1	17.2	1.9	11%
Other foreign countries	35.8	35.0	0.8	2%
	<u>\$ 323.1</u>	<u>\$ 297.9</u>	<u>\$ 25.2</u>	<u>8%</u>

Net sales in the United States increased \$10.2 million (6%) to \$181.5 million during the second quarter of 2005 compared to the same period in the prior year. The Company's sales in regions outside of the United States increased \$15.0 million (12%) to \$141.6 million during the second quarter of 2005 compared to the same quarter in 2004. The overall increase in international sales is primarily attributable to a \$13.6 million (82%) increase in sales in Japan due to new Japan-specific product offerings for 2005 that were not available in 2004. The Company's net sales were also affected by changes in foreign currency rates. See below, "Certain Factors Affecting Callaway Golf Company — Foreign Currency Risk."

For the second quarter of 2005, gross profit increased \$18.9 million to \$146.7 million from \$127.8 million compared to the same period in the prior year. Gross profit as a percentage of net sales increased to 45% of net sales in the second quarter of 2005 from 43% in the comparable period of 2004. This increase in the Company's gross profit percentage was primarily attributable to improved golf ball margins, favorable foreign

[Table of Contents](#)

currency exchange rate fluctuations and improved margins on irons. This increase was partially offset by lower average selling prices for many of the Company's products as discussed above.

Selling expenses increased \$16.1 million (22%) to \$90.6 million in the second quarter of 2005 as compared to \$74.5 million in the same period of 2004. As a percentage of sales, selling expenses increased to 28% in the second quarter of 2005 from 25% in the second quarter of 2004. This increase was primarily due to increases in advertising expense of \$6.6 million and promotional expenses of \$6.9 million in the second quarter of 2005 compared to the same quarter in the prior year. These increases were primarily due to costs associated with brand investment and the timing of marketing expenses in support of second and third quarter product launches.

General and administrative expenses decreased \$0.6 million (3%) in the second quarter of 2005 to \$21.2 million from \$21.8 million in the second quarter of 2004. As a percentage of sales, general and administrative expenses remained constant at 7%. The dollar decrease was primarily due to a decrease in legal expense due to the settlement of certain litigation in 2004.

Research and development expenses decreased \$0.5 million (6%) in the second quarter of 2005 to \$7.1 million from \$7.6 million in the comparable period of 2004. As a percentage of sales, research and development expenses decreased to 2% in the second quarter of 2005 from 3% in the comparable period of 2004. The dollar decrease was primarily due to lower employee costs in the second quarter of 2005 compared to the same period in the prior year.

Other expense increased \$0.2 million in the second quarter of 2005 to \$1.8 million as compared to other expense of \$1.6 million in the comparable period of 2004. The \$0.2 million of additional expense is primarily attributable \$0.7 million of increased interest expense partially offset by \$0.5 million of net foreign currency fluctuation gains and other income.

The income tax provisions reflect quarterly tax rates of 29.2% and 38.6% for the quarter ended June 30, 2005 and 2004, respectively. This decrease in tax rate is primarily attributable to approximately \$1.6 million of net favorable adjustments recorded during the second quarter of 2005 related to the reassessment and resolution of various tax exposures during the second quarter 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 three months ended June 30, 2005 increased 34% to \$18.4 million from \$13.7 million in the comparable period of 2004. Diluted earnings per share increased to \$0.27 per share in the second quarter of 2005 compared to \$0.20 per share in the second quarter of 2004. Net income was negatively impacted by after-tax charges related to the integration of the Callaway Golf and Top-Flite operations in the amounts of \$2.0 million and \$6.7 million in the second quarter of 2005 and 2004, respectively. Diluted earnings per share was negatively impacted by after-tax charges related to the integration of the Callaway Golf and Top-Flite operations in the amounts of \$0.03 and \$0.10 per share in the second quarter of 2005 and 2004, respectively.

Six-Month Periods Ended June 30, 2005 and 2004

Net sales decreased 6% to \$623.0 million for the six months ended June 30, 2005 as compared to \$661.7 million for the comparable period in the prior year. The overall decrease in net sales is primarily due to a \$64.1 million (32%) decrease in the sale of woods combined with a \$16.8 million (11%) decrease in the sale of golf balls. These decreases were partially offset by a \$36.1 million (20%) increase in the sale of irons and a \$6.5 million (10%) increase in sales of accessories and other products in the first half of 2005 as compared to the first half of 2004. The Company expected that its sales for the first half of 2005 would be less than the first half of 2004. The Company reported record sales in the first quarter of 2004, but ultimately resorted to heavy discounting of products in the second half of 2004 to stimulate retail sales. The Company is comfortable with retail inventory levels in 2005 and does not expect the discounting of products in 2005 similar to that which occurred in 2004.

[Table of Contents](#)

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

	Six Months Ended June 30,		Growth (Decline)	
	2005	2004	Dollars	Percent
Net sales:				
Woods	\$ 135.1	\$ 199.2	\$ (64.1)	(32)%
Irons	219.6	183.5	36.1	20%
Putters	65.8	66.2	(0.4)	—
Golf balls	129.8	146.6	(16.8)	(11)%
Accessories and other	72.7	66.2	6.5	10%
	<u>\$ 623.0</u>	<u>\$ 661.7</u>	<u>\$ (38.7)</u>	<u>(6)%</u>

The \$64.1 million (32%) decrease in net sales of woods to \$135.1 million resulted from lower sales volumes as well as lower average selling prices in 2005 compared to the same period in the prior year. This decrease reflects fewer new woods products, as well as the absence of a new driver product at the super premium price point in the 2005 product line as compared to 2004. 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 products including new hybrid woods products, multi-material fairway woods and titanium drivers.

The \$36.1 million (20%) increase in net sales of irons to \$219.6 million for the six months ended June 30, 2005 resulted from higher sales volumes as well as higher average selling prices in the first half of 2005 compared to the same period in the prior year. The higher sales volume is primarily attributable to the Company having more new irons models in its 2005 product line than its 2004 product line, including multi-material irons products which were not introduced until 2005. 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 steel irons products which were in the second and third years of their product life cycles.

The \$0.4 million (0%) decrease in net sales of putters to \$65.8 million is attributable to decreased sales of the Company's Odyssey White Hot 2-ball putter (which is in its third year of sales) and DFX line of Odyssey putters partially offset by the current year introduction of the Odyssey White Steel and Callaway Golf I-Trax putter models.

The \$16.8 million (11%) decrease in net sales of golf balls to \$129.8 million resulted from decreased Top-Flite golf ball sales volumes and lower average selling prices partially offset by an increase in Callaway Golf ball sales volumes. The decrease in sales of Top-Flite golf balls was primarily due to a planned reduction in the number of golf ball models in the 2005 product line as a result of the Company's discontinuance of certain less profitable golf ball models.

The \$6.5 million (10%) increase in sales of accessories and other products to \$72.7 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.

[Table of Contents](#)

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

	Six Months Ended June 30,		Growth (Decline)	
	2005	2004	Dollars	Percent
Net sales:				
United States	\$ 366.5	\$ 388.9	\$ (22.4)	(6)%
Europe	107.7	125.0	(17.3)	(14)%
Japan	55.1	48.3	6.8	14%
Rest of Asia	33.7	33.1	0.6	2%
Other foreign countries	60.0	66.4	(6.4)	(10)%
	<u>\$ 623.0</u>	<u>\$ 661.7</u>	<u>\$ (38.7)</u>	<u>(6)%</u>

Net sales in the United States decreased \$22.4 million (6%) to \$366.5 million during the first half of 2005 versus the first half of 2004. In addition, the Company's sales in regions outside of the United States decreased \$16.3 million (6%) to \$256.5 million during the first half of 2005 compared to the same period in 2004. The overall decrease in international sales is primarily attributable to a \$17.3 million (14%) decrease in sales in Europe combined with a \$6.4 million (10%) decrease in other foreign countries partially offset by a \$6.8 million (14%) increase in sales in Japan. The decrease in sales in Europe was primarily attributable to lower sales volumes in the first quarter of 2005 as compared to the same period in 2004 as the result of the Company's failure to supply sufficient product to satisfy demand. The Company's net sales were also affected by changes in foreign currency rates. See below, "Certain Factors Affecting Callaway Golf Company — Foreign Currency Risk."

For the six months ended June 30, 2005, gross profit decreased \$14.7 million to \$279.3 million from \$294.0 million in the comparable period of 2004. Gross profit as a percentage of net sales increased to 45% of net sales in the first six months of 2005 from 44% in the comparable period of 2004. This increase in the Company's gross profit percentage was primarily attributable to favorable foreign currency exchange rate fluctuations, improved golf ball margins and decreased club manufacturing costs. This was partially offset by lower average selling prices in certain product categories.

Selling expenses increased \$20.7 million (14%) in the first half of 2005 to \$166.4 million from \$145.7 million in the comparable period of 2004, and were 27% and 22% of net sales, respectively. This increase was primarily due to increases in advertising expense of \$7.9 million and tour and promotional expenses of \$12.1 million in the first half of 2005 compared to the same period in the prior year. These increases were primarily due to costs associated with brand investment and the timing of marketing expenses in support of second and third quarter product launches.

General and administrative expenses decreased \$4.4 million (10%) in the first half of 2005 to \$40.3 million from \$44.7 million in the comparable period of 2004. As a percentage of sales, general and administrative expenses decreased to 6% in the first half of 2005 from 7% in the comparable period of 2004. The decrease was primarily due to a decrease in legal expense of \$3.1 million, primarily as the result of the settlement of certain litigation in 2004, and a decrease in employee costs of \$2.5 million.

Research and development expenses decreased \$2.3 million (15%) in the first half of 2005 to \$13.3 million from \$15.7 million in the comparable period of 2004. As a percentage of sales, research and development expenses remained constant at 2%. The dollar decrease was primarily due to lower employee costs.

Other expense increased to \$3.0 million in the first half of 2005 as compared to other expense of \$1.3 million in the comparable period of 2004. The \$1.7 million of additional other expense is primarily attributable to \$0.7 million of net foreign currency fluctuation losses as well as an increase in interest expense of approximately \$1.0 million due to an increase in average outstanding borrowings under the Company's line of credit in 2005 compared to the same period of the prior year.

Table of Contents

The income tax provisions reflect tax rates of 34.7% and 37.4% for the period ended June 30, 2005 and 2004, respectively. This decrease in tax rate is primarily attributable to approximately \$1.6 million of net favorable adjustments recorded during the second quarter of 2005 related to the reassessment and resolution of various tax exposures during the second quarter 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 half of 2005 decreased \$17.6 million (32%) to \$36.7 million from \$54.3 million in the comparable period in 2004. Diluted earnings per share for the first half of 2005 decreased 32% to \$0.54 from \$0.79 in the comparable period in 2004. Net income was negatively impacted by after-tax charges related to the integration of the Callaway Golf and Top-Flite operations in the amounts of \$4.4 million and \$9.9 million in the first half of 2005 and 2004, respectively. Diluted earnings per share were negatively impacted by after-tax charges related to the integration of the Callaway Golf and Top-Flite operations in the amounts of \$0.06 and \$0.15 per share in the first half of 2005 and 2004, respectively. The Company expects to complete the integration of the Top-Flite operations and incur additional integration charges of approximately \$5.0 million during the second half of 2005.

Financial Condition

Cash and cash equivalents increased \$11.0 million (35%) to \$42.7 million at June 30, 2005, from \$31.7 million at December 31, 2004. The increase in cash primarily resulted from cash provided by financing activities of \$35.6 million offset by cash used in operating activities of \$4.1 million and cash used in investing activities of \$19.0 million. Cash flows used in operating activities for the six months ended June 30, 2005, reflect net income of \$36.8 million, adjusted for depreciation and amortization of \$22.7 million, a \$48.5 million increase in accounts payable and accrued expenses, a \$27.6 million decrease in income taxes receivable, and an \$8.9 million increase in accrued employee compensation benefits. These cash inflows were offset by a \$137.0 million increase in net accounts receivable. Cash flows used in investing activities reflects capital expenditures of \$19.1 million during the first half of 2005. Cash flows provided by financing activities are primarily attributable to an increase in net borrowings under the Company's line of credit of \$37.0 million partially offset by the issuance of common stock under employee benefit plans during the period. Additionally, during the six months ended June 30, 2005, the Company declared two dividends totaling \$9.6 million in the aggregate. Of this amount, \$4.8 million was paid to shareholders in April 2005 and \$4.8 million was payable as of June 30, 2005.

As of June 30, 2005, the Company's net accounts receivable increased \$133.1 million to \$238.3 million from \$105.2 million at December 31, 2004. The increase in accounts receivable is the result of increased sales in the second quarter of 2005 due to the launch of new products and the general seasonality of the golf industry as compared to the fourth quarter of 2004. The Company's net accounts receivable decreased \$22.8 million at June 30, 2005 as compared to the Company's net accounts receivable at June 30, 2004. This decrease is primarily attributable to shorter payment terms offered in 2005 compared to the extended payment terms offered in 2004. The Company's days sales outstanding ("DSO") were 67 days at June 30, 2005, compared to 67 days at December 31, 2004, and 79 days at June 30, 2004.

As of June 30, 2005, the Company's net inventory increased \$12.1 million to \$193.4 million from \$181.2 million at December 31, 2004. The Company's net inventory increased \$38.8 million as of June 30, 2005 as compared to the Company's net inventory as of June 30, 2004. This increase in inventory is primarily due to an increase in the number of iron models and the addition of a new Ben Hogan line of woods in the 2005 product line as well as the timing of sales during 2005 as compared to 2004.

As of June 30, 2005, the Company's net property, plant and equipment decreased \$3.8 million to \$132.1 million from \$135.9 million at December 31, 2004. This decrease is primarily due to depreciation of \$21.1 million during the first six months of 2005, partially offset by additions of \$19.1 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 June 30, 2005, the maximum amount that could be borrowed under the Line of Credit was approximately \$200.0 million and of that amount, the Company had \$50.0 million outstanding and Letters of Credit issued of \$1.7 million.

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 June 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 \$1.1 million as of June 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 second quarter of 2005, the Company did not repurchase any of its shares under the May 2002 authorization. The Company, however, did reacquire 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. (See Part II, Item 2. Unregistered Sales of Equity Securities and Use of Proceeds).

As of June 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.

[Table of Contents](#)

Other Significant Cash and Contractual Obligations

The following table summarizes certain significant cash and contractual obligations as of June 30, 2005 that will affect the Company's future liquidity (in millions):

Line of credit	Payments Due By Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Operating leases ⁽¹⁾	\$ 50.0	\$ 50.0	\$ —	\$ —	\$ —
Capital leases ⁽²⁾	14.0	5.7	6.1	1.5	0.7
Unconditional purchase obligations ⁽³⁾	0.1	0.1	—	—	—
Deferred compensation ⁽⁴⁾	125.1	29.4	58.8	36.0	0.9
Total ⁽⁵⁾	7.5	0.9	0.7	0.5	5.4
	<u>\$ 196.7</u>	<u>\$ 86.1</u>	<u>\$ 65.6</u>	<u>\$ 38.0</u>	<u>\$ 7.0</u>

- (1) The Company leases certain warehouse, distribution and office facilities, vehicles and office equipment under operating leases. The amounts presented in this line item represent commitments for minimum lease payments under 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 \$9.7 million at June 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

Table of Contents

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

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

Revenue Recognition

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

Allowance for Doubtful Accounts

The Company maintains an allowance for estimated losses resulting from the failure of its customers to make required payments. An estimate of uncollectable amounts is made by management based upon historical bad debts, current customer receivable balances, age of customer receivable balances, the customer's financial condition and current economic trends, 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 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

[Table of Contents](#)

and therefore there can be no assurance that the demand for the Company's products will permit the Company to experience growth in sales, or maintain historical levels of sales, in the future.

New Product Introduction and Product Cyclicity

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

The Company's newly introduced golf club products generally, but not always, have a product life cycle of up to two years. These products generally sell significantly better in the first year after introduction as compared to the second year. In certain markets, such as Japan, the decline in sales occurs sooner in the product cycle and is more significant. The Company's fusion woods generally sell at higher price points than its titanium metal woods, and its titanium metal woods generally sell at higher price points than its steel metal woods. Historically, the Company's 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.

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, “close-outs” (including close-outs 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 affect on the Company’s pre-owned club business as the gap between the cost of a new club and a pre-owned club lessens. There can be no assurance that successful marketing activities, discounted pricing, consignment sales, extended payment terms or new product introductions by competitors will not negatively impact the Company’s future sales.

Golf Balls. The golf ball business is also highly competitive. 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 5% and 4% of the Company’s revenue during the first six months ended June 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 six months of 2005, the top five golf ball customers accounted for approximately 17% 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 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

Table of Contents

U.S. dollar. For the effect of the Company's hedging activities during the current reporting periods, see below "Quantitative and Qualitative Disclosures about Market Risk." The Company's future financial results could be significantly 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 deferments 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, such as the hurricanes in Florida and along the east coast in late 2004, can negatively affect golf rounds played not only during the storms but also for a significant period of time afterward as storm damaged golf courses are

repaired and golfers focus on repairing the damage to their homes, businesses and communities. Consequently, sustained adverse weather conditions, especially during the warm weather months, could materially affect the Company's sales.

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 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 licensees various restrictions on the products, and on the manner, on which such trademarks may be used. In

Table of Contents

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 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 accounting standard been in effect during the six months ended June 30, 2005, the Company's net income and diluted earnings per share would have decreased by \$2.3 million and \$0.04, respectively.

Analyst Guidance, Media Reports and Market Volatility

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

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

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.

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

Table of Contents

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 June 30, 2005 and 2004, the notional amounts of the Company's foreign exchange contracts were approximately \$78.8 million and \$85.0 million, respectively. The Company estimates the fair values of derivatives based on quoted market prices or pricing models using current market rates, and records all derivatives on the balance sheet at fair value. At June 30, 2005, the fair value of foreign currency-related derivatives was recorded as current assets of \$2.0 million and current liabilities of \$0.1 million.

As of June 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 six months ended June 30, 2005, no gain or loss was recorded as a result of changes in the spot-forward differential. During the six months ended June 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 June 30, 2005 and 2004, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$78.8 million and \$85.0 million, respectively. The gains and losses on foreign currency contracts used to hedge balance sheet exposures are recognized as a component of other income (expense), net in the same period as the remeasurement gain and loss of the related foreign currency denominated assets and liabilities and thus offset these gains and losses. During the three months ended June 30, 2005 and 2004, the Company recorded a net gain of \$2.8 million and a net gain of \$1.1 million, respectively, due to net realized and unrealized gains and losses on contracts used to hedge balance sheet exposures. During the six months ended June 30, 2005 and 2004, the Company recorded net gains of \$3.6 million and \$0.6 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 June 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

[Table of Contents](#)

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 \$7.9 million at June 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 \$7.9 million at June 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 7 to the Company's Consolidated Condensed Financial Statements). Outstanding borrowings accrue interest at the Company's election, based upon the Company's consolidated leverage ratio and trailing four quarters 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 5 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 June 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 first quarter of 2005, the Company changed certain aspects of its golf club manufacturing process, including the method of tracking inventory within that process. As a result of this change, the Company implemented new internal controls for tracking inventory within the manufacturing process. During the second quarter of 2005, the Company made further changes to its golf club manufacturing process and as a result also made further changes to its internal controls for tracking inventory within the manufacturing process. The Company believes that its internal controls for tracking inventory were effective as of June 30, 2005. During the quarter ended June 30, 2005, there were no other 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

Table of Contents

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.

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 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 has not made a determination that the case may proceed in the form of a class action. The parties are engaged in discovery and motion practice. Plaintiff has moved for summary judgment and to certify the case as a nationwide class action. On July 13, 2005 the court denied the plaintiff's motion for summary judgment. On July 20, 2005, the court denied plaintiff's motion to certify the case as a nationwide class action.

Table of Contents

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. It is expected that if Maxfli is ultimately unsuccessful with its post-trial motions, it will appeal the verdict. If Maxfli is successful with its post-trial motions, or an appeal of the verdict, and Maxfli's counterclaims are ultimately resolved in Maxfli's favor, such matters could have a significant adverse effect upon the Company's results of operations, cash flows and financial position.

On December 14, 2004, Callaway Golf Sales Company was served with a complaint captioned York v. Callaway Golf Sales Company, filed in the Circuit Court for Dade County, Florida, Case No. 04-25625 CA 11, asserting a purported class action on behalf of all consumers who purchased allegedly defective HX Red golf balls with cracked covers. The complaint contains causes of action for strict liability, breach of implied and express warranties, and violation of the Magnuson-Moss Consumer Product Warranty Act. On January 12, 2005, Callaway Golf removed the case to the United States District Court for the Southern District of Florida. Plaintiff subsequently dismissed his federal claim, and two of his state court claims, and the case was remanded to the Circuit Court for Dade County, Florida. Thereafter, plaintiff dismissed the complaint without prejudice, terminating 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 Maxfli litigation and 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.

[Table of Contents](#)**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 second quarter of 2005, the Company did not repurchase any of its shares under the May 2002 authorization. The Company, however, did reacquire 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. Set forth below is a summary of the shares reacquired during the second quarter of 2005 (in thousands except per share amounts):

	<u>Total # of Shares Purchased⁽¹⁾</u>	<u>Average Price Paid per Share</u>	<u>Total # of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Approximate Dollar Value of Shares that may yet be Purchased Under the Plans or Programs</u>
April 1, 2005 — April 30, 2005	—	—	—	\$ 7,900
May 1, 2005 — May 31, 2005	—	—	—	\$ 7,900
June 1, 2005 — June 30, 2005	3	\$ 12.36	—	\$ 7,900

(1) All share acquisitions set forth in this table were made in connection with the satisfaction of employee tax obligations upon the vesting of restricted stock awards.

As of June 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 average 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

On May 24, 2005, the Company held its 2005 Annual Meeting of Shareholders. William C. Baker, Samuel H. Armacost, Ronald S. Beard, John C. Cushman, III, Yotaro Kobayashi, Richard L. Rosenfield and Anthony S. Thornley were elected to the Board of Directors. In addition, the Company's shareholders ratified the appointment of Deloitte & Touche LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2005.

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

<u>Name</u>	<u>Votes For</u>	<u>Votes Withheld</u>
William C. Baker	65,678,243	4,490,829
Samuel H. Armacost	67,022,161	3,146,911
Ronald S. Beard	67,024,942	3,144,130
John C. Cushman, III	68,881,623	1,287,449
Yotaro Kobayashi	68,701,951	1,467,121
Richard L. Rosenfield	68,012,408	2,156,664
Anthony S. Thornley	67,491,237	2,677,835

The voting results for the ratification to appoint Deloitte & Touche LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2005 are as follows:

<u>Votes For</u>	<u>Votes Against</u>	<u>Abstain</u>
69,679,051	374,675	115,346

Table of Contents

Item 5. Other Information

None

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). |
| 10.56 | Third Amendment to First Amended Executive Officer Employment Agreement by and between the Company and Bradley J. Holiday.† |
| 10.57 | Form of Restricted Stock Grant for Officers.† |
| 31.1 | Certification of George Fellows pursuant to Rule13a-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 Rule13a-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: August 4, 2005

EXHIBIT INDEX

Exhibit	Description
10.56	Third Amendment to First Amended Executive Officer Employment Agreement by and between the Company and Bradley J. Holiday.
10.57	Form of Restricted Stock Grant for Officers.
31.1	Certification of George Fellows pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Bradley J. Holiday pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of George Fellows and Bradley J. Holiday pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

THIRD AMENDMENT TO
FIRST AMENDED EXECUTIVE OFFICER EMPLOYMENT AGREEMENT

This Third Amendment to the First Amended Executive Officer Employment Agreement ("Third Amendment") is made effective as of March 30, 2005 by and between CALLAWAY GOLF COMPANY, a Delaware corporation (the "Company"), and BRADLEY J. HOLIDAY ("Employee").

A. The Company and Employee are parties to that certain First Amended Executive Officer Employment Agreement entered into as of June 1, 2002, as amended by a First Amendment entered into as of March 1, 2003, and as further amended by a Second Amendment effective as of September 15, 2003 (as amended, the "First Amended Agreement").

B. The Company and Employee desire to amend further the First Amended Agreement pursuant to Section 15 thereof, in the manner set forth herein.

NOW THEREFORE, in consideration of the foregoing and other consideration, the value and sufficiency of which are hereby acknowledged, the Company and Employee hereby agree as follows:

1. Section 19(a) of the First Amended Agreement is amended to read as follows:

"(a) AMOUNT. Special Severance shall consist of (i) severance payments equal to one-half of Employee's then current base salary at the same rate and on the same payment schedule as in effect at the time of termination for a period equal to the greater of twenty-four (24) months from the date of termination or the remainder of any Renewal Term; (ii) the payment of premiums owed for COBRA insurance benefits for a period of time equal to the maximum time allowable under COBRA, but not to exceed twenty-four (24) months in any event; and (iii) no other severance."

2. Section 20(a) of this First Amended Agreement is amended to read as follows:

"(a) TERMS AND CONDITIONS. Subject to the requirements set forth in this Section, Employee shall be eligible for Incentive Payments in the event that Employee is terminated by the Company without substantial cause pursuant to Sections 8(a) or 9(a), or terminates employment for good reason pursuant to Section 8(c). Incentive Payments shall be equal to one-half of Employee's then-current base salary paid at the rate and on the same payment schedule as in effect at the time of termination for a period of time equal to the greater of twenty-four (24) months from the date of termination or the remainder of any Renewal Term. Incentive Payments shall be conditioned upon Employee choosing not to engage (whether as an owner, employee, agent, consultant, or in any other capacity) in any business or venture that competes with the business of the Company or any of its affiliates. If Employee chooses to engage in such activities, then the Company shall have no obligation to make Incentive Payments for the period of time during which Employee chooses to do so."

3. But for the amendments contained herein, and any other written amendments properly executed by the parties, the First Amended Agreement shall otherwise remain unchanged.

IN WITNESS WHEREOF, the parties have executed this Third Amendment to be effective as of the date first written above.

EMPLOYEE

COMPANY

Callaway Golf Company,
a Delaware corporation

Bradley J. Holiday

By: -----
William C. Baker
Chairman of the Board and CEO

CALLAWAY GOLF COMPANY
RESTRICTED STOCK GRANT

RECIPIENT:
EFFECTIVE GRANT DATE:
NUMBER OF SHARES:
PLAN: 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, 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"):

NUMBER OF SHARES

DATE RESTRICTIONS LAPSE

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); and PROVIDED, FURTHER, that 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. 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.
- (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, 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 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:

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: August 4, 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: August 4, 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 three and six months ended June 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 August 4, 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.