

CALLAWAY GOLF CO  
Form 10-Q  
May 05, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2008

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 001-10962

**Callaway Golf Company**

(Exact name of registrant as specified in its charter)

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**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 a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

The number of shares outstanding of the Registrant's Common Stock, \$.01 par value, as of April 30, 2008 was 66,274,452.

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**Important Notice to Investors:** Statements made in this report that relate to future plans, events, liquidity, financial results or performance including statements relating to future cash flows and liquidity, as well as estimated unrecognized compensation expense, projected capital expenditures and future contractual obligations, are forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. These statements are based upon current information and expectations. Accurately estimating the Company's future financial performance is based upon various unknowns including consumer acceptance and demand for the Company's products as well as future consumer discretionary purchasing activity, which can be significantly affected by unfavorable economic or market conditions. Actual results may differ materially from those estimated or anticipated as a result of these unknowns or other risks and uncertainties, including delays, difficulties, changed strategies, or unanticipated factors affecting the implementation of the Company's gross margin improvement initiatives, as well as the general risks and uncertainties applicable to the Company and its business. For details concerning these and other risks and uncertainties, see Part I, Item IA, "Risk Factors" of our most recent Form 10-K as well as the Company's other reports subsequently filed with the Securities and Exchange Commission from time to time. Investors are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to update forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Investors should also be aware that while the Company from time to time does communicate with securities analysts, it is against the Company's policy to disclose to them any material non-public information or other confidential commercial information. Furthermore, the Company has a policy against distributing or confirming financial forecasts or projections issued by analysts and any reports issued by such analysts are not the responsibility of the Company. Investors should not assume that the Company agrees with any report issued by any analyst or with any statements, projections, forecasts or opinions contained in any such report.

**Callaway Golf Company Trademarks:** *The following marks and phrases, among others, are trademarks of Callaway Golf Company: A Better Game By Design A Passion For Excellence Apex Ben Hogan BH Big Bertha Callaway Callaway Collection Callaway Golf Callaway Golf Drysport Callaway Golf X Series Chev Chevron Device Complete Demonstrably Superior and Pleasingly Different Dual Force ERC Explosive Distance.Amazing Soft Feel Flying Lady FT-i FT-ibrid FT-3 FT-5 FTX Fusion Game Series Gems Great Big Bertha Heavenwood Hogan Hybrid 45 Hyper X HX HX Hot HX Hot Bite HX Pearl HX Tour I-Mix Marksman Molitor Number One Putter in Golf Odyssey OptiFit Rossie S2H2 Sabertooth SRT SenSert Speed Slot Squareway Steelhead Strata Stronomic Sure-Out TF Design Tech Series Top-Flite Top Flite D2 Top-Flite XL Tour Authentic Tour Deep Tour i Tour iX Trade In! Trade Up! TriBall Tru Bore Tunité VFT Warbird Warbird White Hot White Hot XG White Steel World's Friendliest X-18 X-20 X460 XL 5000 XL Extreme X-Forged X Hot X-Series X-Sole X-SPANN Xtra Traction Technology X-Tour XTT Xtra Width Technology XWT.*

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**CALLAWAY GOLF COMPANY**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****CALLAWAY GOLF COMPANY****CONSOLIDATED CONDENSED BALANCE SHEETS****(Unaudited)****(In thousands, except share and per share data)**

|  | <b>March 31,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|--|---------------------------|------------------------------|
| <b>ASSETS</b>  |                           |                              |
| Current assets:  |                           |                              |
| Cash and cash equivalents  | \$ 39,385                 | \$ 49,875                    |
| Accounts receivable, net   | 300,495                   | 112,064                      |
| Inventories, net   | 264,319                   | 253,001                      |
| Deferred taxes   | 42,512                    | 42,219                       |
| Income taxes receivable  |                           | 9,232                        |
| Other current assets   | 33,377                    | 30,190                       |
| <b>Total current assets</b>  | <b>680,088</b>            | <b>496,581</b>               |
| Property, plant and equipment, net   | 131,584                   | 128,036                      |
| Intangible assets, net   | 140,187                   | 140,985                      |
| Goodwill   | 32,548                    | 32,060                       |
| Deferred taxes   | 19,094                    | 18,885                       |
| Other assets   | 39,799                    | 40,416                       |
|  | <b>\$ 1,043,300</b>       | <b>\$ 856,963</b>            |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                           |                              |
| Current liabilities:   |                           |                              |
| Accounts payable and accrued expenses  | \$ 159,124                | \$ 130,410                   |
| Accrued employee compensation and benefits   | 30,204                    | 44,245                       |
| Accrued warranty expense   | 12,990                    | 12,386                       |
| Income taxes payable   | 10,549                    |                              |
| Credit facilities  | 155,570                   | 36,507                       |
| <b>Total current liabilities</b>   | <b>368,437</b>            | <b>223,548</b>               |
| Long-term liabilities:   |                           |                              |
| Deferred taxes   | 22,129                    | 21,252                       |
| Energy derivative valuation account  | 19,922                    | 19,922                       |
| Income taxes payable   | 13,819                    | 13,833                       |
| Deferred compensation and other  | 7,642                     | 8,200                        |
| Minority interest in consolidated subsidiary   | 1,526                     | 1,978                        |
| Commitments and contingencies (Note 8)   |                           |                              |
| Shareholders' equity:  |                           |                              |
| Preferred Stock, \$.01 par value, 3,000,000 shares authorized, none issued and outstanding at March 31, 2008 and December 31, 2007                                 |                           |                              |
| Common Stock, \$.01 par value, 240,000,000 shares authorized, 66,278,525 shares and 66,281,693 shares issued at March 31, 2008 and December 31, 2007, respectively | 663                       | 663                          |

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|   |              |            |
|---|--------------|------------|
| Additional paid-in capital  | 107,438      | 111,953    |
| Unearned compensation   | (1,248)      | (2,158)    |
| Retained earnings   | 505,607      | 470,469    |
| Accumulated other comprehensive income  | 21,182       | 18,904     |
| Less: Grantor Stock Trust held at market value, 1,617,495 shares and 1,813,010 shares at March 31, 2008 and December 31, 2007, respectively | (23,745)     | (31,601)   |
| Less: Common Stock held in treasury, at cost, 4,073 shares and 0 shares at March 31, 2008 and December 31, 2007, respectively               | (72)         |            |
| Total shareholders' equity  | 609,825      | 568,230    |
|   | \$ 1,043,300 | \$ 856,963 |

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

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**CALLAWAY GOLF COMPANY**  
**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**

(Unaudited)

(In thousands, except per share data)

|                                      | Three Months Ended |      |                   |      |
|--------------------------------------|--------------------|------|-------------------|------|
|                                      | 2008               |      | March 31,<br>2007 |      |
| Net sales                            | \$ 366,452         | 100% | \$ 334,607        | 100% |
| Cost of sales                        | 190,918            | 52%  | 173,886           | 52%  |
| Gross profit                         | 175,534            | 48%  | 160,721           | 48%  |
| Operating expenses:                  |                    |      |                   |      |
| Selling expenses                     | 80,161             | 22%  | 75,291            | 23%  |
| General and administrative expenses  | 22,488             | 6%   | 21,558            | 6%   |
| Research and development expenses    | 7,924              | 2%   | 8,016             | 2%   |
| Total operating expenses             | 110,573            | 30%  | 104,865           | 31%  |
| Income from operations               | 64,961             | 18%  | 55,856            | 17%  |
| Other income (expense), net          | 695                |      | (1,338)           |      |
| Income before income taxes           | 65,656             | 18%  | 54,518            | 16%  |
| Provision for income taxes           | 25,990             |      | 21,682            |      |
| Net income                           | \$ 39,666          | 11%  | \$ 32,836         | 10%  |
| Earnings per common share:           |                    |      |                   |      |
| Basic                                | \$ 0.62            |      | \$ 0.49           |      |
| Diluted                              | \$ 0.61            |      | \$ 0.48           |      |
| Weighted-average shares outstanding: |                    |      |                   |      |
| Basic                                | 63,895             |      | 67,272            |      |
| Diluted                              | 64,843             |      | 68,318            |      |
| Dividends declared per share         | \$ 0.07            |      | \$ 0.07           |      |

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

**Table of Contents****CALLAWAY GOLF COMPANY****CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS****(Unaudited)****(In thousands)**

|  | <b>Three Months Ended<br/>March 31,</b> |                  |
|--|---|------------------|
|  | <b>2008</b>                             | <b>2007</b>      |
| <b>Cash flows from operating activities:</b>   |   |                  |
| Net income   | \$ 39,666                               | \$ 32,836        |
| <b>Adjustments to reconcile net income to net cash used in operating activities:</b> |   |                  |
| Depreciation and amortization  | 8,794                                   | 9,009            |
| Deferred taxes   | 8,521                                   | (538)            |
| Non-cash share-based compensation  | 1,468                                   | 3,127            |
| (Gain) loss on disposal of long-lived assets   | (230)                                   | 3                |
| <b>Changes in assets and liabilities:</b>  |   |                  |
| Accounts receivable, net   | (187,322)                               | (160,039)        |
| Inventories, net   | (7,714)                                 | (4,802)          |
| Other assets   | (1,972)                                 | (45)             |
| Accounts payable and accrued expenses  | 19,996                                  | 13,903           |
| Accrued employee compensation and benefits   | (14,172)                                | 8,231            |
| Accrued warranty expense   | 604                                     | 792              |
| Income taxes payable   | 11,352                                  | 20,271           |
| Deferred compensation  | (372)                                   | (368)            |
| <b>Net cash used in operating activities</b>   | <b>(121,381)</b>                        | <b>(77,620)</b>  |
| <b>Cash flows from investing activities:</b>   |   |                  |
| Capital expenditures   | (11,732)                                | (7,987)          |
| <b>Net cash used in investing activities</b>   | <b>(11,732)</b>                         | <b>(7,987)</b>   |
| <b>Cash flows from financing activities:</b>   |   |                  |
| Issuance of Common Stock   | 2,767                                   | 12,833           |
| Acquisition of Treasury Stock  | (72)                                    | (15,155)         |
| Proceeds from credit facilities, net   | 119,063                                 | 75,000           |
| Other financing activities   | (254)                                   | 951              |
| <b>Net cash provided by financing activities</b>                                     | <b>121,504</b>                          | <b>73,629</b>    |
| <b>Effect of exchange rate changes on cash and cash equivalents</b>                  | <b>1,119</b>                            | <b>210</b>       |
| <b>Net decrease in cash and cash equivalents</b>                                     | <b>(10,490)</b>                         | <b>(11,768)</b>  |
| <b>Cash and cash equivalents at beginning of year</b>                                | <b>49,875</b>                           | <b>46,362</b>    |
| <b>Cash and cash equivalents at end of year</b>                                      | <b>\$ 39,385</b>                        | <b>\$ 34,594</b> |

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



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## CALLAWAY GOLF COMPANY

## CONSOLIDATED CONDENSED STATEMENT OF SHAREHOLDERS' EQUITY

(Unaudited)

(In thousands)

|  | Common Stock |        |                            |                       |                   | Accumulated Other Comprehensive Income (Loss) | Grantor Stock Trust | Treasury Stock |         |            | Comprehensive Income (Loss) |
|--|--------------|--------|----------------------------|-----------------------|-------------------|---|---------------------|----------------|---------|------------|-----------------------------|
|  | Shares       | Amount | Additional Paid-in Capital | Unearned Compensation | Retained Earnings |   |                     | Shares         | Amount  | Total      |                             |
| <b>Balance, December 31, 2007</b>                        | 66,282       | \$ 663 | \$ 111,953                 | \$ (2,158)            | \$ 470,469        | \$ 18,904                                     | \$ (31,601)         |                | \$      | \$ 568,230 |                             |
| Exercise of stock options                                |              |        | (430)                      |                       |                   |   | 1,674               |                |         | 1,244      |                             |
| Tax benefit from exercise of stock options               |              |        | 16                         |                       |                   |   |                     |                |         | 16         |                             |
| Issuance of restricted stock                             | (1)          |        |                            | 910                   |                   |   |                     |                |         | 910        |                             |
| Compensatory stock and stock options                     | (2)          |        | 558                        |                       |                   |   |                     |                |         | 558        |                             |
| Acquisition of Treasury Stock                            |              |        |                            |                       |                   |   |                     | (4)            | (72)    | (72)       |                             |
| Employee stock purchase plan                             |              |        | (213)                      |                       |                   |   | 1,736               |                |         | 1,523      |                             |
| Cash dividends declared                                  |              |        |                            |                       | (4,528)           |   |                     |                |         | (4,528)    |                             |
| Adjustment of Grantor Stock Trust shares to market value |              |        | (4,446)                    |                       |                   |   | 4,446               |                |         |            |                             |
| Equity adjustment from foreign currency translation      |              |        |                            |                       |                   | 2,278   |                     |                |         | 2,278      | \$ 2,278                    |
| Net income   |              |        |                            |                       | 39,666            |   |                     |                |         | 39,666     | 39,666                      |
| <b>Balance, March 31, 2008</b>                           | 66,279       | \$ 663 | \$ 107,438                 | \$ (1,248)            | \$ 505,607        | \$ 21,182                                     | \$ (23,745)         | (4)            | \$ (72) | \$ 609,825 | \$ 41,944                   |

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

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**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, 2007 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. Income Taxes**

The Company calculates its interim income tax provision in accordance with Accounting Principles Board Opinion No. 28, *Interim Financial Reporting* and FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*. At the end of each interim period, the Company estimates the annual effective tax rate and applies that rate to its ordinary quarterly earnings. The tax expense or benefit related to significant, unusual, or extraordinary items that will be separately reported or reported net of their related tax effect, and are individually computed are recognized in the interim period in which those items occur. In addition, the effect of changes in enacted tax laws or rates or tax status is recognized in the interim period in which the change occurs.

The computation of the annual estimated effective tax rate at each interim period requires certain estimates and significant judgment including, but not limited to, the expected operating income for the year, projections of the proportion of income earned and taxed in foreign jurisdictions, permanent and temporary differences as a result of differences between amounts measured and recognized in accordance with tax laws and financial accounting standards, and the likelihood of recovering deferred tax assets generated in the current year. The accounting estimates used to compute the provision for income taxes may change as new events occur, additional information is obtained or as the tax environment changes.

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 federal, state and international 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 tax positions taken by the Company (uncertain tax positions) and therefore require the Company to pay additional taxes. As required under applicable accounting rules, the Company therefore accrues an amount for its estimate of additional tax liability, including interest and penalties, which the Company could incur as a result of the ultimate resolution of the uncertain tax positions. The Company reviews and updates the accrual for uncertain tax positions as more

**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

definitive information becomes available from taxing authorities, completion of tax audits, expiration of statute of limitations, or upon occurrence of other events.

Effective January 1, 2007, the Company was required to adopt and implement the provisions of FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), which requires the Company to accrue for the estimated additional amount of taxes for the uncertain tax positions if it is more likely than not that the Company would be required to pay such additional taxes. An uncertain income tax position will not be recognized if it has less than 50% likelihood of being sustained. The accrual for uncertain tax positions can result in a difference between the estimated benefit recorded in the Company's financial statements and the benefit taken or expected to be taken in the Company's income tax returns. This difference is generally referred to as an unrecognized tax benefit.

As of March 31, 2008, the liability for income taxes associated with uncertain tax benefits was \$17,720,000 and can be reduced by \$8,370,000 of offsetting tax benefits associated with the correlative effects of potential transfer pricing adjustments which was recorded as a long-term income tax receivable as well as \$1,290,000 of tax benefits associated with state income taxes and other timing adjustments which are recorded as deferred income taxes pursuant to FIN 48. The net amount of \$8,060,000, if recognized, would affect the Company's financial statements and favorably affect the Company's effective income tax rate.

Although the timing and ultimate resolution of audits is uncertain, the Company does not believe it is reasonably possible that the total amounts of unrecognized tax benefits will materially change in the next 12 months.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense. For the quarter ended March 31, 2008 the Company recognized approximately \$51,000 of interest and penalties in the provision for income taxes. As of March 31, 2008 and December 31, 2007, the Company had accrued \$1,575,000 and \$1,524,000, respectively, (before income tax benefit) for the payment of interest and penalties.

The Internal Revenue Service field examination of tax years 2001 through 2003 is complete and certain issues are pending before IRS Appeals. It is reasonably possible that resolution can be reached prior to September 30, 2008. Any possible settlement could increase/(decrease) earnings but is not expected to be significant. Audit outcomes and the timing of audit settlements are subject to significant uncertainty.

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

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

**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)****3. Inventories**

Inventories are summarized below (in thousands):

|                   | March 31,<br>2008 | December 31,<br>2007 |
|-------------------|-------------------|----------------------|
| Inventories, net: |                   |                      |
| Raw materials     | \$ 83,403         | \$ 82,185            |
| Work-in-process   | 2,124             | 1,932                |
| Finished goods    | 178,792           | 168,884              |
|                   | \$ 264,319        | \$ 253,001           |

**4. Goodwill and Intangible Assets**

The Company accounts for its goodwill and other non-amortizing intangible assets in accordance with the provisions of 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. Patents and other intangible assets are recorded at cost at the time of acquisition and amortized using the straight-line method over their estimated useful lives, which range over periods between 1-16 years. During the three months ended March 31, 2008 and 2007, aggregate amortization expense was approximately \$798,000 and \$836,000, respectively. The following sets forth the intangible assets by major asset class (dollars in thousands):

|                                       | Useful<br>Life<br>(Years) | March 31, 2008 |                             |                   | December 31, 2007 |                             |                   |
|---------------------------------------|---------------------------|----------------|-----------------------------|-------------------|-------------------|-----------------------------|-------------------|
|                                       |                           | Gross          | Accumulated<br>Amortization | Net Book<br>Value | Gross             | Accumulated<br>Amortization | Net Book<br>Value |
| <b>Non-Amortizing:</b>                |                           |                |                             |                   |                   |                             |                   |
| Trade name, trademark and trade dress | NA                        | \$ 121,794     | \$                          | \$ 121,794        | \$ 121,794        | \$                          | \$ 121,794        |
| <b>Amortizing:</b>                    |                           |                |                             |                   |                   |                             |                   |
| Patents                               | 3-16                      | 36,459         | 18,992                      | 17,467            | 36,459            | 18,288                      | 18,171            |
| Other                                 | 1-9                       | 2,853          | 1,927                       | 926               | 2,853             | 1,833                       | 1,020             |
| Total intangible assets               |                           | \$ 161,106     | \$ 20,919                   | \$ 140,187        | \$ 161,106        | \$ 20,121                   | \$ 140,985        |

Amortization expense related to intangible assets at March 31, 2008 in each of the next five fiscal years and beyond is expected to be incurred as follows (in thousands):

|                   |          |
|-------------------|----------|
| Remainder of 2008 | \$ 2,393 |
| 2009              | 2,945    |
| 2010              | 2,838    |
| 2011              | 2,587    |

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|            |           |
|------------|-----------|
| 2012       | 2,158     |
| 2013       | 1,341     |
| Thereafter | 4,131     |
|            | \$ 18,393 |

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**CALLAWAY GOLF COMPANY**

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

**(Unaudited)**

Goodwill at March 31, 2008 was \$32,548,000. Changes in goodwill during the three months ended March 31, 2008 of \$488,000 were due to favorable foreign currency fluctuations.

**5. Investments**

**Investment in Golf Entertainment International Limited Company**

During the fourth quarter of 2006, the Company made an investment in Golf Entertainment International Limited ( GEI ), the owner and operator of TopGolf entertainment centers. In connection with the investment, the Company acquired Preferred Shares of GEI for approximately \$10,000,000. The Company accounts for this investment under the cost method in accordance with the provisions of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock and reflected the balance in other long-term assets in the accompanying consolidated condensed balance sheet as of March 31, 2008.

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

In August 2007, the Company and other GEI shareholders entered into a loan agreement with GEI to provide funding to GEI for certain capital projects as well as operational needs. In December 2007, the Company and other GEI shareholders entered into a second loan agreement with GEI to supplement GEI's cash flows from operations as a result of the seasonal fluctuations of the business. Both loan agreements extend to all shareholders of GEI, whereby each shareholder may participate by funding up to an amount agreed upon by GEI. As of March 31, 2008, the Company funded a combined total of \$3,813,000 under both loan agreements, which includes accrued interest of \$610,000. The loan agreements provide for the option, at the Company's discretion, to convert up to 100 percent of the amount drawn by GEI, including accrued interest, into convertible preferred shares. In connection with the loans, the Company has received underwriting fees and will receive annual interest at market rates on loaned amounts. The Company is conditionally committed to fund an additional \$705,000 under the second loan agreement during 2008 if called upon by GEI and if not otherwise funded by other shareholders.

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

**Investment in Qingdao Suntech Sporting Goods Limited Company**

In October 2006, the Company entered into a Golf Ball Manufacturing and Supply Agreement with Qingdao Suntech Sporting Goods Limited Company ( Suntech ), where Suntech manufactures and supplies certain golf balls solely for and to the Company. Suntech is a wholly owned subsidiary of Suntech Mauritius Limited Company ( Mauritius ). In connection with the agreement, the Company provides Suntech with golf ball raw materials, packing materials, molds, tooling, as well as manufacturing equipment in order to carry out the manufacturing and supply obligations set forth in the agreement. Suntech provides the personnel as well as the facilities to effectively perform these manufacturing and supply obligations. Due to the nature of the

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arrangement, as well as the controlling influence the Company has in the Suntech operations, the Company is required to consolidate the financial results of Suntech in its consolidated condensed financial statements as of March 31, 2008 and December 31, 2007, in accordance with the provisions of FASB Interpretation No. 46R, Consolidation of Variable Interest Entities.

In addition, the Company has entered into a Loan Agreement with Mauritius in order to provide working capital for Suntech. In connection with this Loan Agreement, the Company loaned Mauritius a total of \$3,200,000 as of March 31, 2008.

**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 satisfying future warranty claims at the time the sale is recorded. In estimating its future warranty obligations, the Company considers various relevant factors, including the Company's stated warranty policies and practices, the historical frequency of claims, and the cost to replace or repair its products under warranty. The following table provides a reconciliation of the activity related to the Company's reserve for warranty expense (in thousands):

|                            | <b>Three Months Ended</b> |             |
|----------------------------|---------------------------|-------------|
|                            | <b>March 31,</b>          |             |
|                            | <b>2008</b>               | <b>2007</b> |
| Beginning balance          | \$ 12,386                 | \$ 13,364   |
| Provision                  | 3,035                     | 3,090       |
| Claims paid/costs incurred | (2,431)                   | (2,298)     |
| Ending balance             | \$ 12,990                 | \$ 14,156   |

**7. Financing Arrangements**

The Company's principal sources of liquidity are cash flows provided by operations and the Company's credit facilities in effect from time to time. The Company currently expects this to continue. The Company's primary line of credit, which is scheduled to expire on February 15, 2012, is a \$250,000,000 line of credit with Bank of America, N.A., and certain other lenders party to the Company's November 5, 2004 Amended and Restated Credit Agreement (as amended, the Line of Credit).

The Line of Credit provides for revolving loans of up to \$250,000,000, although actual borrowing availability can be effectively limited by the financial covenants contained therein. As of March 31, 2008, the maximum amount that could be borrowed under the Line of Credit was \$250,000,000, of which \$155,000,000 was outstanding. In addition, the Company had approximately \$570,000 outstanding under other credit facilities at March 31, 2008.

Under the Line of Credit, the Company is required to pay certain fees, including an unused commitment fee of between 10.0 to 25.0 basis points per annum of the unused commitment amount, with the exact amount determined based upon the Company's consolidated leverage ratio and trailing four quarters' earnings before interest, income taxes, depreciation and amortization, as well as other non-cash expense and income items (EBITDA) (each as defined in the agreement governing the Line of Credit). Outstanding borrowings under the Line of Credit accrue interest, at the Company's election, based upon the Company's consolidated leverage ratio.

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**(Unaudited)**

and trailing four quarters EBITDA, of (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, or (ii) the Eurodollar Rate (as defined in the agreement governing the Line of Credit) plus a margin of 50.0 to 125.0 basis points.

The Line of Credit requires the Company to meet certain financial covenants and includes certain other restrictions, including restrictions limiting dividends, stock repurchases, capital expenditures and asset sales. As of March 31, 2008, the Company was in compliance with the covenants and other terms of the Line of Credit, as then applicable.

The total origination fees incurred in connection with the Line of Credit, including fees incurred in connection with the amendments, were \$2,130,000 and are being amortized into interest expense over the remaining term of the Line of Credit agreement. Unamortized origination fees were \$1,103,000 as of March 31, 2008, of which \$282,000 was included in prepaid and other current assets and \$821,000 in other long-term assets in the accompanying consolidated condensed balance sheet.

**8. Commitments and Contingencies**

***Legal Matters***

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

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

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

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

**(Unaudited)**

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

Acushnet also filed petitions for reexamination with the United States Patent and Trademark Office (PTO) challenging the validity of the patents asserted by Callaway Golf. Although the PTO agreed the petitions for reexamination raised substantial new questions of patentability, and issued multiple office actions rejecting the claims of all four of the patents, the PTO has not made a final and binding determination as to the validity of any of the patents. The Company expects that some of the prior claims or newly framed claims submitted as part of the reexamination proceeding will be affirmed by the PTO. To the extent claims previously approved are no longer allowed upon the conclusion of the reexamination process, the Company is likely to appeal such actions. The interim rulings by the PTO do not void the Court's judgment.

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

On February 27, 2007, the Company and Dailey & Associates (an advertising agency) filed a complaint in the United States District Court for the Southern District of California, Case No. 07 CV 0373, asserting claims against the Screen Actors Guild (SAG) and the Trustees of SAG's Pension and Health Plans (Plans) seeking declaratory and injunctive relief. Specifically, the Plans contend that Callaway Golf is required to treat a significant portion of the sums paid to professional golfers who endorse the Company's products as compensation for acting services, and to make contributions to the Plans based upon a percentage of that total amount. The Company is seeking a declaration that it is not required to contribute beyond the contributions already made, or alternatively, is obligated to pay nothing and is entitled to restitution for all contributions previously made to the Plans. SAG and the Plans have filed a counterclaim to compel an audit and to recover unpaid Plan contributions. SAG and the Plans also seek liquidated damages, interest, and reasonable audit and attorneys' fees. The parties are engaged in discovery. Motions for Judgment on the Pleadings and to Stay Proceedings filed by SAG and the Plans were denied by the Court on March 26, 2008. A pretrial conference is set for December 29, 2008. No trial date has been set.

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**(Unaudited)**

On January 16, 2008, the Company issued a notice of default to Ashworth Inc. under the parties' May 14, 2001 License Agreement, as amended from time to time ( Agreement ). Under the Agreement, Ashworth has thirty (30) days from the date of notice in which to cure a default. Ashworth has denied that any breach has occurred, and has not taken the steps requested by the Company to cure. Accordingly, it is the Company's belief that it has the right to terminate the Agreement and it has communicated that assessment to Ashworth. The parties conducted a mediation of the issue on April 23, 2008, pursuant to dispute resolution procedures specified in the Agreement. The matter was not resolved at the mediation and the Company is therefore demanding binding arbitration. Ashworth has stated that it believes it would have claims against the Company in the event that the Company wrongfully terminates or interferes with the Agreement. The Company is not aware of what such claims might be, but it currently is unaware of any basis for a meritorious claim against it based upon the handling of the alleged breach by Ashworth.

On February 13, 2008, Ogio International Inc. filed a complaint for patent infringement against Callaway Golf in the United States District Court, for the District of Utah, Case No. 08cv116. Specifically, Ogio alleges that Callaway Golf's sales of Warbird XTT, Warbird Hot, Terra Firma X, Terra Firma XI and Hyper-X golf bags infringe one or more claims of United States Patents numbered 6,877,604 and 7,213,705. The complaint seeks compensatory damages and an injunction. The complaint has not been served on the Company. However, the parties and their attorneys are in discussions regarding 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. Management believes at this time that the final resolution of these matters, individually and in the aggregate, will not have a material adverse effect upon the Company's consolidated annual results of operations, cash flows or financial position.

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

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

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

Because the Enron Contract provided for the Company to purchase an amount of energy in excess of what it expected to be able to use in its operations, the Company accounted for the Enron Contract as a derivative instrument in accordance with SFAS No. 133. Accounting for Derivative Instruments and Hedging Activities. The Enron Contract did not qualify for hedge accounting under SFAS No. 133. Therefore, the Company

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

**(Unaudited)**

recognized changes in the estimated fair value of the Enron Contract currently in earnings. The estimated fair value of the Enron Contract was based upon present value determination of the net differential between the contract price for electricity and the estimated future market prices for electricity as applied to the remaining amount of unpurchased electricity under the Enron Contract. Through September 30, 2001, the Company had recorded unrealized pre-tax losses of \$19,922,000.

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

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

As a result of the Company's notice of termination to EESI, and certain other automatic termination provisions under the Enron Contract, the Company believes that the Enron Contract has been terminated. As a result, the Company adjusted the estimated value of the Enron Contract through the date of termination, at which time the terminated Enron Contract ceased to represent a derivative instrument in accordance with SFAS No. 133. Because the Enron Contract is terminated and neither party to the contract is performing pursuant to the terms of the contract, the Company no longer records valuation adjustments for changes in electricity rates.

The Company continues to reflect on its balance sheet the derivative valuation account of \$19,922,000, subject to quarterly review in accordance with applicable law and accounting regulations, including SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. The Company believes the Enron Contract has been terminated, and as of March 31, 2008, EESI has not asserted any claim against the Company. There can be no assurance, however, that EESI or another party will not assert a future claim against the Company or that a court or arbitrator will not ultimately nullify the Company's termination of the Enron Contract. No provision has been made for contingencies or obligations, if any, under the Enron Contract beyond November 30, 2001.

***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 March 31, 2008, the Company has entered into many of these contractual agreements with terms ranging from one to six years. The minimum obligation that the Company is required to pay under these agreements is \$120,948,000 over the next six 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

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settled by cash payments upon delivery of goods and services and are not reflected in this total. Future purchase commitments as of March 31, 2008 are as follows (in thousands):

|            |            |
|------------|------------|
| 2008       | \$ 63,975  |
| 2009       | 32,949     |
| 2010       | 15,122     |
| 2011       | 6,881      |
| 2012       | 1,928      |
| 2013       | 93         |
| Thereafter |            |
|            | \$ 120,948 |

***Other Contingent Contractual Obligations***

During its normal course of business, the Company has made certain indemnities, commitments and guarantees under which it may be required to make payments in relation to certain transactions. These include (i) intellectual property indemnities to the Company's customers and licensees in connection with the use, sale and/or license of Company products, (ii) indemnities to various lessors in connection with facility leases for certain claims arising from such facilities or leases, (iii) indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct of the Company and (iv) indemnities involving the accuracy of representations and warranties in certain contracts. In addition, the Company has made contractual commitments to each of its officers and certain other employees providing for severance payments upon the termination of employment. The Company also has consulting agreements that provide for payment of nominal fees upon the issuance of patents and/or the commercialization of research results. The Company has also issued guarantees in the form of two standby letters of credit as security for contingent liabilities under certain workers' compensation insurance policies and as collateral for a loan issued to GEI. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation on the maximum amount of future payments the Company could be obligated to make. Historically, costs incurred to settle claims related to indemnities have not been material to the Company's financial position, results of operations or cash flows. In addition, the Company believes the likelihood is remote that material payments will be required under the indemnities, commitments and guarantees described above. The fair value of indemnities, commitments and guarantees that the Company issued during the three months ended March 31, 2008 was not material to the Company's financial position, results of operations or cash flows.

***Employment Contracts***

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

**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)****9. Share-Based Employee Compensation**

As of March 31, 2008, the Company had the following two shareholder approved stock plans under which shares were available for equity-based awards: the Callaway Golf Company Amended and Restated 2004 Incentive Plan (the 2004 Plan) and the 2001 Non-Employee Directors Stock Incentive Plan (the 2001 Directors Plan). The 2004 Plan permits the granting of stock options, stock appreciation rights, restricted stock/units, performance share units and other equity-based awards to the Company's officers, employees, consultants and certain other non-employees who provide services to the Company. All grants under the 2004 Plan are discretionary, although no participant may receive awards in any one year in excess of 1,000,000 shares. The 2001 Directors Plan permits the granting of stock options, restricted stock and restricted stock units. Directors receive an initial equity award grant not to exceed 20,000 shares upon their initial appointment to the Board and thereafter an annual grant not to exceed 10,000 shares upon being re-elected at each annual meeting of shareholders. The maximum number of shares issuable over the term of the 2004 Plan and the 2001 Directors Plan is 12,250,000 and 500,000 shares, respectively.

The following table presents shares authorized, available for future grant and outstanding under each of the Company's plans as of March 31, 2008:

|   | Authorized    | Available<br>(In thousands) | Outstanding <sup>(1)</sup> |
|---|---------------|-----------------------------|----------------------------|
| 1991 Stock Incentive Plan                                 | 10,000        |                             | 75                         |
| Promotion, Marketing and Endorsement Stock Incentive Plan | 3,560         |                             | 570                        |
| 1995 Employee Stock Incentive Plan                        | 10,800        |                             | 2,254                      |
| 1996 Stock Option Plan                                    | 9,000         |                             | 622                        |
| 2001 Directors Plan                                       | 500           | 255                         | 233                        |
| 2004 Plan   | 12,250        | 3,035                       | 3,727                      |
| Employee Stock Purchase Plan                              | 6,000         | 3,060                       |                            |
| Non-Employee Directors Stock Option Plan                  | 840           |                             | 104                        |
| <b>Total</b>  | <b>52,950</b> | <b>6,350</b>                | <b>7,585</b>               |

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

**Stock Options**

All stock option grants made under the 2004 Plan and the 2001 Directors Plan are made at exercise prices no less than the Company's closing stock price on the date of grant. Outstanding stock options generally vest over a three year period from the grant date and generally expire up to 10 years after the grant date. The Company recorded \$782,000 and \$1,195,000 of compensation expense relating to outstanding stock options for the three months ended March 31, 2008 and 2007, respectively.

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The model uses various assumptions, including a risk-free interest rate, the expected term of the options, the expected stock price volatility over the expected term of the options, and the expected dividend yield. Compensation expense for employee stock options is recognized ratably over the vesting term and is reduced by an estimate for pre-vesting forfeitures, which is based on the Company's historical forfeitures of unvested options and awards. For the three months ended March 31, 2008 and 2007, the average estimated pre-vesting forfeiture rate used was 5.1% and



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5.4%, respectively. The table below summarizes the average fair value assumptions used in the valuation of stock options granted during the three months ended March 31, 2008 and 2007.

|                         | <b>Three Months Ended<br/>March 31,</b> |             |
|-------------------------|---|-------------|
|                         | <b>2008</b>                             | <b>2007</b> |
| Dividend yield          | 1.9%                                    | 2.0%        |
| Expected volatility     | 35.3%                                   | 37.4%       |
| Risk free interest rate | 2.6%                                    | 4.8%        |
| Expected term           | 4.1 years                               | 3.0 years   |

The dividend yield is based upon a three-year historical average. The expected volatility is based on the historical volatility, among other factors, of the Company's stock. The risk free interest rate is based on the U.S. Treasury yield curve at the date of grant with maturity dates approximately equal to the expected term of the options at the date of the grant. The expected life of the Company's options is based on evaluations of historical and expected future employee exercise behavior. The valuation model applied in this calculation utilizes highly subjective assumptions that could potentially change over time. Changes in the subjective input assumptions can materially affect the fair value estimates of an option. Furthermore, the estimated fair value of an option does not necessarily represent the value that will ultimately be realized by the employee holding the option.

The following table summarizes the Company's stock option activities for the quarter ended March 31, 2008 (in thousands, except price per share and contractual term):

| <b>Options</b>  | <b>Number of<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise Price<br/>Per Share</b> | <b>Weighted-<br/>Average<br/>Remaining<br/>Contractual<br/>Term</b> | <b>Aggregate<br/>Intrinsic Value</b> |
|---|-----------------------------|---|---|--------------------------------------|
| Outstanding at January 1, 2008                              | 6,186                       | \$ 16.51  |   |                                      |
| Granted   | 838                         | \$ 14.92  |   |                                      |
| Exercised   | (96)                        | \$ 12.96  |   |                                      |
| Forfeited   | (20)                        | \$ 14.46  |   |                                      |
| Expired   | (7)                         | \$ 19.05  |   |                                      |
| Outstanding at March 31, 2008                               | 6,901                       | \$ 16.37  | 5.55  | \$ 2,184                             |
| Vested and expected to vest in the future at March 31, 2008 | 6,708                       | \$ 16.42  | 5.46  | \$ 2,150                             |
| Exercisable at March 31, 2008                               | 5,173                       | \$ 16.91  | 4.39  | \$ 1,904                             |

The weighted-average grant-date fair value of options granted during the three months ended March 31, 2008 and 2007 was \$3.99 and \$3.86 per share, respectively, and the total intrinsic value for options exercised was \$338,000 and \$2,844,000, respectively.

Cash received from the exercise of stock options for the quarter ended March 31, 2008 was approximately \$1,244,000. The actual tax benefit realized for the tax deductions from option exercises for the three months ended March 31, 2008 totaled approximately \$16,300.



**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)*****Restricted Stock, Restricted Stock Units and Performance Share Units***

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

The Company recorded \$343,000 and \$385,000 of compensation expense relating to Restricted Stock awards during the three months ended March 31, 2008 and 2007, respectively. In connection with shares underlying Restricted Stock Units and Performance Share Units, the Company recorded compensation expense of \$683,000 and \$340,000 during the three months ended March 31, 2008 and 2007, respectively.

The table below summarizes the total number of Restricted Stock shares and shares underlying Restricted Stock Units and Performance Share Units granted to certain employee participants and directors during the three months ended March 31, 2008 and 2007, as well as the related weighted average grant date fair value for each type of award (number of shares are in thousands).

|                         | # of Shares Granted<br>Three months ended<br>March 31, |      | Weighted Average<br>Grant-Date Fair Value<br>Three months ended<br>March 31, |          |
|-------------------------|--|------|--|----------|
|                         | 2008   | 2007 | 2008   | 2007     |
| Restricted Stock Awards |  |      | \$   | \$       |
| Restricted Stock Units  | 222  | 233  | \$ 14.92   | \$ 14.38 |
| Performance Share Units |  |      | \$   | \$       |

The fair value of nonvested Restricted Stock awards, Restricted Stock Units and Performance Share Units (collectively nonvested shares) is determined based on the closing trading price of the Company's Common Stock on the grant date. A summary of the Company's nonvested share activity for the quarter ended March 31, 2008 is as follows (in thousands, except fair value amounts):

**Restricted Stock,****Restricted Stock Units and****Performance Share Units**

|                              | Shares | Weighted-Average<br>Grant-Date<br>Fair Value |       |
|------------------------------|--------|--|-------|
| Nonvested at January 1, 2008 | 1,103  | \$   | 13.22 |
| Granted                      | 222    | \$   | 14.92 |
| Vested                       | 10     | \$   | 15.04 |
| Forfeited                    | 22     | \$   | 14.70 |
| Nonvested at March 31, 2008  | 1,293  | \$   | 13.50 |

At March 31, 2008, there was \$9,137,000 of total unrecognized compensation expense related to nonvested shares granted to both employees and non-employees under the Company's share-based payment plans, of which \$8,704,000 relates to Restricted Stock awards and Restricted

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Stock Units and \$433,000 relates to Performance Share Units. That cost is expected to be recognized over a weighted-average period of 1.6 years. The amount of

**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

unrecognized compensation expense noted above does not necessarily represent the amount that will ultimately be realized by the Company in its Statement of Operations due to the application of forfeiture rates as well as the uncertainty regarding the Company's ability to meet certain performance requirements on Performance Share Units.

***Employee Stock Purchase Plan***

Under the Callaway Golf Company Employee Stock Purchase Plan (the Plan), participating employees authorize the Company to withhold compensation and to use the withheld amounts to purchase shares of the Company's Common Stock at 85% of the closing price on the last day of each six month offering period. During the three months ended March 31, 2008 and 2007 approximately 100,000 and 91,000 shares, respectively, of the Company's Common Stock were purchased under the Plan. As of March 31, 2008, there were 3,060,000 shares reserved for future issuance under the Plan. In connection with the Plan, the Company recorded \$134,000 and \$115,000 of compensation expense during the three months ended March 31, 2008 and 2007, respectively.

***Employee Share-Based Compensation Expense***

The table below summarizes the non-cash amounts recognized in the financial statements for the three months ended March 31, 2008 and 2007 for share-based compensation related to employees (in thousands).

|  | <b>Three months ended<br/>March 31,</b> |                 |
|--|---|-----------------|
|  | <b>2008</b>                             | <b>2007</b>     |
| Cost of sales  | \$ 171                                  | \$ 64           |
| Operating expenses   | 1,771                                   | 1,970           |
| <b>Total cost of employee share-based compensation included in income, before income tax</b> | <b>1,942</b>                            | <b>2,034</b>    |
| Amount of income tax recognized in earnings  | (510)                                   | (635)           |
| <b>Amount charged against net income</b>   | <b>\$ 1,432</b>                         | <b>\$ 1,399</b> |
| Impact on net income per common share:   |   |                 |
| Basic  | \$ (0.02)                               | \$ (0.02)       |
| Diluted  | \$ (0.02)                               | \$ (0.02)       |

In addition, during the three months ended March 31, 2008, the Company reversed \$474,000 of compensation expense to revalue shares of Restricted Stock granted to non-employees at market value. The Company recorded expense of \$2,182,000 for Restricted Stock awards granted to certain non-employees during the three months ended March 31, 2007. There were no amounts relating to employee share-based compensation capitalized in inventory during the three months ended March 31, 2008 and 2007.

**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)****10. Earnings per Share**

A reconciliation of the weighted-average shares used in the basic and diluted earnings per common share computations for the three months ended March 31, 2008 and 2007 is presented below (in thousands):

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2008</b>                             | <b>2007</b> |
| Weighted-average shares outstanding:        |   |             |
| Weighted-average shares outstanding Basic   | 63,895                                  | 67,272      |
| Dilutive securities                         | 948                                     | 1,046       |
| Weighted-average shares outstanding Diluted | 64,843                                  | 68,318      |

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 March 31, 2008 and 2007, options outstanding totaling 3,342,000 and 4,807,000 shares, respectively, were excluded from the calculations, as their effect would have been antidilutive.

**11. Fair Value of Financial Instruments**

The Company adopted Statement of Financial Accounting Standards No. 157 ( SFAS No. 157 ) as of January 1, 2008. SFAS No. 157 applies to certain assets and liabilities that are being measured and reported on a fair value basis. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosure about fair value measurements. This statement enables the reader of the financial statements to assess the inputs used to develop those measurements by establishing a hierarchy for ranking the quality and reliability of the information used to determine fair values. The statement requires that assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

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

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

The following table summarizes the valuation of our short-term investments and financial instruments by the above SFAS No. 157 pricing levels as of the valuation dates listed:

|  | <b>March 31, 2008</b>     |   | <b>December 31, 2007</b>  |   |
|--|---------------------------|---|---------------------------|---|
|  | <b>Carrying<br/>Value</b> | <b>Quoted market<br/>prices in<br/>active markets<br/>(Level 1)</b> | <b>Carrying<br/>Value</b> | <b>Quoted market<br/>prices in<br/>active markets<br/>(Level 1)</b> |

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|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Derivative instruments asset position     | 567   | 567   |       |       |
| Derivative instruments liability position | 4,339 | 4,339 | 421   | 421   |
| Deferred compensation plan                | 8,678 | 8,678 | 9,103 | 9,103 |

The fair value of the Company's foreign currency exchange contracts is determined 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. The fair value of the Company's deferred compensation plan assets is determined based on quoted market prices.

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**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)****12. Derivatives and Hedging**

The Company from time to time 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 Nos. 138 and 149, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* and SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*. As amended, SFAS No. 133 requires that an entity recognize all derivatives as either assets or liabilities in the balance sheet, measure those instruments at fair value and recognize changes in the fair value of derivatives in earnings in the period of change unless the derivative qualifies as an effective hedge that offsets certain exposures.

***Foreign Currency Exchange Contracts***

The Company from time to time enters into foreign exchange contracts to hedge against exposure to changes in foreign currency exchange rates. Such contracts are designated at inception to the related foreign currency exposures being hedged, which 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 March 31, 2008 and 2007, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$134,371,175 and \$105,488,000, 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 March 31, 2008, the fair values of foreign currency-related derivatives were recorded as current assets of \$567,000 and current liabilities of \$4,339,000. The gains and losses on foreign currency contracts used to manage balance sheet exposures are recognized as a component of other income (expense) in the same period as the remeasurement gain and loss of the related foreign currency denominated assets and liabilities and thus generally offset these gains and losses. During the three months ended March 31, 2008 and 2007, the Company recorded net losses of \$4,548,000 and \$774,000, 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. These net losses were offset by net foreign currency transaction gains of \$6,074,000 and \$666,000 during the three months ended March 31, 2008 and 2007, respectively. As of March 31, 2008 and 2007, there were no foreign exchange contracts designated as cash flow hedges.

**13. Segment Information**

The Company has two operating segments that are organized on the basis of products, which are segregated between golf clubs and golf balls. The golf clubs segment consists primarily of Callaway Golf, Top-Flite and Ben

**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Hogan woods, hybrids, irons, wedges and putters as well as Odyssey putters, other golf-related accessories and royalties from licensing of the Company's trademarks and service marks as well as sales of pre-owned golf clubs. The golf balls segment consists primarily of Callaway Golf, Top-Flite and Ben Hogan golf balls. There are no significant intersegment transactions.

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

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2008</b>                             | <b>2007</b> |
| <b>Net sales</b>                                |   |             |
| Golf Clubs <sup>(1)</sup>                       | \$ 308,019                              | \$ 281,059  |
| Golf Balls <sup>(1)</sup>                       | 58,433                                  | 53,548      |
|   | \$ 366,452                              | \$ 334,607  |
| <b>Income before provision for income taxes</b> |   |             |
| Golf Clubs <sup>(1)</sup>                       | \$ 76,199                               | \$ 65,343   |
| Golf Balls <sup>(1)</sup>                       | 4,445                                   | 5,728       |
| Reconciling items <sup>(2)</sup>                | (14,988)                                | (16,553)    |
|   | \$ 65,656                               | \$ 54,518   |
| <b>Additions to long-lived assets</b>           |   |             |
| Golf Clubs                                      | \$ 8,246                                | \$ 6,545    |
| Golf Balls                                      | 3,025                                   | 1,348       |
|   | \$ 11,271                               | \$ 7,893    |

(1) Prior year amounts have been reclassified to conform to the current year presentation.

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

**14. Recent Accounting Pronouncements**

In March 2008, the FASB issued Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities" an amendment of FASB Statement No. 133 (SFAS 161). The Statement requires companies to provide enhanced disclosures regarding derivative instruments and hedging activities. It requires companies to better convey the purpose of derivative use in terms of the risks that such company is intending to manage. Disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows are required. This Statement retains the same scope as SFAS No. 133 and is effective for fiscal years and interim periods beginning after November 15, 2008. The Company is currently evaluating the impact, if any, that the adoption of this Statement will have on the Condensed Consolidated Financial Statements of the Company.

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In December 2007, the FASB issued Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51 ( SFAS 160 ). This Statement amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the

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**CALLAWAY GOLF COMPANY**

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

**(Unaudited)**

deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Additionally, this Statement requires that consolidated net income include the amounts attributable to both the parent and the noncontrolling interest. This Statement is effective for interim periods beginning on or after December 15, 2008. The Company is currently evaluating the impact, if any, that the adoption of this Statement will have on the Condensed Consolidated Financial Statements of the Company.

In December 2007, the FASB issued Statement No. 141R, Business Combinations (a revision of Statement No. 141) ( SFAS 141R ). This Statement applies to all transactions or other events in which an entity obtains control of one or more businesses, including those combinations achieved without the transfer of consideration. This Statement retains the fundamental requirements in Statement No. 141 that the acquisition method of accounting be used for all business combinations. This Statement expands the scope to include all business combinations and requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their fair values as of the acquisition date. Additionally, SFAS No. 141R changes the way entities account for business combinations achieved in stages by requiring the identifiable assets and liabilities to be measured at their full fair values. Additionally, contractual contingencies and contingent consideration shall be measured at fair value at the acquisition date. This Statement is effective on a prospective basis to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company is currently evaluating the impact, if any, that the adoption of this Statement will have on the Condensed Consolidated Financial Statements of the Company.

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**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 page 2 of this report.*

**Results of Operations**

***Overview of Business and Seasonality***

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

The Company has two operating segments that are organized on the basis of products, which are segregated between golf clubs and golf balls. The golf clubs segment consists primarily of Callaway Golf, Top-Flite and Ben Hogan woods, hybrids, irons, wedges and putters as well as Odyssey putters. This segment also includes other golf-related accessories described above and royalties from licensing of the Company's trademarks and service marks as well as sales of pre-owned golf clubs. The golf balls segment consists primarily of Callaway Golf and Top-Flite golf balls. As discussed above in Note 13 to the Company's consolidated condensed financial statements, the Company's operating segments exclude a significant amount of corporate and general administrative expenses and other income (expense) not utilized by management in determining segment profitability. While the Company's golf clubs segment has been profitable, the Company's golf balls segment has historically reported annual operating losses for all periods until 2007. The Company's golf balls segment results of operations have improved significantly from a loss of \$52.7 million in 2003 (including charges of \$24.1 million for Top-Flite integration initiatives) to profitability of \$0.9 million in 2007 (including charges of \$0.3 million and \$3.2 million related to the 2005 restructuring initiatives and the gross margin improvement initiatives, respectively). The Company is continuing to take actions to improve the profitability of its golf ball business.

In most of the Company's key markets, the game of golf is played primarily on a seasonal basis. Weather conditions generally restrict golf from being played year-round, except in a few small markets, with many of the Company's on-course customers closing for the cold weather months. The Company's business is therefore also subject to seasonal fluctuations. In general, during the first quarter, the Company begins selling its products into the golf retail channel for the new golf season. This initial sell-in generally continues into the second quarter. The Company's second quarter sales are also significantly affected by the amount of re-order business of the products sold during the first quarter. The Company's third quarter sales are generally dependent on re-order business but are generally less than the second quarter as many retailers begin decreasing their inventory levels in anticipation of the end of the golf season. The Company's fourth quarter sales are generally less than the other quarters due to the end of the golf season in many of the Company's key markets. This seasonality, and therefore quarter to quarter fluctuations, can be affected by many factors, including the timing of new product introductions. In general, however, because of this seasonality, a majority of the Company's sales and most, if not all, of its profitability generally occurs during the first half of the year.

**Table of Contents****Three-Month Periods Ended March 31, 2008 and 2007**

Net sales increased \$31.8 million (10%) to \$366.4 million for the three months ended March 31, 2008 as compared to \$334.6 million for the comparable period in the prior year. The overall increase in net sales is primarily due to an increase in the number of product introductions during the first quarter of 2008 compared to the first quarter of 2007, in addition to the timing of product introductions, which occurred earlier in the quarter in 2008. The Company's net sales by operating segment is set forth below (dollars in millions):

|            | Three Months Ended |                | Growth (Decline) |         |
|------------|--------------------|----------------|------------------|---------|
|            | 2008               | March 31, 2007 | Dollars          | Percent |
| Net sales  |                    |                |                  |         |
| Golf clubs | \$ 308.0           | \$ 281.1       | \$ 26.9          | 10%     |
| Golf balls | 58.4               | 53.5           | 4.9              | 9%      |
|            | \$ 366.4           | \$ 334.6       | \$ 31.8          | 10%     |

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

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

|                         | Three Months Ended |                | Growth/(Decline) |         |
|-------------------------|--------------------|----------------|------------------|---------|
|                         | 2008               | March 31, 2007 | Dollars          | Percent |
| Net sales:              |                    |                |                  |         |
| United States           | \$ 184.4           | \$ 183.8       | \$ 0.6           | 0%      |
| Europe                  | 66.1               | 56.0           | 10.1             | 18%     |
| Japan                   | 53.3               | 38.0           | 15.3             | 40%     |
| Rest of Asia            | 26.5               | 22.8           | 3.7              | 16%     |
| Other foreign countries | 36.1               | 34.0           | 2.1              | 6%      |
|                         | \$ 366.4           | \$ 334.6       | \$ 31.8          | 10%     |

Net sales in the United States increased \$0.6 million to \$184.4 million during the first quarter of 2008 compared to the same period in the prior year. The Company's sales in regions outside of the United States increased \$31.2 million (21%) to \$182.0 million during the first quarter of 2008 compared to the same quarter in 2007. This increase in international net sales is primarily attributable to increases of \$15.3 million and \$10.1 million in Japan and Europe, respectively, primarily due to strong retailer demand for the Company's new products launched in those regions. The Company's 2008 net sales were also affected by \$11.7 million of favorable changes in foreign currency rates primarily in Japan, Canada, Australia and Europe, partially offset by \$0.2 million of unfavorable changes in foreign currency rates in Korea during the period.

For the first quarter of 2008, gross profit increased \$14.8 million to \$175.5 million from \$160.7 million in the first quarter of 2007. Gross profit as a percentage of net sales remained consistent at 48% in both the first quarter of 2008 and 2007. Gross margins were positively affected by cost reductions on golf club component costs as a result of the Company's gross margin improvement initiatives, partially offset by an increase in golf ball manufacturing costs. In addition, gross margins were affected by a less favorable club product mix due to the current year launch of irons products and titanium drivers with lower margins than the X-Series irons and premium drivers launched during the first quarter of 2007. This decline in gross margins was partially offset by the current year launch of higher margin fairway woods and putters, compared to the products introduced during the same period of the prior year. See Segment Profitability below for further discussion of gross margins. Gross profit for the first quarter of 2008 was negatively affected by charges of \$1.1 million related to the Company's gross margin improvement initiatives compared to \$1.4 million for the comparable period in 2007.

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Selling expenses increased \$4.9 million (6%) to \$80.2 million in the first quarter of 2008 compared to \$75.3 million in the same period of 2007. As a percentage of sales, selling expenses decreased to 22% in the first quarter of 2008 compared to 23% in the first quarter of 2007. The dollar increase in selling expense was primarily due to a \$2.1 million increase in advertising and promotional activity in support of the Company's new products launched during the first quarter, as well as increases of \$2.4 million in employee costs and \$0.8 million in consulting expenses. Additionally, the Company's selling expenses were unfavorably impacted by changes in foreign exchange rates on non-U.S. selling expenses. These increases were partially offset by a \$1.6 million decrease in share-based compensation expense related to non-employees.

General and administrative expenses increased \$0.9 million (4%) to \$22.5 million in the first quarter of 2008 compared to \$21.6 million in the same period of 2007. As a percentage of sales, general and administrative expenses remained consistent at 6% in the first quarter of 2008 and 2007. The dollar increase was primarily due to increases of \$1.4 million in employee costs, partially offset by decreases of \$0.5 million in deferred compensation expenses.

Research and development expenses decreased \$0.1 million (1%) to \$7.9 million in the first quarter of 2008 compared to \$8.0 million in the comparable period of 2007. As a percentage of sales, research and development expenses remained consistent at 2% for the first quarter of 2008 and 2007. The slight dollar decrease was primarily due to decreases of \$0.2 million in consulting costs.

Other income (expense) improved by \$2.0 million in the first quarter of 2008 to other income of \$0.7 million compared to other expense of \$1.3 million in the comparable period of 2007. This improvement in other income (expense) is primarily attributable to an increase of \$1.6 million in net foreign currency transaction gains and a \$0.7 million decrease in interest expense as a result of a decrease in average outstanding borrowings and a decline in interest rates.

Net income for the first quarter of 2008 improved 21% to \$39.7 million from net income of \$32.8 million in the comparable period of 2007. Diluted earnings per share improved to \$0.61 per share in the first quarter of 2008 compared to earnings of \$0.48 per share in the first quarter of 2007. Net income for the first quarter of 2008 and 2007 was negatively impacted by after-tax charges of \$0.7 million (\$0.01 per share) and \$0.9 million (\$0.01 per share), respectively, related to costs associated with the Company's gross margin improvement initiatives.

***Golf Clubs and Golf Balls Segments Results for the Three Months Ended March 31, 2008 and 2007*****Golf Clubs Segment**

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

|                       | Three Months Ended<br>March 31, |                     | Growth/(Decline) |         |
|-----------------------|---------------------------------|---------------------|------------------|---------|
|                       | 2008                            | 2007 <sup>(1)</sup> | Dollars          | Percent |
| Net sales:            |                                 |                     |                  |         |
| Woods                 | \$ 116.6                        | \$ 103.1            | \$ 13.5          | 13%     |
| Irons                 | 96.5                            | 100.1               | (3.6)            | (4)%    |
| Putters               | 34.6                            | 29.1                | 5.5              | 19%     |
| Accessories and other | 60.3                            | 48.8                | 11.5             | 24%     |
|                       | \$ 308.0                        | \$ 281.1            | \$ 26.9          | 10%     |

(1) Prior year amounts have been reclassified to conform to the current year presentation.

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The \$13.5 million (13%) increase in net sales of woods to \$116.6 million for the three months ended March 31, 2008 is primarily attributable to an increase in sales volume partially offset by a decrease in average selling prices in the first quarter of 2008 compared to the same period in the prior year. The increase in sales volume was driven by strong retailer demand for the Company's new products, including the Company's new fairway wood and hybrid models launched during the first quarter of 2008. In the first quarter of 2007, the Company launched a more extensive line of drivers relative to the first quarter of 2008. This expected decrease in new driver introductions contributed to a reduction in overall average selling prices within the woods category, as drivers, particularly premium Fusion Technology drivers, carry a higher sales price than fairway woods and hybrids. In addition, average selling prices were negatively impacted in the first quarter of 2008 by a price reduction on Big Bertha 460 titanium drivers, which were in the third year of their product lifecycles.

The \$3.6 million (4%) decrease in net sales of irons to \$96.5 million for the three months ended March 31, 2008 resulted from a decrease in sales volume partially offset by an increase in average selling prices in the first quarter of 2008 compared to the same period in the prior year. The decrease in sales volume was primarily due to an anticipated decline in sales of the X-Series irons that were launched during the first quarter of 2007, combined with a decline in sales of the Company's older irons products. These decreases were partially offset by an increase in sales volume of the current year Big Bertha and Fusion Technology irons as well as X-Forged Series wedges. The increase in average selling prices is primarily due to a favorable shift in product mix primarily due to the higher priced premium Fusion Technology irons, which were launched during the first quarter of 2008, combined with the X-Forged Series wedges. These increases in average selling prices were partially offset by decreases in average selling prices of the Company's older Big Bertha and X-Series irons as well as X-Tour Series wedges.

The \$5.5 million (19%) increase in net sales of putters to \$34.6 million for the three months ended March 31, 2008 resulted from higher average selling prices as well as an increase in sales volumes in the first quarter of 2008 compared to the same period in the prior year. This increase in putter sales is primarily attributable to the Black Series and White Hot Tour putter product lines, which were introduced during the first quarter of 2008, combined with the continued favorable consumer acceptance of the Company's White Hot XG and Divine putter lines, which were in the second year of their product lifecycles. This increase was partially offset by a decrease in sales of the Company's older White Hot XG two-ball and two-ball SRT putter models, which were in the third year of their product lifecycles.

The \$11.5 million (24%) increase in sales of accessories and other products to \$60.3 million is primarily attributable to the new Callaway Golf packaged junior golf club sets and the Top-Flite packaged recreational sets, which were both launched during the first quarter of 2008 as well as an increase in sales of golf headwear.

**Golf Balls Segment**

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

|            | Three Months Ended |         | Growth/(Decline) |         |
|------------|--------------------|---------|------------------|---------|
|            | 2008               | 2007    | Dollars          | Percent |
| Net sales: |                    |         |                  |         |
| Golf balls | \$ 58.4            | \$ 53.5 | \$ 4.9           | 9%      |

The \$4.9 million (9%) increase in net sales of golf balls to \$58.4 million for the three months ended March 31, 2008 was due to a \$5.7 million increase Callaway Golf ball sales, partially offset by a decrease of \$0.6 million in sales of Top-Flite golf balls. The increase in Callaway Golf ball sales is due to an increase in sales volume as well as average selling prices. The increase in sales volume was primarily driven by the increase in Callaway Golf ball product introductions during the first quarter of 2008 compared to the first quarter of 2007. The increase in average selling prices is primarily due to a shift in product mix with the introduction of the

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premium HX Tour ix golf ball as well as the HX Hot Bite and HX Hot Pearl golf balls, which have higher average selling prices than the Big Bertha and HX Hot golf ball models launched during the same period in the prior year. The decrease in Top-Flite golf ball sales is primarily due to a decrease in sales volumes partially offset by a slight increase in average selling prices. The decrease in sales volumes was largely due to a reduction in sales of the D2 golf ball model which was introduced during the first quarter in 2007, partially offset by an increase in sales volume of the Gamer and Freak golf ball models, which were both sold to limited retailers during the first three months in 2008. The increase in average selling prices was primarily driven by a slight shift in product mix with the introduction of the Gamer and Freak golf balls during the first quarter of 2008, which have higher average selling prices than the D2 and XL golf ball models.

**Segment Profitability**

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

|  | Three Months Ended<br>March 31, |                        | Growth (Decline) |         |
|--|---------------------------------|------------------------|------------------|---------|
|  | 2008                            | 2007 <sup>(2)</sup>    | Dollars          | Percent |
| Income before provision for income taxes |                                 |                        |                  |         |
| Golf clubs                               | \$ 76.2                         | \$ 65.4                | \$ 10.8          | 17%     |
| Golf balls                               | 4.4                             | 5.7                    | (1.3)            | (23)%   |
|  | \$ 80.6 <sup>(1)</sup>          | \$ 71.1 <sup>(1)</sup> | \$ 9.5           | 13%     |

(1) Amounts shown are before the deduction of corporate general and administration expenses and other income (expenses) of \$15.0 million and \$16.6 million for the three months ended March 31, 2008 and 2007, respectively, which are not utilized by management in determining segment profitability. For further information on segment reporting see Note 13 to the Consolidated Condensed Financial Statements Segment Information in this Form 10-Q.

(2) Prior year amounts have been reclassified to conform to the current year presentation.

Pre-tax income in the Company's golf clubs operating segment improved to \$76.2 million for the quarter ended March 31, 2008 from \$65.4 million for the comparable period in the prior year. The increase in the golf clubs operating segment pre-tax income is primarily attributable to improved net sales as discussed above combined with a slight improvement in gross margin. This improvement in gross margin is primarily due to cost reductions on club components partially offset by a less favorable club product mix during the first quarter of 2008 compared to the first quarter in 2007. During the first quarter of 2008, the Company introduced a new line of multi-material Fusion Technology irons as well as Big Bertha irons, which generally carry lower margins than the X-Series irons, which were introduced during the same time period in 2007. This decrease in gross margin was partially offset by a favorable shift in product mix within the woods category. This shift in woods product mix primarily resulted from the introduction of fairway woods and hybrid products during the first quarter of 2008, which generally carry higher margins than the Company's driver products that were introduced during the same period in 2007. In addition, golf club gross margins were favorably impacted by increased sales of the White Hot XG and Divine putter product lines, which have higher margins compared to the Black Series putter line, which was introduced during the first three months in 2008.

Pre-tax income in the Company's golf balls operating segment decreased to \$4.4 million for the quarter ended March 31, 2008 from \$5.7 million for the comparable period in the prior year. The decrease in the golf balls operating segment pre-tax income is primarily due to a decline in gross margins, resulting primarily from increased costs due to the absorption of fixed costs on lower golf ball production volumes during the fourth quarter of 2007. The lower production volumes were consistent with the Company's planned inventory reduction initiatives and the recent improvements in inventory management and planning, which enables the Company to

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operate its golf ball business with less inventory on hand. Although the higher manufacturing costs occurred during the fourth quarter of 2007, they are allocated to the golf balls sold during the first quarter under the applicable accounting rules. The effect of the fourth quarter manufacturing costs on first quarter gross margins was consistent with the Company's expectations and should not affect the Company's second quarter golf ball segment profitability.

The Company has been actively implementing the gross margin improvement initiatives, which were announced during the fourth quarter of 2006. As a result of these initiatives, the Company's golf clubs and golf balls operating segments absorbed charges of \$0.8 million and \$0.3 million, respectively, during the first quarter of 2008 and \$0.7 million and \$0.7 million, respectively, during the comparable period in 2007.

## **Financial Condition**

The Company's cash and cash equivalents decreased \$10.5 million (21%) to \$39.4 million at March 31, 2008, from \$49.9 million at December 31, 2007. Most of this decrease is due to the general seasonality of the Company's business. Generally, during the first quarter, the Company will rely more heavily on its credit facilities to fund operations as cash inflows from operations begin to increase during the second quarter as a result of cash collections from customers. During the three months ended March 31, 2008, the Company used proceeds from its credit facilities of \$119.1 million to fund cash used in operating activities of \$121.4 million as well as approximately \$11.7 million in capital expenditures. Management expects to fund the Company's future operations from cash provided by its operating activities combined with borrowings from its credit facilities, as deemed necessary.

The Company's accounts receivable balance fluctuates throughout the year as a result of the general seasonality of the Company's business. The Company's accounts receivable balance will generally be at its highest during the first and second quarters and decline significantly during the third and fourth quarters as a result of an increase in cash collections. As of March 31, 2008, the Company's net accounts receivable increased \$188.4 million to \$300.5 million from \$112.1 million as of December 31, 2007. The increase in accounts receivable is primarily attributable to net sales of \$366.5 million during the first quarter of 2008 compared to net sales of \$174.4 million during the fourth quarter of 2007. The Company's net accounts receivable increased \$21.9 million as of March 31, 2008 compared to the Company's net accounts receivable as of March 31, 2007. This increase was primarily attributable to a \$31.8 million increase in net sales during the first quarter of 2008 compared to the same period in the prior year.

The Company's inventory balance also fluctuates throughout the year as a result of the general seasonality of the Company's business. Generally, the Company's buildup of inventory levels begins during the fourth quarter and continues heavily into the first quarter as well as into the beginning of the second quarter in order to meet demand during the height of the golf season. Inventory levels start to decline toward the end of the second quarter and are at their lowest during the third quarter. The Company's net inventory increased \$11.3 million to \$264.3 million as of March 31, 2008 compared to \$253.0 million as of December 31, 2007. This increase is consistent with the seasonality of the Company's business, as it continues to prepare for increased demand into the second quarter during the peak of the golf season. The Company's net inventory decreased \$6.3 million as of March 31, 2008 compared to the Company's net inventory as of March 31, 2007. This decrease is consistent with the Company's inventory reduction initiatives.

## **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

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primary line of credit, which is scheduled to expire on February 15, 2012, is a \$250.0 million line of credit with Bank of America, N.A., and certain other lenders party to the Company's November 5, 2004 Amended and Restated Credit Agreement (as amended, the "Line of Credit").

The Line of Credit provides for revolving loans of up to \$250.0 million, although actual borrowing availability can be effectively limited by the financial covenants contained therein. As of March 31, 2008, the maximum amount that could be borrowed under the Line of Credit was \$250.0 million, of which \$155.0 million was outstanding. In addition, the Company had approximately \$0.6 million outstanding under other credit facilities at March 31, 2008.

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

The Line of Credit requires the Company to meet certain financial covenants and includes certain other restrictions, including restrictions limiting dividends, stock repurchases, capital expenditures and asset sales. As of March 31, 2008, the Company was in compliance with the covenants and other terms of the Line of Credit, as then applicable.

The total origination fees incurred in connection with the Line of Credit, including fees incurred in connection with the Second and Third Amendments, were \$2.1 million and are being amortized into interest expense over the remaining term of the Line of Credit agreement. Unamortized origination fees were \$1.1 million as of March 31, 2008, of which \$0.3 million was included in prepaid and other current assets and \$0.8 million in other long-term assets in the accompanying consolidated balance sheet.

**Other Significant Cash and Contractual Obligations**

The following table summarizes certain significant cash and contractual obligations as of March 31, 2008 that will affect the Company's future liquidity (in millions):

|   | Total           | Payments Due By Period |                |                |                      |
|---|-----------------|------------------------|----------------|----------------|----------------------|
|   |                 | Less Than<br>1 Year    | 1-3 Years      | 4-5 Years      | More Than<br>5 Years |
| Line of credit                                    | \$ 155.6        | \$ 155.6               | \$             | \$             | \$                   |
| Operating leases <sup>(1)</sup>                   | 34.6            | 9.3                    | 11.5           | 7.3            | 6.5                  |
| Unconditional purchase obligations <sup>(2)</sup> | 120.9           | 64.0                   | 54.9           | 1.9            | 0.1                  |
| Deferred compensation <sup>(3)</sup>              | 7.4             | 0.4                    | 0.4            | 0.2            | 6.4                  |
| Investment commitments <sup>(4)</sup>             | 0.7             | 0.7                    |                |                |                      |
| Uncertain income tax contingencies <sup>(5)</sup> | 16.3            | 2.1                    | 5.7            | 5.5            | 3.0                  |
| <b>Total<sup>(6)</sup></b>                        | <b>\$ 335.5</b> | <b>\$ 232.1</b>        | <b>\$ 72.5</b> | <b>\$ 14.9</b> | <b>\$ 16.0</b>       |

(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) 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

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- 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, endorsement agreements with professional golfers and other endorsers 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.
- (3) The Company has an unfunded, non-qualified deferred compensation plan. The deferred compensation 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 \$8.7 million at March 31, 2008.
- (4) This amount is in connection with the Company's investment in Golf Entertainment International Limited Company. See Note 5 to the Consolidated Financial Statements Investments in this Form 10-Q.
- (5) Amount represents total uncertain income tax positions related to the adoption FIN 48, which is comprised of a short-term income tax payable of \$2.5 million and a long-term income tax payable of \$13.8 million. For further discussion see Note 2 to the Consolidated Condensed Financial Statements Income Taxes in this Form 10-Q.
- (6) During the third quarter of 2001, the Company entered into a derivative commodity instrument to manage electricity costs in the volatile California energy market. The contract was originally effective through May 2006. During the fourth quarter of 2001, the Company notified the energy supplier that, among other things, the energy supplier was in default of the energy supply contract and that based upon such default, and for other reasons, the Company was terminating the energy supply contract. The Company continues to reflect the \$19.9 million derivative valuation account on its balance sheet, subject to periodic review, in accordance with SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. The \$19.9 million represents unrealized losses resulting from changes in the estimated fair value of the contract and does not represent contractual cash obligations. The Company believes the energy supply contract has been terminated, and therefore, the Company does not have any further cash obligations under the contract. Accordingly, the energy derivative valuation account is not included in the table. There can be no assurance, however, that a party will not assert a future claim against the Company or that a bankruptcy court or arbitrator will not ultimately nullify the Company's termination of the contract. No provision has been made for contingencies or obligations, if any, under the contract beyond November 2001. For further discussion, see Note 8 to the Company's Consolidated Condensed Financial Statements 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 each of its officers and certain other employees providing for severance payments

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upon the termination of employment. The Company also has consulting agreements that provide for payment of nominal fees upon the issuance of patents and/or the commercialization of research results. The Company has also issued guarantees in the form of two standby letters of credit as security for contingent liabilities under certain workers' compensation insurance policies and as collateral for a loan issued to Golf Entertainment International Limited ( GEI ). The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation on the maximum amount of future payments the Company could be obligated to make. Historically, costs incurred to settle claims related to indemnities have not been material to the Company's financial position, results of operations or cash flows. In addition, the Company believes the likelihood is remote that material payments will be required under the commitments and guarantees described above. The fair value of indemnities, commitments and guarantees that the Company issued during the three months ended March 31, 2008 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 at least 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.

### ***Capital Resources***

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

### ***Off-Balance-Sheet Arrangements***

In connection with the Company's investment in GEI, (see Note 5 to the Consolidated Condensed Financial Statements Investments in this Form 10-Q), in February 2008, the Company and another GEI shareholder entered into an arrangement to provide collateral in the form of a letter of credit in the amount of \$8.0 million for a loan that was issued to a subsidiary of GEI. The Company is currently responsible for \$5.5 million of the total guaranteed amount. This letter of credit will expire one year from the date of issuance.

In addition, at March 31, 2008, the Company had total outstanding commitments on non-cancelable operating leases of approximately \$34.6 million related to certain warehouse, distribution and office facilities, vehicles as well as office equipment. Lease terms range from 1 to 10 years expiring at various dates through November 2017, with options to renew at varying terms.

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

There have been no material changes to our critical accounting policies and estimates from the information provided in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, included in our 10-K for the fiscal year ended December 31, 2007.

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**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 currency exchange rates. Transactions involving these financial instruments are with creditworthy firms. The use of these instruments exposes the Company to market and credit risk which may at times be concentrated with certain counterparties, although counterparty nonperformance is not anticipated. The Company is also exposed to interest rate risk from its credit facility.

**Foreign Currency Fluctuations**

In the normal course of business, the Company is exposed to foreign currency exchange rate risks (see Note 12 to the Company's Consolidated Condensed Financial Statements) that could impact the Company's results of operations. The Company's risk management strategy includes the use of derivative financial instruments, including forwards and purchase options, to hedge certain of these exposures. The Company's objective is to offset gains and losses resulting from these exposures with gains and losses on the derivative contracts used to hedge them, thereby reducing volatility of earnings. The Company does not enter into any trading or speculative positions with regard to foreign currency related derivative instruments.

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

The Company enters into foreign exchange contracts to hedge against exposure to changes in foreign currency exchange rates. Such contracts are designated at inception to the related foreign currency exposures being hedged, which include anticipated intercompany sales of inventory denominated in foreign currencies, payments due on intercompany transactions from certain wholly-owned foreign subsidiaries, and anticipated sales by the Company's wholly owned European subsidiary for certain Euro-denominated transactions. Hedged transactions are denominated primarily in European currencies, Japanese Yen, Korean Won, Canadian Dollars and Australian Dollars. To achieve hedge accounting, contracts must reduce the foreign currency exchange rate risk otherwise inherent in the amount and duration of the hedged exposures and comply with established risk management policies. Pursuant to its foreign exchange hedging policy, the Company may hedge anticipated transactions and the related receivables and payables denominated in foreign currencies using forward foreign currency exchange rate contracts and put or call options. Foreign currency derivatives are used only to meet the Company's objectives of minimizing variability in the Company's operating results arising from foreign exchange rate movements. The Company does not enter into foreign exchange contracts for speculative purposes. Hedging contracts mature within 12 months from their inception.

At March 31, 2008 and 2007, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$134.4 million and \$105.5 million, respectively. At March 31, 2008 and 2007, there were no outstanding foreign exchange contracts designated as cash flow hedges.

As part of the Company's risk management procedure, a sensitivity analysis model is used to measure the potential loss in future earnings of market-sensitive instruments resulting from one or more selected hypothetical changes in interest rates or foreign currency values. The sensitivity analysis model quantifies the estimated potential effect of unfavorable movements of 10% in foreign currencies to which the Company was exposed at March 31, 2008 through its derivative financial instruments.

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The estimated maximum one-day loss from the Company's foreign currency derivative financial instruments, calculated using the sensitivity analysis model described above, is \$14 million at March 31, 2008. 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 \$14 million at March 31, 2008 and would impact earnings. The Company believes that such a hypothetical loss from its derivatives would be offset by increases in the value of the underlying transactions being hedged.

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

## **Interest Rate Fluctuations**

The Company is exposed to interest rate risk from its Line of Credit (see Note 7 to the Company's Consolidated Condensed Financial Statements in this Form 10-Q). Outstanding borrowings under the Line of Credit accrue interest, at the Company's election, based upon the Company's consolidated leverage ratio and trailing four quarters' EBITDA, of (i) the higher of (a) the Federal Funds Rate plus 50.0 basis points or (b) Bank of America's prime rate, or (ii) the Eurodollar Rate (as defined in the agreement governing the Line of Credit) plus a margin of 50.0 to 125.0 basis points.

As part of the Company's risk management procedures, a sensitivity analysis was performed to determine the impact of unfavorable changes in interest rates on the Company's cash flows. The sensitivity analysis quantified that the estimated potential cash flows impact would be approximately \$0.1 million in additional interest expense if interest rates were to increase by 10% over a three month period.

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

*Disclosure Controls and Procedures.* The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness, as of March 31, 2008, of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective.

*Changes in Internal Control Over Financial Reporting.* During the quarter ended March 31, 2008, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

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**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. The Company is also active internationally. For example, it has worked with other manufacturers to encourage Chinese government officials to conduct raids of identified counterfeiters, resulting in the seizure and destruction of counterfeit golf clubs. Defendants in these actions may, among other things, contest the validity and/or the enforceability of some of the Company's patents and/or trademarks. Others may assert counterclaims against the Company. Historically, these matters individually and in the aggregate have not had a material adverse effect upon the financial position or results of operations of the Company. It is possible, however, that in the future one or more defenses or claims asserted by defendants in one or more of those actions may succeed, resulting in the loss of all or part of the rights under one or more patents, loss of a trademark, a monetary award against the Company or some other material loss to the Company. One or more of these results could adversely affect the Company's overall ability to protect its product designs and ultimately limit its future success in the marketplace.

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

On February 9, 2006, the Company filed a complaint in the United States District Court for the District of Delaware, Case No. C.A. 06-91, asserting claims against Acushnet Company for patent infringement. Specifically, Callaway Golf asserted that Acushnet's sale of the Titleist Pro V1 family of golf balls infringes four golf ball patents that Callaway Golf acquired when it acquired the assets of Top-Flite. Callaway Golf is seeking damages and an injunction to prevent future infringement by Acushnet. In its answer to the Complaint, Acushnet responded that the patents at issue are invalid and not infringed by the Pro V1 golf balls. On November 20, 2007, the District Court granted Callaway Golf's motion for summary judgment on a breach of contract claim, holding that Acushnet's initiation of parallel re-examination proceedings, described below, constituted a breach of a pre-existing dispute resolution agreement with Callaway Golf. The Court also rejected various legal challenges by Acushnet as to the validity of the patents, permitting Callaway Golf's claims against Acushnet to proceed to trial, and ruled that the issues of damages and willfulness would be decided in a second trial between the parties. On the eve of trial, Acushnet stipulated that its Pro V1 golf balls infringe one or more of the nine claims in the four patents asserted by Callaway Golf. As a result of the Court's rulings, and Acushnet's concession as to infringement, only the validity of the patents was tried before a jury commencing on December 5, 2007. On December 14, 2007, after a six day trial, a unanimous jury decided that eight of the nine patent claims asserted by Callaway Golf against Acushnet are valid. The Court entered judgment in favor of Callaway Golf and against Acushnet on December 20, 2007. Callaway Golf has requested that the Court enter a permanent injunction requiring Acushnet to stop production and sale of the Pro V1 golf balls. Acushnet has asked the Court to enter judgment notwithstanding the verdict or, alternatively, for a new trial. Those two motions are pending.

Acushnet also filed petitions for reexamination with the United States Patent and Trademark Office (PTO) challenging the validity of the patents asserted by Callaway Golf. Although the PTO agreed the petitions for reexamination raised substantial new questions of patentability, and issued multiple office actions rejecting the claims of all four of the patents, the PTO has not made a final and binding determination as to the validity of any of the patents. The Company expects that some of the prior claims or newly framed claims submitted as part of the reexamination proceeding will be affirmed by the PTO. To the extent claims previously approved are no longer allowed upon the conclusion of the reexamination process, the Company is likely to appeal such actions. The interim rulings by the PTO do not void the Court's judgment.

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

On February 27, 2007, the Company and Dailey & Associates (an advertising agency) filed a complaint in the United States District Court for the Southern District of California, Case No. 07 CV 0373, asserting claims against the Screen Actors Guild (SAG) and the Trustees of SAG's Pension and Health Plans (Plans) seeking declaratory and injunctive relief. Specifically, the Plans contend that Callaway Golf is required to treat a significant portion of the sums paid to professional golfers who endorse the Company's products as compensation for acting services, and to make contributions to the Plans based upon a percentage of that total amount. The Company is seeking a declaration that it is not required to contribute beyond the contributions already made, or alternatively, is obligated to pay nothing and is entitled to restitution for all contributions previously made to the Plans. SAG and the Plans have filed a counterclaim to compel an audit and to recover unpaid Plan contributions. SAG and the Plans also seek liquidated damages, interest, and reasonable audit and attorneys' fees. The parties are engaged in discovery. Motions for Judgment on the Pleadings and to Stay Proceedings filed by SAG and the Plans were denied by the Court on March 26, 2008. A pretrial conference is set for December 29, 2008. No trial date has been set.

On January 16, 2008, the Company issued a notice of default to Ashworth Inc. under the parties' May 14, 2001 License Agreement, as amended from time to time (Agreement). Under the Agreement, Ashworth has thirty (30) days from the date of notice in which to cure a default. Ashworth has denied that any breach has occurred, and has not taken the steps requested by the Company to cure. Accordingly, it is the Company's belief that it has the right to terminate the Agreement and it has communicated that assessment to Ashworth. The parties conducted a mediation of the issue on April 23, 2008, pursuant to dispute resolution procedures specified in the Agreement. The matter was not resolved at the mediation and the Company is therefore demanding binding arbitration. Ashworth has stated that it believes it would have claims against the Company in the event that the Company wrongfully terminates or interferes with the Agreement. The Company is not aware of what such claims might be, but it currently is unaware of any basis for a meritorious claim against it based upon the handling of the alleged breach by Ashworth.

On February 13, 2008, Ogio International Inc. filed a complaint for patent infringement against Callaway Golf in the United States District Court, for the District of Utah, Case No. 08cv116. Specifically, Ogio alleges that Callaway Golf's sales of Warbird XTT, Warbird Hot, Terra Firma X, Terra Firma XI and Hyper-X golf bags infringe one or more claims of United States Patents numbered 6,877,604 and 7,213,705. The complaint seeks compensatory damages and an injunction. The complaint has not been served on the Company. However, the parties and their attorneys are in discussions regarding 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. Management believes at this time that the final resolution of these

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matters, individually and in the aggregate, will not have a material adverse effect upon the Company's consolidated annual results of operations, cash flows or financial position.

**Item 1A. Risk Factors**  
**Certain Factors Affecting Callaway Golf Company**

The Company has included in Part I, Item 1A of its Annual Report on Form 10-K for the year ended December 31, 2007, a description of certain risks and uncertainties that could affect the Company's business, future performance or financial condition (the Risk Factors). There are no material changes from the disclosure provided in the Form 10-K for the year ended December 31, 2007 with respect to the Risk Factors. Investors should consider the Risk Factors prior to making an investment decision with respect to the Company's stock.

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

In November 2007, the Board of Directors authorized a new repurchase program (the November 2007 repurchase program) for the Company to repurchase shares of its common stock up to a maximum cost to the Company of \$100.0 million, which will remain in effect until completed or otherwise terminated by the Board of Directors.

During the three months ended March 31, 2008, the Company repurchased 4,073 shares of its common stock at a weighted average cost per share of \$17.57 for a total cost of \$0.1 million under the November 2007 repurchase program. As of March 31, 2008, the Company remained authorized to repurchase up to an additional \$99.9 million of its common stock under this program.

The following schedule summarizes the status of the Company's repurchase programs (in thousands, except per share data):

|                  |                   | Three Months Ended March 31,<br>2008   |   |   |   |
|------------------|-------------------|--|---|---|---|
|                  |                   | Total Number<br>of Shares<br>Purchased | Weighted<br>Average Price<br>Paid per Share | Total Number<br>of Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Programs | Maximum<br>Dollar<br>Value that<br>May Yet Be<br>Purchased<br>Under the<br>Programs |
| January 1, 2008  | January 31, 2008  | 2                                      | \$ 17.99                                    | 2   | \$ 99,965   |
| February 1, 2008 | February 29, 2008 | 2                                      | \$ 17.19                                    | 2   | \$ 99,928   |
| March 1, 2008    | March 31, 2008    |  | \$  |   | \$ 99,928   |
| Total            |                   | 4                                      | \$ 17.57                                    | 4   | \$ 99,928   |

**Item 3. Defaults upon Senior Securities**  
None.

**Item 4. Submission of Matters to a Vote of Security Holders**  
None.

**Item 5.**     *Other Information*  
None.

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**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 Fourth Amended and Restated Bylaws, as amended and restated as of February 21, 2008, incorporated herein by this reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 2007, as filed with the Commission on February 28, 2008 (file no. 1-10962).
- 4.1 Dividend Reinvestment and Stock Purchase Plan, incorporated herein by this reference to the Prospectus in the Company's Registration Statement on Form S-3, as filed with the Commission on March 29, 1994 (file no. 33-77024).
- 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 of George Fellows and Bradley J. Holiday pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

( ) Included with this Report.

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**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: May 1, 2008

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**EXHIBIT INDEX**

| <b>Exhibit</b> | <b>Description</b>   |
|----------------|--|
| 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.              |
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