CALLAWAY GOLF CO /CA
Form 10-Q
August 01, 2006
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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 June 30, 2006

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)

Delaware	**95-3797580**
(State or other jurisdiction of incorporation or organization)	**(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 x 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 x Accelerated filer ¨ Non-accelerated filer ¨

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

The number of shares outstanding of the Registrant s Common Stock, $.01 par value, as of June 30, 2006 was 73,920,920.

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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 gross margins, cash flows and liquidity, as well as estimated unrecognized compensation, estimated integration and restructuring benefits, savings and charges, projected capital expenditures, and future contractual obligations, are forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. These statements are based upon current information and expectations. Actual results may differ materially from those anticipated as a result of certain risks and uncertainties, including delays, difficulties, changed strategies, or unanticipated factors affecting the implementation of the restructuring initiatives, as well as the general risks and uncertainties applicable to the Company and its business. For details concerning these and other risks and uncertainties, see 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: Apex Baby Ben Ben Hogan BH BH-5 Big Ben Big Bertha C455 CS-3 Callaway Callaway Golf Chev Chevron Device Complete Demonstrably Superior and Pleasingly Different Dual Force ERC Explosive Distance.Amazing Soft Feel Flying Lady FT-3 FTX Fusion Game Series-Gems Great Big Bertha Heavenwood Hogan Hybrid 45 HX I-Trax Little Ben Molitor Number One Putter in Golf Odyssey ORG.14 Pencil Rossie S2H2 SRT Se Slot-Steelhead Strata Stronomic Sure-Out T design Tech Series The Hawk Top-Flite Top Flite Quartz Top-Flite XL Tour Authentic Tri-Ball-Tour Deep Trade In! Trade Up! TriBall Tru Bore Tunite VFT War Bird Warbird White Hot White Hot XG White Steel World s Friendliest X-16 X-18 X460 XL 3000 XL Extreme X-Series X-Sole X-SPANN Xtra Traction Technology X-Tour XTT XWT.*

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CALLAWAY GOLF COMPANY

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

CALLAWAY GOLF COMPANY

CONSOLIDATED CONDENSED BALANCE SHEETS

(Unaudited)

(In thousands, except share and per share data)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 48,113	$ 49,481
Accounts receivable, net	257,782	98,082
Inventories, net	232,236	241,577
Deferred taxes	30,849	30,064
Income taxes receivable		2,026
Other current assets	19,259	17,360
Total current assets	588,239	438,590
Property, plant and equipment, net	136,024	127,739
Intangible assets, net	146,001	146,123
Goodwill	30,097	29,068
Deferred taxes	4,657	6,516
Other assets	15,072	16,462
	$ 920,090	$ 764,498
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 128,930	$ 102,134
Accrued employee compensation and benefits	20,176	24,783
Accrued warranty expense	15,469	13,267
Bank line of credit	110,300	
Income taxes payable	10,590	
Capital leases, current portion		21
Total current liabilities	285,465	140,205
Long-term liabilities:		
Deferred compensation	7,024	8,323
Energy derivative valuation account	19,922	19,922
Commitments and contingencies (Note 9)		
Shareholders equity:		
Preferred Stock, $.01 par value, 3,000,000 shares authorized, none issued and outstanding at June 30, 2006 and December 31, 2005		
Common Stock, $.01 par value, 240,000,000 shares authorized, 85,104,614 shares and 84,950,694 shares issued at June 30, 2006 and December 31, 2005, respectively	851	850

Additional paid-in capital	390,980	393,676
Unearned compensation	(4,557)	(9,014)
Retained earnings	466,699	430,996
Accumulated other comprehensive income	8,868	3,377
Less: Grantor Stock Trust held at market value, 5,453,798 shares and 5,954,747 shares at June 30, 2006 and December 31, 2005, respectively	(70,845)	(82,414)
Less: Common Stock held in treasury, at cost, 11,183,694 shares and 8,500,811 shares at June 30, 2006 and December 31, 2005, respectively	(184,317)	(141,423)
Total shareholders equity	607,679	596,048
	$ 920,090	$ 764,498

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 June 30, 2006		Three Months Ended June 30, 2005		Six Months Ended June 30, 2006		Six Months Ended June 30, 2005	
Net sales	$ 341,815	100%	$ 323,132	100%	$ 644,260	100%	$ 622,989	100%
Cost of sales	201,729	59%	176,399	55%	372,662	58%	343,650	55%
Gross profit	140,086	41%	146,733	45%	271,598	42%	279,339	45%
Operating expenses:								
Selling expense	77,045	23%	90,640	28%	145,173	23%	166,385	27%
General and administrative expense	18,101	5%	21,239	7%	38,325	6%	40,324	6%
Research and development expense	6,194	2%	7,083	2%	12,998	2%	13,323	2%
Total operating expenses	101,340	30%	118,962	37%	196,496	30%	220,032	35%
Income from operations	38,746	11%	27,771	9%	75,102	12%	59,307	10%
Other expense, net	(1,273)		(1,806)		(971)		(2,987)	
Income before income taxes	37,473	11%	25,965	8%	74,131	12%	56,320	9%
Provision for income taxes	14,934		7,573		28,731		19,568	
Net income	$ 22,539	7%	$ 18,392	6%	$ 45,400	7%	$ 36,752	6%
Earnings per common share:								
Basic	$ 0.33		$ 0.27		$ 0.66		$ 0.54	
Diluted	$ 0.33		$ 0.27		$ 0.65		$ 0.54	
Weighted-average shares outstanding:								
Basic	67,799		68,270		68,479		68,226	
Diluted	68,577		68,660		69,356		68,643	
Dividends declared per share	$ 0.07		$ 0.07		$ 0.14		$ 0.14	

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

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CALLAWAY GOLF COMPANY

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Cash flows from operating activities:		
Net income	$ 45,400	$ 36,752
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	15,225	22,659
Non-cash compensation	6,331	3,957
Loss on disposal of long-lived assets	324	856
Deferred taxes	1,165	(1,184)
Changes in assets and liabilities, net of effects from acquisitions:		
Accounts receivable, net	(152,881)	(137,015)
Inventories, net	15,255	(15,815)
Income tax receivable and payable	12,397	27,635
Other assets	530	183
Accounts payable and accrued expenses	14,269	48,495
Accrued employee compensation and benefits	(4,856)	8,864
Accrued warranty expense	2,202	1,189
Other liabilities	(1,299)	(914)
Net cash used in operating activities	(45,938)	(4,338)
Cash flows from investing activities:		
Capital expenditures	(20,463)	(19,046)
Acquisitions, net of cash acquired	(5,911)	
Proceeds from sale of capital assets	120	20
Net cash used in investing activities	(26,254)	(19,026)
Cash flows from financing activities:		
Issuance of Common Stock	6,519	3,560
Dividends paid, net	(4,901)	(4,853)
Acquisition of Treasury Stock	(42,894)	(39)
Tax benefit from exercise of stock options	481	269
Proceeds from line of credit, net	110,300	37,000
Payments on financing arrangements	(20)	(22)
Net cash provided by financing activities	69,485	35,915
Effect of exchange rate changes on cash and cash equivalents	1,339	(1,552)
Net increase (decrease) in cash and cash equivalents	(1,368)	10,999
Cash and cash equivalents at beginning of period	49,481	31,657
Cash and cash equivalents at end of period	$ 48,113	$ 42,656

Non-cash financing activities:				
Dividends payable	$	4,796	$	4,853
Issuance of restricted stock	$	4,902	$	

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		Additional			Accumulated	Grantor	Treasury Stock		
						Other	Stock			
			Paid-in	Unearned	Retained	Comprehensive	Trust			
	Shares	Amount	Capital	Compensation	Earnings	Income		Shares	Amount	Total
Balance, December 31, 2005	84,951	$ 850	$ 393,676	$ (9,014)	$ 430,996	$ 3,377	$ (82,414)	(8,501)	$ (141,423)	$ 596,048
Reclass due to adoption of SFAS 123R			(2,382)	2,382						
Exercise of stock options		(1)	(983)				5,636			4,652
Tax benefit from exercise of stock options			481							481
Issuance of Restricted Common Stock	154	2	588							590
Compensatory stock and stock options			3,666	2,075						5,741
Acquisition of Treasury Stock								(2,683)	(42,894)	(42,894)
Employee stock purchase plan			(188)				2,055			1,867
Cash dividends declared					(9,697)					(9,697)
Adjustment of Grantor Stock Trust shares to market value			(3,878)				3,878			
Equity adjustment from foreign currency translation						5,491				5,491
Net income					45,400					45,400
Balance, June 30, 2006	85,105	$ 851	$ 390,980	$ (4,557)	$ 466,699	$ 8,868	$ (70,845)	(11,184)	$ (184,317)	$ 607,679

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

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated condensed financial statements have been prepared by Callaway Golf Company (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 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. Share-Based Employee Compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R (SFAS 123R), Share-Based Payment, which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated fair values. SFAS 123R supersedes the Company s previous accounting methodology using the intrinsic value method under Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees. Under the intrinsic value method, no share-based compensation expense related to stock option awards granted to employees had been recognized in the Company s Consolidated Statements of Operations, as all stock option awards granted under the plans had an exercise price equal to or greater than the market value of the Common Stock on the date of the grant.

The Company adopted SFAS 123R using the modified prospective transition method. Under this transition method, periods prior to December 31, 2005 are not revised for comparative purposes. Compensation expense for all share-based awards outstanding as of the effective date is calculated for pro-forma disclosure purposes based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 and recognized over the remaining service period. The valuation provisions of SFAS 123R apply to new share-based awards granted subsequent to December 31, 2005.

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

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CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Stock Plans

At June 30, 2006, the Company had the following two shareholder approved stock plans under which shares were available for equity-based awards: the 2004 Equity Incentive Plan (the 2004 Plan) and the 2001 Non-Employee Directors Stock Option Plan (the 2001 Directors Plan). The 2004 Plan permits the granting of stock options, stock appreciation rights, restricted stock/units, performance 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 2001 Directors Plan is 8,000,000 shares and 500,000 shares, respectively.

Stock Options

All stock option grants made under the 2004 Plan and the Directors Stock 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 periods ranging from one to three years from the grant date and generally expire up to 10 years after the grant date. The Company recorded $1,979,000 and $3,590,000 of compensation expense relating to outstanding stock options during the three and six months ended June 30, 2006. No compensation expense was recorded related to outstanding options during the three and six months ended June 30, 2005.

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 with the assumptions included in the table below. These assumptions include the risk-free interest rate, the expected life of the options, the expected stock price volatility over the expected life of the options, and the expected dividend yield. Compensation expense for employee stock options includes an estimate for forfeitures and is recognized ratably over the vesting term. The table below illustrates the assumptions used to estimate the fair value of options granted during the three and six months ended June 30, 2006 and 2005 using the Black-Scholes option-pricing model. There were no stock options granted during the three months ended June 30, 2006. There were 572,000 stock options granted during the six months ended June 30, 2006.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Dividend yield		2.0%	2.0%	2.0%
Expected volatility		42.4%	41.3%	42.4%
Risk free interest rate		3.7%	4.8%	3.3%
Expected life		4 years	3.4 years	4 years

The expected life of the options is based on evaluations of historical and expected future employee exercise behavior. 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. Volatility is based on historical volatility of the Company s stock. The valuation model applied in this calculation utilizes highly subjective assumptions that could potentially change over time, including the expected forfeiture rate, expected stock price volatility and the expected life of an option. Therefore, the estimated fair value of an option does not necessarily represent the value that will ultimately be realized by an employee.

CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the Company s stock option activities with respect to its stock option plans for the first six months of 2006 as follows (in thousands, except price per share and contractual term):

Options	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2006	10,294	$ 17.19		
Granted	572	$ 15.08		
Exercised	(352)	$ 13.19		
Forfeited	(24)	$ 15.00		
Expired	(630)	$ 21.81		
Outstanding at June 30, 2006	9,860	$ 16.92	6.04	$ 1,083
Vested and expected to vest in the future at June 30, 2006	9,722	$ 16.96	6.04	$ 1,067
Exercisable at June 30, 2006	7,444	$ 17.71	5.21	$ 789

The weighted-average grant-date fair value of options granted during the six months ended June 30, 2006 was $5.30 per share. There were no options granted during the three months ended June 30, 2006. The weighted-average grant-date fair value of options granted during the three and six months ended June 30, 2005 was $4.01 per share and $4.59 per share, respectively. The total intrinsic value for options exercised during the three and six months ended June 30, 2006 was $217,000 and $1,227,000, respectively. The total intrinsic value for options exercised during the three and six months ended June 30, 2005 was $389,000 and $438,000, respectively.

Cash received from option exercises under all plans for the three and six months ended June 30, 2006 was approximately $757,000 and $4,651,000, respectively, and $1,507,000 and $1,757,000, for the comparable periods in the prior year, respectively. The actual tax benefit realized for the tax deductions from option exercises under all plans totaled approximately $55,000 and $481,000, respectively, for the three months and six months ended June 30, 2006 and $228,000 and $269,000 during the comparable periods in 2005.

Restricted Stock, Restricted Stock Units and Performance Units

The Company granted 154,000 shares of Restricted Stock during the six months ended June 30, 2006, as well as 22,000 and 51,000 of shares underlying Restricted Stock Units during the three and six months ended June 30, 2006, respectively, to certain employee participants under the Company s 2004 Equity Incentive Plan. The Company did not grant shares of Restricted Stock during the three months ended June 30, 2006, as well as shares of Restricted Stock or Restricted Stock Units during the three and six months ended June 30, 2005. Restricted Stock awards and Restricted Stock Units generally vest over a period of 3 to 5 years.

The weighted average grant date fair value of the shares granted during the three and six months ended June 30, 2006 was $13.54 and $14.91 per share, respectively. The Company recorded approximately $421,000 and $783,000 of compensation expense related to outstanding shares of Restricted Stock and Restricted Stock Units held by employees during the three and six months ended June 30, 2006, respectively, and $116,000 and $214,000, during the three and six months ended June 30, 2005, respectively. In addition, the Company recorded $1,394,000 and $3,744,000 of compensation expense related to shares of Restricted Stock held by non-employees during the six months ended June 30, 2006 and 2005, respectively, and $2,362,000 during the three months ended June 30, 2005. During the three months ended June 30, 2006, the Company reversed

$787,000 of compensation expense to revalue shares of Restricted Stock granted to non-employees at market value as of June 30, 2006.

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CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

(Unaudited)

During the six months ended June 30, 2006, the Company granted 142,000 Performance Units to certain employee participants under the Company s 2004 Equity Incentive Plan. There were no Performance Units awarded during the three months ended June 30, 2006 and during the three and six month ended June 30, 2005. Performance Units generally cliff vest at the end of a three year performance period. Performance Units are a form of stock-based award in which the number of shares ultimately received depends on the Company s performance against specified performance targets over a three year period ending on December 31, 2008. At the end of the performance period, the number of shares of stock issued will be determined by adjusting upward or downward from the target in a range between 50% and 150%. The final performance percentage payout is based upon performance metrics established by the Compensation and Management Succession Committee of the Company s Board of Directors. The weighted average grant date fair value of the Performance Units awarded during the six months ended June 30, 2006 was $15.09 per unit. The Company recorded $152,000 and $254,000 of compensation expense related to these Performance Units during the three and six months ended June 30, 2006. There was no compensation expense related to Performance Units during the three and six months ended June 30, 2005.

The fair value of nonvested Restricted Stock awards, Restricted Stock Units and Performance 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 Shares activity for the six months ended June 30, 2006 is as follows (in thousands, except fair value amounts):

Restricted Stock, Restricted Stock Units and Performance Units	**Shares**	**Weighted-Average Grant-Date Fair Value**	
Nonvested at January 1, 2006	1,001	$	11.36
Granted	347	$	14.98
Vested	12	$	15.23
Forfeited	5	$	15.04
Nonvested at June 30, 2006	1,331	$	12.27

At June 30, 2006, there was $11,107,000 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 $9,220,000 relates to Restricted Stock awards and Restricted Stock Units and $1,887,000 relates to Performance Units. That cost is expected to be recognized over a weighted-average period of 2.2 years. The amount of unrecognized compensation expense noted above does not necessarily represent the value that will ultimately be realized by the Company in its Statement of Operations. Unrecognized compensation expense related to nonvested shares of Restricted Stock awards, Restricted Stock Units and Performance Units granted to employees was recorded as unearned share-based compensation in shareholder s equity at December 31, 2005. As part of the adoption of SFAS 123R, $2,382,000 of unrecognized compensation expense was reclassified as a component of additional paid-in capital as of June 30 2006.

Employee Stock Purchase Plan

On February 1, 2006, the Company amended and restated the Callaway Golf Company Employee Stock Purchase Plan (the Plan) to eliminate the look-back provision. Under the amended and restated Plan, participating employees authorize the Company to withhold compensation and to use the withheld amounts to purchase shares of the Company s Common Stock at 85% of the closing price on the last day of each six month exercise period. During the six months ended June 30, 2006 and 2005, approximately 149,000 and 177,000 shares, respectively, of the Company s Common Stock were purchased under the Plan.

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CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Employee Share-Based Compensation Expense

The table below shows the amounts recognized in the financial statements for the three and six months ended June 30, 2006 for share-based compensation related to employees. Amounts are in thousands, except for per share data.

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of sales	$ 161	$ 262
Operating expenses	2,553	4,670
Total cost of employee share-based compensation included in income, before income tax	2,714	4,932
Amount of income tax recognized in earnings	(826)	(1,627)
Amount charged against net income	$ 1,888	$ 3,305
Impact on net income per common share:		
Basic	$ (0.03)	$ (0.05)
Diluted	$ (0.03)	$ (0.05)

There were no amounts relating to employee share-based compensation capitalized in inventory during the three and six months ended June 30, 2006.

Pro Forma Employee Share-Based Compensation Expense

Prior to December 31, 2005, the Company accounted for share-based employee compensation arrangements in accordance with the provisions and related interpretations of APB 25. Had compensation cost for share-based awards been determined consistent with SFAS No. 123R, the net income and earnings per share would have been adjusted to the following pro forma amounts (in thousands, except for per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income, as reported	$ 18,392	$ 36,752
Add: Share-based employee compensation expense included in reported net income, net of related tax effects	82	139
Deduct: Total share-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,295)	(2,483)
Pro forma net income	$ 17,179	$ 34,408

Earnings per common share:				
Basic as reported	$	0.27	$	0.54
Basic pro forma	$	0.25	$	0.50
Diluted as reported	$	0.27	$	0.54
Diluted pro forma	$	0.25	$	0.50

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CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

(Unaudited)

3. Restructuring and Integration Initiatives

In September 2005, the Company began the implementation of several company-wide restructuring initiatives designed to improve the Company s business processes and reduce the Company s overall expenses (the 2005 Restructuring Initiatives). The 2005 Restructuring Initiatives include, among other things, the consolidation of the Callaway Golf, Odyssey, Top-Flite and Ben Hogan selling functions, as well as the elimination or reduction of other operating expenses. The 2005 Restructuring Initiatives and estimated charges for such initiatives are in addition to the previously reported integration of the Callaway Golf and Top-Flite operations and the charges for such integration.

In connection with the 2005 Restructuring Initiatives, the Company committed to staff reductions that will involve the elimination of approximately 500 positions worldwide, including full-time and part-time employees, temporary staffing and open positions. Most of the employee terminations were completed by December 31, 2005 and all such employee terminations are expected to be substantially completed by December 31, 2006. During the second half of 2005, the Company recorded charges to cost of sales, selling expense, general and administrative expense, and research and development expense in the amount of $8,324,000 in connection with the Restructuring Initiatives. The Company incurred charges of $600,000 during the six months ended June 30, 2006 and may incur additional charges of approximately $3,400,000 related to the 2005 Restructuring Initiatives.

In October 2005, the Company completed its full integration of the Callaway Golf ball manufacturing with the Top-Flite golf ball manufacturing at the Chicopee, Massachusetts and Gloversville, New York locations. As of June 30, 2006, the Company has incurred approximately $67,400,000 of non-cash charges for acceleration of depreciation on certain golf ball manufacturing equipment and cash charges related to severance and facility consolidations in connection with the integration. During the three and six months ended June 30, 2006, the Company recorded $1,734,000 and $2,764,000, respectively, to pre-tax earnings and anticipates additional charges of approximately $500,000 during the remainder of 2006 in order to complete the restoration of the former ball manufacturing plant in Carlsbad, California to its original condition.

4. Inventories

Inventories are summarized below (in thousands):

	June 30, 2006	December 31, 2005
Inventories, net:		
Raw materials	$ 81,299	$ 84,188
Work-in-process	3,017	5,313
Finished goods	147,920	152,076
	$ 232,236	$ 241,577

5. 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. Intangible assets with definite lives are amortized using the straight-line method over periods ranging from 1-16 years. During the three months ended June 30, 2006 and 2005, aggregate amortization expense

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CALLAWAY GOLF COMPANY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

(Unaudited)