

PETROHAWK ENERGY CORP

Form 424B3

July 26, 2005

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Filed Pursuant To  
Rule 424(b)(3)  
Registration No. 333-124899

**PROSPECTUS**

\$250,000,000

Debt Securities  
Preferred Stock  
Common Stock  
Warrants

**PETROHAWK ENERGY CORPORATION**

We may offer, from time to time, in one or more series:

unsecured senior debt securities;

unsecured subordinated debt securities;

shares of common stock;

shares of preferred stock; and

warrants to purchase debt securities, common stock, or preferred stock.

The securities:

will have a maximum aggregate offering price of \$250,000,000;

will be offered at prices and on terms to be set forth in an accompanying prospectus supplement;

may be offered separately or together, or in separate series;

may be convertible into or exchangeable for other securities; and

may be listed on a national securities association, if specified in an accompanying prospectus supplement.

Our common stock is quoted on the Nasdaq National Market under the symbol HAWK.

We will provide the specific terms of the securities in supplements to this prospectus. This prospectus may be used to offer and sell securities only if it is accompanied by a prospectus supplement.

Investing in our common stock involves risks. Please read carefully the information under the headings Risk Factors beginning on page 3 and Forward-Looking Statements on page 24 of this prospectus before you invest in our common stock.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

This prospectus is dated July 26, 2005

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## ABOUT THIS PROSPECTUS

In this prospectus, unless the context otherwise requires, Petrohawk, we, us, our or ours refer to Petrohawk Energy Corporation, together with its operating subsidiaries.

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission utilizing a shelf registration process or continuous offering process. Under this shelf registration process, we may, from time to time, sell the securities described in this prospectus in one or more offerings up to a total offering amount of \$250,000,000. This prospectus provides you with a general description of the securities we may offer. Each time we sell securities, we will provide you with this prospectus and, in certain cases, a prospectus supplement that will contain specific information about the terms of that offering and the securities offered by us in that offering. The prospectus supplement may include additional risk factors or other special considerations applicable to those securities. Any prospectus supplement may also add, update, or change information contained in this prospectus. If there is any inconsistency between the information in this prospectus and any prospectus supplement, you should rely on the information in that prospectus supplement. You should read both this prospectus and any prospectus supplement together with additional information described under Where You Can Find More Information.

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**THE COMPANY**

We are an independent energy company engaged in the acquisition, development, production and exploration of natural gas and oil properties located in North America. Our properties are concentrated in the South Texas, Anadarko, Permian Basin, East Texas, Arkoma, and Gulf Coast regions. At December 31, 2004, we had estimated total net proved reserves of approximately 219 Bcfe, consisting of 9.7 million barrels of oil and 160.9 Bcf of natural gas. Proved reserves are approximately 73% were natural gas on an equivalent basis and approximately 78% were classified as proved developed. Year-end prices used to determine proved reserves were \$40.25 per barrel of oil and \$6.18 per Mmbtu of gas.

We have increased our proved reserves and production principally through acquisitions. We focus on properties within our core operating areas that have a significant proved reserve component and which management believes have additional development and exploration opportunities.

Petrohawk is a Delaware corporation originally organized in Nevada in June 1997 as Beta Oil & Gas, Inc. Our principal offices are located at 1100 Louisiana Street, Suite 4400, Houston, Texas 77002, telephone number (832) 204-2700, fax number (832) 204-2800, and our website can be found at [www.petrohawk.com](http://www.petrohawk.com). Unless specifically incorporated by reference in this prospectus, information that you may find on our website is not part of this prospectus.

**Recent Developments**

We have recently engaged in several transactions:

***Conversion of Note by PHAWK, LLC***

On June 30, 2005, we entered into an agreement to amend that certain \$35,000,000, 8% convertible promissory note dated as of May 25, 2004, due May 25, 2009, that we entered into in favor of PHAWK, LLC, as payee and which is an affiliate of ours. The promissory note contained a provision providing for conversion into 8,750,000 shares of our common stock at any time after May 25, 2006. The agreement that we entered into to amend the note provided that the promissory note would convert on June 30, 2005 upon us making a premium payment in the amount of \$2,410,621.73 to PHAWK, LLC, which amount represented the interest that would have been payable under the note had it been held until May 25, 2006, less a 10% discount. Pursuant to terms of the agreement to amend the note, PHAWK, LLC exercised its right to convert the note into 8,750,000 shares of Petrohawk common stock on June 30, 2005.

***Pending Merger with Mission Resources Corporation***

On April 4, 2005, we announced the execution of an Agreement and Plan of Merger, dated as of April 3, 2005 (the Merger Agreement) pursuant to which we have agreed to purchase all of the issued and outstanding shares of common stock of Mission Resources Corporation, a Delaware corporation.

Mission is an independent oil and gas exploration and production company headquartered in Houston, Texas. Mission drills for, acquires, develops and produces natural gas and crude oil primarily, in the Permian Basin (in West Texas and Southeast New Mexico), along the Texas and Louisiana Gulf Coast and in both the state and federal waters of the Gulf of Mexico. At December 31, 2004, Mission's estimated net proved reserves, using constant prices that were in effect at such date, were 93 Bcf of natural gas, 43 Bcfe of natural gas liquids, and 15 MMBbl of oil, for total reserves of approximately 226 Bcfe. Approximately 60% of Mission's estimated net proved reserves were natural gas or natural gas liquids, and approximately 78% were classified as proved developed at December 31, 2004.

Total consideration for the shares of Mission common stock will be comprised of approximately 60% of Petrohawk common stock and 40% cash, and is fixed at approximately \$135 million in cash and approximately 19.2 million shares of our common stock, not including outstanding options to purchase Mission common stock. Outstanding options to purchase Mission common stock will be converted into options to purchase our common stock pursuant to the terms of the Merger Agreement. Mission stockholders will have the right to elect cash, shares of our common stock, or a combination of cash and our common stock, subject to a proration if either the cash or common stock portion is oversubscribed. While the per share consideration is initially fixed in the Merger Agreement at \$8.15 in cash or 0.7718 shares of our common stock, the per share consideration is subject to adjustment upwards or downwards so that each share of Mission common stock receives consideration representing equal value. This adjustment will reflect 46.3% of the difference between \$10.56 and the price of our common stock during a specified period prior to closing. Based on the closing price of \$11.53 per share of our common stock on April 1, 2005, the adjusted per share consideration would be valued at \$8.60 or 0.7458 shares of our common stock. In addition, we will assume Mission's \$170 million of long-term debt.

Consummation of the transactions contemplated by the Merger Agreement is conditioned upon, among other things, (1) approval by the stockholders of Mission and Petrohawk, (2) the receipt of all required regulatory approvals, (3) absence of any order or injunction prohibiting the consummation of the merger, (4) subject to certain exceptions, the accuracy of representations and warranties with respect to Mission's or Petrohawk's business, as applicable, (5) receipt of customary tax opinions, and (6) the effectiveness of a registration statement relating to the shares of our common stock to be issued in the merger. The Merger Agreement contains certain termination rights and provides that, upon the termination of the Merger Agreement under specified circumstances, Mission will be required to pay us a termination fee of \$12.5 million.

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***Proton Oil & Gas Corporation Acquisition***

On February 25, 2005, Petrohawk completed the purchase of Proton Oil & Gas Corporation for approximately \$53 million. This transaction included estimated proved reserves of approximately 28 Bcfe, approximately 46% of which are natural gas, and 47% of which are classified as proved developed. Current estimated production from these properties is approximately 5.0 Mmcfe per day. Proton's properties are located in South Louisiana and South Texas.

***Sale of Royalty Interest Properties***

On February 25, 2005, Petrohawk completed the disposition of certain royalty interest properties previously acquired from Wynn-Crosby Energy, Inc. (described below) for approximately \$80 million in cash. Petrohawk sold estimated proved reserves of approximately 26 Bcfe with current estimated production of approximately 5.0 Mmcfe per day.

***Wynn-Crosby Acquisition***

On November 23, 2004, we acquired Wynn-Crosby Energy, Inc. and eight of the limited partnerships it managed for a purchase price of approximately \$425 million. Estimated proved reserves at July 1, 2004, the effective date of the transaction, were approximately 200 Bcfe with estimated production of approximately 46 Mmcfe per day. At December 31, 2004, estimated proved reserves were approximately 190 Bcfe, 74% of which were natural gas and approximately 76% were classified as proved developed. The acquired properties are primarily located in the South Texas, East Texas, Anadarko, Arkoma, and Permian Basin regions and include approximately 75,000 net undeveloped acres in the Arkoma Basin region, as well as significant exploration opportunities in South Louisiana, South Texas, and the Anadarko Basin.

***PHAWK, LLC Transaction***

On August 11, 2004, we acquired from PHAWK certain oil and gas properties in the Breton Sound area, Plaquemines Parish, Louisiana, and in the West Broussard field in Lafayette Parish, Louisiana having approximately 2.9 Bcfe of estimated proved reserves for \$8.5 million.

***Recapitalization by PHAWK, LLC***

On May 25, 2004, PHAWK, LLC (formerly known as Petrohawk Energy, LLC), which is owned by affiliates of EnCap Investments, L.P., Liberty Energy Holdings LLC, Floyd C. Wilson and other members of our management, recapitalized us with \$60 million in cash. The \$60 million investment was structured as the purchase by PHAWK of 7.576 million shares of our common stock for \$25 million, a \$35 million five year 8% subordinated note convertible into approximately 8.75 million shares of our common stock, and warrants to purchase 5 million shares of our common stock at a price of \$3.30 per share.

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**RISK FACTORS**

In addition to the other information set forth elsewhere or incorporated by reference in this prospectus, the following factors relating to our company and our common stock should be considered carefully before making an investment decision.

**Risk Factors Relating to Our Business**

*Oil and natural gas prices are volatile, and low prices could have a material adverse impact on our business.*

Our revenues, profitability and future growth and the carrying value of our properties depend substantially on prevailing oil and natural gas prices. Prices also affect the amount of cash flow available for capital expenditures and our ability to borrow and raise additional capital. The amount we will be able to borrow under our revolving credit facility will be subject to periodic redetermination based in part on changing expectations of future prices. Lower prices may also reduce the amount of oil and natural gas that we can economically produce and have an adverse effect on the value of our properties.

Prices for oil and natural gas have increased significantly over the past twelve months. Historically, the markets for oil and natural gas have been volatile, and they are likely to continue to be volatile in the future. Among the factors that can cause volatility are:

the domestic and foreign supply of oil and natural gas;

the ability of members of the Organization of Petroleum Exporting Countries and other producing countries to agree upon and maintain oil prices and production levels;

political instability, armed conflict or terrorist attacks, whether or not in oil or natural gas producing regions;

the level of consumer product demand;

the growth of consumer product demand in emerging markets, such as China;

labor unrest in oil and natural gas producing regions;

weather conditions;

the price and availability of alternative fuels;

the price of foreign imports;

worldwide economic conditions; and

the availability of liquid natural gas imports.

These external factors and the volatile nature of the energy markets make it difficult to estimate future prices of oil and natural gas.

*We may not be able to replace production with new reserves through our drilling or acquisition activities.*

In general, the volume of production from oil and natural gas properties declines as reserves are depleted. Our reserves will decline as they are produced unless we acquire properties with proved reserves or conduct successful development and exploration activities. Our future oil and natural gas production is highly dependent upon our level of success in finding or acquiring additional reserves. However, we cannot assure you that our future acquisition, development and exploration activities will result in any specific amount of additional proved reserves or that we will be able to drill productive wells at acceptable costs.

The successful acquisition of producing properties requires an assessment of a number of factors. These factors include recoverable reserves, future oil and natural gas prices, operating costs and potential environmental and other liabilities, title issues and other factors. Such assessments are inexact and their accuracy is inherently uncertain. In connection with such assessments, we perform a review of the subject



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properties that we believe is thorough. However, there is no assurance that such a review will reveal all existing or potential problems or allow us to fully assess the deficiencies and capabilities of such properties. We cannot assure you that we will be able to acquire properties at acceptable prices because the competition for producing oil and natural gas properties is particularly intense at this time and many of our competitors have financial and other resources which are substantially greater than those available to us.

***Our level of indebtedness may adversely affect our cash available for operations, thus limiting our growth, our ability to make interest and principal payments on our indebtedness as they become due and our flexibility to respond to market changes.***

We intend to finance our development, acquisition and exploration activities with cash flow from operations, bank borrowings and other financing activities. In addition, we may significantly alter our capitalization in order to make future acquisitions or develop our properties. These changes in capitalization may significantly increase our level of debt. If we incur additional debt for these or other purposes, the related risks that we now face could intensify. A higher level of debt also increases the risk that we may default on our debt obligations. Our ability to meet our debt obligations and to reduce our level of debt depends on our future performance which is affected by general economic conditions and financial, business and other factors. Many of these factors are beyond our control. Our level of debt affects our operations in several important ways, including the following:

a portion of our cash flow from operations is used to pay interest on borrowings;

the covenants contained in the agreements governing our debt limit our ability to borrow additional funds, pay dividends, dispose of assets or issue shares of preferred stock and otherwise may affect our flexibility in planning for, and reacting to, changes in business conditions;

a high level of debt may impair our ability to obtain additional financing in the future for working capital, capital expenditures, acquisitions, general corporate or other purposes;

a leveraged financial position would make us more vulnerable to economic downturns and could limit our ability to withstand competitive pressures; and

any debt that we incur may be at variable rates which makes us vulnerable to increases in interest rates.

***Our ability to finance our business activities will require us to generate substantial cash flow.***

Our business activities require substantial capital. We intend to finance our capital expenditures in the future through cash flow from operations, the incurrence of additional indebtedness and/or the issuance of additional equity securities. We cannot be sure that our business will continue to generate cash flow at or above current levels. Future cash flows and the availability of financing will be subject to a number of variables, such as:

the level of production from existing wells;

prices of oil and natural gas;

our results in locating and producing new reserves;

the success and timing of development of proved undeveloped reserves; and

general economic, financial, competitive, legislative, regulatory and other factors beyond our control.

If we are unable to generate sufficient cash flow from operations to service our debt, we may have to obtain additional financing through the issuance of debt and/or equity. We cannot be sure that any additional financing will be available to us on acceptable terms. Issuing equity securities to satisfy our financing requirements could cause substantial dilution to our existing stockholders. The level of our debt financing could also materially affect our operations.

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If our revenues were to decrease due to lower oil and natural gas prices, decreased production or other reasons, and if we could not obtain capital through our revolving credit facility or otherwise, our ability to execute our development and acquisition plans, replace our reserves or maintain production levels could be greatly limited.

***Drilling wells is speculative, often involves significant costs and may not result in additions to our production or reserves.***

Developing and exploring for oil and natural gas reserves involves a high degree of operating and financial risk. The actual costs of drilling, completing and operating wells often exceed our budget for such costs and can increase significantly when drilling costs rise due to a tightening in the supply of various types of oilfield equipment and related services. Drilling may be unsuccessful for many reasons, including title problems, weather, cost overruns, equipment shortages, mechanical difficulties, and faulty assumptions about geological features. Moreover, the drilling of a productive oil or natural gas well does not ensure a profitable investment. Exploratory wells bear a much greater risk of loss than development wells. A variety of factors, including geological and market-related, can cause a well to become uneconomical or only marginally economic. In addition to their cost, unsuccessful wells can hurt our efforts to replace reserves.

***Estimates of oil and natural gas reserves are uncertain and any material inaccuracies in these reserve estimates will materially affect the quantities and the value of our reserves.***

This prospectus and the information incorporated by reference contains estimates of our proved oil and natural gas reserves and the estimated future net revenues from such reserves. These estimates are based upon various assumptions, including assumptions required by the SEC relating to oil and natural gas prices, drilling and operating expenses, capital expenditures, taxes and availability of funds. The process of estimating oil and natural gas reserves is complex. This process requires significant decisions and assumptions in the evaluation of available geological, geophysical, engineering and economic data for each reservoir.

Actual future production, oil and natural gas prices, revenues, taxes, development expenditures, operating expenses and quantities of recoverable oil and natural gas reserves will vary from those estimated. Any significant variance could materially affect the estimated quantities and the value of our reserves. Our properties may also be susceptible to hydrocarbon drainage from production by other operators on adjacent properties. In addition, we may adjust estimates of proved reserves to reflect production history, results of exploration and development, prevailing oil and natural gas prices and other factors, many of which are beyond our control.

At December 31, 2004, approximately 22% of our estimated proved reserves were undeveloped. Estimates of undeveloped reserves are less certain than estimates of developed reserves. Recovery of undeveloped reserves requires significant capital expenditures and successful drilling operations. The reserve data assumes that we will make significant capital expenditures to develop our reserves. Although we have prepared estimates of these oil and natural gas reserves and the costs associated with development of these reserves in accordance with SEC regulations, we cannot assure you that the estimated costs or estimated reserves are accurate, that development will occur as scheduled or that the actual results will be as estimated.

In addition, you should not construe our estimate of discounted future net revenues as the current market value of the estimated oil and natural gas reserves attributable to our properties. We have based the estimated discounted future net cash flows from proved reserves on prices and costs as of the date of the estimate, in accordance with applicable SEC regulations, whereas actual future prices and costs may be materially higher or lower. Many factors will affect actual future net cash flow, including:

prices of oil and natural gas;

the amount and timing of actual production;

the cost, timing and success in developing proved undeveloped reserves;

supply and demand for oil and natural gas;

curtailments or increases in consumption by oil and natural gas purchasers; and

changes in governmental regulations or taxation.

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The timing of the production of oil and natural gas properties and of the related expenses affect the timing of actual future net cash flow from proved reserves and, thus, their actual value. In addition, the 10% discount factor, which is used to calculate discounted future net revenues for reporting purposes, is not necessarily the most appropriate discount factor given actual interest rates and risks to which our business or the oil and natural gas industry in general are subject.

***We depend on the skill, ability and decisions of third party operators to a significant extent.***

The success of the drilling, development and production of the oil and natural gas properties in which we have or expect to have a non-operating working interest is substantially dependent upon the decisions of such third-party operators and their diligence to comply with various laws, rules and regulations affecting such properties. The failure of any third-party operator to

make decisions,

perform their services,

discharge their obligations,

deal with regulatory agencies, and

comply with laws, rules and regulations, including environmental laws and regulations in a proper manner with respect to properties in which we have an interest could result in material adverse consequences to our interest in such properties, including substantial penalties and compliance costs. Such adverse consequences could result in substantial liabilities to us or reduce the value of our properties, which could negatively affect our results of operations.

***Our business is highly competitive.***

The oil and natural gas industry is highly competitive in many respects, including identification of attractive oil and natural gas properties for acquisition, drilling and development, securing financing for such activities and obtaining the necessary equipment and personnel to conduct such operations and activities. In seeking suitable opportunities, we compete with a number of other companies, including large oil and natural gas companies and other independent operators with greater financial resources, larger numbers of personnel and facilities, and, in some cases, with more expertise. There can be no assurance that we will be able to compete effectively with these entities.

***Hedging transactions may limit our potential gains.***

In order to manage our exposure to price risks in the marketing of our oil and natural gas production, from time to time we enter into oil and natural gas price hedging arrangements with respect to a portion of our expected production. While intended to reduce the effects of volatile oil and natural gas prices, such transactions may limit our potential gains and increase our potential losses if oil and natural gas prices were to rise substantially over the price established by the hedge. In addition, such transactions may expose us to the risk of loss in certain circumstances, including instances in which:

our production is less than expected;

there is a widening of price differentials between delivery points for our production and the delivery point assumed in the hedge arrangement; or

the counterparties to our hedging agreements fail to perform under the contracts.

***Our oil and natural gas activities are subject to various risks which are beyond our control.***

Our operations are subject to many risks and hazards incident to exploring and drilling for, producing, transporting, marketing and selling oil and natural gas. Although we may take precautionary measures, many of these risks and hazards are beyond our control and unavoidable under the circumstances. Many of these risks or hazards could materially and adversely affect our revenues and expenses, the ability of certain of our wells to produce oil and natural gas in commercial quantities, the rate of production and the economics of the development of, and our investment in the prospects in which we have or will acquire an interest. Any of these risks and hazards could

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materially and adversely affect our financial condition, results of operations and cash flows. Such risks and hazards include:

human error, accidents, labor force and other factors beyond our control that may cause personal injuries or death to persons and destruction or damage to equipment and facilities;

blowouts, fires, hurricanes, pollution and equipment failures that may result in damage to or destruction of wells, producing formations, production facilities and equipment;

unavailability of materials and equipment;

engineering and construction delays;

unanticipated transportation costs and delays;

unfavorable weather conditions;

hazards resulting from unusual or unexpected geological or environmental conditions;

environmental regulations and requirements;

accidental leakage of toxic or hazardous materials, such as petroleum liquids or drilling fluids, into the environment;

changes in laws and regulations, including laws and regulations applicable to oil and gas activities or markets for the oil and natural gas produced;

fluctuations in supply and demand for oil and gas causing variations of the prices we receive for our oil and natural gas production; and

the internal and political decisions of OPEC and oil and natural gas producing nations and their impact upon oil and gas prices.

As a result of these risks, expenditures, quantities and rates of production, revenues and cash operating costs may be materially adversely affected and may differ materially from those anticipated by us.

***Governmental and environmental regulations could adversely affect our business.***

Our business is subject to federal, state and local laws and regulations on taxation, the exploration for and development, production and marketing of oil and natural gas and safety matters. Many laws and regulations require drilling permits and govern the spacing of wells, rates of production, prevention of waste, unitization and pooling of properties and other matters. These laws and regulations have increased the costs of planning, designing, drilling, installing, operating and abandoning our oil and natural gas wells and other facilities. In addition, these laws and regulations, and any others that are passed by the jurisdictions where we have production, could limit the total number of wells drilled or the allowable production from successful wells, which could limit our revenues.

Our operations are also subject to complex environmental laws and regulations adopted by the various jurisdictions in which we have or expect to have oil and natural gas operations. We could incur liability to governments or third parties for any unlawful discharge of oil, natural gas or other pollutants into the air, soil or water, including responsibility for remedial costs. We could potentially discharge these materials into the environment in any

of the following ways:

from a well or drilling equipment at a drill site;

from gathering systems, pipelines, transportation facilities and storage tanks;

damage to oil and natural gas wells resulting from accidents during normal operations; and

blowouts, hurricanes, cratering and explosions.

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Because the requirements imposed by laws and regulations are frequently changed, we cannot assure you that laws and regulations enacted in the future, including changes to existing laws and regulations, will not adversely affect our business. In addition, because we acquire interests in properties that have been operated in the past by others, we may be liable for environmental damage caused by the former operators.

*We cannot be certain that the insurance coverage maintained by us will be adequate to cover all losses which may be sustained in connection with all oil and gas activities.*

We maintain general and excess liability policies, which we consider to be reasonable and consistent with industry standards. These policies generally cover:

personal injury;

bodily injury;

third party property damage;

medical expenses;

legal defense costs;

pollution in some cases;

well blowouts in some cases; and

workers compensation.

There can be no assurance that this insurance coverage will be sufficient to cover every claim made against us in the future. A loss in connection with our oil and natural gas properties could have a materially adverse effect on our financial position and results of operation to the extent that the insurance coverage provided under our policies cover only a portion of any such loss.

*Title to the properties in which we have an interest may be impaired by title defects.*

We generally obtain title opinions on significant properties that we drill or acquire. However, there is no assurance that we will not suffer a monetary loss from title defects or failure. Generally, under the terms of the operating agreements affecting our properties, any monetary loss is to be borne by all parties to any such agreement in proportion to their interests in such property. If there are any title defects or defects in assignment of leasehold rights in properties in which we hold an interest, we will suffer a financial loss.

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Unless we specify otherwise in the applicable prospectus supplement, the net proceeds we receive from the sale of the securities offered by this prospectus and any prospectus supplement will be used for general corporate purposes. General corporate purposes may include any of the following:

repaying debt;

providing working capital;

funding capital expenditures;

paying for possible acquisitions or the expansion of our business; or

repurchasing our capital stock.

We may temporarily invest the net proceeds we receive from any offering of securities or use the net proceeds to repay short-term debt until we can use them for their stated purposes.

**RATIO OF EARNINGS TO FIXED CHARGES**

The following table contains our ratio of earnings to fixed charges for the periods indicated. You should read these ratios in connection with our consolidated financial statements, including the notes to those statements, incorporated by reference into this prospectus.

		Year Ended December 31,				
	2000	2001	2002	2003	2004	
Ratio of earnings to fixed charges	4.95	X <sup>(1)</sup>	X <sup>(2)</sup>	2.88	3.83	
Ratio of earnings to combined fixed charges and preferred dividends	4.95	X <sup>(3)</sup>	X <sup>(4)</sup>	1.54	3.31	

X<sup>(1)</sup> Due to the Company's loss in 2001, the ratio coverage was less than 1:1. The Company must generate additional earnings of \$12,551 to achieve a coverage ratio of 1:1.

X<sup>(2)</sup> Due to the Company's loss in 2002, the ratio coverage was less than 1:1. The Company must generate additional earnings of \$6,882 to achieve a coverage ratio of 1:1.

X<sup>(3)</sup> Due to the Company's loss in 2001, the ratio coverage was less than 1:1. The Company must generate additional earnings of \$12,873 to achieve a coverage ratio of 1:1.

X<sup>(4)</sup> Due to the Company's loss in 2002, the ratio coverage was less than 1:1. The Company must generate additional earnings of \$7,329 to achieve a coverage ratio of 1:1.

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**DESCRIPTION OF DEBT SECURITIES**

The following description of debt securities sets forth certain general terms and provisions of the debt securities to which this prospectus and any prospectus supplement may relate. The particular terms of any series of debt securities and the extent to which the general provisions may apply to a particular series of debt securities will be described in a prospectus supplement relating to that series. The debt securities will be issued under one or more separate indentures between us and a trustee to be named in the prospectus supplement. Senior debt securities will be issued under a senior indenture and subordinated debt securities will be issued under a subordinated indenture. Together the senior indenture and the subordinated indenture are called indentures.

Because we have included only a summary of the indenture terms, you must read the indentures in full to understand every detail of the terms of the debt securities. The summary is not complete. The forms of the indentures have been filed as exhibits to the registration statement to which this prospectus relates and you should read the indentures for provisions that may be important to you.

*General*

Unless otherwise indicated in the applicable prospectus supplement, the debt securities will be our direct, unsecured obligations. The senior debt securities will rank equally with all of our other senior and unsubordinated debt. The subordinated debt securities will have a junior position to certain of our debt, as described in the subordinated securities themselves or under the supplemental indenture under which they are issued.

We conduct a substantial part of our operations through our subsidiaries. To the extent of such operations, holders of debt securities will have a position junior to the prior claims of creditors of our subsidiaries, including trade creditors, debtholders, secured creditors, taxing authorities and guarantee holders, and any preferred stockholders, except to the extent that we may ourselves be a creditor with recognized and unsubordinated claims against any subsidiary. Our ability to pay principal of and premium, if any, and interest on any debt securities is, to a large extent, dependent upon the payment to us of dividends, interest or other charges by our subsidiaries.

If specified in the prospectus supplement, the debt securities will be general obligations of our subsidiaries that execute subsidiary guarantees. Unless otherwise specified in the prospectus supplement, such subsidiary guarantees will be unsecured obligations. See [Subsidiary Guarantees](#).

A prospectus supplement and a supplemental indenture relating to any series of debt securities being offered will include specific terms relating to the offering. These terms will include some or all of the following:

The title and type of the debt securities;

Any limit upon the total principal amount of the debt securities;

The dates on which the principal and premium (if any) of the debt securities will be payable;

The interest rate or rates, or the method of determination thereof, that the debt securities will bear and the interest payment dates for the debt securities;

Places where payments of the principal, premium, if any, and interest may be made on the debt securities;

Any optional redemption periods;

Any subordination and the terms thereof;

Any sinking fund, amortization or other provisions that would obligate us to redeem, repurchase or repay some or all of the debt securities;

If other than US dollars, the currency or currencies, or the form of other securities or property in which principal of (and premium, if any) and/or interest on the debt securities will or may be payable;

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Any index or other method used to determine the amount of payment of principal of (and premium, if any) and/or interest on the debt securities;

Whether any portion of the principal amount of such debt securities is payable upon declaration of the acceleration of the maturity thereof;

Any additional means of satisfaction or discharge of the debt securities;

Whether our subsidiaries will provide guarantees of the debt securities, and the terms of any subordination of such guarantee;

Any deletions, modifications, or additions to the events of default or covenants pertaining to the debt securities or made for the benefit of the holders thereof;

Whether the debt securities will be convertible or exchangeable and, if so, the provisions regarding convertibility or exchangeability of the debt securities;

Whether the debt securities will be subject to certain optional interest rate reset provisions;

Whether the debt securities will be issued as a global debt security and, in that case, the identity of the depository for the debt securities; and

Any other terms of the debt securities.

Neither of the indentures limits the amount of debt securities that may be issued. Each indenture allows debt securities to be issued up to the principal amount that may be authorized by us and may be in any currency or currency unit designated by us.

Debt securities of a series may be issued in registered, bearer, coupon or global form.

The prospectus supplement for each series of debt securities will state whether the debt securities will be issued in registered form and whether the debt securities will be in denominations other than \$1,000 each or multiples thereof.

*Original Issue Discount*

One or more series of debt securities offered by this prospectus may be sold at a substantial discount below their stated principal amount, bearing no interest or interest at a rate that at the time of issuance is below market rates. The federal income tax consequences and special considerations applicable to any series of debt securities generally will be described in the applicable prospectus supplement.

*Subsidiary Guarantees*

Our payment obligations under any series of the debt securities may be jointly and severally guaranteed by one or more of our subsidiaries. If a series of debt securities is so guaranteed by any of our subsidiaries, such subsidiaries will execute a supplemental indenture or notation of guarantee as further evidence of their guarantee. The applicable prospectus supplement will describe the terms of any guarantee by our subsidiaries.

The obligations of each subsidiary under its subsidiary guarantee may be limited to the maximum amount that will not result in such guarantee obligations constituting a fraudulent conveyance or fraudulent transfer under federal

or state law, after giving effect to all other contingent and fixed liabilities of that subsidiary and any collections from or payments made by or on behalf of any other subsidiary guarantor in respect to its obligations under its subsidiary guarantee.

Each indenture may restrict consolidations or mergers with or into a subsidiary guarantor or provide for the release of a subsidiary from a subsidiary guarantee, as set forth in a related prospectus supplement, the applicable indenture, and any applicable related supplemental indenture.

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If a series of debt securities is guaranteed by our subsidiaries and is designated as subordinate to our senior debt, then the guarantee by those subsidiaries will be subordinated to their senior debt and will be subordinated to any guarantees by those subsidiaries of our senior debt. See Subordination.

### *Subordination*

Under the subordinated indenture, payment of the principal, interest and any premium on the subordinated debt securities will generally be subordinated and junior in right of payment to the prior payment in full of any debt specified in the applicable prospectus supplement and supplemental indenture.

### *Consolidation, Merger or Sale*

The indentures generally permit a consolidation or merger between us and another entity. They also permit the sale by us of all or substantially all of our property and assets. If this happens, the remaining or acquiring entity shall assume all of our responsibilities and liabilities under the indentures, including the payment of all amounts due on the debt securities and performance of the covenants in the indentures. However, we will consolidate or merge with or into any other corporation or sell all or substantially all of our assets only according to the terms and conditions of the indentures. The remaining or acquiring entity will be substituted for us in the indentures with the same effect as if it had been an original party to the indentures. Thereafter, the successor entity may exercise our rights and powers under any indenture, in our name or in its own name. Any act or proceeding required or permitted to be done by our board of directors or any of our officers may be done by the board or officers of the successor entity. If we sell all or substantially all of our assets, upon compliance with these provisions, we shall be released from all our liabilities and obligations under any indenture and under the debt securities.

### *Modification of Indentures*

Under each indenture our rights and obligations and the rights of the holders may be modified with the consent of the holders of a majority in aggregate principal amount of the outstanding debt securities of each series affected by the modification. No modification of the principal or interest payment terms, and no modification reducing the percentage required for modifications, is effective against any holder without its consent.

### *Events of Default*

Each of the indentures defines an event of default with respect to debt securities of any series as any of the following events:

failure to pay interest on any debt security for 30 days after it is due;

failure to pay the principal of or premium, if any, on any debt security when due;

failure to deposit any sinking fund payment for 30 days after it is due;

failure to perform any other covenant in the indenture that continues for 60 days after being given written notice;

certain events in bankruptcy, insolvency or reorganization; or

any other event of default included in any indenture or supplemental indenture.

An event of default for a particular series of debt securities does not necessarily constitute an event of default for any other series of debt securities issued under an indenture. The trustee may withhold notice to the holders of debt securities of any default (except in the payment of principal or interest) if it considers such withholding of notice to be in the best interests of the holders.

If an event of default for any series of debt securities occurs and continues, the trustee or the holders of at least 25% in aggregate principal amount of the debt securities of the series may declare the entire principal of all the debt securities of that series to be due and payable immediately. If an event of default occurs and is continuing with respect to all series of debt securities as a result of a failure to perform a covenant applicable to all securities or because of bankruptcy, insolvency or reorganization, the trustee or the holders of at least 25% in aggregate principal amount of all of the debt securities may declare the entire principal of all the debt securities to be due and payable



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immediately. If either of these happens, subject to certain conditions, the holders of a majority of the aggregate principal amount of the debt securities of that series (or of the debt securities of all series, as the case may be) can void the declaration. There is no automatic acceleration, even in the event of bankruptcy, insolvency or reorganization.

Other than its duties in case of a default, a trustee is not obligated to exercise any of its rights or powers under any indenture at the request, order or direction of any holders, unless the holders offer the trustee reasonable indemnity. If they provide this reasonable indemnification, the holders of a majority in principal amount of any series of debt securities may direct the time, method and place of conducting any proceeding or any remedy available to the trustee, or exercising any power conferred upon the trustee, for any series of debt securities.

### *Covenants*

Under the indentures, we will:

pay the principal of, and interest and any premium on, the debt securities when due;

maintain a place of payment;

deliver a report to the trustee at the end of each fiscal year reviewing our obligations under the indentures; and

deposit sufficient funds with any paying agent on or before the due date for any principal, interest or premium.

### *Equal and Ratable Securitization*

Neither we nor any restricted subsidiary may secure senior debt securities of any series unless the debt securities of every other series are also equally and ratably secured. The subordinated securities have no such restrictive covenant.

### *Payment and Transfer*

Principal, interest and any premium on fully registered securities will be paid at designated places. Payment will be made by check mailed to the persons in whose names the debt securities are registered on days specified in the indentures or any prospectus supplement. Debt securities payments in other forms will be paid at a place designated by us and specified in a prospectus supplement.

Fully registered securities may be transferred or exchanged at the corporate trust office of the trustee or at any other office or agency maintained by us for such purposes without the payment of any service charge except for any tax or governmental charge.

### *Global Securities*

Certain series of the debt securities may be issued as permanent global debt securities to be deposited with a depository with respect to that series. Unless otherwise indicated in the prospectus supplement, the following is a summary of the depository arrangements applicable to debt securities issued in permanent global form and for which The Depository Trust Company ( DTC ) acts as depository.

Each global debt security will be deposited with, or on behalf of, DTC, as depository, or its nominee and registered in the name of a nominee of DTC. Except under the limited circumstances described below, global debt

securities are not exchangeable for definitive certificated debt securities.

Ownership of beneficial interests in a global debt security is limited to institutions that have accounts with DTC or its nominee ( participants ) or persons that may hold interests through participants. In addition, ownership of beneficial interests by participants in a global debt security will be evidenced only by, and the transfer of that ownership interest will be effected only through, records maintained by DTC or its nominee for a global debt security. Ownership of beneficial interests in a global debt security by persons that hold through participants will be evidenced only by, and the transfer of that ownership interest within that participant will be effected only through, records maintained by that participant. DTC has no knowledge of the actual beneficial owners of the debt securities. Beneficial owners will not receive written confirmation from DTC of their purchase, but beneficial owners are expected to receive written confirmations providing details of the

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transaction, as well as periodic statements of their holdings, from the participants through which the beneficial owners entered the transaction. The laws of some jurisdictions require that certain purchasers of securities take physical delivery of such securities in definitive form. Such laws may impair the ability to transfer beneficial interests in a global debt security.

Payment of principal of, and interest on, debt securities represented by a global debt security registered in the name of or held by DTC or its nominee will be made to DTC or its nominee, as the case may be, as the registered owner and holder of the global debt security representing those debt securities. We have been advised by DTC that upon receipt of any payment of principal of, or interest on, a global debt security, DTC will immediately credit accounts of participants on its book-entry registration and transfer system with payments in amounts proportionate to their respective beneficial interests in the principal amount of that global debt security as shown in the records of DTC. Payments by participants to owners of beneficial interests in a global debt security held through those participants will be governed by standing instructions and customary practices, as is now the case with securities held for the accounts of customers in bearer form or registered in street name, and will be the sole responsibility of those participants, subject to any statutory or regulatory requirements that may be in effect from time to time.

Neither we, any trustee nor any of our respective agents will be responsible for any aspect of the records of DTC, any nominee or any participant relating to, or payments made on account of, beneficial interests in a permanent global debt security or for maintaining, supervising or reviewing any of the records of DTC, any nominee or any participant relating to such beneficial interests.

A global debt security is exchangeable for definitive debt securities registered in the name of, and a transfer of a global debt security may be registered to, any person other than DTC or its nominee, only if:

DTC notifies us that it is unwilling or unable to continue as depository for that global debt security or at any time DTC ceases to be registered under the Securities Exchange Act of 1934;

we determine in our discretion that the global debt security shall be exchangeable for definitive debt securities in registered form; or

there shall have occurred and be continuing an event of default or an event which, with notice or the lapse of time or both, would constitute an event of default under the debt securities.

Any global debt security that is exchangeable pursuant to the preceding sentence will be exchangeable in whole for definitive debt securities in registered form, of like tenor and of an equal aggregate principal amount as the global debt security, in denominations specified in the applicable prospectus supplement (if other than \$1,000 and integral multiples of \$1,000). The definitive debt securities will be registered by the registrar in the name or names instructed by DTC. We expect that these instructions may be based upon directions received by DTC from its participants with respect to ownership of beneficial interests in the global debt security.

Except as provided above, owners of the beneficial interests in a global debt security will not be entitled to receive physical delivery of debt securities in definitive form and will not be considered the holders of debt securities for any purpose under the indentures. No global debt security shall be exchangeable except for another global debt security of like denomination and tenor to be registered in the name of DTC or its nominee. Accordingly, each person owning a beneficial interest in a global debt security must rely on the procedures of DTC and, if that person is not a participant, on the procedures of the participant through which that person owns its interest, to exercise any rights of a holder under the global debt security or the indentures.

We understand that, under existing industry practices, in the event that we request any action of holders, or an owner of a beneficial interest in a global debt security desires to give or take any action that a holder is entitled to give

or take under the debt securities or the indentures, DTC would authorize the participants holding the relevant beneficial interests to give or take that action, and those participants would authorize beneficial owners owning through those participants to give or take that action or would otherwise act upon the instructions of beneficial owners owning through them.

DTC has advised us that DTC is a limited purpose trust company organized under the laws of the State of New York, a banking organization within the meaning of the New York Banking Law, a member of the Federal Reserve System, a clearing corporation within the meaning of the New York Uniform Commercial Code and a clearing agency registered under the Securities Exchange Act of 1934. DTC

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was created to hold securities of its participants and to facilitate the clearance and settlement of securities transactions among its participants in those securities through electronic book-entry changes in accounts of the participants, thereby eliminating the need for physical movement of securities certificates. DTC's participants include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. DTC is owned by a number of its participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Access to DTC's book-entry system is also available to others, such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a participant, either directly or indirectly. The rules applicable to DTC and its participants are on file with the Securities and Exchange Commission.

### *Defeasance*

We will be discharged from our obligations on the debt securities of any series at any time if we deposit with the trustee sufficient cash or government securities to pay the principal, interest, any premium and any other sums due to the stated maturity date or a redemption date of the debt securities of the series. If this happens, the holders of the debt securities of the series will not be entitled to the benefits of the indenture except for registration of transfer and exchange of debt securities and replacement of lost, stolen or mutilated debt securities.

We must also obtain an opinion of counsel to the effect that as a result of the defeasance, holders of that series of debt securities will not recognize income, gain or loss for federal income tax purposes and will be subject to federal income tax on the same amount, in the same manner and at the same time as would have been the case if such defeasance had not occurred.

### *Meetings*

Each indenture contains provisions describing how meetings of the holders of debt securities of a series may be convened. A meeting may be called at any time by the trustee, and also, upon request, by us or the holders of at least 20% in principal amount of the outstanding debt securities of a series. A notice of the meeting must always be given in the manner described under *Notices* below. Generally speaking, except for any consent that must be given by all holders of a series as described under *Modification of Indentures* above, any resolution presented at a meeting of the holders of a series of debt securities may be adopted by the affirmative vote of the holders of a majority in principal amount of the outstanding debt securities of that series, unless the indenture allows the action to be voted upon to be taken with the approval of the holders of a different specific percentage of principal amount of outstanding debt securities of a series. In that case, the holders of outstanding debt securities of at least the specified percentage must vote in favor of the action. Any resolution passed or decision taken at any meeting of holders of debt securities of any series in accordance with the applicable indenture will be binding on all holders of debt securities of that series and any related coupons, unless, as discussed in *Modification of Indentures* above, the action is only effective against holders that have approved it. The quorum at any meeting called to adopt a resolution, and at any reconvened meeting, will be holders holding or representing a majority in principal amount of the outstanding debt securities of a series.

### *Governing Law*

Each indenture and the debt securities will be governed by and construed in accordance with the laws of the State of New York.

### *Notices*

Notices to holders of debt securities will be given by mail to the addresses of such holders as they appear in the security register.

**DESCRIPTION OF PETROHAWK CAPITAL STOCK**

Set forth below is a description of the material terms of our capital stock. However, this description is not complete and is qualified by reference to our certificate of incorporation (including our certificates of designation) and bylaws. Copies of our certificate of incorporation (including our certificates of designation) and bylaws are have been filed with the SEC and are incorporated by reference into this registration statement. Please read [Where You Can Find More Information](#). You should also be aware that the summary below does not give full

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effect to the provisions of statutory or common law which may affect your rights as a stockholder.

### **Authorized Capital Stock**

Our authorized capital stock consists of 75 million shares of common stock, par value of \$0.001 per share, and 5 million shares of preferred stock, par value \$0.001 per share, 1.5 million shares of which have been designated 8% cumulative convertible preferred stock. As of April 30, 2005, we had approximately 40.1 million shares of common stock and 598,271 shares of 8% cumulative convertible preferred stock outstanding.

Selected provisions of our organizational documents are summarized below, however, you should read the organizational documents, which are filed as exhibits to our periodic filings with the SEC and incorporate herein by reference, for other provisions that may be important to you. In addition, you should be aware that the summary below does not give full effect to the terms of the provisions of statutory or common law which may affect your rights as a stockholder.

### **Common Stock**

***Voting rights.*** Each share of common stock is entitled to one vote in the election of directors and on all other matters submitted to a vote of stockholders. Stockholders do not have the right to cumulate their votes in the election of directors.

***Dividends, distributions and stock splits.*** Holders of common stock are entitled to receive dividends if, as and when such dividends are declared by the board of directors out of assets legally available therefore after payment of dividends required to be paid on shares of preferred stock, if any. Our existing credit facilities restrict our ability to pay cash dividends.

***Liquidation.*** In the event of any dissolution, liquidation, or winding up of our affairs, whether voluntary or involuntary, after payment of debts and other liabilities and making provision for any holders of its preferred stock who have a liquidation preference, our remaining assets will be distributed ratably among the holders of common stock.

***Fully paid.*** All shares of common stock outstanding are fully paid and nonassessable.

***Other rights.*** Holders of common stock have no redemption or conversion rights and no preemptive or other rights to subscribe for our securities.

### **Preferred Stock**

Our board of directors has the authority to issue up to 5 million shares of preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions thereof, including dividend rights, dividend rates, conversion rates, voting rights, terms of redemption, redemption prices, liquidation preferences and the number of shares constituting any series or the designation of that series, which may be superior to those of the common stock, without further vote or action by the stockholders. One of the effects of undesignated preferred stock may be to enable our board of directors to render more difficult or to discourage an attempt to obtain control of Petrohawk by means of a tender offer, proxy contest, merger or otherwise, and as a result to protect the continuity of our management. The issuance of shares of the preferred stock by the board of directors as described above may adversely affect the rights of the holders of common stock. For example, preferred stock issued by Petrohawk may rank superior to the common stock as to dividend rights, liquidation preference or both, may have full or limited voting rights and may be convertible into shares of common stock. Accordingly, the issuance of shares of preferred stock may discourage bids

for our common stock or may otherwise adversely affect the market price of our common stock.

**8% cumulative convertible preferred stock**

Our 8% cumulative convertible preferred stock entitles holders of such shares to the right to receive quarterly dividends of 8% per annum. The following discussion summarizes some, but not all, of the provisions of the certificate of designation governing the 8% cumulative convertible preferred stock. We urge you to read the certificate of designation, because it, and not this description, defines the rights of holders of the 8% cumulative convertible preferred stock. A copy of the certificate of designation governing the 8% cumulative convertible preferred stock is filed as Exhibit 3.1 to our Form 8-K filed with the SEC on July 3, 2001 and is incorporated by referenced in this prospectus.



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**Ranking.** The 8% cumulative convertible preferred stock ranks senior to the common stock and any other series of our stock with respect to dividend rights and rights upon liquidation, dissolution or winding up.

**Dividend Rights.** Each holder of the 8% cumulative convertible preferred stock is entitled to receive cumulative dividends at an annual rate of 8% of the liquidation value per share of 8% cumulative convertible preferred stock, or \$0.74 per year. The dividends are cumulative from the original issue date of the 8% cumulative convertible preferred stock, whether or not in any period we were legally permitted to pay such dividends or such dividends were declared. Dividends are payable quarterly, within 15 days of the end of the calendar quarters ending March 31, June 30, September 30 and December 31 of each year.

We may not declare or pay any dividend or other distribution to holders of common stock, Series B preferred stock, or any other class or series of our stock, unless all accrued and unpaid dividends on the 8% cumulative convertible preferred stock have been paid or declared and set apart for payment.

**Liquidation Rights.** Upon any liquidation, dissolution or winding up, no distribution will be made to any holders of common stock or any other series of our stock, unless the holders of our 8% cumulative convertible preferred stock have received an amount equal to \$9.25 per share, plus any accrued but unpaid dividends and cumulated dividends, an amount we refer to as the liquidation preference. The following transactions will not be deemed to be a liquidation, dissolution or winding up for purposes of determining the rights of holders of the 8% cumulative convertible preferred stock (so long as the holders of 8% cumulative convertible preferred stock have essentially equivalent rights following any such transaction, as determined by our board of directors in the reasonable exercise of its discretion):

our consolidation or merger with or into any other corporation or corporations,

a sale of all or substantially all of our assets, or

a series of related transactions in which more than 50% of our voting power is disposed of.

Any other reorganization, consolidation, merger or sale will be deemed to be a liquidation and entitle the holders of the 8% cumulative convertible preferred stock to a liquidation preference.

**Conversion.** The 8% cumulative convertible preferred stock is convertible into common stock at the option of a holder at any time. In addition, the 8% cumulative convertible preferred stock automatically converts into common stock effective on the first trading day after the reported high selling price for our common stock is at least 150% of the initial liquidation price, or \$13.875 per share, for any 10 trading days. The 8% cumulative convertible preferred stock is convertible at a rate of one-half share of common stock for each share of 8% cumulative convertible preferred stock converted. The conversion rate is subject to adjustment in certain circumstances, including stock splits or combinations of our common stock.

The holder of any shares of 8% cumulative convertible preferred stock may exercise the conversion right by surrendering to us or the transfer agent the certificate or certificates for the shares to be converted, though in the case of an optional conversion, the holder must first give us notice that such holder elects to convert. We will deliver to such holder the certificate or certificates for the number of shares of our common stock to which the holder is entitled. In the case of an optional conversion, conversion will be deemed to have been effected immediately prior to the close of business on the day we receive notice of conversion; otherwise, conversion will be deemed to have occurred at the close of business on the day the automatic conversion occurs.

No fractional shares of com) 4,415

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Net cash used in financing activities

(23,943) (142,609)

Effect of exchange rate changes on cash

(2,168) 1,994

Net increase (decrease) in cash and cash equivalents

767 (14,722)

Cash and cash equivalents at beginning of year

49,875 46,362

Cash and cash equivalents at end of period

\$50,642 \$31,640

Supplemental disclosures:

Cash paid for income taxes

\$26,624 \$27,670

Cash paid for interest and fees

\$3,616 \$5,250

Dividends payable

\$4,422 \$

Payable for the acquisition of treasury stock

\$ \$2,327

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

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**CALLAWAY GOLF COMPANY**  
**CONSOLIDATED CONDENSED STATEMENT OF SHAREHOLDERS' EQUITY**  
**AND COMPREHENSIVE INCOME**  
**(Unaudited)**  
**(In thousands)**

	Common Stock			Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Grantor Stock Trust	Treasury Stock		Total	Comprehensive Income
	Shares	Amount	Additional Paid-in Capital					Shares	Amount		
<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			(442)				1,901			1,459	
Tax benefit from exercise of stock options			(623)							(623)	
Compensatory stock and stock options	(6)		3,449	1,595						5,044	
Acquisition of Treasury Stock								(1,695)	(22,970)	(22,970)	
Employee stock purchase plan			(382)				3,631			3,249	
Cash dividends declared					(13,373)					(13,373)	
Adjustment of Grantor Stock Trust shares to market value			(5,800)				5,800				
Equity adjustment from foreign currency translation						(13,977)				(13,977)	\$ (13,977)
Net income					69,330					69,330	69,330
<b>Balance, September 30, 2008</b>	66,276	\$ 663	\$ 108,155	\$ (563)	\$ 526,426	\$ 4,927	\$ (20,269)	(1,695)	\$ (22,970)	\$ 596,369	\$ 55,353

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

**Table of Contents****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. Restructuring**

In connection with the Company's gross margin improvement initiatives and its actions to improve the profitability of its golf ball business, the Company has taken actions to consolidate its golf ball operations into other existing locations. As a result of these initiatives, in May 2008, the Company announced the closure of its golf ball manufacturing facility in Gloversville, New York. This closure resulted in the recognition of non-cash charges for the acceleration of depreciation on certain golf ball manufacturing equipment and cash charges related to severance benefits and facility costs. During the three and nine months ended September 30, 2008, the Company recorded pre-tax charges of \$869,000 and \$3,934,000 in connection with the closure of this facility. In addition, the Company expects to incur through 2009 additional charges of approximately \$400,000 primarily related to the costs associated with the closure of the manufacturing facility.

The activity and liability balances recorded as part of the Company's golf ball manufacturing consolidation were as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Charges to cost and expense	\$ 1,264	\$ 2,670	\$ 3,934
Non-cash items		(1,798)	(1,798)
Cash payments	(684)	(316)	(1,000)
Restructuring payable balance, September 30, 2008	\$ 580	\$ 556	\$ 1,136

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

Inventories are summarized below (in thousands):

	September 30, 2008	December 31, 2007
Inventories:		
Raw materials	\$ 76,468	\$ 82,185
Work-in-process	497	1,932
Finished goods	143,341	168,884
	\$ 220,306	\$ 253,001

**4. Income Taxes**

The Company calculates its interim income tax provision in accordance with Accounting Principles Board Opinion ( APB ) No. 28, *Interim Financial Reporting* and Financial Accounting Standards Board ( 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 is recognized in the interim period in which those items occur. In addition, the effect of changes in enacted tax laws, 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 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 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



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

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 September 30, 2008, the liability for income taxes associated with uncertain tax benefits was \$17,300,000 and could be reduced by \$8,600,000 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 \$1,500,000 of tax benefits associated with state income taxes. The net amount of \$7,200,000, 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 three months ended September 30, 2008 and 2007, the Company recognized approximately (\$82,000) and \$29,000, respectively, of interest and penalties in the provision for income taxes, and (\$473,000) and \$270,000 for the nine months ended September 30, 2008 and 2007, respectively. As of September 30, 2008 and December 31, 2007, the Company had accrued \$1,051,000 and \$1,524,000, respectively, (before income tax benefit) for the payment of interest and penalties. The reduction in the amount of interest and penalties during the three and nine months ended September 30, 2008 resulted from the settlement of tax matters before the IRS Appeals Office and the expiration of the statute of limitations for 2004 as described below.

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

<b>Tax Jurisdiction</b>	<b>Years No Longer Subject to Audit</b>
U.S. federal	2004 and prior
California (U.S.)	2000 and prior
Massachusetts (U.S.)	2003 and prior
Australia	2003 and prior
Canada	2003 and prior
Japan	2003 and prior
South Korea	2002 and prior
United Kingdom	2001 and prior

**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)****5. Goodwill and Intangible Assets**

The Company accounts for its goodwill and other non-amortizing intangible assets in accordance with the provisions of Statement of Financial Accounting Standards ( 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 nine months ended September 30, 2008 and 2007, aggregate amortization expense was approximately \$2,389,000 and \$2,508,000, respectively. The following sets forth the intangible assets by major asset class (dollars in thousands):

	Useful Life (Years)	September 30, 2008			December 31, 2007		
		Gross	Accumulated Amortization	Net Book Value	Gross	Accumulated Amortization	Net Book Value
Non-Amortizing:							
Trade name, trademark and trade dress	NA	\$ 121,794	\$	\$ 121,794	\$ 121,794	\$	\$ 121,794
Amortizing:							
Patents	3-16	36,459	20,401	16,058	36,459	18,288	18,171
Other	1-9	2,873	2,109	764	2,853	1,833	1,020
Total intangible assets		\$ 161,126	\$ 22,510	\$ 138,616	\$ 161,106	\$ 20,121	\$ 140,985

Amortization expense related to intangible assets at September 30, 2008 in each of the next five fiscal years and beyond is expected to be incurred as follows (in thousands):

Remainder of 2008	\$ 798
2009	2,954
2010	2,842
2011	2,591
2012	2,162
2013	1,343
Thereafter	4,132
	\$ 16,822

Goodwill at September 30, 2008 was \$30,873,000. Increases in goodwill during the three and nine months ended September 30, 2008 were \$1,682,000 and \$1,187,000 respectively due to net favorable foreign currency fluctuations.

**6. Investments****Investment in Golf Entertainment International Limited Company**

The Company has a \$10,000,000 investment in the Preferred Shares of Golf Entertainment International Limited ( GEI ), the owner and operator of TopGolf entertainment centers. 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



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accompanying consolidated condensed balance sheet as of September 30, 2008.

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**CALLAWAY GOLF COMPANY**

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

**(Unaudited)**

In addition, the Company and GEI entered into a Preferred Partner Agreement under which the Company is granted preferred signage rights, 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 September 30, 2008, the Company funded a combined total of \$4,846,000 under both loan agreements, which includes accrued interest of \$856,000. The Company does not have any further obligation to loan GEI any additional amounts under these loan agreements. 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 the loaned amounts.

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 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. In connection with the agreement, the Company provides Suntech with golf ball raw materials, packing materials, molds, tooling, as well as manufacturing equipment in order to carry out the manufacturing and supply obligations set forth in the agreement. Suntech provides the personnel as well as the facilities to effectively perform these manufacturing and supply obligations. Due to the nature of the arrangement, as well as the controlling influence the Company has in the Suntech operations, the Company is required to consolidate the financial results of Suntech in its consolidated condensed financial statements as of September 30, 2008 and December 31, 2007, in accordance with the provisions of FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*.

Suntech is a wholly-owned subsidiary of Suntech Mauritius Limited Company (Mauritius). 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 September 30, 2008.

**7. Product Warranty**

The Company has a stated two-year warranty policy for its golf clubs, although the Company's historical practice has been to honor warranty claims well after the two-year stated warranty period. The Company's policy is to accrue the estimated cost of 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

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

warranty policies and practices, the historical frequency of claims, and the cost to replace or repair its products under warranty. The decrease in estimated future warranty obligation is due to a decline in warranty return rates due to the improved durability of newer products. 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>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Beginning balance	\$ 13,342	\$ 14,365	\$ 12,386	\$ 13,364
Provision	1,458	2,071	7,953	8,702
Claims paid/costs incurred	(3,015)	(3,369)	(8,554)	(8,999)
Ending balance	\$ 11,785	\$ 13,067	\$ 11,785	\$ 13,067

**8. Financing Arrangements**

The Company's principal sources of liquidity are cash flows provided by operations and the Company's credit facilities. 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 September 30, 2008, the maximum amount that could be borrowed under the Line of Credit was \$250,000,000, of which \$40,000,000 was outstanding.

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 September 30, 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 to the Line of Credit, 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 \$942,000 as of September 30, 2008, of which \$282,000 was included in prepaid and other current assets and \$660,000 in other long-term assets in the accompanying consolidated condensed balance sheet.

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**CALLAWAY GOLF COMPANY**

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

**(Unaudited)**

**9. 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 golf equipment manufacturers to encourage Chinese and other foreign government officials to conduct raids of identified counterfeiters, resulting in the seizure and destruction of counterfeit golf clubs and, in some cases, criminal prosecution of the counterfeiters. 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 family of 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 family of golf balls collectively infringe 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 family of golf balls. Acushnet has asked the Court to enter judgment notwithstanding the verdict or, alternatively, for a new trial. Those post-trial motions are pending.

Acushnet 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 has issued multiple administrative decisions

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**CALLAWAY GOLF COMPANY**

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

**(Unaudited)**

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 to the Board of Patent Appeals and then, if not successful, to the United States Court of Appeals for the Federal Circuit. In the meantime, 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, against Acushnet Company asserting that sales of certain Titleist and Cobra branded drivers infringe one or more of Callaway Golf's U.S. patent numbers 6,348,015; 6,478,692; 6,669,579; 6,685,576; and 6,949,032. In a counterclaim, Acushnet has asserted that sales of certain Callaway Golf drivers infringe one or more of three patents issued to Acushnet, namely U.S. patent numbers 6,960,142, 7,041,003, and 7,140,975. The parties have agreed in principle to resolve this matter on confidential terms.

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. The Plans filed a counterclaim to compel an audit and to recover unpaid Plan contributions, as well as liquidated damages, interest, and reasonable audit and attorneys' fees. The Company recently agreed to dismiss its claims against SAG in return for SAG's agreement to be bound by the result of the Company's litigation with the Plans. A pretrial conference is set for February 9, 2009. 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 had thirty (30) days from the date of notice in which to cure a default. Ashworth denied that any breach has occurred, and did not take 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 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 demanded binding arbitration of its right to terminate. The arbitration is set to commence on November 3, 2008. Ashworth announced on October 13, 2008, that TaylorMade-adidas Golf, through a subsidiary of TaylorMade Golf Company, Inc., is seeking to acquire all of the shares of Ashworth in a tender offer of \$1.90 per share. A change in control of Ashworth provides Callaway Golf with additional termination rights pursuant to the Agreement.

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, CX Cart, Euro Stand, and Matrix 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 Company has answered the complaint denying that it infringes the patents. Discovery has not yet commenced and no trial date has been set.

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**CALLAWAY GOLF COMPANY**

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

**(Unaudited)**

On May 8, 2008, Mr. Inaba filed a suit against Callaway Golf Japan in the Osaka District Court in Japan. Mr. Inaba has alleged that certain golf balls sold by Callaway Golf Japan with a hex aerodynamic pattern infringe his Japanese utility design patent No. 3,478,303 and his Japanese design patent No. 1,300,582. Mr. Inaba is seeking damages pursuant to a royalty based on sales. The Court has ordered Callaway Golf Japan to submit a brief outlining its non-infringement and invalidity positions on or before October 30, 2008, and set a further hearing for November 7, 2008 to consider Callaway Golf Japan's defenses.

On May 13, 2008, Clear with Computers, LLC ( CWC ) filed a patent infringement suit against Callaway Golf Company, Callaway Golf Interactive, Inc., and forty-five other defendants in the Eastern District of Texas. CWC alleges that Callaway Golf's websites (www.callawaygolf.com, www.odysseygolf.com, www.benhogan.com, and www.topflite.com) infringe U.S. Pat. Nos. 5,615,342 and 5,367,627, relating to computer-assisted proposal generation and part sales methods. Pursuant to its complaint, CWC seeks compensatory damages and an injunction. Callaway Golf Company and Callaway Golf Interactive, Inc. have answered the complaint, denying infringement and asserting that the patents are invalid. At a scheduling conference held on October 6, 2008, the Court set various pretrial dates and a trial date on March 8, 2010.

On July 11, 2008, the Company was sued in the Eastern District of Texas by Nicholas Colucci, dba EZ Line Putters, pursuant to a complaint asserting that the Odyssey White Hot XG No. 7, White Hot XG (Long) No. 7, Black Series i No. 7, and White Hot XG Sabertooth putters infringe U.S. Patent No. 4,962,927 and infringe the alleged trade dress of plaintiff's EZ Line putters. The Company responded to the complaint on September 5, 2008, denying that it infringes the patent or the trade dress. Pursuant to a scheduling conference held on October 6, 2008, the Court set various pretrial deadlines and a trial date of March 1, 2010.

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.

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**CALLAWAY GOLF COMPANY**

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

**(Unaudited)**

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

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

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

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

The Company continues to reflect on its balance sheet the derivative valuation account of \$19,922,000, subject to quarterly review in accordance with applicable law and accounting regulations, including SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Company believes the Enron Contract has been terminated, and as of September 30, 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. 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

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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. As of September 30, 2008, the Company has entered into many of these contractual agreements with terms ranging from one to five years. The minimum obligation that the Company is required to pay under these agreements is \$118,661,000 over the next five years. In addition, the Company also enters into unconditional purchase obligations with various vendors and suppliers of goods and services in the normal course of operations through purchase orders or other documentation or that are undocumented except for an invoice. Such unconditional purchase obligations are generally outstanding for periods less than a year and are settled by cash payments upon delivery of goods and services and are not reflected in this total. Future purchase commitments as of September 30, 2008 are as follows (in thousands):

2008	\$ 67,877
2009	30,602
2010	13,350
2011	5,446
2012	1,324
2013	62
	<b>\$ 118,661</b>

***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 or trademarks, (ii) indemnities to various lessors in connection with facility leases for certain claims arising from such facilities or leases, (iii) indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct of the Company and (iv) indemnities involving the accuracy of representations and warranties in certain contracts. In addition, the Company has made contractual commitments to each of its officers and certain other employees providing for severance payments upon the termination of employment. The Company also has consulting agreements that provide for payment of nominal fees upon the issuance of patents and/or the commercialization of research results. The Company has also issued guarantees in the form of two standby letters of credit as security for contingent liabilities under certain workers' compensation insurance policies and as collateral for a loan issued to Golf Entertainment International Limited (GEI) (for further discussion see Note 6 Investments above). 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 and nine months ended September 30, 2008 was not material to the Company's financial position, results of operations or cash flows.



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

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

**10. Share-Based Employee Compensation**

As of September 30, 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). From time to time, the Company grants Stock Options, Restricted Stock Awards, Restricted Stock Units, Performance Share Units and other awards under these two plans.

The table below summarizes the non-cash amounts recognized in the financial statements for the three and nine months ended September 30, 2008 and 2007 for share-based compensation related to employees (in thousands).

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Cost of sales	\$ 71	\$ 142	\$ 406	\$ 329
Operating expenses	939	1,552	4,669	5,299
Total cost of employee share-based compensation included in income, before income tax	1,010	1,694	5,075	5,628
Amount of income tax recognized in earnings	(208)	(499)	(1,342)	(1,715)
Amount charged against net income	\$ 802	\$ 1,195	\$ 3,733	\$ 3,913
Impact on net income per common share:				
Basic	\$ (0.01)	\$ (0.02)	\$ (0.06)	\$ (0.06)
Diluted	\$ (0.01)	\$ (0.02)	\$ (0.06)	\$ (0.06)

In addition, during the three months ended September 30, 2008 and 2007, the Company recorded \$1,073,000 and reversed \$148,000, respectively, of compensation expense to revalue shares of Restricted Stock granted to non-employees at market value. During the nine months ended September 30, 2008 and 2007, the Company recorded \$33,000 and \$2,445,000 of compensation expense to revalue shares of Restricted Stock Awards granted to non-employees at market value.

***Stock Options***

The Company granted 259,000 and 1,126,000 shares underlying Stock Options during the three and nine months ended September 30, 2008, respectively, at a weighted average grant-date fair value of \$3.87 and \$3.95 per share. During the three and nine months ended September 30, 2007, the Company granted 26,000 and 915,000 shares underlying Stock Options, respectively, at a weighted average grant-date fair value of \$5.04 and \$3.93 per share.



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

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 table below summarizes the weighted average Black-Scholes fair value assumptions used in the valuation of Stock Options granted during the three and nine months ended September 30, 2008 and 2007.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Dividend yield	1.9%	2.0%	1.9%	2.0%
Expected volatility	36.4%	37.4%	35.6%	37.4%
Risk free interest rate	2.8%	4.1%	2.7%	4.7%
Expected life	4.0 years	4.1 years	4.1 years	3.1 years

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

The Company granted 324,000 and 264,000 shares underlying Restricted Stock Units during the nine months ended September 30, 2008 and 2007, respectively, at a weighted average grant-date fair value of \$14.57 and \$14.77, respectively. During the three months ended September 30, 2008 and 2007, the Company granted 71,000 and 10,000 shares underlying Restricted Stock Units, respectively, at a weighted average grant-date fair value of \$14.04 and \$16.31. There were no Restricted Stock or Performance Share Units granted during the three and nine months ended September 30, 2008 and 2007. At September 30, 2008, the Company had \$7,450,000 of total unrecognized compensation expense related to non-vested shares granted to both employees and non-employees under the Company's share-based payment plans related to Restricted Stock and Restricted Stock Units. The amount of unrecognized compensation expense noted above does not necessarily represent the amount that will ultimately be realized by the Company in its Statement of Operations due to the application of forfeiture rates as well as the impact of mark-to-market revaluations on Restricted Stock awards granted to non-employees. During the three months ended September 30, 2008, the Company reversed \$890,000 of stock compensation expense in connection with Performance Share Units that were granted during 2006 due to the fact that the Company does not expect to achieve the performance requirements specific to these awards.

**11. Earnings per Share**

A reconciliation of the weighted-average shares used in the basic and diluted earnings per common share computations for the three and nine months ended September 30, 2008 and 2007 is presented below (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Weighted-average shares outstanding:				
Weighted-average shares outstanding Basic	62,494	66,516	63,187	67,250
Dilutive securities		1,123	842	1,157
Weighted-average shares outstanding Diluted	62,494	67,639	64,029	68,407

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 September 30, 2008 and 2007,



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options outstanding totaling 5,353,000 and 2,593,000 shares, respectively, were excluded from the calculations, as their effect would have been antidilutive. For the nine months ended September 30, 2008 and 2007, options outstanding totaling 5,551,000 and 2,987,000 shares, respectively, were excluded from the calculations, as their effect would have been antidilutive.

**12. Fair Value of Financial Instruments**

The Company adopted SFAS No. 157, *Fair Value Measurements* ( 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. SFAS No. 157 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. SFAS No. 157 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 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:

	September 30, 2008		December 31, 2007	
	Carrying Value	Observable market based inputs (Level 2)	Carrying Value	Observable market based inputs (Level 2)
Derivative instruments asset position	\$ 883	\$ 883	\$	\$
Derivative instruments liability position	55	55	421	421
Deferred compensation plan	8,002	8,002	9,103	9,103

The fair value of the Company's foreign currency exchange contracts and deferred compensation plan assets is determined based on observable inputs that are corroborated by market data. All derivatives on the balance sheet are recorded at fair value with changes in fair value recorded in the statement of operations.

**13. 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.



**Table of Contents****CALLAWAY GOLF COMPANY****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****(Unaudited)*****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, Canadian Dollars and Australian Dollars. To achieve hedge accounting, contracts must reduce the foreign currency exchange rate risk otherwise inherent in the amount and duration of the hedged exposures and comply with established risk management policies. Pursuant to its foreign exchange hedging policy, the Company may hedge anticipated transactions and the related receivables and payables denominated in foreign currencies using forward foreign currency exchange rate contracts and put or call options. Foreign currency derivatives are used only to meet the Company's objectives of minimizing variability in the Company's operating results arising from foreign exchange rate movements which may include derivatives that do not meet the criteria for hedge accounting. The Company does not enter into foreign exchange contracts for speculative purposes. Hedging contracts mature within twelve months from their inception.

At September 30, 2008 and 2007, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$62,287,000 and \$39,416,000, respectively. The Company estimates the fair values of derivatives based on quoted market prices or pricing models using current market rates, and records all derivatives on the balance sheet at fair value with changes in fair value recorded in the statement of operations. At September 30, 2008, the fair values of foreign currency-related derivatives were recorded as current assets of \$883,000 and current liabilities of \$55,000. 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 September 30, 2008 and 2007, the Company recorded net gains of \$2,800,000 and net losses of \$2,933,000, 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 gains and losses were offset by net foreign currency transaction losses of \$3,549,000 and net gains of \$3,491,000 during the three months ended September 30, 2008 and 2007, respectively. During the nine months ended September 30, 2008 and 2007, the Company recorded net gains of \$1,558,000 and net losses of \$5,528,000, 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 gains and losses were offset by net foreign currency transaction losses of \$2,468,000 and net gains of \$5,608,000 during the nine months ended September 30, 2008 and 2007, respectively. As of September 30, 2008 and 2007, there were no foreign exchange contracts designated as cash flow hedges.

**14. 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 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 and Top-Flite golf balls. There are no significant intersegment transactions.

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net sales				
Golf clubs <sup>(1)</sup>	\$ 165,038	\$ 186,172	\$ 764,851	\$ 774,833
Golf balls <sup>(1)</sup>	48,413	49,377	181,081	175,340
	\$ 213,451	\$ 235,549	\$ 945,932	\$ 950,173
Income before provision for income taxes				
Golf clubs <sup>(1)</sup>	\$ 2,825	\$ 16,750	\$ 146,192	\$ 155,795
Golf balls <sup>(1)</sup>	(2,654)	(2,818)	10,048	8,661
Reconciling items <sup>(2)</sup>	(14,290)	(11,833)	(47,013)	(47,609)
	\$ (14,119)	\$ 2,099	\$ 109,227	\$ 116,847
Additions to long-lived assets				
Golf clubs	\$ 8,851	\$ 4,421	\$ 28,332	\$ 18,791
Golf balls	1,609	1,111	6,341	4,218
	\$ 10,460	\$ 5,532	\$ 34,673	\$ 23,009

- (1) Prior year amounts have been reclassified to conform to the current year presentation. Net sales for the Company's golf clubs and golf balls segments for the three and nine months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the three and nine months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.
- (2) Represents corporate general and administrative expenses and other income (expense) not utilized by management in determining segment profitability.

**15. Recent Accounting Pronouncements**

In October 2008, the FASB Issued FASB Staff Position ( FSP ) No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* ( FSP No. 157-3 ). FSP No. 157-3 clarifies the application of FASB Statement No. 157, *Fair Value Measurements*, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP No. 157-3 is effective upon issuance. Based on the Company's evaluation of FSP No. 157-3, the adoption of this standard does not have a material impact on the Condensed Consolidated Financial Statements of the Company.

In September 2008, the FASB issued FASB Staff Position No. 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161* ( FSP No. 133-1 and Fin 45-4 ). FSP No. 133-1 and Fin 45-4 are intended to improve disclosures about credit derivatives by requiring more information about the potential adverse effects of changes in credit risk on the financial position, financial performance, and cash



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flows of the sellers of credit derivatives. It amends FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to require disclosures by sellers of credit derivatives, including credit derivatives embedded in hybrid instruments. FSP No. 133-1 and FIN 45-4 are effective for

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**CALLAWAY GOLF COMPANY**

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

**(Unaudited)**

annual and interim reporting periods beginning after November 15, 2008. The Company is currently evaluating the impact, if any, that the adoption of FSP No. 133-1 and FIN 45-4 will have on the Condensed Consolidated Financial Statements of the Company.

In March 2008, the FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133* ( SFAS No. 161 ). SFAS No. 161 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. SFAS No. 161 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 SFAS No. 161 will have on the Condensed Consolidated Financial Statements of the Company.

In December 2007, the FASB issued Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* ( SFAS No. 160 ). SFAS No. 160 amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the 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, SFAS No. 160 requires that consolidated net income include the amounts attributable to both the parent and the noncontrolling interest. SFAS No. 160 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 SFAS No. 160 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 No. 141R ). SFAS No. 141R 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. SFAS No. 141R retains the fundamental requirements in Statement No. 141 that the acquisition method of accounting be used for all business combinations. SFAS No. 141R 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. SFAS No. 141R 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 SFAS No. 141R 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, namely the golf clubs segment and golf balls segment. 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 in Note 14 to the Company's consolidated condensed financial statements, the Company's operating segments exclude a significant amount of corporate 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 for the year ended December 31, 2003 (including charges of \$24.1 million for Top-Flite integration initiatives) to profitability of \$0.9 million for the year ended December 31, 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, including the consolidation of its golf ball production operations into other existing locations. As a result of this consolidation, the Company announced the closure of its ball manufacturing facility in Gloversville, New York in May of 2008.

In most of the Company's key markets, the game of golf is played primarily on a seasonal basis. Weather conditions generally restrict golf from being played year-round, except in a few 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.

Approximately half of the Company's business is conducted outside of the United States and is conducted in currencies other than the U.S. dollar. For reporting purposes, transactions conducted in foreign currencies must be translated into U.S. Dollars based upon applicable foreign currency exchange rates. Fluctuations in foreign currency rates therefore can have a significant effect on the Company's reported financial results. In general, the Company's financial results are affected positively by a weaker U.S. dollar and are affected negatively by a stronger U.S. dollar as compared to the foreign currencies in which the Company conducts its business. The

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Company's hedging activities can mitigate but do not eliminate the effects of the foreign currency fluctuations. Overall, during the first nine months of 2008, the Company's reported financial results generally benefited from foreign currency rates. During the third quarter, however, the U.S. dollar began to strengthen and the translation of foreign currency exchange rates had only a nominal effect on the Company's third quarter results. If the dollar continues to strengthen as compared to the currencies in which the Company conducts business, the Company's future reported financial results could be significantly adversely affected.

### ***Executive Summary***

The Company had record sales and earnings during the first half of 2008. These record results reflect the strength of the Company's brands, progress on the Company's gross margin improvement initiatives and the Company's international business, which was able to more than offset the deteriorating economic conditions in the United States during the first half of 2008.

During the third quarter, however, the deteriorating economic conditions began to spread to most of the Company's international markets and the conditions in the United States worsened. The recessionary conditions experienced during the third quarter had a significant adverse effect on consumer and retailer confidence, which exacerbated the normal end of season sales slowdown and resulted in a \$22.0 million decline in net sales compared to the third quarter of 2007.

The deteriorating global economic conditions also adversely affected the Company's gross profit, which as a percentage of net sales declined to 38% as compared to 40% for the third quarter of 2007. Given the uncertain economic conditions, consumers trended toward lower priced products and the Company reduced prices of certain older model products, which overall resulted in a decrease in average selling price during the third quarter as compared to the prior year. This decline in gross profit was partially offset by the Company's continued successful implementation of its gross margin improvement initiatives.

Operating expenses for the third quarter of 2008 were essentially flat with 2007 despite inflationary pressures. In addition, the business process improvements implemented by the Company over the past couple years have increased the Company's flexibility to respond more quickly to changing market conditions. Despite a rapid decline in reorders during the latter part of the third quarter, the Company was able to finish the quarter with inventory as a percentage of trailing 12 months net sales at 19.7%, which is in line with the Company's year-end target of 20%. The Company was also able to implement the expense contingency plans it established earlier this year and reduce its planned spending as net sales declined.

Despite the impact of the macroeconomic conditions on the Company's third quarter results, the Company was able to increase earnings per share by approximately 5% for the first nine months of 2008 compared to the first nine months of 2007.

**Table of Contents****Three-Month Periods Ended September 30, 2008 and 2007**

Net sales decreased \$22.0 million (9%) to \$213.5 million for the three months ended September 30, 2008 compared to \$235.5 million for the same period in the prior year. This decrease reflects a \$21.0 million decrease in net sales of the Company's golf clubs segment and a \$1.0 million decrease in net sales of the Company's golf balls segment as set forth below (dollars in millions):

	Three Months Ended September 30,		Growth (Decline)	
	2008	2007 <sup>(1)</sup>	Dollars	Percent
Net sales				
Golf clubs	\$ 165.1	\$ 186.1	\$ (21.0)	(11)%
Golf balls	48.4	49.4	(1.0)	(2)%
	\$ 213.5	\$ 235.5	\$ (22.0)	(9)%

- (1) Prior year amounts have been reclassified to conform to the current year presentation. Net sales for the Company's golf clubs and golf balls segments for the three months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the three months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.

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 September 30,		Growth/(Decline)	
	2008	2007	Dollars	Percent
Net sales:				
United States	\$ 104.6	\$ 124.3	\$ (19.7)	(16)%
Europe	33.4	41.0	(7.6)	(19)%
Japan	32.8	25.2	7.6	30%
Rest of Asia	18.5	20.5	(2.0)	(10)%
Other Countries	24.2	24.5	(0.3)	(1)%
	\$ 213.5	\$ 235.5	\$ (22.0)	(9)%

Net sales in the United States decreased \$19.7 million (16%) to \$104.6 million during the third quarter of 2008 compared to the same period in the prior year. This decline was primarily caused by reduced demand as a result of a less favorable economic environment in the United States in the current year. The Company's sales in regions outside of the United States decreased \$2.3 million (2%) to \$108.9 million during the third quarter of 2008 compared to the same quarter in 2007. The Company's international sales were also affected by deteriorating global economic conditions, resulting in a net decrease of \$9.9 million in international regions, excluding Japan, with Japan increasing by \$7.6 million primarily due to continued strong sales of a region specific driver introduced in 2008 as well as an overall increase in demand of other golf products. The impact of changes in foreign currency rates on international net sales was nominal during the three months ended September 30, 2008.

Gross profit decreased \$13.9 million to \$80.1 million in the third quarter of 2008 from \$94.0 million in the same period of 2007. Gross profit as a percentage of net sales declined to 38% in the third quarter of 2008 compared to 40% for the comparable period in 2007. The decline in gross margin is primarily due to an unfavorable shift in product mix from higher margin woods and irons products to lower margin accessories and other products as well as price reductions taken on certain older woods and irons products in response to the



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weakening global economy. See Segment Profitability below for further discussion of gross margins. These decreases in gross margin were partially offset by reductions in golf club component costs and improved manufacturing efficiencies as a result of the Company's gross margin improvement initiatives. Additionally, gross margins were positively affected by changes in foreign currency rates during the quarter. Gross profit for the third quarter of 2008 was negatively affected by charges of \$3.6 million related to the implementation of the Company's gross margin improvement initiatives compared to \$4.1 million for the comparable period in 2007.

Selling expenses remained relatively flat at \$65.7 million in the third quarter of 2008 compared to \$65.8 million in the comparable period of 2007. As a percentage of sales, selling expenses were 31% in the third quarter of 2008 compared to 28% in the third quarter of 2007. During the quarter selling expenses decreased \$2.8 million in employee costs primarily as a result of a decrease in employee incentive compensation expense partially offset by increases of \$1.2 million in share-based compensation expense related to non-employees, \$0.8 million in advertising and promotional activities and \$0.7 million in travel and entertainment.

General and administrative expenses increased \$0.8 million (4%) to \$20.2 million in the third quarter of 2008 compared to \$19.4 million in the comparable period of 2007. As a percentage of sales, general and administrative expenses increased to 9% in the third quarter of 2008 compared to 8% in the third quarter of 2007. This increase in general and administrative expenses was primarily generated by a \$3.8 million gain which was recognized in connection with the sale of a building during the third quarter of 2007. This increase was partially offset by a decrease of \$3.7 million in employee costs primarily as a result of decreases in employee incentive compensation expense and deferred compensation expense in the third quarter of 2008.

Research and development expenses decreased \$1.2 million (16%) to \$6.7 million in the third quarter of 2008 compared to \$7.9 million in the comparable period of 2007. As a percentage of sales, research and development expenses remained consistent at 3% for the third quarter of 2008 and 2007. The dollar decrease in research and development expenses was primarily due to a decrease in employee incentive compensation expense.

Other income (expense) declined by \$2.9 million in the third quarter of 2008 to expense of \$1.7 million compared to income of \$1.2 million in the comparable period of 2007. This decline is primarily attributable to a decrease of \$1.3 million in net foreign currency fluctuation gains combined with a \$0.9 million net expense recognized in connection with unfavorable changes in the asset value of the Company's deferred compensation plan during the third quarter of 2008 compared to the same period of the prior year.

The effective tax rate for the quarter ended September 30, 2008 was 47% compared to 40% for the quarter ended September 30, 2007. The change in the effective tax rate is primarily due to the release of tax contingencies related to an examination that was effectively settled during the third quarter of 2008 and the relative impact of these changes when compared to the pre-tax loss during the current quarter.

Net income for the third quarter of 2008 decreased by \$8.7 million to a net loss of \$7.4 million compared to net income of \$1.3 million in the comparable period of 2007. Diluted earnings per share declined to a loss of \$0.12 per share (based on 62.5 million shares outstanding) in the third quarter of 2008 compared to diluted earnings of \$0.02 per share (based on 67.6 million shares outstanding) in the third quarter of 2007. The Company's results for the third quarter of 2008 were negatively impacted by after-tax charges of \$2.2 million (\$0.04 per share) associated with the implementation of the Company's gross margin improvement initiatives. Net income for the third quarter of 2007 was positively impacted by an after-tax gain of \$2.3 million (\$0.03 per share) that was recognized in connection with the sale of a building in August 2007, and negatively affected by after-tax charges of \$2.5 million (\$0.04 per share) related to costs associated with the implementation of the Company's gross margin improvement initiatives.

**Table of Contents****Golf Clubs and Golf Balls Segments Results for the Three Months Ended September 30, 2008 and 2007****Golf Clubs Segment**

Overall, during the third quarter of 2008, the Company's net sales of its golf clubs segment products were adversely affected by deteriorating global economic conditions. Net sales information by product category is summarized as follows (in millions):

	Three Months Ended September 30,		Growth/(Decline)	
	2008	2007 <sup>(1)</sup>	Dollars	Percent
Net sales:				
Woods	\$ 34.5	\$ 57.3	\$ (22.8)	(40)%
Irons	63.8	66.6	(2.8)	(4)%
Putters	21.3	21.8	(0.5)	(2)%
Accessories and other	45.5	40.4	5.1	13%
	\$ 165.1	\$ 186.1	\$ (21.0)	(11)%

(1) Prior year amounts have been reclassified to conform to the current year presentation. Net sales for the Company's golf clubs and golf balls segments for the three months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the three months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.

The \$22.8 million (40%) decrease in net sales of woods to \$34.5 million for the quarter ended September 30, 2008 is primarily attributable to a decrease in sales volume and in average selling prices in the third quarter of 2008 compared to the same period in the prior year. The decrease in sales volume was primarily due to a decline in sales of the Company's older more premium FT-5 and FT-i multi-material drivers and fairway woods which were in the second year of their product lifecycles. This decrease was partially offset by sales of the Legacy driver launched in Asia during the current year. The decrease in average selling prices was driven by a less extensive line of drivers launched during 2008 compared to 2007. This expected decrease in new driver introductions contributed to a reduction in the 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 affected by planned price reductions taken on older woods products, primarily on Fusion Technology drivers and X hybrids during the third quarter of 2008 and X fairway woods during the second quarter of 2008.

The \$2.8 million (4%) decrease in net sales of irons to \$63.8 million for the quarter ended September 30, 2008 resulted primarily from a decrease in sales volume and a slight decline in average selling prices in the third quarter of 2008 compared to the same period in the prior year. The decrease in sales volume was primarily driven by an anticipated decline in sales of X Series irons which were in the second year of their product lifecycles. The decrease in irons sales volumes was partially offset by an increase in net sales of X Forged wedges, launched in the current year. The decline in average selling prices was primarily due to planned close out pricing on older Big Bertha irons.

The \$0.5 million (2%) decrease in net sales of putters to \$21.3 million for the quarter ended September 30, 2008 resulted primarily from a decrease in sales volume. This decrease in putter sales is primarily attributable to decreases in sales of the Company's older White Hot XG putter lines, which are in the second and third years of their product lifecycles as well as a decrease of the older generation Black Series putter line, which was in the second year of its product lifecycle. This decrease was partially offset by an increase in sales of White Hot Tour and the White Hot XG Sabertooth putters, which were introduced in the first quarter of 2008.

The \$5.1 million (13%) increase in sales of accessories and other products to \$45.5 million for the quarter ended September 30, 2008 is primarily attributable to the current year introduction of the Top-Flite packaged recreational sets in addition to an increase in sales of the Callaway Golf Collection line of accessories and golf bags.



**Table of Contents****Golf Balls Segment**

Overall, during the third quarter of 2008, the Company's net sales of its golf balls segment products were adversely affected by deteriorating global economic conditions. Net sales information for the golf balls segment is summarized as follows (dollars in millions):

	Three Months Ended		Growth/(Decline)	
	September 30, 2008	September 30, 2007 <sup>(1)</sup>	Dollars	Percent
Net sales:				
Golf balls	\$ 48.4	\$ 49.4	\$ (1.0)	(2)%

- (1) Prior year amounts have been reclassified to conform to the current year presentation. Net sales for the Company's golf clubs and golf balls segments for the three months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the three months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.

The \$1.0 million (2%) decrease in net sales of golf balls to \$48.4 million for the quarter ended September 30, 2008 was due to a decrease of \$2.3 million in sales of Top-Flite golf balls partially offset by a \$1.5 million increase in Callaway Golf ball sales. The decrease in Top-Flite golf ball sales is primarily due to a decrease in both sales volume and average selling prices. The decrease in sales volumes was largely due to a decline in sales of the older generation XL golf ball models and D2 golf balls, introduced in the first quarter of 2007. The decrease in average selling prices was primarily driven by a shift in product mix due to the introduction of the new XL golf ball models, which carry lower average selling prices than the D2 golf balls. The increase in Callaway Golf ball sales is due to increases in both average selling prices and sales volume. The increase in average selling prices is due to a favorable shift in product mix as a result of the current year introduction of the premium Tour i and Tour ix golf balls, which have higher average selling prices than the Big Bertha and HX Hot golf ball models launched in the prior year. The increase in sales volume is due to the current year introduction of the Tour i, Tour ix and HX Hot Bite golf balls, partially offset by a decrease in sales of older generation HX Hot and HX Tour golf ball models.

**Segment Profitability**

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

	Three Months Ended		Growth (Decline)	
	September 30, 2008	September 30, 2007 <sup>(2)</sup>	Dollars	Percent
Income before provision for income taxes				
Golf clubs	\$ 2.8	\$ 16.7	\$ (13.9)	(83)%
Golf balls	(2.7)	(2.8)	0.1	4%
	\$ 0.1 <sup>(1)</sup>	\$ 13.9 <sup>(1)</sup>	\$ (13.8)	(99)%

- (1) Amounts shown are before the deduction of corporate general and administrative expenses and other income (expenses) of \$14.3 million and \$11.8 million for the three months ended September 30, 2008 and 2007, respectively, which are not utilized by management in determining segment profitability. For further information on segment reporting see Note 14 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. Net sales for the Company's golf clubs and golf balls segments for the three months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the three months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.



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Pre-tax income in the Company's golf clubs operating segment declined to \$2.8 million for the quarter ended September 30, 2008 from \$16.7 million for the comparable period in the prior year. This decrease is primarily attributable to a decline in net sales as discussed above as well as a decline in gross margin partially offset by a slight improvement in operating expenses. The decline in gross margin is primarily due to planned price reductions on older products as well as a less favorable club product mix during the third quarter of 2008 compared to the third quarter of 2007. This unfavorable shift in product mix is due in part to an overall increase in sales of titanium driver products during the third quarter in 2008, which generally carry lower margins than the Fusion Technology drivers introduced in 2007, as well as an increase in sales of accessories and other products, which generally carry lower margins compared to club products. This unfavorable shift in product mix was partially offset by cost reductions on club components and improved club manufacturing efficiencies as a result of the Company's gross margin improvement initiatives. The decrease in operating expenses is primarily due to a decrease in employee incentive compensation expense during the third quarter of 2008 compared to the same period in 2007.

Pre-tax income (loss) in the Company's golf balls operating segment improved to a loss of \$2.7 million for the quarter ended September 30, 2008 from a loss of \$2.8 million for the comparable period in the prior year. This decline is primarily due to an improvement in gross margins, resulting primarily from a favorable shift in ball product mix as well as improved ball manufacturing efficiencies. These improvements were partially offset by an increase in golf ball raw material costs.

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 \$1.9 million and \$1.7 million, respectively, during the third quarter of 2008 and \$1.4 million and \$2.8 million, respectively, during the comparable period in 2007.

**Nine-Month Periods Ended September 30, 2008 and 2007**

Net sales decreased \$4.3 million (1%) to \$945.9 million for the nine months ended September 30, 2008 compared to \$950.2 million for the comparable period in the prior year. This decrease reflects a \$10.0 million decrease in net sales of the Company's golf clubs segment partially offset by a \$5.7 million increase in net sales of the Company's golf balls segment as set forth below (dollars in millions):

	Nine Months Ended September 30,		Growth (Decline)	
	2008	2007 <sup>(1)</sup>	Dollars	Percent
Net sales				
Golf clubs	\$ 764.8	\$ 774.8	\$ (10.0)	(1)%
Golf balls	181.1	175.4	5.7	3%
	\$ 945.9	\$ 950.2	\$ (4.3)	(1)%

- (1) Prior year amounts have been reclassified to conform to the current year presentation. Net sales for the Company's golf clubs and golf balls segments for the nine months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the nine months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.

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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):

	Nine Months Ended September 30,		Growth/(Decline)	
	2008	2007	Dollars	Percent
Net sales:				
United States	\$ 465.1	\$ 512.5	\$ (47.4)	(9)%
Europe	171.3	167.3	4.0	2%
Japan	132.7	96.9	35.8	37%
Rest of Asia	67.0	69.0	(2.0)	(3)%
Other Countries	109.8	104.5	5.3	5%
	\$ 945.9	\$ 950.2	\$ (4.3)	(1)%

Net sales in the United States decreased \$47.4 million (9%) to \$465.1 million during the first nine months of 2008 compared to the same period in the prior year. This decline was primarily due to reduced demand caused by a less favorable economic environment in the United States in the current year. The Company's sales in regions outside of the United States increased \$43.1 million (10%) to \$480.8 million during the first nine months of 2008 compared to the same period in 2007. This increase in international net sales is primarily attributable to an increase of \$35.8 million in Japan, primarily due to continued strong sales of a region specific driver introduced in 2008. The increase in international net sales was affected by \$19.8 million of net favorable changes in foreign currency rates primarily in Japan and Other Countries. The favorable fluctuations in foreign currency rates were partially offset by selective price reductions taken during 2008 in response to the weakened U.S. dollar.

For the nine months ended September 30, 2008, gross profit decreased \$3.1 million to \$426.7 million from \$429.8 million in the comparable period of 2007. Gross profit as a percentage of net sales remained consistent at 45% in the nine months ended September 30, 2008 and 2007. Gross margins were positively affected by reductions in golf club component costs and improved manufacturing efficiencies as a result of the Company's gross margin improvement initiatives. Additionally, gross margins were positively affected by favorable changes in foreign currency rates during the nine months ended September 30, 2008. These increases were partially offset by an unfavorable shift in product mix from higher margin woods products to lower margin accessories and other products. See Segment Profitability below for further discussion of gross margins. Gross profit for the nine months ended September 30, 2008 was negatively affected by charges of \$9.4 million related to the implementation of the Company's gross margin improvement initiatives compared to \$7.5 million for the comparable period in 2007. The increase in gross margin improvement charges during the nine months ended September 30, 2008 is primarily due to costs associated with the consolidation of golf ball production operations into other existing locations, which resulted in the closure of the Company's golf ball manufacturing facility in Gloversville, New York during 2008.

Selling expenses increased \$4.4 million (2%) to \$226.4 million in the nine months ended September 30, 2008 compared to \$222.0 million in the comparable period of 2007. As a percentage of sales, selling expenses increased to 24% for the first nine months in 2008 compared to 23% for the comparable period of 2007. The dollar increase in selling expense was primarily due to increases of \$2.0 million in travel and entertainment expenses, \$1.6 million in consulting costs to support brand awareness initiatives and \$0.8 million in depreciation expense as a result of the current year purchase of displays and shelving fixtures. In addition, employee costs increased slightly primarily as a result of an increase in salaries and wages almost entirely offset by a decrease in employee incentive compensation expense. These increases were partially offset by a decrease of \$2.5 million in share-based compensation expense related to non-employees. Additionally, the Company's selling expenses were unfavorably impacted by changes in foreign exchange rates on non-U.S. selling expenses.

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General and administrative expenses increased \$0.4 million (1%) to \$65.5 million in the nine months ended September 30, 2008 compared to \$65.1 million in the comparable period of 2007. As a percentage of sales, general and administrative expenses remained consistent at 7% during the first nine months in 2008 and 2007. This increase in general and administrative expenses was primarily generated by a \$3.8 million gain which was recognized in connection with the sale of a building during the first nine months of 2007. This increase was partially offset by a decrease of \$1.7 million in legal expenses associated with intellectual property rights litigation. In addition, employee costs decreased by \$1.5 million primarily as a result of decreases in employee incentive compensation expense and deferred compensation expense, partially offset by an increase in salaries and wages due to salary merit increases year over year.

Research and development expenses decreased \$1.8 million (7%) to \$22.1 million in the nine months ended September 30, 2008 compared to \$23.9 million in the comparable period of 2007. As a percentage of sales, research and development expenses decreased to 2% in the first nine months of 2008 compared to 3% in the comparable period in 2007. The dollar decrease was primarily due to a decrease in employee incentive compensation expense.

Other expense increased by \$1.6 million in the nine months ended September 30, 2008 to \$3.6 million compared to \$2.0 million in the comparable period of 2007. This increase is primarily attributable to \$1.8 million in net expenses recognized in connection with unfavorable changes in the asset value of the Company's deferred compensation plan combined with a decrease of \$1.0 million in net foreign currency fluctuation gains. These increases in expense were partially offset by a \$0.9 million decrease in interest expense as a result of a decline in interest rates.

The effective tax rate for the nine months ended September 30, 2008 was 37% compared to 39% for the nine months ended September 30, 2007. The decrease in the tax rate is primarily due to the release of tax contingencies related to both the settlement of the Internal Revenue Service examination for tax years 2001 through 2003 and the expiration of the statute of limitations for the 2004 tax year.

Net income for the nine months ended September 30, 2008 decreased by \$1.4 million (2%) to \$69.3 million from net income of \$70.7 million in the comparable period of 2007. Diluted earnings per share improved to \$1.08 per share (based on 64.0 million shares outstanding) in the nine months ended September 30, 2008 compared to diluted earnings of \$1.03 per share (based on 68.4 million shares outstanding) in the comparable period of 2007. Net income and earnings per share were favorably impacted during the first nine months in 2008 by a reduction in unrecognized tax benefits of \$1.4 million (\$0.02 per share) as a result of the settlement of tax matters before the IRS Appeals Office, and negatively impacted by after-tax charges of \$5.9 million (\$0.09 per share) related to costs associated with the implementation of the Company's gross margin improvement initiatives. Net income for the first nine months in 2007 was positively impacted by an after-tax gain of \$2.3 million (\$0.03 per share) that was recognized in connection with the sale of a building in August 2007, and negatively affected by after-tax charges of \$4.6 million (\$0.07 per share) related to costs associated with the implementation of the Company's gross margin improvement initiatives.

***Golf Clubs and Golf Balls Segments Results for the Nine Months Ended September 30, 2008 and 2007***

The Company experienced an increase in net sales during the first half of 2008 primarily due to an increase in international sales as a result of strong demand for its current year product introductions and favorable changes in foreign currency rates. This increase in sales internationally was partially offset by a decline in sales in the United States primarily due to reduced demand caused by a less favorable economic environment compared to the prior year. During the third quarter of 2008, the deteriorating economic conditions in the United States began to spread to most of the Company's international markets and the conditions in the United States worsened resulting in an overall decrease in net sales for the nine months ended September 30, 2008.

**Table of Contents****Golf Clubs Segment**

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

	Nine Months Ended		Growth/(Decline)	
	September 30, 2008	September 30, 2007 <sup>(1)</sup>	Dollars	Percent
Net sales:				
Woods	\$ 237.0	\$ 273.6	\$ (36.6)	(13)%
Irons	260.3	263.8	(3.5)	(1)%
Putters	88.8	88.5	0.3	
Accessories and other	178.7	148.9	29.8	20%
	\$ 764.8	\$ 774.8	\$ (10.0)	(1)%

- (1) Prior year amounts have been reclassified to conform to the current year presentation. Net sales for the Company's golf clubs and golf balls segments for the nine months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the nine months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.

The \$36.6 million (13%) decrease in net sales of woods to \$237.0 million for the nine months ended September 30, 2008 is primarily attributable to a decrease in both average selling prices and sales volume in the first nine months of 2008 compared to the same period in the prior year. In 2007, the Company launched a more extensive line of drivers relative to 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 affected during the nine months ended September 30, 2008 by planned price reductions on older woods products, primarily on Big Bertha 460 titanium drivers, Fusion Technology drivers and X fairway woods. The decrease in sales volume was due to a decline in sales of the Company's older Fusion Technology drivers as well as fairway woods which were in the second year of their product lifecycles.

The \$3.5 million (1%) decrease in net sales of irons to \$260.3 million for the nine months ended September 30, 2008 resulted from a decrease in sales volume partially offset by an increase in average selling prices in the first nine months 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-20 and X-Forged irons, which were launched during the first quarter of 2007. These decreases were partially offset by an increase in sales volume of the current year Fusion Technology irons and X-Forged series wedges. The increase in average selling prices is primarily due to a favorable shift in product mix as a result of the current year introduction of premium Fusion Technology irons and X-Forged Series wedges, which carry higher average sales prices than the X-20 and X-Forged irons, launched in the prior year. In addition, average selling prices were negatively affected by close out pricing taken on older Big Bertha irons during the first nine months of 2008.

The \$0.3 million increase in net sales of putters to \$88.8 million for the nine months ended September 30, 2008 resulted from an increase in average selling prices partially offset by a decrease in sales volumes during the first nine months of 2008 compared to the same period in the prior year. The increase in average selling prices is primarily attributable to the current year introduction of the premium Black Series-i putter line, which carries a higher sales price than the Black Series putters launched in the prior year. This increase was partially offset by a decrease in sales of the Company's older White Hot XG series putter models.

The \$29.8 million (20%) increase in sales of accessories and other products to \$178.7 million is primarily attributable to the current year introduction of the Top-Flite packaged recreational sets in addition to an increase in sales of the Callaway Golf Collection line of accessories and golf bags.

**Table of Contents****Golf Balls Segment**

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

	Nine Months Ended September 30,		Growth/(Decline)	
	2008	2007 <sup>(1)</sup>	Dollars	Percent
Net sales:				
Golf balls	\$ 181.1	\$ 175.4	\$ 5.7	3%

(1) Prior year amounts have been reclassified to conform to the current year presentation. Net sales for the Company's golf clubs and golf balls segments for the nine months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the nine months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.

The \$5.7 million (3%) increase in net sales of golf balls to \$181.1 million for the nine months ended September 30, 2008 was due to a \$10.7 million increase in Callaway Golf ball sales, partially offset by a decrease of \$4.2 million in sales of Top-Flite golf balls. The increase in Callaway Golf ball sales is due to an increase in average selling prices as well as an increase in sales volume. The increase in average selling prices and sales volume is primarily due to favorable consumer acceptance of the current year premium HX Tour i and Tour ix series golf balls and the HX Hot Bite 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 volume. The decrease in sales volumes was largely due to a reduction in sales of the older generation XL golf ball models as well as the D2 golf balls. This decrease is partially offset by an increase in sales volume of the new Gamer and Freak golf ball models, which were introduced during the first quarter of 2008.

**Segment Profitability**

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

	Nine Months Ended September 30,		Growth (Decline)	
	2008	2007 <sup>(2)</sup>	Dollars	Percent
Income before provision for income taxes				
Golf clubs	\$ 146.2	\$ 155.8	\$ (9.6)	(6)%
Golf balls	10.0	8.7	1.3	15%
	\$ 156.2 <sup>(1)</sup>	\$ 164.5 <sup>(1)</sup>	\$ (8.3)	(5)%

(1) Amounts shown are before the deduction of corporate general and administration expenses and other income (expenses) of \$47.0 million and \$47.6 million for the nine months ended September 30, 2008 and 2007, respectively, which are not utilized by management in determining segment profitability. For further information on segment reporting see Note 14 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. Net sales for the Company's golf clubs and golf balls segments for the nine months ended September 30, 2007 have been reclassified to include sales in connection with the Company's special markets in their appropriate product categories. During the nine months ended September 30, 2007, these sales were included in accessories and other within the golf clubs segment.

Pre-tax income in the Company's golf clubs operating segment decreased to \$146.2 million for the nine months ended September 30, 2008 from \$155.8 million for the comparable period in the prior year. The decrease





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in the golf clubs operating segment pre-tax income is primarily attributable to a decline in net sales as discussed above combined with a slight decline in gross margin as well as an increase in operating expense. The decline in gross margin is primarily due to a less favorable club product mix during the first nine months of 2008 compared to the first nine months of 2007. This unfavorable shift in product mix is due in part to an overall increase in sales of titanium driver products during the first half of 2008, which generally carry lower margins than the Fusion Technology drivers introduced in 2007, as well as an increase in sales of accessories and other products, which generally carry lower margins compared to club products. This unfavorable shift in product mix was partially offset by cost reductions on club components and improved club manufacturing efficiencies as a result of the Company's gross margin improvement initiatives. In addition, operating expenses increased as a result of an increase in travel expense in connection with the Company's international growth as well as an increase in consulting expenses during the first nine months of 2008 compared to the same time period in 2007. These increases in operating expenses were partially offset by a decrease in employee incentive compensation and share-based compensation expense related to non-employees.

Pre-tax income in the Company's golf balls operating segment increased to \$10.0 million for the nine months ended September 30, 2008 from \$8.7 million for the comparable period in the prior year. The increase in the golf balls operating segment pre-tax income is primarily due to an increase in net sales as discussed above combined with a slight improvement in gross margins. This improvement was primarily due to a favorable shift in product mix as a result of the higher margin HX Hot Bite, Tour i series and legacy golf balls launched during the first nine months of 2008 compared to lower margin HX Hot golf balls launched during the same time period in 2007, as well as improved ball manufacturing efficiencies as a result of the Company's gross margin improvement initiatives.

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 \$4.1 million and \$5.4 million, respectively, during the nine months ended September 30, 2008 and \$4.6 million and \$2.9 million, respectively, during the comparable period in 2007.

**Financial Condition**

The Company's cash and cash equivalents increased \$0.7 million (2%) to \$50.6 million at September 30, 2008, from \$49.9 million at December 31, 2007. Although cash and cash equivalents remained relatively flat period over period, the Company's cash generated from operating activities during the nine months ended September 30, 2008 decreased \$85.5 million to \$60.3 million compared to the same period in the prior year. This decrease is primarily due to a greater decline in inventory levels during the nine months ended September 30, 2007 compared to the nine months ended September 2008 due to the implementation of the Company's inventory reduction initiatives announced in February 2007. Additionally, the Company paid its 2007 employee bonuses in February 2008, whereas no bonuses were paid during the fiscal year ended 2007, resulting in a greater use of cash for employee incentive compensation during the nine months ended September 30, 2008 compared to the same period in the prior year. During the nine months ended September 30, 2008, the Company used its cash generated from operating activities of \$60.3 million to fund \$33.5 million in capital projects and repurchase \$23.0 million of Company stock. 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 September 30, 2008, the Company's net accounts receivable increased \$40.6 million to \$152.7 million from \$112.1 million as of December 31, 2007. The increase in accounts receivable reflects the seasonality of the Company's business and is primarily attributable to net sales of \$213.5 million during the third quarter of 2008 compared to net sales of \$174.4 million during the fourth quarter of 2007. The Company's net accounts receivable decreased \$12.3 million as of September 30, 2008 compared to

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the Company's net accounts receivable as of September 30, 2007. This decrease is primarily due to the \$22.1 million decline in sales during the third quarter of 2008 compared to the same period of 2007. This decrease was partially offset by slightly longer standard payment terms for the Company's off-course customers in connection with the current year sales programs.

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 decreased \$32.7 million to \$220.3 million as of September 30, 2008 compared to \$253.0 million as of December 31, 2007. The Company's net inventory increased \$6.4 million as of September 30, 2008 compared to the Company's net inventory as of September 30, 2007. This increase in inventory is to support an increase in planned product launches for the fourth quarter of 2008 compared to the prior year. As a percent of trailing twelve month sales, inventory at September 30, 2008 was 19.7% compared to 19.0% for the same period in the prior year.

## **Liquidity and Capital Resources**

### ***Sources of Liquidity***

The Company's principal sources of liquidity are cash flows provided by operations and the Company's credit facilities in effect from time to time. The Company currently expects this to continue. The Company's 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 September 30, 2008, the maximum amount that could be borrowed under the Line of Credit was \$250.0 million, of which \$40.0 million was outstanding and due within one year.

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 September 30, 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 amendments to the Line of Credit, 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 \$1.0 million as of September 30, 2008, of which \$0.3 million was included in prepaid and other current assets and \$0.7 million in other long-term assets in the consolidated condensed balance sheet included in this report.

**Table of Contents****Other Significant Cash and Contractual Obligations**

The following table summarizes certain significant cash and contractual obligations as of September 30, 2008 that will affect the Company's future liquidity (in millions):

Line of credit	Payments Due By Period				
	Total	Less Than 1 Year	1-3 Years	4-5 Years	More Than 5 Years
Operating leases <sup>(1)</sup>	\$ 40.0	\$ 40.0	\$	\$	\$
Unconditional purchase obligations <sup>(2)</sup>	35.1	11.0	12.8	5.6	5.7
Deferred compensation <sup>(3)</sup>	118.7	67.9	49.4	1.3	0.1
Uncertain income tax contingencies <sup>(4)</sup>	7.0	0.6	0.3	0.3	5.8
Total <sup>(5)</sup>	15.1	1.0	4.6	6.0	3.5
	\$ 215.9	\$ 120.5	\$ 67.1	\$ 13.2	\$ 15.1

- (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 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 \$8.0 million at September 30, 2008.
- (4) Amount represents total uncertain income tax positions related to the adoption of FIN 48, which is comprised of a short-term income tax payable of \$1.2 million and a long-term income tax payable of \$13.9 million. For further discussion see Note 4 to the Consolidated Condensed Financial Statements – Income Taxes in this Form 10-Q.
- (5) During the third quarter of 2001, the Company entered into a derivative commodity instrument to manage electricity costs in the volatile California energy market. The contract was originally effective through May 2006. During the fourth quarter of 2001, the Company notified the energy supplier that, among other things, the energy supplier was in default of the energy supply contract and that based upon such default, and for other reasons, the Company was terminating the energy supply contract. The Company continues to reflect the \$19.9 million derivative valuation account on its balance sheet, subject to periodic review, in accordance with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of*

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*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 9 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 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" ) (see Note 6 to the Consolidated Condensed Financial Statements - Investments in this Form 10-Q). 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 September 30, 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 \$45 to \$50 million for the year ended December 31, 2008. Of this amount, approximately \$12 million will be used in support of the Company's building improvement and

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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 6 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 is scheduled to expire one year from the date of issuance.

In addition, at September 30, 2008, the Company had total outstanding commitments on non-cancelable operating leases of approximately \$35.1 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 Form 10-K for the fiscal year ended December 31, 2007.

### **Item 3. *Quantitative and Qualitative Disclosures about Market Risk***

The Company uses derivative financial instruments for hedging purposes to mitigate 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 13 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, 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

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sales by the Company's wholly-owned European subsidiary for certain Euro denominated transactions. Hedged transactions are denominated primarily in European currencies, Japanese Yen, 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 September 30, 2008 and 2007, the notional amounts of the Company's foreign exchange contracts used to hedge outstanding balance sheet exposures were approximately \$62.3 million and \$39.4 million, respectively. At September 30, 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 September 30, 2008 through its derivative financial instruments.

The estimated maximum one-day loss from the Company's foreign currency derivative financial instruments, calculated using the sensitivity analysis model described above, is \$6.6 million at September 30, 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 \$6.6 million at September 30, 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 8 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 \$0.7 million in additional interest expense if interest rates were to increase by 10% over a three month period.

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**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 September 30, 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 September 30, 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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**Table of Contents****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 golf equipment manufacturers to encourage Chinese and other foreign government officials to conduct raids of identified counterfeiters, resulting in the seizure and destruction of counterfeit golf clubs and, in some cases, criminal prosecution of the counterfeiters. 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 family of 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 family of golf balls collectively infringe 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 family of golf balls. Acushnet has asked the Court to enter judgment notwithstanding the verdict or, alternatively, for a new trial. Those post-trial motions are pending.

Acushnet 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 has issued multiple administrative decisions 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



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appeal such actions to the Board of Patent Appeals and then, if not successful, to the United States Court of Appeals for the Federal Circuit. In the meantime, 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, against Acushnet Company asserting that sales of certain Titleist and Cobra branded drivers infringe one or more of Callaway Golf's U.S. patent numbers 6,348,015; 6,478,692; 6,669,579; 6,685,576; and 6,949,032. In a counterclaim, Acushnet has asserted that sales of certain Callaway Golf drivers infringe one or more of three patents issued to Acushnet, namely U.S. patent numbers 6,960,142, 7,041,003, and 7,140,975. The parties have agreed in principle to resolve this matter on confidential terms.

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. The Plans filed a counterclaim to compel an audit and to recover unpaid Plan contributions, as well as liquidated damages, interest, and reasonable audit and attorneys' fees. The Company recently agreed to dismiss its claims against SAG in return for SAG's agreement to be bound by the result of the Company's litigation with the Plans. A pretrial conference is set for February 9, 2009. 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 had thirty (30) days from the date of notice in which to cure a default. Ashworth denied that any breach has occurred, and did not take 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 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 demanded binding arbitration of its right to terminate. The arbitration is set to commence on November 3, 2008. Ashworth announced on October 13, 2008, that TaylorMade-adidas Golf, through a subsidiary of TaylorMade Golf Company, Inc., is seeking to acquire all of the shares of Ashworth in a tender offer of \$1.90 per share. A change in control of Ashworth provides Callaway Golf with additional termination rights pursuant to the Agreement.

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, CX Cart, Euro Stand, and Matrix 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 Company has answered the complaint denying that it infringes the patents. Discovery has not yet commenced and no trial date has been set.

On May 8, 2008, Mr. Inaba filed a suit against Callaway Golf Japan in the Osaka District Court in Japan. Mr. Inaba has alleged that certain golf balls sold by Callaway Golf Japan with a hex aerodynamic pattern infringe his Japanese utility design patent No. 3,478,303 and his Japanese design patent No. 1,300,582. Mr. Inaba is seeking damages pursuant to a royalty based on sales. The Court has ordered Callaway Golf Japan to submit a brief outlining its non-infringement and invalidity positions on or before October 30, 2008, and set a further hearing for November 7, 2008 to consider Callaway Golf Japan's defenses.

On May 13, 2008, Clear with Computers, LLC (CWC) filed a patent infringement suit against Callaway Golf Company, Callaway Golf Interactive, Inc., and forty-five other defendants in the Eastern District of Texas.

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CWC alleges that Callaway Golf's websites (www.callawaygolf.com, www.odysseygolf.com, www.benhogan.com, and www.topflite.com) infringe U.S. Pat. Nos. 5,615,342 and 5,367,627, relating to computer-assisted proposal generation and part sales methods. Pursuant to its complaint, CWC seeks compensatory damages and an injunction. Callaway Golf Company and Callaway Golf Interactive, Inc. have answered the complaint, denying infringement and asserting that the patents are invalid. At a scheduling conference held on October 6, 2008, the Court set various pretrial dates and a trial date on March 8, 2010.

On July 11, 2008, the Company was sued in the Eastern District of Texas by Nicholas Colucci, dba EZ Line Putters, pursuant to a complaint asserting that the Odyssey White Hot XG No. 7, White Hot XG (Long) No. 7, Black Series i No. 7, and White Hot XG Sabertooth putters infringe U.S. Patent No. 4,962,927 and infringe the alleged trade dress of plaintiff's EZ Line putters. The Company responded to the complaint on September 5, 2008, denying that it infringes the patent or the trade dress. Pursuant to a scheduling conference held on October 6, 2008, the Court set various pretrial deadlines and a trial date of March 1, 2010.

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

### **Item 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 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 September 30, 2008, the Company repurchased 219,000 shares of its common stock at a weighted average cost per share of \$13.21 for a total cost of \$2.9 million under the November 2007 repurchase program. As of September 30, 2008, the Company remained authorized to repurchase up to an additional \$77.0 million of its common stock under this program.

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

		Three Months Ended September 30, 2008			
		Total Number of Shares Purchased	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Dollar Value that May Yet Be Purchased Under the Programs
July 1, 2008	July 31, 2008		\$		\$ 79,924
August 1, 2008	August 31, 2008	219	\$ 13.21	219	\$ 77,030
September 1, 2008	September 30, 2008		\$		\$ 77,030
Total		219	\$ 13.21	219	\$ 77,030

**Item 3. Defaults upon Senior Securities**

None.

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

None.

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**Item 5. Other Information**

None.

**Item 6. Exhibits**

- 3.1 Certificate of Incorporation, incorporated herein by this reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, as filed with the Securities and Exchange Commission ( Commission ) on July 1, 1999 (file no. 1-10962).
- 3.2 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).
- 10.50 Callaway Golf Company First Amended and Restated Chief Executive Officer Employment Agreement, effective as of September 3, 2008, by and between Callaway Golf Company and George Fellows, incorporated herein by this reference to Exhibit 10.50 to the Company's Current Report on Form 8-K, as filed with the Commission on September 5, 2008 (file no. 1-10962).
- 10.51 Notice of Grant of Stock Option and Option Agreement, effective as of September 3, 2008, by and between Callaway Golf Company and George Fellows, incorporated herein by this reference to Exhibit 10.51 to the Company's Current Report on Form 8-K, as filed with the Commission on September 5, 2008 (file no. 1-10962).
- 10.52 Employee Stock Unit Grant Agreement, effective as of September 3, 2008, by and between Callaway Golf Company and George Fellows, incorporated herein by this reference to Exhibit 10.52 to the Company's Current Report on Form 8-K, as filed with the Commission on September 5, 2008 (file no. 1-10962).
- 10.53 Cash Unit Grant Agreement, effective as of September 3, 2008, by and between Callaway Golf Company and George Fellows, incorporated herein by this reference to Exhibit 10.53 to the Company's Current Report on Form 8-K, as filed with the Commission on September 5, 2008 (file no. 1-10962).
- 31.1 Certification of George Fellows pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Bradley J. Holiday pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of George Fellows and Bradley J. Holiday pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

( ) Included 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: October 30, 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.
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.