

ADAMS GOLF INC
Form 10-Q
November 08, 2006

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

FORM 10-Q

(Mark One)

☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006

or

☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number: 0-24583

ADAMS GOLF, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

75-2320087

(I.R.S. Employer Identification No.)

300 Delaware Avenue, Suite 572, Wilmington, Delaware
(Address of principal executive offices)

19801
(Zip Code)

(302) 427-5892

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

☒ Yes ☐ No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one)

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

☐ Yes ☒ No

The number of outstanding shares of the Registrant's common stock, par value \$.001 per share, was 23,660,860 on November 3, 2006.

ADAMS GOLF, INC. AND SUBSIDIARIES

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ADAMS GOLF, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

ASSETS

September 30, December 31,
2006 2005
(unaudited)

Current assets:		
Cash and cash equivalents	\$ 11,701	\$ 10,747
Trade receivables, net of allowance for doubtful accounts of \$624 (unaudited) and \$952 in 2006 and 2005, respectively	13,869	14,171
Inventories, net	22,869	16,151
Prepaid expenses	759	754
Other current assets	<u>14</u>	<u>27</u>
Total current assets	49,212	41,850
Property and equipment, net	635	630
Other assets, net	<u>1,231</u>	<u>1,622</u>
	\$ 51,078	\$ 44,102

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	\$ 7,228	\$ 4,691
Accrued expenses	<u>6,296</u>	<u>7,284</u>
Total liabilities	<u>13,524</u>	<u>11,975</u>
Stockholders' equity:		
Preferred stock, \$0.01 par value; authorized 5,000,000 shares; none issued	--	--
Common stock, \$.001 par value; authorized 50,000,000 shares; 24,454,994 and 23,471,653 shares issued and 23,660,110 and 22,814,153 shares outstanding at September 30, 2006 (unaudited) and December 31, 2005, respectively	24	23
Additional paid-in capital	90,280	89,499
Accumulated other comprehensive income	1,099	888
Accumulated deficit	(50,527)	(55,147)
Treasury stock, 794,884 and 657,500 common shares, at cost, at September 30, 2006 (unaudited) and December 31, 2005,	<u>(3,322)</u>	<u>(3,136)</u>

respectively

Total stockholders' equity	<u>37,554</u>	<u>32,127</u>
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\$ 51,078	\$ 44,102
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Contingencies

See accompanying notes to unaudited condensed consolidated financial statements.

ADAMS GOLF, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (in thousands, except per share amounts) (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Net sales	\$ 14,960	\$ 10,180	\$ 62,958	\$ 46,769
Cost of goods sold	<u>8,575</u>	<u>6,027</u>	<u>34,952</u>	<u>24,734</u>
Gross profit	6,385	4,153	28,006	22,035
Operating expenses:				
Research and development expenses	652	598	1,889	1,725
Selling and marketing expenses	4,292	4,172	15,805	13,435
General and administrative expenses	1,979	1,649	5,820	5,474
Reversal of settlement expenses	<u>-</u>	<u>(1,788)</u>	<u>-</u>	<u>(1,771)</u>
Total operating expenses	<u>6,923</u>	<u>4,631</u>	<u>23,514</u>	<u>18,863</u>
Operating income (loss)	<u>(538)</u>	<u>(478)</u>	<u>4,492</u>	<u>3,172</u>
Other income (expense):				
Interest income (expense), net	68	68	146	154
Other income (expense), net	<u>(8)</u>	<u>12</u>	<u>35</u>	<u>1,005</u>
Income (loss) before income taxes	<u>(478)</u>	<u>(398)</u>	<u>4,673</u>	<u>4,331</u>
	<u>22</u>	<u>6</u>	<u>53</u>	<u>64</u>
Income tax expense				
Net income (loss)	\$ (500)	\$ (404)	\$ 4,620	\$ 4,267
Net income (loss) per common share - basic	\$ (0.02)	\$ (0.02)	\$ 0.20	\$ 0.19
diluted	\$ (0.02)	\$ (0.02)	\$ 0.16	\$ 0.15

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See accompanying notes to unaudited condensed consolidated financial statements.

ADAMS GOLF, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(in thousands, except share amounts)

Nine Months Ended September 30, 2006
(unaudited)

	Shares of		Additional	Accumulated			Cost of	Total
	Common	Common	Paid-in	Other	Accumulated	Comprehensive	Treasury	Stockholders'
	<u>Stock</u>	<u>Stock</u>	<u>Capital</u>	<u>Income</u>	<u>Deficit</u>	<u>Income</u>	<u>Stock</u>	<u>Equity</u>
Balance, December 31, 2005	23,471,653	\$ 23	\$ 89,499	\$ 888	\$ (55,147)		\$ (3,136)	\$ 32,127
Comprehensive income:								
Net income	--	--	--	--	4,620	\$ 4,620	--	4,620
Foreign currency translation	--	--	--	211	--	<u>211</u>	--	211
Comprehensive income	--	--	--	--	--	\$ 4,831	--	--
Stock options exercised	983,341	1	2	--	--		--	3
Treasury stock purchases (137,384 shares)	--	--	--	--	--		(186)	(186)
Amortization of deferred compensation	<u>--</u>	<u>--</u>	<u>779</u>	<u>--</u>	<u>--</u>		<u>--</u>	<u>779</u>
Balance, September 30, 2006	24,454,994	\$ 24	\$ 90,280	\$ 1,099	\$ (50,527)		\$ (3,322)	\$ 37,554

See accompanying notes to unaudited condensed consolidated financial statements.

ADAMS GOLF, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

Nine Months Ended
September 30,

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	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Net income	\$ 4,620	\$ 4,267
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization of property and equipment and intangible assets	255	340
Amortization of deferred compensation	779	1,157
Provision for doubtful accounts	632	350
Reversal of settlement expense	--	(1,771)
Changes in assets and liabilities:		
Trade receivables	(331)	(5,123)
Inventories	(6,718)	(1,466)
Prepaid expenses	(5)	(2,222)
Other current assets	13	123
Other assets	391	21
Accounts payable	2,537	1,502
Accrued expenses	<u>(953)</u>	<u>(326)</u>
Net cash provided by (used in) operating activities	1,220	(3,148)
Cash flows from investing activities:		
Purchases of equipment	<u>(262)</u>	<u>(265)</u>
Net cash provided by (used in) investing activities	(262)	(265)
Cash flows from financing activities:		
Principal payments under capital lease obligation	(32)	(32)
Exercise of stock options	3	38
Treasury stock purchase	(186)	--
Debt financing costs	<u>--</u>	<u>(2)</u>
Net cash provided by (used in) financing activities	(215)	4
Effects of exchange rate changes on cash and cash equivalents	<u>211</u>	<u>351</u>
Net increase (decrease) in cash and cash equivalents	954	(3,058)
Cash and cash equivalents at beginning of period	<u>10,747</u>	<u>16,367</u>
Cash and cash equivalents at end of period	\$ 11,701	\$ 13,309
Supplemental disclosure of cash flow information		
Interest paid	\$ 3	\$ 5
Income taxes paid	\$ 53	\$ 64

See accompanying notes to unaudited condensed consolidated financial statements.

ADAMS GOLF, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

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The unaudited condensed consolidated financial statements of Adams Golf, Inc. and its subsidiaries (the "Company", "Adams Golf", "we", "us", or "our") for the three and nine month period ended September 30, 2006 and 2005 have been prepared by us pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). The information included reflects all adjustments (consisting only of normal recurring accruals and adjustments) which are, in the opinion of management, necessary to fairly state the operating results for the respective periods. However, these operating results are not necessarily indicative of the results expected for the full fiscal year. Certain information and footnote disclosures normally included in annual consolidated financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to SEC rules and regulations. The notes to the unaudited condensed consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements contained in our 2005 Annual Report on Form 10-K filed, as amended, with the SEC on March 22, 2006.

Founded in 1987, Adams Golf, Inc initially operated as a component supplier and contract manufacturer. Thereafter, we established our custom fitting operation. Today we design, assemble, market and distribute premium quality, technologically innovative golf clubs, including the RPM drivers and fairway woods, Ovation drivers and fairway woods, the Idea A2 and A2 OS irons, and Idea A2 I-woods, Idea Pro irons, Idea, A1 and A1 Pro Irons and Idea i-Woods, the Tight Lies family of fairway woods, the Redline family of fairway woods and drivers, the Tight Lies GT3 and GT2 irons and i-Woods, the Tom Watson signature and Puglielli series of wedges, and certain accessories. Our Company was incorporated in 1987 and re-domesticated in Delaware in 1990. We completed an internal reorganization in 1997, and we now conduct our operations through several direct and indirect wholly-owned subsidiaries, agencies and distributorships.

2. Inventories

Inventories consisted of the following on the dates indicated (in thousands):

	September 30, <u>2006</u> (unaudited)	December 31, <u>2005</u>
Finished goods	\$ 12,373	\$ 7,453
Component parts	<u>10,496</u>	<u>8,698</u>
Total Inventory	\$ 22,869	\$ 16,151

Inventory is determined using the first-in, first-out method and is recorded at the lower of cost or market value. The inventory balance is comprised of the following: purchased raw materials or finished goods at their respective purchase costs; labor, assembly and other capitalizable overhead costs, which are then applied to each unit after work in process is completed; retained costs representing the excess of manufacturing and other overhead costs that are not yet applied to finished goods; and an estimated allowance for obsolete inventory. At September 30, 2006 and December 31, 2005, inventories included \$572,000 and \$837,000 of consigned inventory, respectively, and \$152,000 and \$215,000 of inventory reserves, respectively.

ADAMS GOLF, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

3. Accrued Expenses

Accrued expenses consisted of the following on the dates indicated (in thousands):

	September 30, <u>2006</u> (unaudited)	December 31, <u>2005</u>
Payroll and commissions	\$ 1,293	\$ 1,362
Advertising	345	130
Product warranty expense and sales returns	1,527	1,546

Professional services	29	43
Deferred revenue	911	1,895
Accrued inventory	239	1,242
Accrued sales promotions	1,003	683
Other	<u>949</u>	<u>383</u>
Total accrued expenses	\$ 6,296	\$ 7,284

4. Income (Loss) per Common Share

The weighted average common shares used for determining basic and diluted loss per common share was

23,241,269, for the three months ended September 30, 2006, and 22,691,023, for the three months ended September 30, 2005.

The effect of all warrants and options to purchase shares of the Company's common stock for the three months ended September 30, 2006 and 2005 were excluded from the calculation of dilutive shares as the effect of inclusion would have been antidilutive.

The weighted average common shares used for determining basic and diluted income per common share were 23,155,348 and 28,774,296, respectively, for the nine months ended September 30, 2006, and 22,678,391 and 28,494,773, respectively, for the nine months ended September 30, 2005.

The effect of all warrants and options to purchase shares of our common stock for the nine months ended September 30, 2006 resulted in additional dilutive shares of 5,618,948. The effect of all warrants and options to purchase shares of the Company's common stock for the nine months ended September 30, 2005 resulted in additional dilutive shares of 5,816,382.

ADAMS GOLF, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

5. Geographic Segment and Data

We generate substantially all revenues from the design, assembly, marketing and distribution of premium quality, technologically innovative golf clubs and accessories. Our products are distributed in both domestic and international markets. Net sales by customer for these markets consisted of the following during the periods indicated (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(unaudited)		(unaudited)	
United States	\$ 12,855	\$ 8,971	\$ 51,755	\$ 40,134
Rest of World	<u>2,105</u>	<u>1,209</u>	<u>11,203</u>	<u>6,635</u>
Total Net Sales	\$ 14,960	\$ 10,180	\$ 62,958	\$ 46,769

Foreign net sales are generated in various regions including, but not limited to, Canada (a majority of our foreign sales), Europe, Japan, Australia, South Africa, and South America. A change in our relationship with one or more of our customers or distributors could negatively impact the volume of foreign sales.

6. Income Taxes

We account for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized

for the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the realizability of deferred income tax assets, we consider whether it is more likely than not that some portion or all of the deferred income tax assets will be realized. The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Due to our historical operating results, management is unable to conclude on a more likely than not basis that all deferred income tax assets generated from net operating losses and other deferred tax assets through December 31, 2002 will be realized. Accordingly, we have recognized a valuation allowance equal to the entire deferred income tax asset. Although we have carryforwards due to historical losses, current tax law for calculating Alternative Minimum Tax allows us to use carryforwards only up to 90% of the annual liability. Accordingly, AMT tax expense for the three months ended September 30, 2006 and 2005 was \$22,000 and \$6,000, respectively, and for the nine months ended September 30, 2006 and 2005 was \$53,000 and \$64,000, respectively.

7. Reclassifications

Certain prior period amounts have been reclassified to conform to current period presentation.

8. Comprehensive Income

Comprehensive income for the nine months ended September 30, 2006 was approximately \$4.8 million.

ADAMS GOLF, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

9. Stock-Based Compensation

In May 2002, the Company adopted the 2002 Equity Incentive Plan for employees, outside directors and consultants. The plan allows for the granting of up to 2,500,000 shares of our common stock at the inception of the plan, plus all shares remaining available for issuance under all predecessor plans on the effective date of this plan, and additional shares as defined in the plan. In addition, the plan automatically increases 1,000,000 shares available for granting on January 1 of each subsequent year for years 2003 through 2008. At September 30, 2006, 5,887,465 outstanding options had been granted with exercise prices at \$0.01 per share at the date of grant. The requisite service periods for the options to vest vary from six months to four years and the options expire ten years from the date of grant. At September 30, 2006, 2,184,632 shares remain available for grant, including forfeitures.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123R"), which established accounting standards for transactions where the entity exchanges equity instruments for goods and services. The revision of this statement focuses on the accounting for transactions where the entity obtains employee services in share-based payment transactions. This statement revision eliminates the alternative use of APB 25 intrinsic value method and requires that entities adopt the fair-value method for all share-based transactions. We adopted the provisions of this standard on a modified prospective basis on January 1, 2006. The following table illustrates the effect on net income (loss) and income (loss) per share for the prior year period as if we had applied the fair value recognition provisions of SFAS 123 and SFAS 148 to stock-based employee compensation for the three and nine months ended September 30, 2005 (in thousands, except for per share amounts):

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	<u>For the Three</u> <u>Months ended</u> <u>September 30, 2005</u>	<u>For the Nine</u> <u>Months ended</u> <u>September 30, 2005</u>
--	--	---

Net income (loss):		
As reported	\$ (404)	\$ 4,267
Add: Stock-based compensation expense included in reported net income, net of related tax effects	324	1,157
Deduct: Total stock-based compensation expense determined under the fair value method	<u>(391)</u>	<u>(1,242)</u>
Pro forma	<u>\$ (471)</u>	<u>\$ 4,182</u>
	=====	=====
Basic income (loss) per common share:		
As reported	\$ (0.02)	\$ 0.19
Pro forma	(0.02)	0.18
Diluted income (loss) per common share:		
As reported	\$ (0.02)	\$ 0.15
Pro forma	(0.02)	0.15

ADAMS GOLF, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

9. Stock-Based Compensation (Continued)

The per share weighted-average fair value of stock options granted during the nine months ended September 30, 2006 and 2005 was \$1.09 and \$1.38, respectively, on the date of grant using the Black Scholes option pricing model with the following weighted-average assumptions: Risk free interest rate, 3.5%; expected life, 10 years; expected dividend yield, 0%; and expected volatility, based on historical daily annualized volatility, of 107.4% and 111.4% during the nine months ended September 30, 2006 and 2005, respectively. We use historical data to estimate option exercise and employee termination factors within the valuation model.

	<u>Number of</u> <u>Outstanding</u> <u>Shares</u>	<u>Weighted</u> <u>Average</u> <u>Exercise price</u>	<u>Aggregate</u> <u>Intrinsic</u> <u>Value of options</u>
Options outstanding at December 31, 2005	7,170,806	\$ 0.03	
Options granted	50,000	1.18	
Options forfeited / expired	(100,000)	0.74	
Options exercised	<u>(983,341)</u>	<u>0.01</u>	\$ 1,344,010
Options outstanding at September 30, 2006	6,137,465	0.04	8,368,077
Options exercisable at September 30, 2006	3,568,370	0.03	4,896,535

The weighted average contractual life of the options outstanding at September 30, 2006 was 7.72 years and for options exercisable at September 30, 2006 was 7.08 years.

The effect of compensation expense associated with adopting SFAS 123R for the three and nine months ended September 30, 2006, had an expense effect on income from operations, income before taxes and net income associated with stock options and warrants of \$260,000 and \$779,000, respectively. The reported basic and diluted earnings per

share were both \$(0.02) for the three months ended September 30, 2006 and \$0.20 and \$0.16, respectively for the nine months ended September 30, 2006. Had we not adopted SFAS 123R, the effect to net income under APB 25 would have been \$271,000 and \$814,000 for the three and nine months ended September 30, 2006, respectively. The basic and diluted earnings per share would have both been \$(0.02) for the three months ended September 30, 2006 and \$0.20 and \$0.16, respectively for the nine months ended September 30, 2006.

Upon the adoption of SFAS 123R in January 2006, the deferred stock-based compensation balance of approximately \$1,845,000 and \$2,570,000 were netted into additional paid in capital at September 30, 2006 and December 31, 2005, respectively.

Under the provisions of the 2002 Equity Incentive Plan, the Company has the authority to repurchase the taxable portion of the employee's shares that become outstanding after the employee exercises their options. At August 15, 2006, the Company repurchased 137,384 shares of common stock at an average price per share of \$1.35 for a total cost of approximately \$186,000. The repurchased shares are held in treasury.

ADAMS GOLF, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

9. Stock-Based Compensation (Continued)

Due to the passage of The American Jobs Creation Act and the subsequent IRS Section 409A rules, stock options that were issued at a strike price less than market value at the date of grant will now be considered deferred compensation by the Internal Revenue Service and the individual who was granted the options will incur adverse tax consequences, including but not limited to excise taxes, unless the individual deemed the future exercise date of the unvested stock options at December 31, 2004 and made this election before December 31, 2005. As a result of our compliance with the American Job Creation Act, a summary of the elected future exercise dates of our employees and consultants who received grants that are subject to section 409A is as follows:

<u>Period of Exercise</u>	<u>Total Options to be exercised</u>
2006	440,232
2007	1,194,667
2008	777,695
2009	360,000
2010	60,000
Beyond 2010	353,199
Total Options	3,185,793
	=====

10. New Accounting Pronouncements

There have been no new material accounting pronouncements that are applicable to our business for this period.

11. Liquidity

In February 2006, we signed a revolving credit agreement with Bank of Texas to provide up to \$10.0 million in short term debt. The agreement is collateralized by all of our assets and requires, among other things, us to maintain certain financial performance levels relative to the cash flow leverage ratio and fixed charge coverage ratio, but only when we have an outstanding balance on the facility. Interest on outstanding balances varies depending on the portion of the

line that is used and accrues at a rate from prime less one percent to prime and is due quarterly.

Our anticipated sources of liquidity over the next twelve months are expected to be cash reserves, projected cash flows from operations, and available borrowings under our credit facility. We anticipate that operating cash flows and current cash reserves will also fund capital expenditure programs. These capital expenditure programs can be suspended or delayed at any time with minimal disruption to our operations if cash is needed in other areas of our operations. In addition, cash flows from operations and cash reserves will be used to support ongoing purchases of component parts for our current and future product lines. The expected operating cash flow, current cash reserves and borrowings available under our credit facility are expected to allow us to meet working capital requirements during periods of low cash flows resulting from the seasonality of the industry.

ADAMS GOLF, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

11. Liquidity (continued)

Management believes that sufficient resources will be available to meet our cash requirements through the next twelve months. Cash requirements beyond twelve months are dependent on our ability to introduce products that gain market acceptance and to manage working capital requirements. We have introduced new products and taken steps to increase the market acceptance of these and our other products. If our products fail to achieve appropriate levels of market acceptance, it is possible that we may have to raise additional capital and/or further reduce our operating expenses including further operational restructurings. If we need to raise additional funds through the issuance of equity securities, the percentage ownership of our stockholders would be reduced, stockholders could experience additional dilution, or such equity securities could have rights, preferences or privileges senior to our common stock. Nevertheless, given the current market price of our common stock and the state of the capital markets generally, we do not expect that we will be able to raise funds through the issuance of our capital stock in the foreseeable future. We may also find it difficult to secure additional debt financing. There can be no assurance that financing will be available when needed on terms favorable to us, or at all. Accordingly, it is possible that our only sources of funding will be current cash reserves, projected cash flows from operations and up to \$10.0 million of borrowings available under our revolving credit facility.

If adequate funds are not available or not available on acceptable terms, we may be unable to continue operations; develop, enhance and market products; retain qualified personnel; take advantage of future opportunities; or respond to competitive pressures, any of which could have a material adverse effect on our business, operating results, financial condition and/or liquidity.

12. Contingencies

Beginning in June 1999, the first of seven class action lawsuits was filed against us, certain of our current and former officers and directors, and the three underwriters of our initial public offering ("IPO") in the United States District Court of the District of Delaware. The complaints alleged violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, as amended, in connection with our IPO. In particular, the complaints alleged that our prospectus, which became effective July 9, 1998, was materially false and misleading in at least two areas. Plaintiffs alleged that the prospectus failed to disclose that unauthorized distribution of our products (gray market sales) threatened our long-term profits. Plaintiffs also alleged that the prospectus failed to disclose that the golf equipment industry suffered from an oversupply of inventory at the retail level, which had an adverse impact on our sales. On May 17, 2000, these cases were consolidated into one amended complaint, and a lead plaintiff was appointed. The plaintiffs were seeking unspecified amounts of compensatory damages, interest and costs, including legal fees. On December 10, 2001, the

United States District Court for the District of Delaware dismissed the consolidated, amended complaint. Plaintiffs appealed. On August 25, 2004, the appellate court affirmed the dismissal of plaintiffs' claims relating to oversupply of retail inventory, while reversing the dismissal of the claims relating to the impact of gray market sales and remanding those claims for further proceedings. On August 3, 2005, the district court certified a class of section 11 claimants, but shortened the proposed class period to end on October 22, 1998, and declined to certify a section 12(a)(2) class against the Adams Golf defendants. On September 1, 2005, plaintiffs filed a motion for leave to amend their complaint, which was granted on January 24, 2006. Defendants filed a motion to dismiss the second amended complaint ("SAC"), which the District Court granted in part and denied in part on April 10, 2006. Now, in addition to the gray-market sales claim, the SAC alleges that the prospectus failed to disclose that we engaged in questionable sales practices (including double shipping and unlimited rights of return), which threatened post-IPO financial results. Fact discovery closed on June 30, 2006. Trial is currently set for June 18, 2007.

ADAMS GOLF, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

12. Contingencies (continued)

We maintain directors' and officers' ("D&O") and corporate liability insurance to cover certain risks associated with these securities claims filed against us or our directors and officers. During the period covering the class action lawsuit, we maintained insurance from multiple carriers, each insuring a different layer of exposure, up to a total of \$50 million. In addition, we have met the financial deductible of our directors' and officers' insurance policy for the period covering the time the class action lawsuit was filed. Specifically, Zurich American Insurance Company provided insurance coverage totaling \$5 million for the layer of exposure between \$15 million and \$20 million. On March 30, 2006, Zurich American Insurance Company notified us that it was denying coverage due to the fact that it was allegedly not timely notified of the class action lawsuit. We are currently assessing whether Zurich's denial of coverage is appropriate and the effect, if any, the denial has on insurance coverage for the layers of exposure exceeding \$20 million. At this point in the legal proceedings, we cannot predict with any certainty the outcome of the matter, per the guidance in SFAS 5, and thus can not reasonably estimate future liability on the conclusion of the events, if any.

The underwriters for the IPO are also defendants in the securities class action. The underwriting agreement that we entered into with the underwriters in connection with the IPO contains an indemnification clause, providing for indemnification against any loss, including defense costs, arising out of the IPO. After the first lawsuit was filed, the underwriters requested indemnification under the agreement. Our D&O insurance policy included an endorsement providing \$1 million to cover indemnification of the underwriters. Our D&O insurer has notified the underwriters of the exhaustion of the \$1 million sublimit. We believe that the \$1 million payment under the insurance policy satisfies our indemnification obligation, or alternatively, that there are reasons why the Company may not have any further indemnification obligations. We are in negotiations with the underwriters, and if necessary, may dispute any further requests for indemnification. At this point, we cannot predict with any certainty the outcome of the matter, per the guidance in SFAS 5, and thus cannot reasonably estimate future liability on the conclusion of the events, if any.

On March 16, 2006, we became aware of a lawsuit filed against us in U.S. District Court in the Southern District of California by TaylorMade, a division of Adidas-Salomon AG. The lawsuit alleges generally that we violated three patents held by TaylorMade (one design patent and two utility patents) in the manufacture of drivers. We have engaged in settlement negotiations with TaylorMade with the common goal of finalizing the settlement agreement by the end of December 2006.

From time to time, we are engaged in various other legal proceedings in the normal course of business. The ultimate liability, if any, for the aggregate amounts claimed cannot be determined at this time.

13. Business and Credit Concentrations

We are currently dependent on five customers, which collectively comprised approximately 28% of net sales for the three months ended September 30, 2006. Of these, two customers individually represented greater than 5% but less than 10% of net sales, and no customers represented greater than 10%. For the three months ended September 30, 2005, three customers comprised approximately 25% of net sales while two customers individually represented greater than 5% but less than 10% of total net sales.

For the nine months ended September 30, 2006, we are currently dependent on four customers, which collectively comprised approximately 25% of net sales. Of these, two customers individually represented greater than 5% but less than 10% of net sales, and no customers represented greater than 10%. For the nine months ended September 30, 2005, four customers comprised approximately 25% of net sales while one customer individually represented greater than 5% but less than 10% of total net sales. Should these customers or our other customers fail to meet their payment obligations to us, our results of operations and cash flows would be adversely impacted.

A significant portion of our inventory purchases are from one supplier. That supplier represents approximately 64% and 53% of total inventory purchases for the nine months ended September 30, 2006 and 2005, respectively. This supplier and many other industry suppliers are located in China. We do not anticipate any changes in the relationships with our suppliers; however, if any changes were to occur, we believe we would have alternative sources available although they might result in possible increased costs, potential changes in terms or possible delays in timing.

14. Leased Properties

The Company has added on August 16, 2006 a second location for its warehouse facilities occupying another 29,136 square feet of warehouse space in Plano, Texas, conveniently located to our existing administration and assembly facility. This facility is leased by the Company pursuant to a lease agreement expiring in 2008. The Company believes that its current facilities encompassing both locations will be sufficient for the foreseeable future.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with the attached unaudited condensed consolidated financial statements and notes thereto, and with our consolidated financial statements and notes thereto for the year ended December 31, 2005 included in our Annual Report on Form 10-K, as amended, filed with the SEC on March 22, 2006.

Forward Looking Statements

This Quarterly Report contains "forward-looking statements" made under the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. The statements include, but are not limited to: statements regarding pending litigation, statements regarding liquidity and our ability to increase revenues or achieve satisfactory operational performance, statements regarding our ability to satisfy our cash requirements and our ability to satisfy our capital needs, including cash requirements during the next twelve months, statements regarding our ability to produce products commercially acceptable to consumers and statements using terminology such as "may," "will," "expect," "intend," "estimate," "anticipate," "plan," "seek" or "believe". Such statements reflect our current view with respect to future events and are subject to certain risks, uncertainties and assumptions related to certain factors including,

without limitation, the following:

- Product development difficulties;
- Product approval and conformity to governing body regulations;
- Assembly difficulties;
- Product introductions;
- Patent infringement risks;
- Uncertainty of the ability to protect intellectual property rights;
- Market demand and acceptance of products;
- The impact of changing economic conditions;
- The future market for our capital stock;
- The success of our marketing strategy;
- Our dependence on one supplier for a majority of our inventory products;
- Our dependence on suppliers who are concentrated in one geographic region;
- Our dependence on a limited number of customers;
- Business conditions in the golf industry;
- Reliance on third parties, including suppliers;
- The impact of market peers and their respective products;
- The actions of competitors, including pricing, advertising and product development risks concerning future technology;
- The management of sales channels and re-distribution;
- The uncertainty of the results of pending litigation;
- The adequacy of the allowance for doubtful accounts, obsolete inventory and warranty reserves;
- The risk associated with the events that may prove unrecoverable under existing insurance policies; and
- The impact of operational restructuring on operating results and liquidity and one-time events and other factors detailed in this Quarterly Report under "Risk Factors" in Part II, Item 1A, below.

Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Based upon changing conditions, should any one or more of these risks or uncertainties materialize, or should any underlying assumptions prove incorrect, actual results may vary materially from those described herein. Except as required by federal securities laws, we undertake no obligation to publicly update or revise any written or oral forward-looking statements, whether as a result of new information, future events, changed circumstances or any other reason after the date of this Quarterly Report. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the applicable cautionary statements.

Overview

Founded in 1987, Adams Golf, Inc. initially operated as a component supplier and contract manufacturer. Thereafter, we established our custom fitting operation. Today we design, assemble, market and distribute premium quality, technologically innovative golf clubs, including RPM drivers and fairway woods, Ovation drivers and fairway woods, the Idea A2 and A2 OS irons, and Idea A2 I-woods, Idea Pro irons, Idea, A1 and A1 Pro Irons and Idea i-Woods, the Tight Lies family of fairway woods, the Redline family of fairway woods and drivers, the Tight Lies GT3 and GT2 irons and i-Woods, the Tom Watson signature and Puglielli series of wedges, and certain accessories. Our Company was incorporated in 1987 and re-domesticated in Delaware in 1990. We completed an internal reorganization in 1997, and we now conduct our operations through several direct and indirect wholly-owned subsidiaries, agencies and distributorships.

Our net sales are primarily derived from sales to on- and off- course golf shops and sporting goods retailers and, to a lesser extent, international distributors and mass merchandisers. No assurances can be given that demand for our

current products or the introduction of new products will allow us to achieve historical levels of sales in the future.

We manage all stages of manufacturing, from sourcing to assembly, in order to maintain a high level of product quality and consistency. We establish product specifications, select the material used to produce the components, and test the specifications of components we receive.

As part of our quality control program, we periodically review the quality assurance programs at the manufacturing facilities of our component part suppliers to monitor adherence to design specifications. Upon arrival at our facilities in Plano, Texas, the components used in our clubs are again checked to ensure consistency with our design specifications. Golf clubs are then assembled using the appropriate component parts.

We have put into place a purchasing procedure that strives to negotiate effective terms with various vendors while continuing to ensure quality of components. We are continually re-evaluating existing vendors while testing potential new vendors for all the various product lines we offer. At any time, we may purchase a substantial majority of our volume of a specific component part from a single vendor, but we continually strive to maintain a primary and several secondary suppliers for each component part. Substantially all of our fairway wood, driver, iron, i-wood, wedge and putter component parts are manufactured in China. Since many of our available component suppliers are located in close proximity in Asia, this concentration could adversely effect our ability to obtain components resulting from negative events such as, but not limited to, foreign government relations, import and export control, political unrest, disruptions or delays in shipments and changes in economic conditions and fluctuation in exchange rates. A significant portion of our inventory purchases are from one supplier representing approximately 64% and 53% for the nine months ended September 30, 2006 and 2005, respectively. This supplier and many other industry suppliers are located predominately in China. We do not anticipate any changes in the relationships with our suppliers; however, if such change were to occur, we could, in the future, experience shortages of components or periods of increased price pressures or changes in terms, which could have a material adverse effect on our business, results of operations, financial position and/or liquidity. To date, we have not experienced any material interruptions in supply from any supplier.

Costs of our clubs consist primarily of component parts, including the head, shaft and grip. To a lesser extent, our cost of goods sold includes labor, occupancy and shipping costs in connection with the inspection, testing, assembly and distribution of our products and certain promotional and advertising costs given in the form of additional merchandise as consideration to customers.

Critical Accounting Policies and Estimates

Our discussion and analysis of our results of operations, financial condition and liquidity are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may materially differ from these estimates under different assumptions or conditions. On an on-going basis, we review our estimates to ensure that the estimates appropriately reflect changes in our business.

Inventories

Inventories are valued at the lower of cost or market and primarily consist of finished golf clubs and component parts. Cost is determined using the first-in, first-out method. The inventory balance, which includes material, labor and assembly overhead costs, is recorded net of an estimated allowance for obsolete inventory. The estimated allowance for obsolete inventory is based upon management's understanding of market conditions and forecasts of

future product demand. Accounting for inventories could result in material adjustments if market conditions and future demand estimates are significantly different than original assumptions, causing the reserve for obsolescence to be materially adversely affected.

Revenue Recognition

We recognize revenue when the product is shipped. At that time, the title and risk of loss transfer to the customer and collectability is reasonably assured. Collectability is evaluated on an individual customer basis taking into consideration historical payment trends, current financial position, results of independent credit evaluations and payment terms. Additionally, an estimate of product returns and warranty costs are recorded when revenue is recognized. Estimates are based on historical trends taking into consideration current market conditions, customer demands and product sell through. We also record estimated reductions in revenue for sales programs such as co-op advertising and spiff incentives. Estimates in the sales program accruals are based on program participation and forecast of future product demand. If actual sales returns and sales programs significantly exceed the recorded estimated allowances, our sales would be adversely affected. We recognize deferred revenue as a result of sales that have extended terms and a right of return of the product under a specified program. Once the product is paid for, we then record revenue.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. An estimate of uncollectable amounts is made by management using an evaluation methodology involving both overall and specific identification. We evaluate each individual customer and measure various key aspects of the customer such as, but not limited to, their overall credit risk (via Dun and Bradstreet reports), payment history, track record for meeting payment plans, industry communications, the portion of the customer's balance that is past due and other various items. From an overall perspective, we also look at the aging of the receivables in total and aging relative to prior periods to determine the necessary reserve requirements. Fluctuations in the reserve requirements will occur from period to period as the change in customer mix or strength of the customers could affect the reserve disproportionately compared to the total change in the accounts receivable balance. Based on management's assessment, we provide for estimated uncollectable amounts through a charge to earnings and a credit to the valuation allowance. Balances that remain outstanding after we have used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. We generally do not require collateral. Accounting for an allowance for doubtful accounts could be significantly affected as a result of a deviation in our assessment of any one or more customers' financial strength. While only two customers represent greater than 5% but less than 10% of net sales and no customer represents greater than 10% of the net sales for the three months ended September 30, 2006, if a combination of customers were to become financially impaired, our financial results could be severely affected.

Product Warranty

Our golf equipment is sold under warranty against defects in material and workmanship for a period of one year with the exception of the graphite tipped (GT) and BiMatrx steel tipped (ST) shafts which carry a five year warranty. An allowance for estimated future warranty costs is recorded in the period products are sold. In estimating our future warranty obligations, we consider various relevant factors, including our stated warranty policies, the historical frequency of claims, and the cost to replace or repair the product. Accounting for product warranty reserve could be adversely affected if one or more of our products were to fail (i.e broken shaft, broken head, etc) to a significant degree above and beyond our historical product failure rates, which determine the product warranty accruals.

Income Taxes

We account for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized

for the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the realizability of deferred income tax assets, we consider whether it is more likely than not that some portion or all of the deferred income tax assets will be realized. The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Due to our historical operating results, management is unable to conclude on a more likely than not basis that all deferred income tax assets generated from net operating losses through December 31, 2002 and other deferred tax assets will be realized. Accordingly, we have recognized a valuation allowance equal to the entire deferred income tax asset.

Impairment of Long-Lived Assets

We follow the guidance in SFAS ("Statement of Financial Accounting Standards") 144 in reviewing long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. During the nine months ended September 30, 2006, there was no impairment of long-lived assets.

Key Performance Indicators

Our management team has defined and tracks performance against several key sales, operational and balance sheet performance indicators. Key sales performance indicators include, but are not limited to, the following:

- Daily sales by product group
- Daily sales by geography
- Sales by customer channel
- Gross margin performance
- Market share by product at retail
- Inventory share by product at retail

Tracking these sales performance indicators on a regular basis allows us to understand whether we are on target to achieve our internal sales plans.

Key operational performance indicators include, but are not limited to, the following:

- Product returns (dollars and percentage of sales)
- Product credits (dollars and percentage of sales)
- Units shipped per man-hour worked
- Orders shipped on time
- Expenses by department
- Freight cost by mode (dollars and dollars per unit)

Tracking these operational performance indicators on a regular basis allows us to understand whether we will achieve our expense targets and efficiently satisfy customer demand.

Key balance sheet performance indicators include, but are not limited to, the following:

- Days of sales outstanding
- Days of inventory (at cost)
- Days of payables outstanding

Tracking these balance sheet performance indicators on a regular basis allows us to understand our working capital performance and forecast cash flow and liquidity.

Results of Operations

The following table sets forth operating results expressed as a percentage of net sales for the periods indicated. All information is derived from the accompanying unaudited condensed consolidated financial statements. Results for any one or more periods are not necessarily indicative of annual results or continuing trends. See "Risk Factors" Part II, Item 1A below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(unaudited)		(unaudited)	
Net sales	100.0 %	100.0 %	100.0 %	100.0 %
Cost of goods sold	<u>57.3</u>	<u>59.2</u>	<u>55.5</u>	<u>52.9</u>
Gross profit	42.7	40.8	44.5	47.1
Operating expenses:				
Research and development expenses	4.4	5.9	3.0	3.7
Sales and marketing expenses	28.7	41.0	25.1	28.7
General and administrative expenses	13.2	16.2	9.2	11.7
Reversal of settlement expenses	<u>--</u>	<u>(17.6)</u>	<u>--</u>	<u>(3.8)</u>
Total operating expenses	<u>46.3</u>	<u>45.5</u>	<u>37.3</u>	<u>40.3</u>
Interest income (expense), net	0.5	0.7	0.2	0.3
Other income (expense), net	<u>(0.1)</u>	<u>0.1</u>	<u>0.0</u>	<u>2.1</u>
Income/(loss) before income taxes	(3.2)	(3.9)	7.4	9.2
Income tax expense	<u>0.1</u>	<u>0.1</u>	<u>0.1</u>	<u>0.1</u>
Net income/(loss)	(3.3)%	(4.0)%	7.3 %	9.1 %

Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005

Total net sales increased to \$15.0 million for the three months ended September 30, 2006 from \$10.2 million for the same comparable period of 2005 primarily resulting from the successful product introductions of the Idea Pro Irons coupled with the continued success of Idea A2 and A2 OS Irons sales. Overall, product family life cycles generally range from one to three years, and each product family varies in its life cycle as there are multiple factors influencing the life cycle, such as, but not limited to, customer acceptance, competition and technology.

Net sales of drivers decreased to \$1.5 million, or 10.3% of total net sales, for the three months ended September 30, 2006 from \$3.3 million, or 32.6% of total net sales, for the comparable period of 2005. A large portion of the driver net sales for the three months ended September 30, 2006 was generated by the RPM Ti and RPM Dual product lines, which were introduced in the second quarter of 2005. The overall decrease in driver net revenue results from lower

sales of RPM and Ovation driver product families as they progress farther in their life cycle.

Net sales of irons increased to \$10.2 million, or 68.3% of total net sales, from \$4.2 million, or 40.8% of total net sales, for the three months ended September 30, 2006 and 2005, respectively. The increase was primarily generated from the net sales of Idea A2 and A2 OS irons which were launched in the late part of third quarter 2005 and GT3 Irons while the prior period net sales primarily resulted from the Original Idea irons and A2 and A2 OS irons for a short period of time.

Net sales of fairway woods decreased to \$2.1 million, or 14.0% of total net sales, compared to \$2.6 million, or 25.5% of total net sales, for the three months ended September 30, 2006 and 2005, respectively. This period's net sales were generated from Idea A2, A2 OS and Idea Pro I-woods and the RPM LP Fairway woods. The prior period's net sales were generated from Ovation fairway woods, Idea, A2 and A2 OS I-woods, RPM SS and Ti Fairway woods and Original Tight Lies fairway woods.

We are currently dependent on five customers, which collectively comprised approximately 28% of net sales for the three months ended September 30, 2006. Of these, two customers individually represented greater than 5% but less than 10% of net sales, and no customers represented greater than 10% of net sales. Should these customers or our other customers fail to meet their payment obligations to us, our results of operations and cash flows would be adversely impacted.

Net sales of our products outside the U.S. increased to \$2.1 million, or 14.1% of total net sales, from \$1.2 million, or 11.8% of total net sales, for the three months ended September 30, 2006 and 2005, respectively. Net sales resulting from countries outside the U.S. excluding Canada increased to 5.0% of total net sales for the three months ended September 30, 2006 compared to 1.7% of total net sales for the three months ended September 30, 2005.

Cost of goods sold increased to \$8.6 million, or 57.3% of total net sales, for the three months ended September 30, 2006 from \$6.0 million, or 59.2% of total net sales, for the comparable period of 2005. The decrease as a percentage of total net sales is primarily due to changes in the product mix and stronger selling prices and volume of the A2 and A2 OS irons during this quarter.

Selling and marketing expenses increased to \$4.3 million for the three months ended September 30, 2006 from \$4.2 million for the comparable period in 2005. The increase is primarily the result of additional commission expense of \$0.3 million as a result of the increased net sales during the period.

General and administrative expenses increased to \$2.0 million for the three months ended September 30, 2006 from \$1.6 million for the comparable period in 2005. The increase is primarily a result of \$0.2 million of bad debt expense resulting from our continued efforts to maintain adequate reserves for accounts receivable.

Research and development expenses, primarily consisting of costs associated with development of new products, increased to \$0.7 million for the three months ended September 30, 2006 from \$0.6 million for the comparable period in 2005.

Settlement expense was zero for the three months ended September 30, 2006 compared to a reversal of expense of \$1.8 million for the three months ended September 30, 2005. The reversal settlement expense in 2005 was a result of the reversal of the accrued expenses for the settlement agreement that was reached with Mr. Nick Faldo in regards to the dispute regarding provisions of his prior professional services agreement with Adams Golf. Since Mr. Faldo did not perform the minimum requirements of his contract, the Company is no longer due to make any future payments under that agreement.

Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

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Total net sales increased to \$63.0 million for the nine months ended September 30, 2006 from \$46.8 million for the same comparable period of 2005 primarily resulting from the successful product introductions of the Idea A2 and A2 OS Irons. Overall, product family life cycles generally range from one to three years, and each product family varies in its life cycle as there are multiple factors influencing the life, such as, but not limited to, customer acceptance, competition and technology.

Net sales of drivers decreased to \$6.8 million, or 10.8% of total net sales, for the nine months ended September 30, 2006 from \$14.5 million, or 31.1% of total net sales, for the comparable period of 2005. A large portion of the driver net sales for the nine months ended September 30, 2006 was generated by the RPM Ti and RPM Dual product lines, which were introduced in the second quarter of 2005, respectively. The overall decrease in driver net revenue results from lower sales of RPM and Ovation driver product families as they progress farther in their life cycle.

Net sales of irons increased to \$42.4 million, or 67.3% of total net sales, from \$18.2 million, or 38.9% of total net sales, for the nine months ended September 30, 2006 and 2005, respectively. The increase was primarily generated from the net sales of Idea A2 and A2 OS irons while the prior period net sales primarily resulted from the Original Idea irons and integrated iron sets.

Net sales of fairway woods increased to \$12.5 million, or 19.9% of total net sales, from \$12.4 million, or 26.4% of total net sales, for the nine months ended September 30, 2006 and 2005, respectively. This period's net sales were generated from RPM Low Profile fairway woods and Idea A2 and A2, A2 OS and Original Idea I-woods. The prior period's net sales were generated from RPM Ti and stainless steel fairway woods, Ovation fairway woods, Idea I-woods and Original Tight Lies fairway woods.

We are currently dependent on four customers, which collectively comprised approximately 25% of net sales for the nine months ended September 30, 2006. Of these, two customers individually represented greater than 5% but less than 10% of net sales and no customers represented greater than 10% of net sales. Should these customers or our other customers fail to meet their obligations to us, our results of operations and cash flows would be adversely impacted.

Net sales of our products outside the U.S. increased to \$11.2 million, or 17.8% of total net sales, from \$6.6 million, or 14.2% of total net sales, for the nine months ended September 30, 2006 and 2005, respectively. Net sales resulting from countries outside the U.S. excluding Canada increased to 6.4% of total net sales for the nine months ended September 30, 2006 compared to 2.9% of total net sales for the nine months ended September 30, 2005.

Cost of goods sold increased to \$35.0 million, or 55.5% of total net sales, for the nine months ended September 30, 2006 from \$24.7 million, or 52.9% of total net sales, for the comparable period of 2005. The increase as a percentage of total net sales is primarily due to changes in the product mix, coupled with decreases in fairway wood and driver net pricing and increases in some component pricing and other inventory related costs.

Selling and marketing expenses increased to \$15.8 million for the nine months ended September 30, 2006 from \$13.4 million for the comparable period in 2005. The increase is primarily the result of additional commission expense of \$1.2 million as a result of the increased net sales during the period. In addition, advertising and promotional expense increased \$0.4 million as a result of our support of the newly launched Idea A2 and A2 OS irons and RPM Low Profile fairway woods and an increase in tour player expenses of \$0.3 million.

General and administrative expenses increased to \$5.8 million for the nine months ended September 30, 2006 from \$5.5 million for the comparable period in 2005. The increase is a result of \$0.3 million of bad debt expense resulting from our continued efforts to maintain adequate reserves for Accounts Receivable.

Research and development expenses, primarily consisting of costs associated with development of new products, increased to \$1.9 million for the nine months ended September 30, 2006 from \$1.7 million for the comparable period

in 2005.

Settlement expense was zero for the nine months ended September 30, 2006 compared to a reversal of expense of \$1.8 million for the nine months ended September 30, 2005. The reversal settlement expense in 2005 was a result of the reversal of the accrued expenses for the settlement agreement that was reached with Mr. Nick Faldo in regards to the dispute regarding provisions of his prior professional services agreement with Adams Golf. Since Mr. Faldo did not perform the minimum requirements of his contract, the Company is no longer due to make any future payments under that agreement.

Other income decreased to zero for the nine months ended September 30, 2006 from \$1.0 million for the comparable period in 2005 which is attributable to our one time receipt of a \$965 thousand insurance claim paid by our insurance carrier in connection with an embezzlement which occurred during the period from 2001 through 2004. This event was disclosed in the Annual Report on Form 10-K for the year ended December 31, 2004.

Our inventory balances were approximately \$22.9 million and \$16.2 million at September 30, 2006 and December 31, 2005, respectively. The increase in inventory levels is primarily a result of the increased purchasing related to the newly released A2 and A2 OS iron sets launched in the third quarter of 2005 and Idea Pro Irons launched in the third quarter of 2006.

Our net accounts receivable balances were approximately \$13.9 million and \$14.2 million at September 30, 2006 and December 31, 2005, respectively. The decrease is primarily due to the seasonality of the business, as a large portion of sales are generated in the first and second quarters of the year and collected thereafter.

Our accounts payable balances were approximately \$7.2 million and \$4.7 million at September 30, 2006 and December 31, 2005, respectively. The increase in accounts payable is primarily associated with increases in inventory purchases associated with the recent product launch of the Idea A2 and A2 OS irons and Idea Pro irons.

Our accrued liabilities balances were approximately \$6.3 million and \$7.3 million at September 30, 2006 and December 31, 2005, respectively. The decrease in accrued liabilities is primarily associated with the reduced levels of inventory in transit at September 30, 2006.

Liquidity and Capital Resources

Cash and cash equivalents increased to \$11.7 million at September 30, 2006 compared to \$10.7 million at December 31, 2005. During the nine months ended September 30, 2006 inventory increased \$6.7 million. These increases were partially offset with a decrease in accounts receivable of \$0.3 million and an increase in accrued expenses and accounts payable of \$1.6 million.

In February 2006, we signed a revolving credit agreement with Bank of Texas to provide up to \$10.0 million in short term debt. The agreement is collateralized by all of our assets and requires, among other things, us to maintain certain financial performance levels relative to the cash flow leverage ratio and fixed charge coverage ratio, but only when we have an outstanding balance on the facility. Interest on outstanding balances varies depending on the portion of the line that is used and accrues at a rate from prime less one percent to prime and is due quarterly. As of November 3, 2006, we have no outstanding borrowings on our credit facility.

Working capital increased at September 30, 2006 to \$35.7 million compared to \$29.9 million at December 31, 2005. Approximately 28% of our current assets are comprised of accounts receivable at September 30, 2006. Due to industry sensitivity to consumer buying trends and available disposable income, we have in the past extended payment terms for specific purchase transactions. Issuance of these terms (i.e. greater than 30 days or specific dating) is dependent on our relationship with the customer and the customer's payment history. Payment terms are extended to selected customers typically during off-peak times in the year in order to promote our brand name and to assure

adequate product availability, often to coincide with planned promotions or advertising campaigns. Although a significant amount of our sales are not affected by these terms, the extended terms do have a negative impact on our financial position and liquidity. We expect to continue to selectively offer extended payment terms in the future, depending upon known industry trends and our financial condition. We generate cash flow from operations primarily by collecting outstanding trade receivables. Because we have limited cash reserves, if collections of a significant portion of trade receivables are unexpectedly delayed, we would have a limited amount of funds available to further expand production until such time as we could collect a significant portion of the trade receivables. If our cash needs in the near term exceed the available cash and cash equivalents on hand and the available borrowing under the credit facility, we would be required to obtain additional financing or limit expenditures to the extent of available cash on hand, all of which could significantly adversely effect our current growth plans and result in a material adverse effect on our results of operations, financial condition and/or liquidity.

Our anticipated sources of liquidity over the next twelve months are expected to be cash reserves, projected cash flows from operations, and available borrowings under our credit facility. We anticipate that operating cash flows and current cash reserves will also fund capital expenditure programs. These capital expenditure programs can be suspended or delayed at any time with minimal disruption to our operations if cash is needed in other areas of our operations. In addition, cash flows from operations and cash reserves will be used to support ongoing purchases of component parts for our current and future product lines. The expected operating cash flow, current cash reserves and borrowings available under our credit facility are expected to allow us to meet working capital requirements during periods of low cash flows resulting from the seasonality of the industry.

Management believes that sufficient resources will be available to meet our cash requirements through the next twelve months. Cash requirements beyond twelve months are dependent on our ability to introduce products that gain market acceptance and to manage working capital requirements. We have introduced new products and taken steps to increase the market acceptance of these and our other products. If our products fail to achieve appropriate levels of market acceptance, it is possible that we may have to raise additional capital and/or further reduce our operating expenses including further operational restructurings. If we need to raise additional funds through the issuance of equity securities, the percentage ownership of the stockholders of our Company would be reduced, stockholders could experience additional dilution, or such equity securities could have rights, preferences or privileges senior to our common stock. Nevertheless, given the current market price of our common stock and the state of the capital markets generally, we do not expect that we will be able to raise funds through the issuance of our capital stock in the foreseeable future. We may also find it difficult to secure additional debt financing. There can be no assurance that financing will be available when needed on terms favorable to us, or at all. Accordingly, it is possible that our only sources of funding will be current cash reserves, projected cash flows from operations and up to \$10.0 million of borrowings available under our revolving credit facility.

If adequate funds are not available or not available on acceptable terms, we may be unable to continue operations; develop, enhance and market products; retain qualified personnel; take advantage of future opportunities; or respond to competitive pressures, any of which could have a material adverse effect on our business, operating results, financial condition and/or liquidity.

Item 4. Controls and Procedures

Introduction

"Disclosure Controls and Procedures" are defined in Exchange Act Rules 13a -15(e) and 15d -15 (e) as the controls and procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time period specified by the SEC's rules and forms. Disclosure Controls and Procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act are accumulated and communicated to our management, including our principal

executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure.

"Internal Control Over Financial Reporting" is defined in Exchange Act Rules 13a-15(f) and 15d-15(f) as a process designed by, or under the supervision of, an issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by an issuer's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and disposition of an issuer; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the issuer's assets that could have a material adverse effect on the financial statements.

We have endeavored to design our Disclosure Controls and Procedures and Internal Controls Over Financial Reporting to provide reasonable assurances that our objectives will be met. All control systems are subject to inherent limitations, such as resource constraints, the possibility of human error, lack of knowledge or awareness, and the possibility of intentional circumvention of these controls. Furthermore, the design of any control system is based, in part, upon assumptions about the likelihood of future events, which assumptions may ultimately prove to be incorrect. As a result, no assurances can be made that our control system will detect every error or instance of fraudulent conduct, including an error or instance of fraudulent conduct, which could have a material adverse impact on our operations or results.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of our Disclosure Controls and Procedures as of the end of the period covered by this report. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that our Disclosure Controls and Procedures as of the end of the period covered by this report were designed to ensure that material information relating to us is made known to the Chief Executive Officer and Chief Financial Officer by others within our Company, particularly during the period in which this report was being prepared, and that our Disclosure Controls and Procedures were effective. There were no changes to our Internal Controls Over Financial Reporting during the nine months ended September 30, 2006 that has materially affected or is reasonably likely to materially affect our Internal Controls Over Financial Reporting.

In addition, it is our policy to not participate in off-balance sheet transactions, including but not limited to special purpose entities.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Beginning in June 1999, the first of seven class action lawsuits was filed against us, certain of our current and former officers and directors, and the three underwriters of our initial public offering ("IPO") in the United States District Court of the District of Delaware. The complaints alleged violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, as amended, in connection with our IPO. In particular, the complaints alleged that our prospectus, which became effective July 9, 1998, was materially false and misleading in at least two areas. Plaintiffs alleged that the prospectus failed to disclose that unauthorized distribution of our products (gray market sales) threatened our long-term profits. Plaintiffs also alleged that the prospectus failed to disclose that the golf equipment industry suffered from an oversupply of inventory at the retail level, which had an adverse impact on our sales. On May 17, 2000, these

cases were consolidated into one amended complaint, and a lead plaintiff was appointed. The plaintiffs were seeking unspecified amounts of compensatory damages, interest and costs, including legal fees. On December 10, 2001, the United States District Court for the District of Delaware dismissed the consolidated, amended complaint. Plaintiffs appealed. On August 25, 2004, the appellate court affirmed the dismissal of plaintiffs' claims relating to oversupply of retail inventory, while reversing the dismissal of the claims relating to the impact of gray market sales and remanding those claims for further proceedings. On August 3, 2005, the district court certified a class of section 11 claimants, but shortened the proposed class period to end on October 22, 1998, and declined to certify a section 12(a)(2) class against the Adams Golf defendants. On September 1, 2005, plaintiffs filed a motion for leave to amend their complaint, which was granted on January 24, 2006. Defendants filed a motion to dismiss the second amended complaint ("SAC"), which the District Court granted in part and denied in part on April 10, 2006. Now, in addition to the gray-market sales claim, the SAC alleges that the prospectus failed to disclose that we engaged in questionable sales practices (including double shipping and unlimited rights of return), which threatened post-IPO financial results. Fact discovery closed on June 30, 2006. Trial is currently set for June 18, 2007.

We maintain directors' and officers' and corporate liability insurance to cover certain risks associated with these securities claims filed against us or our directors and officers. During the period covering the class action lawsuit, we maintained insurance from multiple carriers, each insuring a different layer of exposure, up to a total of \$50 million. In addition, we have met the financial deductible of our directors' and officers' insurance policy for the period covering the time the class action lawsuit was filed. Specifically, Zurich American Insurance Company provided insurance coverage totaling \$5 million for the layer of exposure between \$15 million and \$20 million. On March 30, 2006, Zurich American Insurance Company notified us that it was denying coverage due to the fact that it was allegedly not timely notified of the class action lawsuit. We are currently assessing whether Zurich's denial of coverage is appropriate and the effect, if any, the denial has on insurance coverage for the layers of exposure exceeding \$20 million. At this point in the legal proceedings, we cannot predict with any certainty the outcome of the matter, per the guidance in SFAS 5, and thus can not reasonably estimate future liability on the conclusion of the events, if any.

The underwriters for the IPO are also defendants in the securities class action. The underwriting agreement that we entered into with the underwriters in connection with the IPO contains an indemnification clause, providing for indemnification against any loss, including defense costs, arising out of the IPO. After the first lawsuit was filed, the underwriters requested indemnification under the agreement. Our D&O insurance policy included an endorsement providing \$1 million to cover indemnification of the underwriters. Our D&O insurer has notified the underwriters of the exhaustion of the \$1 million sublimit. We believe that the \$1 million payment under the insurance policy satisfies our indemnification obligation, or alternatively, that there are reasons why the Company may not have any further indemnification obligations. We are in negotiations with the underwriters, and if necessary, may dispute any further requests for indemnification. At this point, we cannot predict with any certainty, per the guidance in SFAS 5, and thus cannot reasonably estimate future liability on the conclusion of the events, if any.

On March 16, 2006, we became aware of a lawsuit filed against us in U.S. District Court in the Southern District of California by TaylorMade, a division of Adidas-Salomon AG. The lawsuit alleges generally that we violated three patents held by TaylorMade (one design patent and two utility patents) in the manufacture of drivers. We have engaged in settlement negotiations with TaylorMade with the common goal of finalizing the settlement agreement by the end of December 2006.

From time to time, we are engaged in various other legal proceedings in the normal course of business. The ultimate liability, if any, for the aggregate amounts claimed cannot be determined at this time.

Item 1A. Risk Factors

We have included in Part I, 1A of our Annual Report on Form 10-K for the year ended December 31, 2005, a description of certain risks and uncertainties that could have an affect on our business, future performance, or financial

condition. We have evaluated our current risk factors and report the following additional risk factor:

Risks of Adequate Insurance Coverage

The Company invests in various insurance policies to cover different aspects of our business, including but not limited to, Property, Commercial Liability, Workers Compensation, Business Interruption, Foreign Liabilities, Auto, Crime, Employment Practices and Directors and Officers Insurance. Although the Company obtains various insurance policies, unforeseen situations or events may arise that could limit the amount or types of insurance coverage.

Currently, we have potential exposure in our Directors and Officers insurance policy covering the time period of the class action lawsuit, where our third layer of coverage for the \$5 million layer between \$15 million and \$20 million is currently being denied by Zurich, as they claim that we did not notify them timely in the class action lawsuit. In addition, there is potential that Zurich's denial of coverage could adversely affect the coverage layers exceeding the \$20 million level. Additionally, our Directors and Officers insurance policy covering the time period of the class action lawsuit has an endorsement that limits the defense costs covered under the policy for the underwriters of the IPO to \$1 million, and at this time the underwriters' attorneys have exhausted this \$1 million sublimit. To the extent that our Company is liable for any material amounts denied under or in excess of our Directors and Officer's insurance, or any other insurance policy for that matter, it could have a material effect on our business and our results of operations.

Item 6(a). Exhibits

See exhibit index on pages 29-30.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, we have duly caused this report to be signed on our behalf by the undersigned thereunto duly authorized.

ADAMS GOLF, INC.

Date: November 7, 2006

By: /S/ OLIVER G. BREWER
III
Oliver G. Brewer, III
Chief Executive Officer and President

Date: November 7, 2006

By: /S/ ERIC LOGAN
Eric Logan
Chief Financial Officer
(Principal Financial Officer)

Date: November 7, 2006

By: /S/ PAMELA J. HIGH
Pamela J. High
Controller
(Principal Accounting Officer)

EXHIBIT INDEX

Exhibit 3.1	Amended and Restated Certificate of Incorporation	Incorporated by reference to Form S-1 File No. 333-51715 (Exhibit 3.1)
Exhibit 3.2	Amended and Restated By-laws	Incorporated by reference to Form S-1 File No. 333-51715 (Exhibit 3.2)
Exhibit 3.3	Amended and Restated Audit Committee charter	Incorporated by reference to Annex A of the 2004 Proxy Statement (Annex A)
Exhibit 4.1	1998 Stock Incentive Plan of the Company dated February 26, 1998, as amended	Incorporated by reference to Form S-8 File No. 333-68129 (Exhibit 4.1)
Exhibit 4.2	1996 Stock Option Plan dated April 10, 1998	Incorporated by reference to Form S-1 File No.333-51715 (Exhibit 4.2)
Exhibit 4.3	Adams Golf, Ltd. 401(k) Retirement Plan	Incorporated by reference to Form S-1 File No.333-51715 (Exhibit 4.3)
Exhibit 4.4	1999 Non-Employee Director Plan of Adams Golf, Inc.	Incorporated by reference to 1999 Form 10-K (Exhibit 4.4)
Exhibit 4.5	1999 Stock Option Plan for Outside Consultants of Adams Golf, Inc.	Incorporated by reference to Form S-8 File No. 333-37320 (Exhibit 4.5)
Exhibit 4.6	2002 Adams Golf Equity Incentive Plan	Incorporated by reference to Annex A of the 2002 Proxy Statement (Annex A)
Exhibit 4.7	Form of Option Agreement under the 2002 Stock Option Plan of Adams Golf, Inc.	Incorporated by reference to Form S-8 February 9, 2004 File No. 333-112622 (Exhibit 4.7)
Exhibit 4.8	Amendment to Form of Option Agreement under the 2002 Stock Option Plan of Adams Golf, Inc.	Incorporated by reference to Form S-8 July 13, 2006 File No. 333-112622 (Exhibit 4.8)
Exhibit 10.1	Settlement Agreement between Adams Golf, Ltd. And Nicholas A. Faldo	Incorporated by reference to the Quarterly Report on Form 10-Q for the quarter ended September 30, 2001 (Exhibit 10.19)
Exhibit 10.2	Amendment dated September 1, 2003 to the Commercial Lease Agreement dated April 6, 1998, between Jackson-Shaw Technology Center II and the Company	Incorporated by reference to the Annual Report on Form 10-K for the year ended December 31, 2003 (Exhibit 10.12)

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Exhibit 10.3	Employment Agreement - Oliver G. (Chip) Brewer	Incorporated by reference to the Annual Report on Form 10-K for the year ended December 31, 2004 (Exhibit 10.16)
Exhibit 10.4*	Golf Consultant Agreement - Thomas S. Watson	Incorporated by reference to the Annual Report on Form 10-K for the year ended December 31, 2004 (Exhibit 10.17)
Exhibit 10.5*	Revolving line of Credit between Adams Golf, Inc and Bank of Texas	Incorporated by reference to the Annual Report on Form 10-K for the year ended December 31, 2005 (Exhibit 10.8)
Exhibit 10.6	Employment Agreement - Byron H. (Barney) Adams	Incorporated by reference to the Annual Report on Form 10-K for the year ended December 31, 2005 (Exhibit 10.9)
Exhibit 10.7	Change of Control - Eric Logan	Incorporated by reference to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 (Exhibit 10.7)
Exhibit 10.8	Commercial Lease Agreement dated August 16, 2006, between MDN/JSC -II Limited and the Company	Included in this filing
Exhibit 31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Included in this filing
Exhibit 31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Included in this filing
Exhibit 32.1	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Included in this filing

* The SEC has granted our request for confidential treatment of certain portions of these agreements.