



CHOICE HOTELS
INTERNATIONAL[®]

Our passion.
Customer profitability.

LETTER TO SHAREHOLDERS

Dear Shareholders:

This time last year I wrote to you about our optimism even in a time of economic and geopolitical uncertainty. Our outstanding 2003 results certainly confirm that optimism was well-founded. They also underscore the soundness of our strategy and our franchising business model, which have served us well in challenging times.

Your company enters 2004 stronger than ever, thanks to the hard work and dedication of our associates and franchisees who are deeply committed to building a franchise success system second to none.

For the year 2003, Choice Hotels earned diluted earnings per share of \$1.96, a 28.9% increase over the prior year. Domestic unit growth rose 4.4% and franchising revenues increased 8.7% to \$187.1 million as the company generated domestic system-wide revenues of \$3.5 billion for our more than 3,600 U.S. properties.

At the core of our 2003 success was record franchise development. We executed 470 new franchise contracts representing 41,000 rooms, marking the first time Choice has ever exceeded the 40,000 room level in annual development activity. Each new franchise agreement provides Choice with a steady stream of royalty revenues, as well as marketing and reservations fees to help build brand awareness and drive occupancy.

This excellent performance occurred against the backdrop of a slowly recovering economy and an industry just starting to come back from the bottom. Despite all the industry ups and downs of the past few years, Choice has been able to continually grow its hotel system because of our strong product portfolio of conversion and new build brands, our ability to deliver strong reservations and marketing programs, and our commitment to partnering with our franchisees to create a true franchise success system.

With our singular focus on our franchising business, we have been able to concentrate our strategy on reaching more consumers, delivering exceptional services, building strong brands and leveraging our size, scale and distribution to deliver more business to our hotels while lowering their costs. Underlying this focus are the mission, vision and passion that guide our operations.

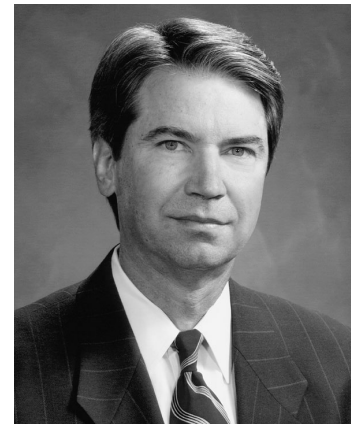
Our Mission: Deliver a franchise success system of strong brands, exceptional services, vast consumer reach, and size, scale and distribution that delivers guests and reduces costs for our hotel owners.

Our Vision: To generate the highest return on investment of any hotel franchise.

Our Passion: Customer Profitability.

Entering 2003, we established overarching objectives for the year:

- To grow the company aggressively, and responsibly, by focusing on RevPAR (revenue per available room) increases, unit growth and greater penetration from partner services, which helps our owners better manage their costs;
- To be totally focused and extraordinarily good at the services we deliver to franchisees at every level—in the field, through technology and with training, and to set the example for customer service to our franchisees;
- To deliver marketing that is impactful, memorable, effective and targeted;
- To keep our brands fresh, continually improving and meeting or exceeding guest expectations by designing products and services that allow franchisees to achieve a superior return on their investment.



Charles A. Ledsinger, Jr.
President and Chief Executive Officer

How did we perform against these objectives? Quite well, as evidenced by our strong results. Here are some highlights:

Company growth: In 2003, we opened a net of 154 domestic hotels, added 470 new franchise contracts and grew our partner services income by almost 11% to \$13.2 million.

Customer service delivery: We refocused our franchise service directors to deliver more customized service to meet each hotel's most critical needs. We also introduced a new quality assurance program that focuses on enhancing guest satisfaction. Our franchisee satisfaction survey showed improvement in a number of service delivery areas, adding to already strong franchisee relations. One measure of franchisee satisfaction is our very high retention rate.

Marketing: Our summer and fall promotions were highly successful in generating more brand awareness and helping our Choice Privileges guest awards program grow by 25% to 2 million members.

Brands: We introduced new prototypes for our Econo Lodge, Sleep Inn and Comfort Suites brands and created a brand extension for our Clarion full-service brand called the Clarion Collection, which features well-established boutique hotels in key urban markets. In addition to our new brand prototypes that reduce construction costs and improve the return on investment, we also enhanced our programs to help owners with renovations and conversions by broadening the scope of goods and services available with our preferred vendors to help franchisees better manage costs and provide amenities desired by their guests.

This significant progress in 2003 sets the stage for even more success this year, in which we will focus even greater attention on working with our franchisee partners to build guest satisfaction and improve hotel performance.

We now are entering a period of economic recovery with hopefully an attendant improvement in RevPAR. We ended the fourth quarter of 2003 with a 5% improvement in RevPAR system-wide, a clear sign that travel is on the rebound. More importantly, that upswing has continued into the first quarter of 2004.

The Travel Industry Association of America (TIA) is forecasting a 4.4% overall increase in travel spending by domestic and international travelers in 2004, with domestic leisure travel predicted to grow by 3.2% and domestic business travel to increase by 4.2%. Arrivals from international travelers are predicted to grow by 5% to 42.2 million. This forecast is good news for our hotel owners, who are well-positioned in the mid-priced and economy segments to capture a good share of that travel increase.

The TIA also predicts that Americans will continue to book their travel at the last minute, with 64% of trips planned within two weeks of taking the trip and with the majority of travel continuing to be highway-related and closer to home, which will match up well with our locations.

So how do we propose to capture more than our fair share of that business? Our marketing programs emphasize the more than 4,800 worldwide locations we offer travelers and the wide range of amenities provided by our eight brands. With more than 57 million room nights booked each year, the Choice system accommodates the traveling public in 49 states and 42 countries and territories globally.

Our marketing promotions focus in part on building the strength of our guest rewards programs, Choice Privileges for the mid-priced brands and EA\$Y CHOICE for the economy brands, by offering travelers the opportunity to earn free nights and airline miles quickly and easily. In turn, these programs help build brand loyalty and provide new opportunities for more direct marketing to our frequent and best customers.

The Internet gives us another powerful marketing tool, with Choicehotels.com, our proprietary Internet site, providing consumers with ease of use, foreign language capability and our Best e-rate Guarantee program. We also have forged agreements with major third-party travel Web sites to obtain preferred placement and reduced fees for our hotels. By leveraging our size, scale and distribution, we have helped our franchisees to capture business more effectively by improving the yield through these sites.

Since I joined Choice in the fall of 1998, the percentage of reservations booked on-line on our own Web site and third-party sites has grown dramatically from 1.3% in 1998 to 33.4% in 2003, as more and more consumers turn to the Internet to transact personal business. Of that Internet business, almost 56% comes directly to our proprietary site, choicehotels.com.

At the same time, our call centers continue to handle more than 10 million reservations inquiries a year, with our ability to convert calls into booked rooms steadily improving.

For 2004 we aim to sustain our unit growth momentum while continuing to improve product quality, enhance brand reputation and build greater guest loyalty. Choice has made great strides in the past five years and has consistently delivered a strong performance for its shareholders despite the economic downturn and the dampening impact on travel of the war on terrorism.

The volatility of world events reminds us that the environment in which we operate will continue to present unexpected challenges. But our resiliency and performance of the past few years gives me confidence in our ultimate ability to persevere and perform well.

I have been extremely fortunate to have the benefit of a dedicated Board of Directors that has provided wise counsel and strong support for our initiatives. This past year we decided to pay a cash dividend on our common stock, and we have continued to build shareholder value through targeted share repurchases.

I also have enjoyed the support of our 1,500 associates who have diligently worked to make Choice a better company and a better place to work, earning us recognition for "Workplace Excellence" from the Maryland Work-Life Alliance and as one of the "50 Great Places to Work" from *Washingtonian* magazine.

As the economy gathers strength and more travelers return to the road, our future looks very bright. At our more than 4,800 hotels worldwide, our owners and their staffs are ready to welcome you. Behind that effort are our associates and vendor partners who share a commitment to deliver great service.

With customer profitability as our passion, we can create a franchise success system unequalled in our industry and a company renowned for steadily growing shareholder value.

A handwritten signature in black ink, appearing to read "Charles A. Ledsinger, Jr.", with a stylized, cursive script.

Charles A. Ledsinger, Jr.
President and Chief Executive Officer

March 22, 2004

A CHOICE YEAR IN REVIEW

- January*
- Choicehotels.com is revamped to offer visitors to the Web site enhanced electronic brochures for each property and a downloadable hotel directory.
 - Southwest Airlines becomes the newest partner in Choice's airline miles program, increasing the number of airline partners to six.
- February*
- Choice signs a three-year agreement to be the official hotel partner of Little League Baseball.
 - The company launches its spring promotions featuring the airline miles program and offering Triple Miles to guests staying at all Choice hotels in the United States and the Caribbean.
 - Choice acquires the remaining 45% interest in Flag Choice Hotels of Australia.
 - The company receives a Workplace Excellence Award and "Excellent Place to Work" designation from the Maryland Work-Life Alliance.
- March*
- Choice introduces the Best Choice e-rate Guarantee to provide customers with the best rate online for all of its domestic brands.
- April*
- Choice renews its commitment to military families by extending government military rates to all active, retired and dependent government and military travelers for all domestic Choice brand hotels.
 - Choice and Arnold Worldwide/Washington, its agency of record, receive the Golden Bell Bronze Advertising award from the Hospitality Sales & Marketing Association for the "Thanks for Traveling" campaign from 2001–2002.
- May*
- Choice's 49th Annual Convention for franchisees in Orlando features an inspiring address by former President George H. W. Bush and entertainment by Bill Cosby.
 - At the convention, Choice announces a brand extension of the full-service Clarion brand called the Clarion Collection, which will feature unique historic boutique hotels.
 - Choice introduces more cost-effective new construction prototypes for the Sleep Inn and Comfort Suites brands to help spur brand growth.
- June*
- Choice partners with two e-wholesale Web sites, Travelocity and Travelweb, to give franchisees preferred placement on both Web sites and their affiliate sites.
 - Summer promotions are launched, with midscale brand hotels offering weekly chances to win free gas and a Jeep Liberty vehicle and economy brand hotels offering a \$50,000 grand prize in a Fast Cash sweepstakes.
 - The company extends the benefits and rewards of the Choice Privileges program to guests at MainStay Suites brand hotels.
- July*
- Choice Hotels Canada re-introduces the "Thanks for Traveling" campaign to assist Canadian hotels facing difficulties in attracting business because of the concerns related to Severe Acute Respiratory Syndrome (SARS) in that country.
 - For the second quarter in a row, the Sleep Inn brand is named the top economy brand by Market Matrix.
- August*
- Choice announces it will initiate a cash dividend on its common stock, beginning with the fourth quarter of 2003.
- September*
- Choice begins its fall promotions by offering guests at its midscale brand hotels a free night for every two stays and, at its economy brand hotels, guests receive double EA\$Y CHOICE stamps for each night's stay or the chance to redeem the stamps for airline miles.
- October*
- Choice Hotels International is named one of "50 Great Places to Work" in the greater Washington D.C. area by *Washingtonian* magazine.
- November*
- Choice announces it will receive a payment in excess of \$45 million from Sunburst Hospitality as prepayment of an outstanding note.
 - Choicehotels.com is upgraded to include localized Japanese content, giving Japanese-speaking travelers access to information about Choice and its brands. The company also signs a 20-year master franchise agreement with Nippon Choice K.K. of Japan, opening the way for rapid development in that country.
- December*
- Choicehotels.com is ranked number one in transactional reliability among hotel company Web sites by the Gomez Performance Index.
 - The Best Choice e-rate Guarantee is extended to all Choice hotels worldwide, encompassing more than 4,800 properties around the globe.

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Financial Highlights

As of or for the years ended December 31,					
	2003	2002	2001	2000	1999
	(in millions, except per share data)				
Company Results					
Total Revenues	\$ 386.1	\$ 365.6	\$ 341.4	\$ 352.8	\$ 324.2
Net Income	71.9	60.8	14.3	42.4	57.2
Net Cash Provided by Operating Activities	115.5	99.0	101.7	53.9	65.0
Basic Earnings per Share	2.01	1.55	0.32	0.80	1.04
Diluted Earnings per Share	1.96	1.52	0.32	0.80	1.03
Total Assets	267.3	316.8	321.2	484.1	464.7
Long-Term Debt	\$ 246.7	\$ 307.8	\$ 281.3	\$ 297.2	\$ 307.4
Franchise System Results (Unaudited)					
Domestic:					
Revenues (estimated in millions)	\$ 3,518	\$ 3,412	\$ 3,383	\$ 3,423	\$ 3,183
Franchised Hotels	3,636	3,482	3,327	3,244	3,123
Franchised Hotels Under Development	401	310	462	493	596
Franchised Rooms	294,268	282,423	270,514	265,962	258,120
Revenue Per Available Room	\$ 34.21	\$ 34.48	\$ 35.83	\$ 36.72	\$ 35.33
Total (Domestic and International)					
Franchised Hotels	4,810	4,664	4,545	4,392	4,248
Franchised Hotels Under Development	491	474	689	703	761
Franchised Rooms	388,618	373,722	362,549	350,351	338,254

Management's Discussion and Analysis of Financial Condition and Results of Operation.

The following Management's Discussion and Analysis ("MD&A") is intended to help the reader understand Choice Hotels International, Inc. and subsidiaries (together "the Company"). MD&A is provided as a supplement to – and should be read in conjunction with – our consolidated financial statements and the accompanying notes.

Overview

We are a hotel franchisor with franchise agreements representing 4,810 hotels open and 491 hotels under development as of December 31, 2003, with 388,618 rooms and 39,877 rooms, respectively, in 44 countries and territories. Our brand names include Comfort Inn, Comfort Suites, Quality, Clarion, Sleep Inn, Econo Lodge, Rodeway Inn, MainStay Suites and Flag Hotels. The Company's franchises operate in 49 states, Puerto Rico and 41 additional countries and territories. Approximately 95% of the Company's revenues are derived from hotels franchised in the United States.

Our Company generates revenues, income and cash flows primarily from initial and continuing royalty fees attributable to our franchise agreements. Revenues are also generated from partner services endorsed vendor arrangements, hotel operations and other sources.

We are contractually required by our franchise agreements to use the marketing and reservation fees we collect for system-wide marketing and reservation activities. These expenditures, which include advertising costs and costs to maintain our central reservations system, help to enhance awareness and increase consumer preference for our brands. Greater awareness and preference promotes long-term growth in business delivery to our franchisees, which ultimately increases franchise fees earned by the Company.

Our Company articulates its mission as a commitment to provide hotel franchises that strive to generate the highest return on investment. We have developed an operating system dedicated to our franchisees' success: One that focuses on delivering guests to our franchised hotels and reducing costs for our hotel owners. More specifically, through our actions we strive every day to continuously improve our franchise offerings to create the highest return on investment of any hotel franchise.

We believe that executing our strategic priorities creates value. Our Company focuses on two key value drivers:

Profitable Growth. Our success is dependent on improving the performance of our hotels and increasing our system size by selling additional hotel franchises. We attempt to improve our franchisees' revenues and overall profitability by providing a variety of products and services designed to increase business delivery to and/or reduce operating and development costs for our franchisees. These products and services include national marketing campaigns, a central reservation system, property and yield management systems, quality assurance standards and endorsed vendor relationships. We believe that healthy brands which deliver a compelling return on investment for franchisees will enable us to sell additional hotel franchises. We have established multiple brands that meet the needs of many types of guests, and can be developed at various price points and applied to both new and existing hotels. This ensures that we have brands suitable for creating growth in a variety of market conditions. Improving the performance of the hotels under franchise and growing the system through additional franchise sales while maintaining a disciplined cost structure are the keys to profitable growth.

Maximizing Financial Returns and Creating Value for Shareholders. Our capital allocation decisions, including capital structure and uses of capital, are intended to maximize our return on invested capital and create value for our shareholders. We believe our strong and predictable cash flows create a strong financial position that provides us a competitive advantage. Our business does not require significant capital to operate and grow, therefore, we can maintain a capital structure that generates high financial returns and use our excess cash flow to increase returns to our shareholders. We have returned value to our shareholders in two primary ways: share

repurchases and dividends. In 1998, we instituted a share repurchase program which has generated substantial value for our shareholders. We have repurchased 29.3 million shares of common stock at a total cost of \$514.8 million, or an average price of \$17.54 per share since the program's inception. Our cash flows from operations support our ability to complete the repurchase of approximately 1.4 million shares presently remaining under our current board of directors authorization. Upon completion of the current authorization we will evaluate the propriety of additional share repurchases with our board of directors. In 2003, we initiated a cash dividend of \$0.20 per share per quarter on our common stock. The initial dividend was declared in December 2003 and paid in January 2004. We presently expect to continue to pay dividends in the future. Based on our present dividend rate and outstanding share count aggregate annual dividends would be approximately \$27.5 million.

We believe these value drivers, when properly implemented, will enhance our profitability, maximize our financial returns and continue to generate value for our shareholders. The ultimate measure of our success will be reflected in the items below.

Results of Operations. Royalty fees, operating income, net income and diluted earnings per share represent key measurements of these value drivers. In 2003, royalty fees revenue totaled approximately \$151.3 million, a 6% increase from 2002. Operating income totaled \$114.0 million in 2003, a 9% increase from 2002. Net income increased to \$71.9 million, an 18% increase from 2002. Diluted earnings per share were \$1.96, a 29% improvement over 2002. Net income and diluted earnings per share include a \$3.4 million gain from the prepayment of a note receivable during 2003. These measurements will continue to be a key management focus in 2004 and beyond. Refer to MD&A heading "Operations Review" for additional analysis of our results.

Liquidity and Capital Resources. In 2003, net cash provided by operating activities was \$115.5 million, a 17% increase from 2002. Since our business does not require significant reinvestment of capital, we utilize cash in ways that management believes provides the greatest returns to our shareholders which include share repurchases and dividends. We believe the Company's cash flow from operations and available financing capacity are sufficient to meet the expected future operating, investing and financing needs of the business.

Refer to MD&A heading "Liquidity and Capital Resources" for additional analysis.

The principal factors that affect the Company's results are: the number and relative mix of franchised hotels; growth in the number of hotels under franchise; occupancy and room rates achieved by the hotels under franchise; the effective royalty rate achieved; and our ability to manage costs. The number of rooms at franchised properties and occupancy and room rates at those properties significantly affect the Company's results because our fees are based upon room revenues at franchised hotels. The key industry standard for measuring hotel operating performance is revenue per available room ("RevPAR"), which is calculated by multiplying the percentage of occupied rooms by the average daily room rate realized. Our variable overhead costs associated with franchise system growth have historically been less than incremental royalty fees generated from new franchisees. Accordingly, continued growth of our franchise business should enable us to realize benefits from the operating leverage in place and improve operating results.

Operations Review

Comparison of 2003 Operating Results and 2002 Operating Results

The Company recorded net income of \$71.9 million for the year ended December 31, 2003, an increase of \$11.1 million from \$60.8 million for the year ended December 31, 2002. Net income in 2003 included a \$3.4 million gain on the prepayment of the Sunburst Hospitality note. In addition to the note prepayment gain, the increase in net income for the period is attributable to improved operating income resulting from a \$15.0 million, or 8.7%, increase in franchise revenues partially offset by increased selling, general and administrative costs.

Summarized financial results for the years ended December 31, 2003 and 2002 are as follows:

	<u>2003</u>	<u>2002</u>
	(In thousands)	
REVENUES:		
Royalty fees	\$151,326	\$142,943
Initial franchise and relicensing fees	16,799	12,881
Partner services	13,227	11,860
Marketing and reservation	195,420	190,145
Hotel operations	3,565	3,331
Other	5,767	4,402
Total revenues	<u>386,104</u>	<u>365,562</u>
OPERATING EXPENSES:		
Selling, general and administrative	62,860	56,520
Depreciation and amortization	11,225	11,251
Marketing and reservation	195,420	190,145
Hotel operations	2,616	2,946
Total operating expenses	<u>272,121</u>	<u>260,862</u>
Operating income	113,983	104,700
Interest expense	11,597	13,136
Interest and other investment income	(6,185)	(4,549)
Gain on prepayment of note receivable from Sunburst	(3,383)	—
Equity in net (income) losses of affiliates	(582)	71
Other	129	224
Income before income taxes	112,407	95,818
Income taxes	40,544	34,974
Net income	<u>\$ 71,863</u>	<u>\$ 60,844</u>

Management analyzes its business based on franchise revenues, which is total revenues excluding marketing and reservation revenues and hotel operations, and franchise operating expenses that are reflected as selling, general and administrative expenses.

Franchise Revenues. Franchise revenues were \$187.1 million for the year ended December 31, 2003 compared to \$172.1 million for the year ended December 31, 2002. Royalty fees increased \$8.4 million to \$151.3 million from \$142.9 million in 2002, an increase of 5.9%. The increase in royalties is attributable to a 4.2% increase in the number of domestic franchised hotel rooms and an increase in the effective royalty rate of the domestic hotel system to 4.01% from 3.97%, partially offset by a 0.8% decrease in RevPAR. Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise contracts increased 36.1% to \$11.3 million for the year ended December 31, 2003 from \$8.3 million for the year ended December 31, 2002. In addition, international royalty fees increased approximately \$2.9 million during 2003 as a result of the consolidation of Flag Choice Hotels beginning in July 2002. The increase reflects domestic franchise agreements executed in 2003 of 470, compared to 304 agreements executed in 2002. Relicensing fees increased 19.6% to \$5.5 million for the year ended December 31, 2003 from \$4.6 million for the year ended December 31, 2002. Relicensing fees are charged to the new property owner of a franchised property whenever an ownership change occurs and the property remains in the franchise system. Revenues generated from partner services increased 10.9% to \$13.2 million for the year ended December 31, 2003 from \$11.9 million for the year ended December 31, 2002.

The number of domestic rooms on-line increased to 294,268 from 282,423, an increase of 4.2% for the year ended December 31, 2003. For 2003, the total number of domestic hotels on-line grew 4.4% to 3,636 from 3,482

for 2002. International rooms on-line increased to 94,350 as of December 31, 2003 from 91,299 as of December 31, 2002, an increase of 3.3%. The total number of international hotels on-line decreased slightly to 1,174 from 1,182, a decrease of 0.7% for the year ended December 31, 2003. As of December 31, 2003, the Company had 401 franchised hotels with 31,409 rooms either in design or under construction in its domestic system. The Company has an additional 90 franchised hotels with 8,468 rooms under development in its international system as of December 31, 2003.

Franchise Expenses. The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative expenses were \$62.9 million for the year ended December 31, 2003, an increase of \$6.4 million from the year ended December 31, 2002 total of \$56.5 million. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 33.6% for the year ended December 31, 2003, compared to 32.8% for 2002. The increase is attributable to increased costs associated with the adoption of the fair value method of accounting for stock options, performance based incentive compensation for sales and other management personnel, retirement plan costs and the consolidation of Flag Choice Hotels upon acquisition of a controlling interest on July 1, 2002.

Marketing and Reservations. The Company's franchise agreements require the payment of franchise fees which include marketing and reservation fees. These fees, which are based on a percentage of the franchisees' gross room revenues, are used exclusively by the Company for expenses associated with providing franchise services such as central reservation systems, national marketing and media advertising. The Company is contractually obligated to expend the marketing and reservation fees it collects from franchisees in accordance with the franchise agreements; as such, no income or loss to the Company is generated.

Total marketing and reservation revenues were \$195.4 million and \$190.1 million for the years ended December 31, 2003 and 2002, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$12.1 million and \$13.0 million for the years ended December 31, 2003 and 2002, respectively. Interest expense attributable to reservation activities was \$1.3 million and \$1.4 million for the years ended December 31, 2003 and 2002, respectively. Marketing and reservation activities provided positive cash flow of \$24.7 million and \$17.2 million for the years ended December 31, 2003 and 2002, respectively. As of December 31, 2003 and 2002, the Company's balance sheet includes a receivable of \$32.4 million and \$44.9 million, respectively, for marketing and reservation fees. This receivable is recorded as an asset in the financial statements as the Company has the contractual authority to require that the franchisees in the system at any given point repay the Company for any deficits related to marketing and reservation activities. The Company's current franchisees are legally obliged to pay any assessment the Company imposes on its franchisees to obtain reimbursement of such deficit regardless of whether those constituents continue to generate gross room revenue. The Company has no present intention to accelerate repayment of the deficit from current franchisees.

Interest and Other. Interest expense of \$11.6 million in the year ended December 31, 2003 is down \$1.5 million from \$13.1 million in the year ended December 31, 2002 due primarily to lower effective interest rates and lower average outstanding debt balances. The Company's weighted average interest rate as of December 31, 2003 was 4.29% compared to 4.39% as of December 31, 2002. Included in the results for 2003 and 2002 is approximately \$4.5 million and \$4.6 million, respectively, of interest income earned on the note receivable from Sunburst.

Comparison of 2002 Operating Results and 2001 Operating Results

The Company recorded net income of \$60.8 million for the year ended December 31, 2002, an increase of \$46.5 million from net income of \$14.3 million for the year ended December 31, 2001. Net income in 2001 included an impairment charge of \$22.7 million associated with the Company's determination to write-off its entire investment in Friendly Hotels PLC (currently known as C.H.E. Group PLC) ("Friendly"). Net income for 2001 also reflects \$10.3 million of equity losses (net of taxes) in Friendly.

Summarized financial results for the years ended December 31, 2002 and 2001 are as follows:

	<u>2002</u>	<u>2001</u>
	(In thousands)	
REVENUES:		
Royalty fees	\$142,943	\$140,185
Initial franchise and relicensing fees	12,881	12,887
Partner services	11,860	12,042
Marketing and reservation	190,145	168,170
Hotel operations	3,331	3,215
Other	4,402	4,929
Total revenues	<u>365,562</u>	<u>341,428</u>
OPERATING EXPENSES:		
Selling, general and administrative	56,520	62,015
Impairment of Friendly investment	—	22,713
Depreciation and amortization	11,251	12,452
Marketing and reservation	190,145	168,170
Hotel operations	2,946	2,501
Total operating expenses	<u>260,862</u>	<u>267,851</u>
Operating income	104,700	73,577
Interest expense	13,136	15,445
Interest and other investment income	(4,549)	(4,329)
Equity in net losses of affiliates	71	16,436
Other	224	608
Income before income taxes	95,818	45,417
Income taxes	34,974	31,090
Net income	<u>\$ 60,844</u>	<u>\$ 14,327</u>

Franchise Revenues. Franchise revenues were \$172.1 million for the year ended December 31, 2002 compared to \$170.0 million for the year ended December 31, 2001. Royalty fees increased \$2.7 million to \$142.9 million from \$140.2 million in 2001, an increase of 1.9%. The increase in royalties is primarily attributable to a 4.4% increase in the number of domestic franchised hotel rooms and an increase in the effective royalty rate of the domestic hotel system to 3.97% from 3.95%, offset by a 3.8% decrease in RevPAR. Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise contracts increased 7.8% to \$8.3 million for the year ended December 31, 2002 from \$7.7 million for the year ended December 31, 2001. Relicensing fees declined 11.5% to \$4.6 million for the year ended December 31, 2002 from \$5.2 million for the year ended December 31, 2001. Relicensing fees are charged to the new property owner of a franchised property whenever an ownership change occurs and the property remains in the franchise system. The decrease in relicensing fees in 2002 reflects a lower number of such ownership changes in 2002 compared to 2001. Total domestic franchise agreements executed in 2002 were 304, compared to 300 total agreements executed in 2001. Revenues generated from partner services were \$11.9 million, compared to \$12.0 million in 2001.

The number of domestic rooms on-line increased to 282,423 from 270,514, an increase of 4.4% for the year ended December 31, 2002. For 2002, the total number of domestic hotels on-line grew 4.7% to 3,482 from 3,327 for 2001. International rooms on-line decreased slightly to 91,299 as of December 31, 2002 from 92,035 as of December 31, 2001, a decrease of 0.8%. The total number of international hotels on-line decreased to 1,182 from 1,218, a decrease of 3.0% for the year ended December 31, 2002. The decrease in international hotels online is primarily due to termination of certain Flag properties which failed to maintain the Company's brand standards

or which declined to formalize a franchise relationship following the Company's acquisition of a controlling interest in Flag Choice Hotels during 2002. As of December 31, 2002, the Company had 310 franchised hotels with 23,766 rooms either in design or under construction in its domestic system. The Company had an additional 164 franchised hotels with 17,799 rooms under development in its international system as of December 31, 2002.

Franchise Expenses. The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative expenses were \$56.5 million (including restructuring charges of \$1.6 million) for the year ended December 31, 2002, a decrease of \$5.5 million from the year ended December 31, 2001 total of \$62.0 million (including restructuring charges of \$5.9 million). As a percentage of net franchise revenues, selling, general and administrative expenses declined to 32.8% in 2002 from 36.5% in 2001. This decline, which increased franchising margins from 63.5% to 67.2%, was largely due to a \$4.3 million reduction in restructuring charges incurred in 2002 compared to 2001.

Marketing and Reservations. Total marketing and reservation revenues were \$190.1 million and \$168.2 million for the years ended December 31, 2002 and 2001, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$13.0 million and \$11.8 million for the years ended December 31, 2002 and 2001, respectively. Interest expense attributable to reservation activities was \$1.4 million and \$2.0 million for the years ended December 31, 2002 and 2001, respectively. Marketing and reservation activities provided a positive cash flow of \$17.2 million and \$20.3 million for the years ended December 31, 2002 and 2001, respectively. As of December 31, 2002 and 2001, the Company's balance sheet included a receivable of \$44.9 million and \$49.4 million, respectively, for marketing and reservation fees. The Company has the contractual authority to require that the franchisees in the system at any given point repay the Company for any deficits related to marketing and reservation activities. The Company's current franchisees are legally obliged to pay any assessment the Company imposes on its franchisees to obtain reimbursement of such deficit regardless of whether those constituents continue to generate gross room revenue. The Company has no present intention to accelerate repayment of the deficit from current franchisees.

Depreciation and Amortization. Depreciation and amortization decreased to \$11.3 million in the year ended December 31, 2002 from \$12.5 million in the year ended December 31, 2001. This decrease is primarily attributable to the Company's adoption of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," pursuant to which the Company stopped amortizing goodwill effective January 1, 2002.

Friendly. The Company's entire investment in Friendly was written off in 2001; accordingly, the Company's 2002 results of operations do not include any equity method losses or other amounts related to Friendly. In addition to the \$22.7 million impairment described below, the Company recorded equity method losses associated with its investment in Friendly totaling \$10.3 million (net of taxes) for the year ended December 31, 2001.

On February 21, 2002, Friendly announced that it had been unable to find an acceptable buyer for its business and would terminate such efforts to sell its business. Given this termination and the adverse economic conditions of Friendly, the Company disposed of its entire investment in Friendly on March 20, 2002. The Company wrote-off its entire investment in Friendly through a \$22.7 million charge to reflect the permanent impairment of this asset as of December 31, 2001.

Interest and Other. Interest expense of \$13.1 million in the year ended December 31, 2002 is down \$2.3 million from \$15.4 million in the year ended December 31, 2001 due primarily to lower effective interest rates. The Company's weighted average interest rate as of December 31, 2002 was 4.39% compared to 4.52% as of December 31, 2001. Included in the results for 2002 and 2001 is approximately \$4.6 million and \$4.2 million, respectively, of interest income earned on the note receivable from Sunburst. The note from Sunburst accrued interest up until June 2002, at which point interest became payable semi-annually in arrears. As of December 31, 2002, the Company's balance sheet included an interest receivable from Sunburst of \$2.3 million which is included in other current assets in the accompanying consolidated balance sheets and was paid to the Company by Sunburst in January 2003.

Liquidity and Capital Resources

Net cash provided by operating activities was \$115.5 million for the year ended December 31, 2003, representing an increase of \$16.5 million from \$99.0 million for the year ended December 31, 2002. The increase in cash provided by operating activities was primarily due to improvements in operating income and repayments related to the marketing and reservation receivable.

During 2002 and 2001, the Company realigned its corporate structure to increase its strategic focus on delivering value-added services and support to franchisees, including centralizing the Company's franchise service and sales operations, consolidating its brand management functions and realigning its call center operations. The Company recorded a \$1.6 million restructuring charge in 2002 of which approximately \$0.9 million and \$0.4 million was paid in 2003 and 2002, respectively. Approximately \$0.3 million of the expense was related to stock compensation for severed employees and was credited directly to additional paid-in capital. The restructuring was initiated and completed in 2002. The Company recorded a \$5.9 million restructuring charge in 2001 of which approximately \$0.9 million of the expense was related to stock compensation for severed employees and was credited directly to additional paid-in capital. Through December 31, 2002 the Company paid \$4.4 million and during 2003 the Company paid an additional \$0.5 million related to this restructuring. As a result of these payments, the Company's obligations related to the 2001 restructuring were satisfied and approximately \$0.1 million was recorded as a reduction of selling, general and administrative expense in 2003. As of December 31, 2003, the Company's obligations related to the 2002 and 2001 restructurings were satisfied resulting in no liability remaining at December 31, 2003. The restructuring charges for 2002 and 2001 are included in selling, general and administrative expenses in the accompanying consolidated statements of income.

Net cash repayments related to marketing and reservation activities totaled \$24.7 million and \$17.2 million during the years ended December 31, 2003 and 2002, respectively. The net repayments are associated with cost reductions from restructured operations, growth in fees from normal operations and increases in property and yield management fees. The Company expects marketing and reservation activities to generate positive cash flows between \$18.5 million and \$21.0 million in 2004.

Cash (used in) provided by investing activities for the years ended December 31, 2003, 2002 and 2001, was \$27.8 million, (\$14.7 million) and \$87.7 million, respectively. During the years ended December 31, 2003, 2002 and 2001, capital expenditures totaled \$8.5 million, \$12.2 million and \$13.5 million, respectively. Capital expenditures include the installation of system-wide property and yield management systems, upgrades to financial and reservation systems, computer hardware and renovations to the Company's corporate headquarters (including a franchisee learning and training center). During 2003, the Company received a cash payment of \$44.7 million from Sunburst related to the prepayment of a note receivable due to the Company. During 2003, approximately \$4.5 million of interest income related to this note was included in net income. As a result of the prepayment, no interest income related to this note will be realized in future periods.

Financing cash flows relate primarily to the Company's borrowings under its credit lines and treasury stock purchases. In June 2001, the Company entered into a five-year \$265 million competitive advance and multi-currency credit facility ("New Credit Facility"). The New Credit Facility provides for a term loan of \$115 million and a revolving credit facility of \$150 million. As of December 31, 2003, the Company had \$81.5 million of term loans and \$62.0 million of revolving loans outstanding pursuant to this facility. The term loan is payable over the next four years, \$21.1 million of which is due in 2004. The New Credit Facility includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage and restrict the Company's ability to make certain investments, incur debt and dispose of assets. Borrowings under the credit facility bear interest at one of several rates, at the option of the Company, including LIBOR plus .60% to 2.0%, based upon the credit rating of the Company and the loan type. In addition, the Company has the option to request participating banks to bid on loan participation at lower rates than those contractually provided by the credit facility. The credit facility requires the Company to pay annual fees ranging, based upon the credit

rating of the Company, between $\frac{1}{15}$ of 1% to $\frac{1}{2}$ of 1% of the aggregate available commitment under the revolving credit facility. The proceeds from the credit facility are used for general corporate purposes, including working capital, debt repayment, stock repurchases, investments and acquisitions.

In 1998, the Company completed a \$100 million senior unsecured note offering (“the Notes”), bearing a coupon rate of 7.13% with an effective rate of 7.22%. The Notes will mature on May 1, 2008, with interest on the Notes to be paid semi-annually. The Company used the net proceeds from the offering of approximately \$99 million to repay amounts outstanding under the Company’s previous credit facility.

The Company has two subordinated lines of credit with banks providing up to an aggregate of \$20 million of borrowings. In April 2003, the company entered into a \$10.0 million revolving line of credit with a maturity date of April 2004. In May 2003, the Company extended the maturity date of an existing \$10.0 million revolving line of credit originally obtained in August 2002 to May 2004. The lines of credit include customary financial and other covenants that require the maintenance of certain ratios identical to those included in the Company’s New Credit Facility. Borrowings under the lines of credit bear interest at rates established at the time of borrowing based on prime minus 175 basis points. As of December 31, 2003, approximately \$2.6 million was outstanding pursuant to one of these lines of credit.

As of December 31, 2003, total long-term debt outstanding for the Company was \$246.7 million, \$23.8 million of which matures in the next twelve months.

Through December 31, 2003, the Company had repurchased 29.3 million shares of its common stock at a total cost of \$514.8 million, including 2.9 million shares at a cost of \$80.4 million during the year ended December 31, 2003. Subsequent to December 31, 2003 and through March 4, 2004, the Company repurchased 0.6 million shares of common stock at a total cost of \$24.2 million.

In the fourth quarter 2003, we declared an initial cash dividend of \$0.20 per share. Dividends declared in 2003 were \$6.9 million. In the first quarter 2004, we declared a cash dividend of \$0.20 per share payable on April 26, 2004 to shareholders of record on April 12, 2004. We expect dividends in 2004 to be approximately \$27.5 million, subject to declaration by our board of directors.

The following table summarizes our contractual obligations as of December 31, 2003.

Contractual Obligations

	Payment due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
			(in millions)		
Long-term debt	\$246.7	\$23.8	\$122.9	\$ 99.9	\$ 0.1
Operating lease obligations	48.8	12.1	18.5	3.9	14.3
Purchase obligations	1.9	1.9	—	—	—
Other long-term liabilities	40.2	—	25.1	8.2	6.9
Total contractual cash obligations	<u>\$337.6</u>	<u>\$37.8</u>	<u>\$166.5</u>	<u>\$112.0</u>	<u>\$21.3</u>

The Company believes that cash flows from operations and available financing capacity are adequate to meet expected future operating, investing and financing needs of the business.

Critical Accounting Policies

Our accounting policies comply with principles generally accepted in the United States. We have described below those policies that we believe are critical and require the use of complex judgment or significant estimates in their application. Additional discussion of these policies is included in Note 1 to our consolidated financial statements.

Revenue Recognition.

We recognize continuing franchise fees, including royalty, marketing and reservations fees, when earned and receivable from our franchisees. Franchise fees are typically based on a percentage of gross room revenues of each franchisee. Our estimate of the allowance for uncollectible royalty fees is charged to selling, general and administrative expense.

Initial franchise and relicensing fees are recognized, in most instances, in the period the related franchise agreement is executed because the initial franchise fee is non-refundable and the Company has no continuing obligations related to the franchisee. We defer the initial franchise fee revenue related to franchise agreements which include incentives until the incentive criteria are met or the agreement is terminated, whichever occurs first.

We account for partner services revenues from endorsed vendors in accordance with Staff Accounting Bulletin No. 104, ("SAB 104") "Revenue Recognition." SAB 104 provides guidance on the recognition, presentation and disclosure of revenue in financial statements. Pursuant to SAB 104, the Company recognizes partner services revenues when the services are performed or the product delivered, evidence of an arrangement exists, the fee is fixed and determinable and collectibility is probable. We defer the recognition of partner services revenues related to certain upfront fees and recognize them over a period corresponding to the Company's estimate of the life of the arrangement.

Marketing and Reservation Revenues and Expenses.

The Company's franchise agreements require the payment of franchise fees, including marketing and reservation fees, which are used exclusively by the Company for expenses associated with providing services such as national marketing, media advertising, central reservation systems and technology services. The Company is contractually obligated to expend the marketing and reservation fees it collects from franchisees to provide these types of services in accordance with the franchise agreements; as such, no income or loss to the Company is generated. In accordance with our contracts, we include in marketing and reservation expenses an allocation of costs for certain activities, such as human resources, legal, accounting, etc., required to carry out marketing and reservation activities.

The Company records marketing and reservation revenues and expenses in accordance with Emerging Issues Task Force ("EITF") Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent," which requires that these revenues and expenses be recorded gross. In addition, net advances to and repayments from the franchise system for marketing and reservation activities are presented as cash flows from operating activities.

Reservation fees and marketing fees not expended in the current year are carried over to the next fiscal year and expended in accordance with the franchise agreements. Shortfall amounts are similarly recovered in subsequent years. Cumulative excess or shortfall amounts from the operation of these programs are recorded as a marketing or reservation fee payable or receivable. Under the terms of the franchise agreements, the Company may advance capital as necessary for marketing and reservation activities and recover such advances through future fees. Our current assessment is that the credit risk associated with the marketing and reservation fee receivable is mitigated due to our contractual right to recover these amounts from a large geographically disperse group of franchisees.

Impairment Policy.

We evaluate the fair value of goodwill to assess potential impairments on an annual basis, or during the year if an event or other circumstance indicates that we may not be able to recover the carrying amount of the asset. We evaluate impairment of goodwill by comparing the fair value of our net assets with the carrying amount of goodwill. We evaluate the potential impairment of property and equipment and other long-lived assets, including franchise rights whenever an event or other circumstance indicates that we may not be able to recover the carrying value of the asset. Our evaluation is based upon future cash flow projections. These projections reflect

management's best assumptions and estimates. Significant management judgment is involved in developing these projections, and they include inherent uncertainties. If different projections had been used in the current period, the balances for noncurrent assets could have been materially impacted. Furthermore, if management uses different projections or if different conditions occur in future periods, future operating results could be materially impacted. The Company reviews outstanding notes receivable on a periodic basis to ensure that each is fully collectible by reviewing the financial condition of its debtors. If the Company concludes that it will be unable to collect all amounts due, the Company will record an impairment charge.

Stock Compensation.

Effective January 1, 2003, the Company adopted, in accordance with SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure," the fair value based method of accounting for stock option awards granted on or after January 1, 2003. No compensation expense related to the grant of stock options under the Company's stock compensation plans was reflected in net income for any years ended on or before December 31, 2002 because the Company accounted for grants in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and all stock options granted in those years had an exercise price equal to the market value of the underlying common stock on the date of grant. The effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 148 to all stock compensation for the three years ended December 31, 2003 is set forth in Note 1 to our consolidated financial statements.

Income Taxes.

Our income tax expense and related balance sheet amounts involve significant management estimates and judgments. Judgments regarding realization of deferred tax assets and the ultimate outcome of tax-related contingencies represent key items involved in the determination of income tax expense and related balance sheet accounts.

Deferred tax assets represent items to be used as a tax deduction or credit in future tax returns for which we have already properly recorded the tax benefit in our income statement. Realization of our deferred tax assets reflects our tax planning strategies. We establish valuation allowances for deferred tax assets that we do not believe will be realized.

Tax assessments and resolution of tax contingencies may arise several years after tax returns have been filed. Predicting the outcome of such tax assessments involves uncertainty; however, we believe that recorded tax liabilities adequately account for our analysis of probable outcomes.

Forward-Looking Statements

Certain statements in this report that are not historical facts constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act. Words such as "believes," "anticipates," "expects," "intends," "estimates," "projects," and other similar expressions, which are predictions of or indicate future events and trends, typically identify forward-looking statements. Such statements are subject to a number of risks and uncertainties which could cause actual results to differ materially from those projected, including: competition within each of our business segments; business strategies and their intended results; the balance between supply of and demand for hotel rooms; our ability to obtain new franchise agreements; our ability to develop and maintain positive relations with current and potential hotel owners; the effect of international, national and regional economic conditions and geopolitical events such as acts of god, acts of war, terrorism or epidemics; the availability of capital to allow potential hotel owners to fund investments in and construction of hotels; the cost and other effects of legal proceedings; and other risks described from time to time in our filings with the Securities and Exchange Commission, including those set forth under the heading "Risk Factors" in our Report on Form 10-K for the year ended December 31, 2003. Given these uncertainties, you are cautioned not to place undue reliance on such statements. We also undertake no obligation to publicly update or revise any forward-looking statement to reflect current or future events or circumstances.

Report of Independent Auditors

To the Board of Directors and Shareholders
of Choice Hotels International, Inc. and subsidiaries:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of shareholders' equity (deficit) and comprehensive income and of cash flows present fairly, in all material respects, the financial position of Choice Hotels International, Inc. and its subsidiaries (the "Company") at December 31, 2003 and December 31, 2002, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. The financial statements of the Company as of December 31, 2001, and for the year then ended, were audited by other independent accountants who have ceased operations. Those independent accountants expressed an unqualified opinion on those financial statements in their report dated March 20, 2002.

As discussed above, the financial statements of the Company as of December 31, 2001, and for the year then ended, were audited by other independent accountants who have ceased operations. As described in Note 3, these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets", which was adopted by the Company as of January 1, 2002. We audited the transitional disclosures described in Note 3. In our opinion, the transitional disclosures for 2001 in Note 3 are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 2001 financial statements of the Company other than with respect to such disclosures and, accordingly, we do not express an opinion or any other form of assurance on the 2001 financial statements taken as a whole.

As discussed in Note 1 to the financial statements, the Company changed the manner in which it accounts for stock based compensation as of January 1, 2003.

PricewaterhouseCoopers LLP

McLean, Virginia
March 5, 2004

WE ARE INCLUDING IN THIS REPORT, PURSUANT TO RULE 2-02(E) OF REGULATION S-X, A COPY OF THE LATEST SIGNED AND DATED REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS FROM OUR PRIOR INDEPENDENT PUBLIC ACCOUNTANTS, ARTHUR ANDERSEN LLP. THIS REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS WAS PREVIOUSLY ISSUED BY ARTHUR ANDERSEN, FOR FILING WITH OUR ANNUAL REPORT ON FORM 10-K FILED BY CHOICE HOTELS INTERNATIONAL, INC. WITH THE SECURITIES AND EXCHANGE COMMISSION ON MARCH 25, 2002, AND HAS NOT BEEN REISSUED BY ARTHUR ANDERSEN LLP. NOTE THAT THIS PREVIOUSLY ISSUED REPORT INCLUDES REFERENCES TO CERTAIN FISCAL YEARS AND PERIODS, WHICH ARE NOT REQUIRED TO BE PRESENTED IN THE ACCOMPANYING FINANCIAL STATEMENTS AS OF AND FOR THE FISCAL YEARS ENDED DECEMBER 31, 2003.

Report of Independent Public Accountants

To Choice Hotels International, Inc. and subsidiaries:

We have audited the accompanying consolidated balance sheets of Choice Hotels International, Inc. and subsidiaries, as of December 31, 2001 and 2000, and the related consolidated statements of income, shareholders' equity and comprehensive income and cash flows for each of the three years in the period ended December 31, 2001. These consolidated financial statements are the responsibility of Choice Hotels International, Inc.'s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Choice Hotels International, Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

As explained in Note 1 to the consolidated financial statements, Choice Hotels International, Inc. and subsidiaries have given retroactive effect to the change in accounting for the presentation of marketing and reservation fees and expenses.

Arthur Andersen LLP

Vienna, Virginia
March 20, 2002

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
	2003	2002	2001
	(In thousands, except per share amounts)		
REVENUES:			
Royalty fees	\$151,326	\$142,943	\$140,185
Initial franchise and relicensing fees	16,799	12,881	12,887
Partner services	13,227	11,860	12,042
Marketing and reservation	195,420	190,145	168,170
Hotel operations	3,565	3,331	3,215
Other	5,767	4,402	4,929
Total revenues	386,104	365,562	341,428
OPERATING EXPENSES:			
Selling, general and administrative	62,860	56,520	62,015
Impairment of Friendly investment	—	—	22,713
Depreciation and amortization	11,225	11,251	12,452
Marketing and reservation	195,420	190,145	168,170
Hotel operations	2,616	2,946	2,501
Total operating expenses	272,121	260,862	267,851
Operating income	113,983	104,700	73,577
OTHER INCOME AND EXPENSES:			
Interest expense	11,597	13,136	15,445
Interest and other investment income	(6,185)	(4,549)	(4,329)
Gain on prepayment of note receivable from Sunburst	(3,383)	—	—
Equity in net (income) losses of affiliates	(582)	71	16,436
Other	129	224	608
Total other income and expenses	1,576	8,882	28,160
Income before income taxes	112,407	95,818	45,417
Income taxes	40,544	34,974	31,090
Net income	\$ 71,863	\$ 60,844	\$ 14,327
Weighted average shares outstanding-basic	35,699	39,333	44,174
Weighted average shares outstanding-diluted	36,674	40,057	44,572
Basic earnings per share	\$ 2.01	\$ 1.55	\$ 0.32
Diluted earnings per share	\$ 1.96	\$ 1.52	\$ 0.32

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31, 2003	December 31, 2002
	(In thousands, except share amounts)	
ASSETS:		
Current assets		
Cash and cash equivalents	\$ 20,031	\$ 12,227
Receivables (net of allowance for doubtful accounts of \$6,743 and \$6,740, respectively)	33,623	32,629
Deferred income taxes	1,957	2,232
Other current assets	2,966	3,349
Total current assets	58,577	50,437
Property and equipment, at cost, net	54,253	64,650
Goodwill	60,620	60,620
Franchise rights, net	35,383	36,336
Receivable—marketing and reservation fees	32,368	44,916
Note receivable from Sunburst	—	41,318
Other assets	26,071	18,496
Total assets	<u>\$ 267,272</u>	<u>\$ 316,773</u>
LIABILITIES AND SHAREHOLDERS' DEFICIT:		
Current liabilities		
Current portion of long-term debt	\$ 23,829	\$ 23,796
Accounts payable	29,740	23,301
Accrued expenses and other	44,704	30,189
Income taxes payable	2,577	7,022
Total current liabilities	100,850	84,308
Long-term debt	222,823	283,995
Deferred income taxes	21,562	29,807
Other liabilities	40,224	32,462
Total liabilities	<u>385,459</u>	<u>430,572</u>
Commitments and Contingencies		
SHAREHOLDERS' DEFICIT:		
Common stock, \$.01 par value; 160,000,000 shares authorized; 62,755,708 shares issued; 34,745,853 and 37,163,216 shares outstanding at December 31, 2003 and 2002, respectively	347	371
Additional paid-in-capital	74,496	73,100
Accumulated other comprehensive income	1,138	42
Deferred compensation	(2,641)	(3,492)
Treasury stock (28,009,855 and 25,592,492 shares at December 31, 2003 and 2002, respectively)	(496,510)	(423,839)
Retained earnings	304,983	240,019
Total shareholders' deficit	<u>(118,187)</u>	<u>(113,799)</u>
Total liabilities and shareholders' deficit	<u>\$ 267,272</u>	<u>\$ 316,773</u>

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2003	2002	2001
	(In thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 71,863	\$ 60,844	\$ 14,327
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	11,225	11,251	12,452
Gain on prepayment of note receivable from Sunburst	(3,383)	—	—
Provision for bad debts	(189)	1,256	476
Non-cash stock compensation and other charges	2,226	1,666	2,210
Non-cash interest and other investment income	(1,532)	(2,128)	(4,219)
Equity in net (income) losses of affiliates	(582)	71	16,436
Impairment of Friendly investment	—	—	22,713
Write-off of deferred financing costs	—	—	650
Changes in assets and liabilities, net of acquisitions:			
Receivables	(887)	(5,538)	6,465
Receivable—marketing and reservation fees, net	24,726	17,219	20,267
Current liabilities	12,185	(3,911)	9,381
Income taxes payable/receivable and other assets	(422)	2,184	2,729
Deferred income taxes and other liabilities	255	16,104	(2,175)
Net cash provided by operating activities	115,485	99,018	101,712
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from prepayment of note receivable from Sunburst	44,701	—	—
Investment in property and equipment	(8,480)	(12,233)	(13,532)
Acquisition of Flag	(1,211)	(2,173)	—
Proceeds from disposition of property	498	—	—
Proceeds from restructuring of Old Note from Sunburst	—	—	101,954
Issuance of notes receivable	(4,433)	(3,440)	(1,228)
(Purchases) sales of investments, net	(2,673)	191	(532)
Other items, net	(618)	2,972	1,076
Net cash provided by (used in) investing activities	27,784	(14,683)	87,738
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from long-term debt	214,900	314,400	772,028
Principal payments of long-term debt	(276,104)	(288,220)	(790,795)
Purchase of treasury stock	(80,358)	(120,931)	(185,807)
Proceeds from exercise of stock options	6,097	5,772	12,294
Net cash used in financing activities	(135,465)	(88,979)	(192,280)
Net change in cash and cash equivalents	7,804	(4,644)	(2,830)
Cash and cash equivalents at beginning of period	12,227	16,871	19,701
Cash and cash equivalents at end of period	\$ 20,031	\$ 12,227	\$ 16,871
Supplemental disclosure of cash flow information			
Cash payments during the year for:			
Income taxes, net of refunds	\$ 49,559	\$ 14,674	\$ 29,013
Interest	13,357	14,132	18,039
Non-cash investing activities:			
Conversion of note receivable into Flag equity interest	\$ —	\$ 1,061	\$ —
Property assumed through the restructuring of Sunburst note	—	—	1,475
Non-cash financing activities:			
Declaration of dividend	\$ 6,899	\$ —	\$ —
Non-cash financing activities related to employee stock options exercised:			
Income tax benefit realized	1,770	1,762	3,895
Treasury shares received for employee tax withholding obligations	98	—	—
Common shares surrendered in-lieu of exercise price	\$ 181	\$ —	\$ —

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (DEFICIT) AND COMPREHENSIVE INCOME
(In thousands, except share amounts)

	Common Stock – Shares Outstanding	Common Stock – Par Value	Additional Paid-in-Capital	Accumulated Other Comprehensive Income (Loss)	Deferred Compensation	Treasury Stock	Comprehensive Income	Retained Earnings	Total
Balance as of December 31, 2000	52,561,568	\$ 526	\$55,245	\$ (54)	\$(1,300)	\$(129,172)		\$164,848	\$ 90,093
Comprehensive income									
Net income	—	—	—	—	—	—	14,327	14,327	14,327
Other comprehensive income:									
Foreign currency translation adjustments ..	—	—	—	—	—	—	(414)	—	(414)
Unrealized loss on available for sale securities, net of taxes, net of reclassification adjustment (Note 16)	—	—	—	—	—	—	(310)	—	(310)
Other comprehensive loss	—	—	—	(724)	—	—	(724)	—	—
Comprehensive income							<u>\$13,603</u>		
Deferred gain on hedge	—	—	—	424	—	—		—	424
Exercise of stock options/grants, net	1,287,454	13	14,885	—	—	1,503		—	16,401
Issuance of restricted stock	155,515	1	—	—	(2,304)	2,303		—	—
Amortization of deferred compensation related to restricted stock grants	—	—	—	—	747	—		—	747
Treasury purchases	(12,006,900)	(120)	—	—	—	(185,687)		—	(185,807)
Balance as of December 31, 2001	<u>41,997,637</u>	<u>\$ 420</u>	<u>\$70,130</u>	<u>\$ (354)</u>	<u>\$(2,857)</u>	<u>\$(311,053)</u>		<u>\$179,175</u>	<u>\$ (64,539)</u>
Comprehensive income									
Net income	—	—	—	—	—	—	60,844	60,844	60,844
Other comprehensive income:									
Foreign currency translation adjustments ..	—	—	—	—	—	—	341	—	341
Amortization of deferred gain on hedge, net of taxes	—	—	—	—	—	—	(67)	—	(67)
Unrealized gain on available for sale securities, net of taxes	—	—	—	—	—	—	122	—	122
Other comprehensive income	—	—	—	396	—	—	396	—	—
Comprehensive income							<u>\$61,240</u>		
Exercise of stock options	442,869	4	1,762	—	—	5,768		—	7,534
Issuance of restricted stock	109,894	1	—	—	(2,301)	2,300		—	—
Stock compensation related to restructuring	—	—	1,208	—	—	—		—	1,208
Amortization of deferred compensation related to restricted stock grants	—	—	—	—	1,666	—		—	1,666
Treasury purchases	(5,387,184)	(54)	—	—	—	(120,854)		—	(120,908)
Balance as of December 31, 2002	<u>37,163,216</u>	<u>\$ 371</u>	<u>\$73,100</u>	<u>\$ 42</u>	<u>\$(3,492)</u>	<u>\$(423,839)</u>		<u>\$240,019</u>	<u>\$(113,799)</u>
Comprehensive income									
Net income	—	—	—	—	—	—	71,863	71,863	71,863
Other comprehensive income:									
Foreign currency translation adjustments	—	—	—	—	—	—	1,101	—	1,101
Amortization of deferred gain on hedge, net of taxes	—	—	—	—	—	—	(67)	—	(67)
Unrealized gain on available for sale securities, net of taxes	—	—	—	—	—	—	62	—	62
Other comprehensive income	—	—	—	1,096	—	—	1,096	—	—
Comprehensive income							<u>\$72,959</u>		
Exercise of stock options	462,522	5	198	—	—	7,845		—	8,048
Issuance and cancellation of restricted stock ..	7,428	—	(108)	—	(72)	180		—	—
Stock compensation related to stock options ..	—	—	1,306	—	—	—		—	1,306
Amortization of deferred compensation related to restricted stock grants	—	—	—	—	923	—		—	923
Dividends declared	—	—	—	—	—	—		(6,899)	(6,899)
Treasury purchases	(2,887,313)	(29)	—	—	—	(80,696)		—	(80,725)
Balance as of December 31, 2003	<u>34,745,853</u>	<u>\$ 347</u>	<u>\$74,496</u>	<u>\$1,138</u>	<u>\$(2,641)</u>	<u>\$(496,510)</u>		<u>\$304,983</u>	<u>\$(118,187)</u>

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Company Information and Significant Accounting Policies

Company Information.

Choice Hotels International, Inc. and subsidiaries (together “the Company”) is in the business of hotel franchising. As of December 31, 2003, the Company had franchise agreements representing 4,810 open hotels and 491 hotels under development in 44 countries and territories under the brand names: Comfort Inn, Comfort Suites, Quality, Clarion, Sleep Inn, Econo Lodge, Rodeway Inn, MainStay Suites and Flag Hotels.

Principles of Consolidation.

The consolidated financial statements include the accounts of Choice Hotels International, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

On July 1, 2002, the Company acquired a controlling interest in Flag Choice Hotels (“Flag”). Flag, based in Melbourne, Australia, is a franchisor of hotels in Australia, Papua New Guinea, Fiji and New Zealand. The results of Flag have been consolidated since that date.

Certain amounts in the prior years’ financial statements have been reclassified to conform to the current year presentation.

Revenue Recognition.

The Company accounts for initial and continuing franchise fees in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 45, “Accounting for Franchise Fee Revenue.” The Company enters into franchise agreements to provide franchisees with various marketing services, a centralized reservation system and limited non-exclusive rights to utilize the Company’s registered tradenames and trademarks. These agreements typically have an initial term of twenty years with provisions permitting franchisees to terminate after five, ten, or fifteen years under certain circumstances. In most instances, initial franchise fees are recognized upon execution of the franchise agreement because the initial franchise fee is non-refundable and the Company has no continuing obligations related to the franchisee. The initial franchise fees related to executed franchise agreements which include incentives, such as future potential rebates, are deferred and recognized when the incentive criteria are met or the agreement is terminated, whichever occurs first.

Royalty fees, which are typically based on a percentage of gross room revenues of each franchisee, are recorded when earned and receivable from the franchisee. Reserves for uncollectible royalty fees are charged to bad debt expense and are included in selling, general and administrative expenses in the accompanying consolidated statements of income.

The Company generates partner services revenues from endorsed vendors. Partner services revenues are generally earned based on the level of goods or services purchased from endorsed vendors by hotel owners and hotel guests who stay in the Company’s franchised hotels. The Company accounts for partner services revenues in accordance with Staff Accounting Bulletin No. 104, (“SAB 104”) “Revenue Recognition.” SAB 104 provides guidance on the recognition, presentation and disclosure of revenue in financial statements. The Company recognizes partner services revenues when the services are performed or the product delivered, evidence of an arrangement exists, the fee is fixed and determinable and collectibility is probable. SAB 104 requires the Company to defer the recognition of partner services revenues related to upfront fees. Such upfront fees are generally recognized over a period corresponding to the Company’s estimate of the life of the arrangement.

Marketing and Reservation Revenues and Expenses.

The Company’s franchise agreements require the payment of franchise fees, including marketing and reservation fees, which are used exclusively by the Company for expenses associated with providing franchise

services such as national marketing, media advertising, central reservation systems and technology services. The Company is contractually obligated to expend the marketing and reservation fees it collects from franchisees in accordance with the franchise agreements; as such, no income or loss to the Company is generated. In accordance with our contracts, we include in marketing and reservation expenses an allocation of costs for certain activities, such as human resources, legal, accounting, etc., required to carry out marketing and reservation activities.

The Company records marketing and reservation revenues and expenses in accordance with Emerging Issues Task Force (“EITF”) Issue No. 99-19, “Reporting Revenue Gross as a Principal versus Net as an Agent,” which requires that these revenues and expenses be recorded gross. In addition, net advances from and repayments related to marketing and reservation activities are presented as cash flows from operating activities.

Credit Risk and Exposure.

Substantially all of the Company’s trade receivables as well as the receivable for marketing and reservation fees are due from hotel franchisees. However, the Company considers its credit risk associated with trade receivables and the receivable for marketing and reservation fees to be partially mitigated due to the dispersion of these receivables across a large number of geographically diverse franchisees.

The Company records bad debt expense in selling, general and administrative expenses and marketing and reservation expenses in the accompanying consolidated statements of income based on its assessment of the ultimate realizability of receivables considering historical collection experience and the economic environment. When the Company determines that an account is not collectible, the account is written-off to the associated allowance for doubtful accounts.

Advertising Costs.

The Company expenses advertising costs as the advertising occurs in accordance with American Institute of Certified Public Accountants, Statement of Position 93-7, “Reporting on Advertising Costs.” Advertising expense was \$52.8 million, \$50.7 million and \$41.8 million for the years ended December 31, 2003, 2002 and 2001, respectively. The Company includes advertising costs primarily in marketing and reservation expenses on the accompanying consolidated statements of income.

Cash and Cash Equivalents.

The Company considers all highly liquid investments purchased with a maturity of three months or less at the date of purchase to be cash equivalents. As of December 31, 2003 and 2002, \$7.2 million and \$5.0 million, respectively, of book overdrafts representing outstanding checks in excess of funds on deposit are included in accounts payable in the accompanying consolidated balance sheets.

Capitalization Policies.

Property and equipment are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Major renovations, replacements and interest incurred during construction are capitalized. Upon sale or retirement of property, the cost and related accumulated depreciation are eliminated from the accounts and any related gain or loss is recognized in the accompanying consolidated statements of income. Maintenance, repairs and minor replacements are charged to expense as incurred.

Impairment Policy.

The Company evaluates the impairment of property and equipment and other long-lived assets, including franchise rights and other definite-lived intangibles, in accordance with SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets.” SFAS No. 144 states that an impairment of long-lived assets has occurred whenever events or changes in circumstances indicate that the carrying amount of an asset may not be

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

recoverable. Recoverability is measured based on net, undiscounted expected cash flows. Assets are considered to be impaired if the net, undiscounted expected cash flows are less than the carrying amount of the assets. Impairment charges are recorded based upon the difference between the carrying value and the fair value of the asset. The Company did not record any impairments on long-lived assets during the three years ended December 31, 2003.

The Company evaluates the impairment of goodwill in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," which requires goodwill to be assessed on at least an annual basis for impairment using a fair value basis. Because the Company has one reporting unit pursuant to SFAS No. 142 the fair value of the Company's net assets are used to determine if goodwill may be impaired. According to SFAS No. 142, quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement if available. The Company did not record any impairment of goodwill during the three years ended December 31, 2003, based on assessments performed by the Company.

The Company evaluates the collectibility of notes receivable in accordance with SFAS No. 114, "Accounting by Creditors For Impairment of a Loan." SFAS No. 114 states that a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. The Company reviews outstanding notes receivable on a periodic basis to ensure that each is fully collectible. If the Company concludes that it will be unable to collect all amounts due, the Company will record an impairment charge based on the present value of expected future cash flows, discounted at the loan's effective interest rate. The Company did not record any impairment charges related to notes receivable during the three years ended December 31, 2003.

Deferred Financing Costs.

Debt financing costs are deferred and amortized, using the effective interest method, over the term of the related debt. As of December 31, 2003 and 2002, unamortized deferred financing costs were \$1.5 million and \$2.1 million, respectively, and are included in other non-current assets in the accompanying consolidated balance sheets.

Investments.

The Company accounts for its investments in the common stock of Choice Hotels Scandinavia ("CHS") in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and SFAS No. 130, "Reporting Comprehensive Income." The Company accounts for its investment in Choice Hotels Canada, Inc. ("CHC") in accordance with Accounting Principles Board Opinion ("APB") No. 18, "The Equity Method of Accounting for Investments in Common Stock."

Derivatives.

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," establishes accounting and reporting standards for derivative instruments, including derivative instruments embedded in other contracts, and for hedging activities. SFAS No. 133 requires the recognition of the fair value of derivatives in the balance sheet, with changes in the fair value recognized either in earnings or as a component of other comprehensive income dependent upon the nature of the derivative. SFAS No. 133 also states that any deferred gain on previous hedging activity does not meet the definition of a liability, due to a lack of expected future cash flows and therefore should be included in comprehensive income. As of December 31, 2003, the Company had no derivative financial instruments.

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock-based compensation.

The Company has stock-based employee compensation plans, which are described more fully in Note 15. Prior to January 1, 2003, the Company accounted for those plans under the recognition and measurement provisions of APB No. 25, "Accounting for Stock Issued to Employees," and related interpretations. No stock-based employee compensation cost is reflected in 2002 or prior years' net income related to the grant of stock options, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2003, the Company adopted, in accordance with the prospective method prescribed by SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure," the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," for all employee awards granted, modified, or settled after January 1, 2003. Therefore, the cost related to stock-based employee compensation included in the determination of net income for the years ended December 31, 2002 and 2001 is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of SFAS 123. The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested awards in each period.

	<u>Years Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>(In millions, except per share amounts)</u>		
Net income, as reported	\$71.9	\$60.8	\$14.3
Stock-based employee compensation cost included in reported net income, net of related tax effects	1.4	1.2	0.5
Total stock-based employee compensation expense determined under fair value method for all awards, net of tax effects	(2.9)	(3.8)	(3.5)
Pro forma net income	\$70.4	\$58.2	\$11.3
Earnings per share:			
Basic—as reported	\$2.01	\$1.55	\$0.32
Basic—pro forma	\$1.97	\$1.48	\$0.25
Diluted—as reported	\$1.96	\$1.52	\$0.32
Diluted—pro forma	\$1.92	\$1.45	\$0.25

Notes Receivable.

From time to time, the Company provides financing to franchisees for property improvements and other purposes in the form of interest free notes. The terms of the notes range from 5 to 10 years and are forgiven and amortized over that time period if the franchisee remains in the system in good standing. As of December 31, 2003 and 2002, other non-current assets included \$7.6 million and \$3.6 million, respectively, related to the unamortized balance of these notes. Amortization expense included in the accompanying consolidated statements of income related to the notes was \$0.8 million, \$0.4 million and \$0.1 million for the years ended December 31, 2003, 2002 and 2001, respectively. As of December 31, 2003 and 2002, other non-current assets includes an allowance for doubtful accounts related to these notes of \$0.8 million and \$0.9 million, respectively.

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Income Taxes.

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the financial statements or income tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted rates expected to apply to taxable income in the years in which those 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. We also estimate and accrue for certain tax assessments and the expected resolution of tax contingencies which arise in the course of our business.

Earnings per Share.

Basic earnings per share excludes dilution and is computed by dividing net income by the weighted-average number of common shares outstanding. Diluted earnings per share, assumes dilution and is computed based on the weighted-average number of common shares outstanding after consideration of the dilutive effect of stock options and unvested restricted stock.

Use of Estimates.

The consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States and require management to make certain 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 from those estimates.

2. Property and Equipment

The components of property and equipment in the consolidated balance sheets are:

	December 31,	
	2003	2002
	(In thousands)	
Land and land improvements	\$ 4,173	\$ 4,117
Facilities in progress	2,313	1,631
Computer equipment and software	88,051	83,790
Buildings and improvements	38,089	36,283
Furniture, fixtures and equipment	10,503	10,479
	143,129	136,300
Less: Accumulated depreciation and amortization	(88,876)	(71,650)
	\$ 54,253	\$ 64,650

As facilities in progress are completed and placed in service, they are transferred to appropriate property and equipment categories and depreciation begins. Depreciation expense, excluding amounts attributable to marketing and reservation activities, for the years ended December 31, 2003, 2002 and 2001 was \$6.5 million, \$5.6 million and \$4.6 million, respectively. Depreciation has been computed for financial reporting purposes

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

using the straight-line method. A summary of the ranges of estimated useful lives upon which depreciation rates are based follows:

Computer equipment and software	3-5 years
Buildings and improvements	10-40 years
Furniture, fixtures and equipment	3-20 years

3. Goodwill

Goodwill relates to the purchase price of a minority interest in the Company for consideration in excess of the recorded minority interest. Prior to January 1, 2002, the Company amortized goodwill on a straight-line basis over 40 years. Such amortization amounted to \$2.0 million for the year ended December 31, 2001.

On January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets," pursuant to which the Company is no longer required to amortize goodwill. The impact of the adoption of SFAS No. 142 on net income, basic earnings per share and diluted earnings per share for the year ended December 31, 2001, as if the adoption had taken place on January 1, 2001 is as follows:

	<u>Year Ended December 31, 2001</u>
	<u>(In thousands, except per share amounts)</u>
Reported net income	\$14,327
Add back: Goodwill amortization	1,995
Adjusted net income	<u>\$16,322</u>
Basic earnings per share:	
Reported net income	\$ 0.32
Goodwill amortization	<u>0.05</u>
Adjusted basic earnings per share	<u>\$ 0.37</u>
Diluted earnings per share:	
Reported net income	\$ 0.32
Goodwill amortization	<u>0.04</u>
Adjusted diluted earnings per share	<u>\$ 0.36</u>

4. Franchise Rights and Other Intangibles

Franchise rights represent the unamortized purchase price assigned to acquired long-term franchise contracts. As of December 31, 2003 and 2002, the unamortized balance relates primarily to the Econo Lodge and Flag franchise rights. The franchise rights are being amortized over lives ranging from 5 to 15 years. Amortization expense for the years ended December 31, 2003, 2002 and 2001 amounted to \$3.4 million, \$3.1 million and \$3.0 million, respectively. Franchise rights are net of accumulated amortization of \$38.5 million and \$35.1 million at December 31, 2003 and 2002, respectively. The estimated annual amortization expense related to the Company's franchise rights for each of the years ending December 31, 2004 through 2008 is \$3.4 million.

Other non-current assets includes approximately \$2.7 million and \$2.5 million of unamortized intangible assets related to trademarks at December 31, 2003 and 2002, respectively. The trademarks are being amortized over ten years. Amortization expense for the years ended December 31, 2003, 2002 and 2001 amounted to \$0.3

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

million, \$0.4 million and \$0.4 million, respectively. The estimated annual amortization expense related to the Company's trademarks for each of the years ending December 31, 2004 through 2008 is \$0.3 million.

5. Investment in Friendly Hotels

As of December 31, 2001, the Company had 1,227,622 shares of common stock and 31,097,755 shares of 5.75% convertible preferred stock in Friendly Hotels PLC (currently known as C.H.E. Group PLC) ("CHE" or "Friendly"), the Company's master franchisor for the Comfort Inn, Quality and Clarion brand hotels in the United Kingdom, Ireland and throughout Europe (with the exception of Scandinavia). Friendly's master franchise rights expire in January 2008 subject to certain renewal rights of CHE.

Until March 2002, the Company appointed three directors to the board of Friendly giving the Company the ability to exercise significant influence over the operations of Friendly. Accordingly, the Company was required to apply the equity method of accounting.

In exchange for granting the master franchise rights to Friendly, the Company received Friendly common stock and was to receive \$8.0 million payable in cash in eight equal annual installments from Friendly.

On January 19, 2001, the shareholders of Friendly approved a capital reorganization intended to provide Friendly with a stronger balance sheet and to improve its operations. Pursuant to the capital reorganization, the Company waived certain royalty and marketing fees due from Friendly for the period between December 27, 1999 and December 31, 2005, waived the then five remaining annual installments related to the master franchise agreement and provided Friendly with a £7.8 million (approximately US \$11.4 million) secured letter of credit in consideration for, among other things, a reduction in the conversion price of the convertible preferred shares held by the Company from 150p to 60p. The letter of credit was secured by substantially all of Friendly's assets in France, valued in excess of £4.2 million (approximately US \$6.1 million). Other modifications to the convertible preferred shares included a change in the dividend rate from 5.75% (payable in cash) to 2% per annum, (payable in additional convertible preferred shares). Friendly was also permitted to elect to pay cash dividends at the rate of 3.5% per annum up until January 13, 2013 and thereafter at the rate of 5.75%. In addition, accrued dividends due to the Company as of February 7, 2001 were converted to additional convertible preferred shares of Friendly. As of December 31, 2001, Friendly had drawn £5.3 million (approximately US \$7.7 million) of the available letter of credit and the balance available on the letter of credit was reduced to £5.0 million (approximately US \$7.3 million) as of January 21, 2002. The letter of credit was terminated on January 28, 2003.

During 2001, Friendly settled a \$4.0 million deferred consideration due to the Company through the issuance of 2,404,013 convertible preferred shares. The effect of the reduction in the conversion price together with the conversion of dividend arrearage to additional convertible preferred shares of Friendly and the settlement of the deferred consideration, both resulting in the issuance of convertible preferred shares, on a fully converted basis, the Company's ownership in Friendly would have been approximately 71%. Due to Friendly's restructuring, the Company recorded equity losses on Friendly of \$16.4 million for the year ended December 31, 2001 in accordance with EITF 99-10, "Percentage Used to Determine the Amount of Equity Method Losses." Adverse fixed asset valuation adjustments due to a decline in economic conditions and incremental professional fees associated with the reorganization primarily account for the \$16.4 million charge in 2001.

The Company waived its royalty fees from Friendly for the periods from 2001 through 2005 as part of Friendly's restructuring. No dividends were accrued during 2001.

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company owned approximately 5.4% of Friendly's outstanding ordinary shares at December 31, 2001. The fair market value of the ordinary shares at December 31, 2001 was \$0.3 million. Summarized unaudited balance sheet data for Friendly is as follows:

	December 31, 2001
	Unaudited (In thousands)
Current assets	\$ 20,530
Non-current assets	107,744
Current liabilities	59,114
Non-current liabilities	45,573
Preferred stock	23,104
Shareholders' equity	23,587

Summarized unaudited income statement data for Friendly is as follows:

	For the Year Ended December 31, 2001
	Unaudited (In thousands)
Net revenues	\$124,845
Gross profit	69,167
Loss from continuing operations	(5,023)
Net loss after preferred dividends	(8,036)

On February 21, 2002, Friendly announced that it had been unable to find an acceptable buyer for its business and would terminate efforts to sell its business. Given this termination and the adverse economic conditions of Friendly, the Company disposed of its entire preferred and common equity interest in Friendly on March 20, 2002, and immediately relinquished its three seats on Friendly's board of directors. The Company wrote-off its entire investment in Friendly through a \$22.7 million charge to reflect the permanent impairment of this asset as of December 31, 2001.

6. Receivable-Marketing and Reservation Fees

The Company's franchise agreements require the payment of franchise fees which include marketing and reservation fees. The Company is obligated to use the marketing and reservation fees it assesses against the current franchisees comprising its various hotel brand systems to provide marketing and reservation services appropriate for the successful operation of the systems. In discharging its obligation to provide sufficient and appropriate marketing and reservation services, the Company has the right to expend funds in an amount reasonably necessary to ensure the provision of such services, whether or not such amount is currently available to the Company for reimbursement. The franchise agreements provide the Company the right to advance monies to the franchise system when the needs of the system surpass the balances currently available.

Under the terms of these agreements, the Company has the legally enforceable right to assess and collect from its current franchisees fees sufficient to pay for the marketing and reservation services the Company has procured for the benefit of the franchise system, including fees to reimburse the Company for past services rendered. The Company has the contractual authority to require that the franchisees in the system at any given point repay any deficits related to marketing and reservation activities. The Company's current franchisees are legally obliged to pay any assessment the Company imposes on its franchisees to obtain reimbursement of such deficit regardless of whether those constituents continue to generate gross room revenue. The Company has no present intention to accelerate repayment of the deficit from current franchisees.

The marketing and reservation fees receivable at December 31, 2003 and 2002 was \$32.4 million and \$44.9 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the years ended December 31, 2003, 2002 and 2001 was \$12.1 million, \$13.0 million and \$11.8 million, respectively. Interest expense attributable to reservation activities was \$1.3 million, \$1.4 million and \$2.0 million for the years ended December 31, 2003, 2002 and 2001, respectively.

7. Transactions with Sunburst

Effective October 15, 1997, Choice Hotels International, Inc. ("CHI"), which at that point included both the franchising business and owned hotel business, separated the businesses via spin-off of the Company. CHI changed its name to Sunburst Hospitality Corporation (referred to hereafter as "Sunburst"). As part of the spin-off, Sunburst and the Company entered into a strategic alliance agreement. Among other things, the strategic alliance agreement, as amended, provided for (i) certain commitments by Sunburst for the development of MainStay Suites hotels; (ii) the determination of liquidated damages related to termination of Choice branded Sunburst properties; and (iii) certain franchise fee credits. The Mainstay development commitments expired in October 2002. The liquidated damage provisions extend through the life of existing franchise agreements. The franchise fee credit provisions expired in October 2003. Other revenues for the year ended December 31, 2003 includes \$1.7 million of liquidated damages received from Sunburst for the termination of franchises. As of December 31, 2003, Sunburst operates 29 hotels under franchise with the Company.

In connection with the spin-off, the Company received a subordinated term note from Sunburst (the "Old Note"). In connection with an amendment of the strategic alliance agreement, effective October 15, 2000, interest on the Old Note accrued at a rate of 11% per annum compounded daily. The Old Note was scheduled to mature in full, along with accrued interest, on October 15, 2002.

In September 2000, the Company and Sunburst agreed to restructure the Old Note. Pursuant to the agreement the Old Note was cancelled and the Company received cash, a parcel of land, and a new subordinated note. On January 5, 2001, the Company received \$102.0 million, a parcel of land valued at approximately \$1.5 million and a \$35 million seven-year senior subordinated note bearing interest at 11 $\frac{3}{8}$ % (the "New Note"). The New Note accrued interest up until June 2002, at which point interest became payable semi-annually in arrears. As of December 31, 2002, the Company's balance sheet included interest receivable from Sunburst of \$2.3 million which was included in other current assets in the accompanying consolidated balance sheets and was paid to the Company by Sunburst in January 2003.

On September 4, 2003, the Company and Sunburst entered into an agreement to amend certain terms of the New Note. At the time of the agreement, the principal amount of the New Note was approximately \$41.3 million. Pursuant to the agreement, as an incentive for Sunburst to accelerate repayment of the New Note, the Company agreed to modify the redemption provisions of the New Note. Pursuant to the agreement, at any time prior to January 31, 2004, upon Sunburst's election to redeem the Note, Choice agreed to amend the existing optional redemption provision to allow Sunburst to redeem the New Note at a percentage of the principal amount equal to (i) 105.6875%, plus (ii) 2.84375% multiplied by the number of days prior to January 5, 2005 that redemption is made, divided by 365 days.

On December 19, 2003, Sunburst redeemed the New Note for approximately \$47.1 million (including accrued interest of \$2.2 million). The Company recognized a gain of \$3.4 million in the accompanying consolidated statement of income for the year ended December 31, 2003. The Company also recognized tax benefits of approximately \$1.3 million in 2003 through reduction of liabilities for tax contingencies as a result of the gain on the transaction.

The Company recognized interest income related to the New Note of \$4.5 million, \$4.6 million and \$4.2 million for the years ended December 31, 2003, 2002 and 2001, respectively.

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Total franchise fees paid by Sunburst to the Company, net of royalty fee credits, included in the accompanying consolidated financial statements were \$5.3 million, \$6.1 million and \$7.8 million for the years ended December 31, 2003, 2002 and 2001, respectively. As of December 31, 2003 and 2002, accounts receivable included \$1.1 million due from Sunburst.

8. Restructuring Programs

During 2002, the Company recognized a restructuring charge expense of \$1.6 million pursuant to Statement of Financial Accounting Standards No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The restructuring charge related to employee severance and termination benefits for 23 employees resulting from corporate realignment initiatives and is included in selling, general and administrative expenses in the accompanying consolidated statements of income. The restructuring was initiated and completed in 2002. Approximately \$0.3 million of the expense was related to stock compensation for certain severed employees and was credited directly to additional paid-in capital. During 2003 and 2002, the Company paid approximately \$0.9 million and \$0.4 million in cash related to this restructuring. The payments made during 2003 satisfied the Company's obligations related to the 2002 restructuring resulting in no liability remaining at December 31, 2003.

During 2001, the Company recognized a restructuring charge expense of \$5.9 million pursuant to Emerging Issues Task Force ("EITF") No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The restructuring charge included \$5.3 million related to a corporate realignment designed to increase the Company's strategic focus on delivering value-added services to franchisees, including centralizing the Company's franchise service and sales operations, consolidating its brand management functions and realigning its call center operations and is included in selling, general and administrative expenses in the accompanying consolidated statements of income. Of this \$5.3 million, \$5.1 million related to severance and termination benefits for 64 employees (consisting of brand management and new hotels support, reservation sales and administrative personnel and franchise sales and operations support) and \$0.2 million relates to the cancellation of preexisting contracts for termination of domestic leases. The remaining \$0.6 million of the \$5.9 million was due to exit costs related to the termination of a corporate hotel construction project. Through December 31, 2002, the Company had paid cash of \$4.4 million related to this restructuring. Approximately \$0.9 million of the restructuring expense related to stock compensation for certain severed employees was reclassified from the restructuring liability during 2002 to additional paid-in capital. The Company paid approximately \$0.5 million in cash related to this restructuring during 2003. As a result of these payments, the Company's obligations related to the 2001 restructuring were satisfied and approximately \$0.1 million was recorded as a reduction of selling, general and administrative expense in the accompanying consolidated statements of income for the year ended December 31, 2003, resulting in no liability remaining at December 31, 2003.

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

9. Accrued Expenses and Other

Accrued expenses and other consisted of the following at:

	December 31,	
	2003	2002
	(In thousands)	
Accrued salaries and benefits	\$17,219	\$15,175
Deferred loyalty program revenue	11,770	6,569
Dividends payable	6,899	—
Deferred revenue	3,114	2,349
Accrued interest	1,392	2,343
Accrued restructuring	—	1,518
Other	4,310	2,235
Total	<u>\$44,704</u>	<u>\$30,189</u>

Deferred loyalty program revenue relates to the Company's Choice Privileges program. Choice Privileges is a frequent guest incentive program that enables members to earn points based on their spending levels at participating brands. The points may be redeemed for free accommodations or other benefits. Points cannot be redeemed for cash.

The Company collects 5% of program member's room revenue from participating franchises. Revenues are deferred equal to the fair value of the future redemption obligation. Actuarial methods are used to estimate the eventual redemption rates and point values. Upon redemption of points, the Company recognizes the previously deferred revenue as well as the corresponding expense relating to the cost of the awards redeemed.

10. Long-Term Debt

Debt consisted of the following at:

	December 31,	
	2003	2002
	(In thousands)	
\$265 million competitive advance and multi-currency revolving credit facility with an effective rate of 2.29% and 3.05% at December 31, 2003 and 2002, respectively	\$143,458	\$200,708
\$100 million senior notes with an effective rate of 7.22% at December 31, 2003 and 2002	99,720	99,655
\$20 million lines of credit with an effective rate of 2.25% and 2.50% at December 31, 2003 and 2002, respectively	2,600	6,400
Other notes with an average effective rate of 2.89% and 3.30% at December 31, 2003 and 2002, respectively	874	1,028
Total debt	<u>\$246,652</u>	<u>\$307,791</u>

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Scheduled maturities of debt as of December 31, 2003 were as follows:

<u>Year</u>	<u>(In thousands)</u>
2004	\$ 23,829
2005	26,513
2006	96,167
2007	146
2008	99,866
Thereafter	131
Total	<u>\$246,652</u>

On June 29, 2001, the Company refinanced its senior credit facility (the “New Credit Facility”) in the amount of \$260 million with a new maturity date of June 29, 2006. The New Credit Facility originally provided for a term loan of \$150 million and a revolving credit facility of \$110 million. On September 29, 2001, the Company signed an amendment to the New Credit Facility, for an additional \$5 million under the revolving credit facility, bringing the total amount of available commitments to \$265 million. The amendment also transferred \$35 million from the term loan to the revolving credit facility. As amended, the initial term loan amount was \$115 million and the revolving credit facility is \$150 million. The term loan (\$81.5 million of which is outstanding at December 31, 2003) is payable over five years, \$21 million of which is due in 2004. Borrowings under the New Credit Facility bear interest, at one of several rates, at the option of the Company, including LIBOR plus 0.60% to 2.0%, based upon the credit rating of the Company and the loan type. The New Credit Facility requires the Company to pay annual fees ranging, based upon the credit rating of the Company, between $\frac{1}{15}$ of 1% to $\frac{1}{2}$ of 1% of the aggregate available commitment under the revolving credit facility.

The New Credit Facility includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage and restricts the Company’s ability to make certain investments, incur debt and dispose of assets, among other restrictions. As of December 31, 2003, the Company is in compliance with all covenants under the New Credit Facility.

On May 1, 1998, the Company issued \$100 million of senior unsecured notes (the “Notes”) at a discount of \$0.6 million, bearing a coupon rate of 7.13% with an effective rate of 7.22%. The Notes will mature on May 1, 2008. Interest on the Notes is paid semi-annually.

The Company has two subordinated lines of credit with banks providing up to an aggregate of \$20 million of borrowings. In April 2003, the Company entered into a \$10.0 million revolving line of credit with a maturity date of April 2004. In May 2003, the Company extended the maturity date of an existing \$10.0 million revolving line of credit originally obtained in August 2002 to May 2004. The lines of credit include customary financial and other covenants that require the maintenance of certain ratios identical to those included in the Company’s New Credit Facility. Borrowings under the lines of credit bear interest at rates established at the time of borrowing based on prime minus 175 basis points. As of December 31, 2003, approximately \$2.6 million was outstanding pursuant to one of these lines of credit.

11. Foreign Operations

The Company accounts for foreign currency translation in accordance with SFAS No. 52, “Foreign Currency Translation.” Revenues generated by foreign operations, including royalty, marketing and reservations fees, for the years ended December 31, 2003, 2002 and 2001 were \$19.1 million, \$14.2 million and \$12.4 million, respectively. Net income (loss), including equity in the income and (loss) of equity method investments,

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

attributable to the Company's foreign operations was \$3.6 million, \$2.4 million and \$(35.2 million) for the years ended December 31, 2003, 2002 and 2001, respectively.

Flag Choice Hotels

On July 1, 2002, the Company acquired a controlling interest in Flag Choice Hotels ("Flag") (the "Flag Transaction"). Flag, based in Melbourne, Australia, is a franchisor of certain hotel brands in Australia, Papua New Guinea, Fiji and New Zealand. The acquisition of a controlling interest in Flag gave the Company the ability to control the Choice and Flag brands in Australia, Papua New Guinea and Fiji and the Flag brand in New Zealand. In September 2003, our master franchise agreement with a third party that included the right to franchise the Choice brands in New Zealand was terminated. At that time, Flag obtained the rights to the Choice brands in New Zealand.

Pursuant to the Flag Transaction, the Company converted an existing \$1.1 million convertible note due from Flag into an additional 15% of Flag's equity (beyond the 15% equity interest held prior to the Flag Transaction) and purchased an additional 25% of Flag's equity for approximately \$1.6 million increasing the Company's total ownership in Flag to 55% as of July 1, 2002.

Pursuant to the Flag Transaction, the Company gave the seller the right to "put" the remaining 45% equity interest in Flag to the Company for approximately \$1.1 million. The put right was permitted to be exercised between January 1, 2003 and June 30, 2007. The Company accounted for the put right in accordance with SFAS 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS 133 requires the recognition of all derivatives, except certain qualifying hedges, as either assets or liabilities measured at fair value, with changes in value reflected as current period income or loss unless specific hedge accounting criteria are met. The fair value of the put rights was \$0 at December 31, 2002, and no income or expense related to this derivative was recorded for the year ended December 31, 2002. The seller exercised the put right in January 2003. The put transaction closed in February 2003, at which time Flag became a wholly-owned subsidiary.

The Company accounted for the Flag Transaction in accordance with SFAS No. 141, "Business Combinations." The excess of the total purchase price over the net tangible assets acquired of approximately \$4.3 million has been allocated to identifiable intangible assets as follows:

	<u>Estimated Fair Value</u> (in thousands)	<u>Estimated Useful Lives</u>
Trademarks and non-compete agreements	\$ 235	5 years
Franchise rights	<u>4,115</u>	5-15 years
	<u>\$4,350</u>	

The Company began consolidating the results of Flag on July 1, 2002. The pro forma results of operations as if Flag had been combined at the beginning of 2001 and 2002, would not be materially different from the Company's reported results for those periods.

Choice Hotels Scandinavia

The Company accounts for its investment, representing 1% of the outstanding common stock of Choice Hotels Scandinavia ("CHS") as an available for sale security in accordance with SFAS 115. The investment is included in other non-current assets in the accompanying consolidated balance sheets at fair value. As of December 31, 2003 and 2002, the fair value of the Company's investment in CHS was \$0.7 million and \$0.6 million, respectively, based on quoted market prices. During the years ended December 31, 2003, 2002 and 2001,

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

the Company recognized approximately \$98,000, \$89,000 and (\$178,000), respectively, of unrealized gains (losses) attributable to this investment.

Choice Hotels Canada, Inc.

The Company has a 50% interest in Choice Hotels Canada, Inc. (“CHC”), a joint venture with a third party. During 2003 and 2002, the Company recorded \$0.6 million and \$0.5 million, respectively, of equity method income related to this investment pursuant to APB No. 18 in the accompanying consolidated statements of income. The Company received dividends from CHC of \$0.4 million and \$0.5 million for the years ended December 31, 2003 and 2002, respectively. During 2003, 2002 and 2001, the Company recognized in the accompanying consolidated statements of income, revenues of \$6.7 million, \$4.7 million and \$5.5 million, respectively, including royalty, marketing, reservation fees and other franchise revenues from CHC.

12. Pension, Profit Sharing, and Incentive Plans

The Company sponsors a 401(k) retirement plan for all eligible employees. For the years ended December 31, 2003, 2002 and 2001, the Company recorded compensation expense of \$1.7 million, \$1.5 million and \$1.7 million, respectively, representing matching contributions for plan participants. In accordance with the plan, the Company makes its matching contribution with Company stock. On an annual basis, the Company purchases shares with a fair value equal to the Company’s matching contribution and deposits the shares in the participant’s accounts with the plan investment custodian.

The Company sponsors a non-qualified defined benefit plan (“SERP”) for certain senior executives. The Company accounts for the SERP in accordance with SFAS No. 87, “Employers Accounting for Pensions.” For the years ended December 31, 2003, 2002 and 2001, the Company recorded \$0.4 million, \$0.3 million and \$0.2 million, respectively, of expense related to the SERP which was included in selling, general and administrative expense in the accompanying consolidated statements of income. As of December 31, 2003 and 2002, a liability of \$1.7 million and \$1.1 million, respectively, related to the SERP was included in other non-current liabilities in the accompanying consolidated balance sheets.

The Company sponsors two non-qualified retirement savings and investment plans for certain employees and certain senior executives whose pre-tax deferrals are limited under the Company’s 401(k) Plan. Employee and Company contributions are maintained in separate irrevocable trusts. Legally, the assets of the trusts remain those of the Company; however, access to the trusts’ assets is severely restricted. The trusts’ cannot be revoked by the Company or an acquiror, but the assets are subject to the claims of the Company’s general creditors. The participants do not have the right to assign or transfer contractual rights in the trusts. The Company accounts for these plans in accordance with Emerging Issues Task Force (“EITF”) No. 97-14, “Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested.” Pursuant to EITF 97-14, as of December 31, 2003 and 2002, the Company had recorded a deferred compensation liability of \$13.3 million and \$8.6 million, respectively, in other non-current liabilities in the accompanying consolidated balance sheets. The change in the deferred compensation obligation related to changes in the fair value of the diversified investments held in trust and to earnings credited to participants is recorded in compensation expense. The diversified investments held in the trusts were \$12.1 million and \$7.9 million as of December 31, 2003 and 2002, respectively, and are recorded at their fair value, based on quoted market prices, in other non-current assets on the accompanying consolidated balance sheets. The change in the fair value of the diversified assets held in trust is recorded in accordance with SFAS 115 as trading security income (loss).

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

13. Income Taxes

Income before income taxes was derived from the following:

	Years ended December 31,		
	2003	2002	2001
	(In thousands)		
Income before income taxes:			
Domestic operations	\$108,760	\$93,418	\$ 80,647
Foreign operations	3,647	2,400	(35,230)
Income before income taxes	<u>\$112,407</u>	<u>\$95,818</u>	<u>\$ 45,417</u>

The provisions for income taxes were as follows:

	Years ended December 31,		
	2003	2002	2001
	(In thousands)		
Current tax expense			
Federal	\$44,040	\$21,374	\$30,890
State	3,979	631	3,675
Foreign	758	661	665
Deferred tax (benefit) expense			
Federal	(7,306)	11,297	(3,602)
State	(942)	1,012	(597)
Foreign	15	(1)	59
Income taxes	<u>\$40,544</u>	<u>\$34,974</u>	<u>\$31,090</u>

Deferred tax assets (liabilities) were comprised of the following:

	December 31,	
	2003	2002
	(In thousands)	
Depreciation and amortization	\$(16,554)	\$(20,171)
Prepaid expenses	(11,478)	(16,083)
Other	(5,510)	(4,379)
Gross deferred tax liabilities	<u>(33,542)</u>	<u>(40,633)</u>
Foreign operations	2,553	2,549
Accrued expenses	8,307	6,239
Other	3,077	4,270
Gross deferred tax assets	<u>13,937</u>	<u>13,058</u>
Net deferred tax liability	<u>(19,605)</u>	<u>(27,575)</u>

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Included in the accompanying consolidated balance sheet as follows:

	December 31,	
	2003	2002
	(In thousands)	
Current net deferred tax assets	\$ 1,957	\$ 2,232
Non-current net deferred tax liabilities	(21,562)	(29,807)
Net deferred tax liability	<u>(19,605)</u>	<u>(27,575)</u>

No provision has been made for U.S. federal income taxes on approximately \$21 million of accumulated and undistributed earnings of foreign subsidiaries at December 31, 2003 since these earnings are considered to be permanently invested in foreign operations.

A reconciliation of income tax expense at the statutory rate to income tax expense included in the accompanying consolidated statements of income follows:

	Years ended December 31,		
	2003	2002	2001
	(In thousands, except Federal income tax rate)		
Federal income tax rate	35%	35%	35%
Federal taxes at statutory rate	\$39,342	\$33,536	\$15,896
State income taxes, net of federal tax benefit	1,974	1,068	1,120
Unrealized tax benefits	(617)	—	12,737
Other	(155)	370	1,337
Income tax expense	<u>\$40,544</u>	<u>\$34,974</u>	<u>\$31,090</u>

We have estimated and accrued for certain tax assessments and the expected resolution of tax contingencies which arise in the course of our business. The ultimate outcome of these tax-related contingencies impact the determination of income tax expense and may not be resolved until several years after the related tax returns have been filed. Predicting the outcome of such tax assessments involves uncertainty; however, we believe that recorded tax liabilities adequately account for our analysis of probable outcomes.

14. Other Non-Current Liabilities

Other non-current liabilities consist of the following at.

	Year ended December 31,	
	2003	2002
	(in thousands)	
Deferred revenue	4,006	1,299
Other liabilities and contingencies	21,160	21,513
Total	<u>\$40,224</u>	<u>\$32,462</u>

Other liabilities and contingencies includes long-term deposits and accruals for tax contingencies. These accruals have been recorded to address potential exposures involving tax positions that could be challenged by taxing authorities.

15. Capital Stock

The Company has stock compensation plans pursuant to which it is authorized to grant restricted stock and options to purchase stock for up to 9.6 million shares of the Company's common stock, of which 1.3 million shares remain available for grant as of December 31, 2003. Restricted stock and stock options may be granted to officers, key employees and non-employee directors.

Restricted Stock.

In 2003, the Company granted non-employee directors 7,428 restricted shares of common stock with a fair value of \$0.2 million at the date of grant, all of which vest over three years. In 2002, the Company granted a key employee and non-employee directors an aggregate of 109,894 restricted shares of common stock with a fair value of \$2.3 million on the date of grant, all of which vest over five years. In 2001, the Company granted key employees and non-employee directors an aggregate of 155,515 restricted shares of common stock with a fair value of \$2.3 million on the date of grant. The shares vest over a three to five year period with 10,015 shares vesting over a three year period and 145,500 shares vesting over a five year period. No restricted shares were forfeited in 2003 or 2002. A total of 9,130 shares of restricted stock were forfeited in 2001. The Company incurred compensation expense totaling \$0.9 million, \$1.7 million and \$0.7 million related to the vesting of restricted stock during the years ended December 31, 2003, 2002 and 2001, respectively. The Company also recorded \$0.3 million of compensation expense related to the vesting of restricted stock as part of its 2001 restructuring accrual related to 46,064 shares.

Stock Options.

A summary of the stock option activity under the Company's stock option plan is as follows as of December 31, 2003, 2002 and 2001:

	2003		2002		2001	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Fixed Options						
Outstanding at beginning of year . .	3,111,991	\$15.03	3,095,589	\$13.56	4,306,584	\$12.39
Granted	683,467	\$20.52	601,895	\$21.53	348,836	\$15.08
Exercised	(462,522)	\$13.58	(442,869)	\$13.01	(1,363,050)	\$ 9.90
Cancelled	(40,696)	\$18.79	(142,624)	\$16.83	(196,781)	\$15.52
Outstanding at end of year . . .	3,292,240	\$16.33	3,111,991	\$15.03	3,095,589	\$13.56
Options exercisable at year end . . .	1,673,129	\$13.71	1,533,471	\$12.96	1,374,395	\$12.52
Weighted average fair value of options granted during the year		\$ 8.65		\$ 8.95		\$ 7.67

The following table summarizes information about stock options outstanding at December 31, 2003:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/03	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at 12/31/03	Weighted Average Exercise Price
\$ 5.01 to 9.00	41,000	6.7 years	\$ 7.82	17,000	\$ 7.82
9.01 to 13.00	1,097,394	4.2 years	\$12.12	992,488	\$12.13
13.01 to 17.65	936,072	5.5 years	\$15.65	570,417	\$15.42
17.66 to 30.00	1,217,774	8.5 years	\$20.94	93,224	\$21.12
	3,292,240	6.2 years	\$16.33	1,673,129	\$13.71

SFAS No. 148 “Accounting for Stock-Based Compensation – Transition and Disclosures,” requires companies to provide additional note disclosures about employee stock-based compensation plans based on a fair value method of accounting.

For purposes of the pro forma disclosure included in the stock based compensation section of Note 1, compensation cost for the Company’s stock option plan was determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123. The fair value of each option grant has been estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2003, 2002 and 2001:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Risk-free interest rate	2.57%	3.58%	5.03%
Volatility	39.69%	35.43%	43.3%
Expected Lives	6 years	6 years	10 years
Dividend Yield	0%	0%	0%

Stock Repurchase Program.

The Company announced a stock repurchase program on June 25, 1998. Treasury stock is carried at cost in the accompany consolidated financial statements. Through December 31, 2003, the Company had repurchased 29.3 million shares of its common stock at a total cost of \$514.8 million, including 2.9 million shares of common stock at a total cost of \$80.4 million during the year ended December 31, 2003. During 2003, the Company repurchased 1.0 million shares at a total cost of \$24.8 million from the Company’s largest shareholder, affiliates and related parties. During 2002, the Company repurchased 1.7 million shares at a total cost of \$41.7 million from the Company’s largest shareholder, affiliates and related parties.

In the fourth quarter 2003, the Company declared an initial cash dividend of \$0.20 per share representing \$6.9 million in the aggregate. The dividends were paid in January 2004.

In the first quarter 2004, the Company declared a cash dividend of \$0.20 per share payable April 26, 2004 to shareholders of record on April 12, 2004.

The Company paid approximately \$298,385 and \$41,000 to and received approximately \$121,040 and \$104,000 from corporations owned or controlled by family members of the Company’s largest shareholder related to the lease of personal and real property during 2003 and 2002.

On February 19, 1998, the Board of Directors adopted a shareholder rights plan under which a dividend of one preferred stock purchase right was distributed for each outstanding share of the Company’s common stock to shareholders of record on April 3, 1998. Each right will entitle the holder to buy $\frac{1}{100}$ th of a share of a newly issued series of a junior participating preferred stock of the Company at an exercise price of \$75 per share. The rights will be exercisable, subject to certain exceptions, 10 days after a person or a group acquires beneficial ownership of 10% or more of the Company’s common stock. Shares owned by a person or group on February 19, 1998, and held continuously thereafter are exempt for purposes of determining beneficial ownership under the rights plan. The rights will be non-voting and will expire on January 31, 2008, unless exercised or previously redeemed by the Company for \$.001 each. If the Company is involved in a merger or certain other business combinations not approved by the Board of Directors, each right will entitle its holder, other than the acquiring person or group, to purchase common stock of either the Company or the acquiror having a value of twice the exercise price of the right.

16. Comprehensive Income

The components of total accumulated other comprehensive income are as follows:

	December 31,		
	2003	2002	2001
	(In thousands)		
Unrealized gains (losses) on available-for-sale securities	\$ (18)	\$ (80)	\$(202)
Foreign currency translation adjustments	866	(235)	(576)
Deferred gain on hedging activity	290	357	424
Total accumulated other comprehensive income (loss)	<u>\$1,138</u>	<u>\$ 42</u>	<u>\$(354)</u>

The components of total accumulated other comprehensive income are as follows:

	Amount Before Taxes	Income Tax (Expense)/Benefit	Amount Net of Taxes
	(In thousands)		
2003			
Net unrealized gains	\$ 99	\$ (37)	\$ 62
Foreign currency translation adjustment, net	1,101	—	1,101
Amortization of deferred gain on hedge	(110)	43	(67)
Total other comprehensive income	<u>\$1,090</u>	<u>\$ 6</u>	<u>\$1,096</u>
2002			
Net unrealized gains	\$ 195	\$ (73)	\$ 122
Foreign currency translation adjustment, net	341	—	341
Amortization of deferred gain on hedge	(110)	43	(67)
Total other comprehensive income	<u>\$ 426</u>	<u>\$ (30)</u>	<u>\$ 396</u>
2001			
Net unrealized losses	\$ (179)	\$(131)	\$ (310)
Foreign currency translation adjustment, net	(414)	—	(414)
Total other comprehensive loss	<u>\$ (593)</u>	<u>\$(131)</u>	<u>\$ (724)</u>

Below represents the detail of other comprehensive income:

	December 31,		
	2003	2002	2001
Unrealized holding gains (losses) arising during the period, net	\$ 62	\$122	\$(352)
Less: reclassification adjustments for losses/gains included in net income	—	—	42
Net unrealized holding gains (losses) arising during the period	<u>\$ 62</u>	<u>\$122</u>	<u>\$(310)</u>
Foreign currency translation adjustments	<u>\$1,101</u>	<u>\$341</u>	<u>\$(414)</u>
Amortization of deferred gain on hedging activity	<u>\$ (67)</u>	<u>\$ (67)</u>	<u>\$ —</u>

In December 1999, the Company entered into an interest rate swap agreement to fix certain of its variable rate debt in order to reduce the Company's exposure to fluctuations in interest rates. On March 3, 2000, the interest rate swap agreement was settled resulting in a deferred gain. In accordance with SFAS 133, the unamortized gain was reclassified in 2001 to other comprehensive income and is being amortized over the remaining life of the related debt as a reduction of interest expense. In each of 2003 and 2002, the Company recorded approximately \$67,000, net of taxes, of amortization related to this deferred gain.

17. Earnings Per Share

The following table reconciles the number of shares used in the basic and diluted earnings per share calculations.

	Years Ended December 31		
	2003	2002	2001
	(In millions, except per share amounts)		
Computation of Basic Earnings Per Share:			
Net income	<u>\$71.9</u>	<u>\$60.8</u>	<u>\$14.3</u>
Weighted average shares outstanding—basic	<u>35.7</u>	<u>39.3</u>	<u>44.2</u>
Basic earnings per share	<u>\$2.01</u>	<u>\$1.55</u>	<u>\$0.32</u>
Computation of Diluted Earnings Per Share:			
Net income for diluted earnings per share	<u>\$71.9</u>	<u>\$60.8</u>	<u>\$14.3</u>
Weighted average shares outstanding—basic	<u>35.7</u>	<u>39.3</u>	<u>44.2</u>
Effect of Dilutive Securities:			
Employee stock option and restricted stock plan	<u>1.0</u>	<u>0.8</u>	<u>0.4</u>
Weighted average shares outstanding—diluted	<u>36.7</u>	<u>40.1</u>	<u>44.6</u>
Diluted earning per share	<u>\$1.96</u>	<u>\$1.52</u>	<u>\$0.32</u>

The effect of dilutive securities is computed using the treasury stock method and average market prices during the period. In 2002, the Company excluded 50,000 anti-dilutive options from the computation of diluted earnings per share.

18. Leases

The Company enters into operating leases primarily for office space and computer equipment. Rental expense under non-cancelable operating leases was approximately \$15.2 million, \$12.9 million and \$12.0 million for the years ended December 31, 2003, 2002 and 2001, respectively. The Company received sublease rental income related to computer equipment leased to franchisees totaling \$10.2 million, \$9.1 million and \$7.6 million during the years ended December 31, 2003, 2002 and 2001, respectively. Future minimum lease payments are as follows:

	2004	2005	2006	2007	2008	Thereafter	Total
	(In thousands)						
Minimum lease payments	\$12,144	\$ 9,358	\$ 5,217	\$3,943	\$3,861	\$14,326	\$48,849
Minimum sublease rentals	(8,236)	(5,595)	(1,266)	—	—	—	(15,097)
	<u>\$ 3,908</u>	<u>\$ 3,763</u>	<u>\$ 3,951</u>	<u>\$3,943</u>	<u>\$3,861</u>	<u>\$14,326</u>	<u>\$33,752</u>

19. Reportable Segment Information

The Company has a single reportable segment encompassing its franchising business. Revenues from the franchising business include royalty fees, initial franchise and relicensing fees, marketing and reservation fees, partner services revenue and other revenue. The Company is obligated under its franchise agreements to provide marketing and reservation services appropriate for the successful operation of its systems. These services do not represent separate reportable segments as their operations are directly related to the Company's franchising business. The revenues received from franchisees that are used to pay for part of the Company's central on-going operations are included in franchising revenues and are offset by the related expenses paid for marketing and reservation activities to calculate franchising operating income. Corporate and other revenue consists of hotel

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operations. The Company does not allocate interest and dividend income, interest expense or income taxes to its franchising segment.

The following table presents the financial information for the Company's franchising segment.

Year Ended December 31, 2003				
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	\$382,539	\$ 3,565	—	\$386,104
Operating income (loss)	142,701	(28,718)	—	113,983
Depreciation and amortization	13,350	9,952	(12,077)	11,225
Capital expenditures	6,539	1,941	—	8,480
Total assets	193,494	73,778	—	267,272

Year Ended December 31, 2002				
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	\$362,231	\$ 3,331	—	\$365,562
Operating income (loss)	136,182	(31,482)	—	104,700
Depreciation and amortization	13,817	10,460	(13,026)	11,251
Capital expenditures	4,925	7,308	—	12,233
Total assets	213,665	103,108	—	316,773

Year Ended December 31, 2001				
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	\$338,213	\$ 3,215	—	\$341,428
Operating income (loss)	138,988	(65,411)	—	73,577
Equity loss on Friendly investment	—	(16,436)	—	(16,436)
Depreciation and amortization	12,485	11,769	(11,802)	12,452
Capital expenditures	6,997	6,535	—	13,532
Total assets	212,877	108,301	—	321,178

Long-lived assets related to international operations were \$9.9 million, \$8.1 million and \$7.1 million as of December 31, 2003, 2002 and 2001, respectively. All other long-lived assets of the Company are associated with domestic activities.

20. Commitments and Contingencies

The Company is a defendant in a number of lawsuits arising in the ordinary course of business. In the opinion of management and general counsel to the Company, the ultimate outcome of such litigation will not have a material adverse effect on the Company's business, financial position, results of operations or cash flows.

The Company has a \$3.0 million letter of credit issued as support for construction and permanent financing of a Sleep Inn and a MainStay Suites located in Atlanta, Georgia. The letter of credit expires in March 2005.

In the ordinary course of business, the Company enters into numerous agreements that contain standard guarantees and indemnities whereby the Company indemnifies another party for breaches of representations and

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warranties. Such guarantees or indemnifications are granted under various agreements, including those governing (i) purchases or sales of assets or businesses, (ii) leases of real estate, (iii) licensing of trademarks, (iv) access to credit facilities, (v) issuances of debt or equity securities, and (vi) other operating agreements. The guarantees or indemnifications issued are for the benefit of the (i) buyers in sale agreements and sellers in purchase agreements, (ii) landlords in lease contracts, (iii) franchisees in licensing agreements, (iv) financial institutions in credit facility arrangements, and (v) underwriters in debt or equity security issuances. In addition, these parties are also indemnified against any third party claim resulting from the transaction that is contemplated in the underlying agreement. While some of these guarantees extend only for the duration of the underlying agreement, many survive the expiration of the term of the agreement or extend into perpetuity (unless subject to a legal statute of limitations). There are no specific limitations on the maximum potential amount of future payments that the Company could be required to make under these guarantees, nor is the Company able to develop an estimate of the maximum potential amount of future payments to be made under these guarantees as the triggering events are not subject to predictability. With respect to certain of the aforementioned guarantees, such as indemnifications of landlords against third party claims for the use of real estate property leased by the Company, the Company maintains insurance coverage that mitigates any potential payments to be made.

21. Fair Value of Financial Instruments

The balance sheet carrying amount of cash and cash equivalents and receivables approximates fair value due to the short term nature of these items. Long-term debt consists of bank loans and senior notes. Interest rates on the Company's bank loans adjust frequently based on current market rates; accordingly, the carrying amount of the Company's bank loans approximates fair value. The \$100 million unsecured senior notes have an approximate fair value at December 31, 2003 and 2002 of \$111.7 million and \$102.5 million, respectively, based on quoted market prices. The New Note from Sunburst was repaid to the Company in December 2003. Its estimated fair value at December 31, 2002 was \$42.7 million.

22. Impact of Recently Issued Accounting Standards

On January 1, 2003, the Company adopted FASB Interpretation ("FIN") No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," in its entirety. Such Interpretation elaborates on the disclosures to be made by a guarantor about its obligations under certain guarantees issued. It also clarifies that a guarantor is required to recognize, at the inception of any guarantee issued or modified after December 31, 2002, a liability for the fair value of the obligation undertaken in issuing the guarantee. The impact of adopting this Interpretation was not material to the Company's results of operations or financial position.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition and disclosure provisions of SFAS No. 148 are effective for financial statements for interim and fiscal years ending after December 15, 2002, with early application permitted for entities with a fiscal year ending prior to December 15, 2002. We adopted the disclosure provisions of SFAS No. 148 effective December 31, 2002 and the transition provisions effective January 1, 2003.

In December 2003, the FASB revised FIN No. 46, "Consolidation of Variable Interest Entities—an Interpretation of "Accounting Research Bulletin" ("ARB") No. 51." This Interpretation, originally issued in

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January 2002, clarifies the application of the majority voting interest requirement of ARB No. 51, "Consolidated Financial Statements," to certain types of variable interest entities that do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The controlling financial interest may be achieved through arrangements that do not involve voting interests. Under FIN No. 46, if an entity is determined to be a variable interest entity, it must be consolidated by the enterprise that absorbs the majority of the entity's expected losses if they occur, receives a majority of the entity's expected residual returns if they occur, or both. The Company adopted the applicable provisions of FIN No. 46 on January 31, 2003. We were not required to consolidate any previously unconsolidated entities as a result of adopting FIN No. 46. The impact of adopting the provisions of FIN No. 46 was not material to the Company's results of operations or financial position.

On May 31, 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This standard addresses how certain financial instruments with characteristics of both liabilities and equity should be classified and measured. The provisions of SFAS No. 150 are effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, or our third quarter of 2003. The adoption of SFAS No. 150 did not have a material impact on the Company's results of operations or financial position.

23. Selected Quarterly Financial Data – (Unaudited)

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>2003</u>
	(In thousands, except per share data)				
Revenues	\$81,556	\$103,497	\$105,893	\$95,158	\$386,104
Operating income	\$17,232	\$ 28,667	\$ 39,772	\$28,312	\$113,983
Income before income taxes	\$15,562	\$ 27,487	\$ 38,554	\$30,804	\$112,407
Net income	\$ 9,687	\$ 17,111	\$ 24,345	\$20,720	\$ 71,863
Per basic share:					
Net income	\$ 0.26	\$ 0.48	\$ 0.68	\$ 0.59	\$ 2.01
Per diluted share:					
Net income	\$ 0.26	\$ 0.47	\$ 0.66	\$ 0.57	\$ 1.96
	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>2002</u>
	(In thousands, except per share data)				
Revenues	\$75,330	\$100,469	\$105,030	\$84,733	\$365,562
Operating income	\$16,044	\$ 27,447	\$ 36,585	\$24,624	\$104,700
Income before income taxes	\$14,056	\$ 25,178	\$ 33,723	\$22,861	\$ 95,818
Net income	\$ 8,574	\$ 15,306	\$ 21,867	\$15,097	\$ 60,844
Per basic share:					
Net income	\$ 0.21	\$ 0.38	\$ 0.55	\$ 0.41	\$ 1.55
Per diluted share:					
Net income	\$ 0.20	\$ 0.38	\$ 0.54	\$ 0.40	\$ 1.52

The matters which effect the comparability of our quarterly results include seasonality, the acquisition of Flag in June 2002, charges related to our fourth quarter 2002 restructuring and the gain related to the fourth quarter 2003 note prepayment by Sunburst.

CORPORATE INFORMATION

BOARD OF DIRECTORS

Stewart Bainum Jr.
Chairman of the Board
Sunburst Hospitality Corporation

Barbara Bainum
Vice Chairman
Commonweal Foundation
Vice Chairman
Realty Investment Company, Inc.

William L. Jews
President and Chief Executive Officer
CareFirst BlueCross BlueShield
Director
Ecolab, Inc.
MBNA
Ryland Group, Inc.

Charles A. Ledsinger, Jr.
President and Chief Executive Officer
Choice Hotels International
Director
FelCor Lodging Trust, Inc.
Friendly's Ice Cream Corporation
TBC Corporation

Lawrence R. Levitan
IRS Oversight Board
Retired Managing Partner
Andersen Consulting's
Worldwide Communications
Industry Group

Jerry E. Robertson, Ph.D.
Retired Executive Vice President
3M Life Sciences Sector and
Corporate Services
Director
Coherent Inc.
Steris Corp.

Raymond E. Schultz
Chairman
RES Investments, L.L.C.
Director
Equity Inns, Inc.
TBC Corporation

Ervin R. Shames
Visiting Lecturer, University of Virginia
Darden Graduate School of Business
Consultant to consumer goods and
services companies
Director
OnLine Resources Corporation
Select Comfort Corporation

CORPORATE EXECUTIVE OFFICERS

Stewart Bainum Jr.
Chairman of the Board

Charles A. Ledsinger, Jr.
President and Chief Executive Officer

Michael J. DeSantis
Senior Vice President,
General Counsel and Secretary

Bruce N. Haase
Senior Vice President, International

Thomas Mirgon
Senior Vice President,
Human Resources and Administration

Janna Morrison
Senior Vice President, Franchise Services

Daniel Rothfeld
Senior Vice President, Partner Services
and Emerging Business Opportunities

Joseph M. Squeri
Senior Vice President, Development
and Chief Financial Officer

Gary Thomson
Senior Vice President and
Chief Information Officer

Wayne W. Wielgus
Senior Vice President, Marketing

CORPORATE OFFICERS

Don Brockway
Vice President, Reservations Operations

David Goldberg
Vice President, Corporate & Brand Strategy
and Treasurer

Kevin M. Rooney
Associate General Counsel and
Assistant Secretary

David L. White
Vice President and Controller

COMPANY INFORMATION

Stock Listing
Choice Hotels International common stock trades
on the New York Stock Exchange under the ticker
symbol CHH.

Transfer Agent & Registrar
SunTrust Bank
P.O. Box 4625
Atlanta, GA 30302-4625
1-800-568-3476

Independent Auditors
PricewaterhouseCoopers LLP
McLean, Virginia

Annual Meeting Date
Choice Hotels International will hold its Annual
Meeting of Stockholders on Tuesday, May 4, 2004,
at 9:00 a.m. in The Chesapeake Room of the
Learning Center, 10720 Columbia Pike, Silver
Spring, Maryland.

Form 10-K
A stockholder may receive without charge a copy
of the Form 10-K Annual Report filed with the
Securities and Exchange Commission by written
request to the Corporate Secretary at the corporate
headquarters. The Form 10-K also is available at
www.choicehotels.com under the "Choice Hotels
Information/About Choice Hotels/Investor
Information" links.

Corporate Headquarters
Choice Hotels International
10750 Columbia Pike
Silver Spring, MD 20901
General Inquiries: (301) 592-5000
Franchise Sales: (800) 547-0007
Investor Inquiries: (800) 404-5050, ext. 5026
or (301) 592-5026
E-mail: investor_relations@choicehotels.com
Media Relations: (301) 592-5032
Corporate Web Site: www.choicehotels.com

Copies of the company's public filings as well as
its Corporate Governance Guidelines, Corporate
Ethics Policy and charters to the Board Audit
Committee and Compensation Committee are
available on www.choicehotels.com under the
"Choice Hotels Information/About Choice
Hotels/Investor Information" links.

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