



CHOICE HOTELS
INTERNATIONAL®



Growing Brands, Growing Stronger.

2004 Annual Report



Choice Hotels International is one of the world's largest lodging franchisors, marketing under the Comfort Inn, Comfort Suites, Quality, Sleep Inn, Clarion, MainStay Suites, Econo Lodge and Rodeway Inn brand names. To that family of nearly 5,000 hotels in more than 40 countries and territories, we welcome a new member, Cambria Suites, to help continue our company's proud heritage of superior franchise development.

LETTER TO SHAREHOLDERS

CHARLES A. LEDSINGER, JR.
President and Chief Executive Officer



Dear Shareholders:

At the outset of last year, our main goals were to sustain our record-setting momentum in unit growth, to improve product quality, to enhance brand reputation and to build greater guest loyalty. I am very pleased to report that we made significant progress in each of these key areas in 2004.

New domestic hotel franchise contracts were up 17% in 2004 to a record 552, while we also exceeded the 400,000 rooms open worldwide mark. For the year, Choice Hotels earned diluted earnings per share of \$2.15, a 10% increase over the previous year. Net income increased to \$74.3 million, up from \$71.9 million in 2003, and total revenues increased 11% to \$428.8 million as the company's 3,800 domestic franchisees generated system-wide revenues of \$3.9 billion.

By any measure, 2004 was a great year. At the heart of that success was another record-setting performance in franchise development, with our 552 new hotel franchise contracts representing 47,277 rooms to be added to our development pipeline. In 2003, we broke the 40,000 room mark for the first time ever, and this past year put us that much closer to the 50,000 room mark.

Each of these new franchise agreements contributes to a predictable stream of royalty revenues and adds more muscle to build brand awareness and drive occupancy through more marketing and reservations fees. In short, Choice has become a franchising powerhouse because the development community views us as a strong partner that can deliver success.

We reinforce our ability to help franchisees generate returns through our daily interaction with franchisees at the hotel level through our franchise services staff, through events like our annual convention and fall regional meetings, through the support provided by our central reservations and marketing staffs, and through our Choice Central intranet site that is available for franchisees 24 hours a day, seven days a week.

As I have noted in the past, brand growth is the engine that drives our business model. We now have enjoyed two consecutive years of record growth, which provides us with a very robust pipeline of 569 hotels under development as of the end of 2004. This 16% growth in our pipeline offers us great optimism for the near term, and the strength of our overall system positions Choice well to remain a strong franchisor for the longer term.

Choice's strong performance in the past few years has put the company in a favorable position to take advantage of the steadily improving economy. Industry forecasters are predicting that 2005 will be the best year for the hotel industry since 2000, when the industry earned record profits.

We enter the year with a strong brand portfolio that we are enhancing through the addition of a new upscale all-suites brand, Cambria Suites, and through the re-imaging of our flagship brand, Comfort Inn.

After extensive consumer and developer research, we concluded that the time was right and the opportunity was there to launch a successful new upscale brand. Developers were looking for this type of product to satisfy growing demand. According to Smith Travel Research, in 2004 demand in the upscale segment increased 5.7%, compared to a 1.3% increase in supply since 2003. In addition, the Travel Industry Association of America has said that business travel is expected to increase 3.6% in 2005, with these travelers being a primary target of upscale, select service brands.

Cambria Suites delivers the functionality, style and service that today's upscale guest demands while offering lower development costs and ongoing fees than its competitors. The result? The potential for a superior return on investment for the franchisee, backed by all of the horsepower that Choice brings to marketing its franchised hotels and delivering room bookings efficiently and effectively on a global basis.

This new product offering, along with our established brands, benefits from the more than \$50 million in marketing support, \$1.2 billion in annual gross room revenue from our central reservations system and 3.4 million members of our Choice Privileges frequency program. We believe Cambria Suites will quickly become a strong brand in this attractive segment and a very compelling product for locations that thrive on commercial, airport and destination leisure business.

At the same time, we are giving more than 1,400 Comfort Inn hotels a new look to compete more effectively for the mid-scale traveler. We are working with Comfort Inn owners to implement new brand amenities and standards that will support the promise offered by the new image. By the latter part of this summer, we anticipate that the overwhelming majority of Comfort Inn properties will have undergone re-imaging.

But our brand initiatives don't stop with Comfort Inn. We continue to improve all of our brands by ensuring that high quality hotels that fit each brand's image enter our system. The brand services and amenities that we are adding are designed to cater to the needs of each brand's hotel guests. By doing so, we can bring greater definition and clarity to our brands, ensuring more consistent product and interior designs. Finally, we are steadily improving our ability to better measure and improve hotel performance in collaboration with our hotel owners.

Last year at this time, we told you about the mission, vision and passion that guided our business focus. Since then, we have refined that focus to ensure that both Choice and its franchisees bring a new intensity to promoting higher guest satisfaction:

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

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

Our Passion: Customer Profitability.

In terms of key goals for 2005, we have four main areas of focus:

1. Guest satisfaction
2. Building brand equity
3. System growth
4. Owner profitability

Guest satisfaction: To help drive improvement in guest satisfaction, we are instituting a system for direct guest feedback to help us identify those hotels where satisfaction can be better and to give us more guidance on the amenities and standards that guests value in their travel.

Building brand equity: We aim to bring more innovation and creativity to our brands in order to build greater guest loyalty and, in turn, greater value and equity for the hotel owner. Our introduction of Cambria Suites and the re-imaging of Comfort Inn are two solid examples of how we are addressing this issue.

System growth: We continue to build our sales capability through experienced, dedicated sales forces to support each brand. Our success in recent years in driving more rapid franchise development has strengthened our brands and made them more desirable to hotel developers.

Owner profitability: Through our franchise services support team in the field, we work with owners at the hotel level to identify specific actions they can take to build occupancy, improve rates, enhance guest satisfaction and maintain their properties through cost-effective renovations and scheduled maintenance.

We are extremely proud of the great progress Choice has made in growing its system of franchised hotels, improving hotel performance for its owners, delivering enhanced value to shareholders and providing better opportunities for our associates.

Through both the creation of a cash dividend and targeted share repurchases, we have delivered real value to our shareholders. In turn, our strong financial condition has enabled us to offer more opportunity to our associates and to deliver on our promise to partner with them to make Choice a great place to work.

In the past year, we have invested significant time in emphasizing core values for our associates and franchisees to emulate: These include: *demonstrating personal character and integrity; leading through serving; embracing diversity; and building trust and value.*

In my business career, I have learned that these values, when demonstrated and reinforced, can positively influence and shape an organization. Already they have received great acceptance from associates and franchisees alike. Going forward, we expect them to provide the ethical framework for all we do.

I am honored to have the support of a very talented Board of Directors who have given me and our senior management team wise counsel in our strategy. All of us would like to particularly thank both Dr. Jerry Robertson and William Jews for their valued service. They are leaving the Board in May with our very best wishes.

We fully expect another strong year in 2005. The economy is moving ahead briskly, travel demand is growing with many experts predicting a very heavy summer season and demand for our hotel products remains high in the development community.

With a great sense of optimism about the future, I believe Choice Hotels has tremendous prospects for growth and success in the years ahead.



Charles A. Ledsinger, Jr.
President and Chief Executive Officer
March 22, 2005

A CHOICE YEAR IN REVIEW

- January* • The successful “Stay Twice. Earn a Free Night.” and double EA\$Y CHOICE stamps promotions are re-launched for the spring.
- February* • Choice teams up with 3Com Corporation to provide wireless connectivity in its U.S.-based Clarion and Comfort Suites brand hotels.
- March* • Choice signs a worldwide automated e-Wholesale agreement with Orbitz giving hotels in competitive markets the chance to receive enhanced sell position on Orbitz.com, the third largest online travel site.
- April* • Choice secures an exclusive position as an Official Broadcast Partner in the hotel category for the NBC broadcast of the 2004 Summer Olympic Games.
• Alaska Airlines becomes the ninth airline partner in Choice’s airline miles program, giving members of the Alaska Airlines Mileage Plan a chance to earn miles when staying at any of Choice’s brands.
- May* • Choice announces a three-year partnership with the Ladies Professional Golf Association (LPGA) that gives Choice national media exposure and the potential for more than 20,000 room nights annually at its brands.
• Choice unveils new prototypes for the MainStay Suites, Comfort Inn and Quality brands, designed to attract guests, improve guest experience, reduce development costs and deliver a more compelling return on investment for franchisees.
- June* • The “Wake Up A Winner” promotion features a sweepstakes on choicehotels.com with a chance to win one of two trips, including airfare, hotel and \$10,000 spending money, for two to attend the Athens Games, followed by visits to Rome and London.
• Choice and Bank of America introduce the Choice Privileges Visa Platinum credit card, which offers extra Choice Privileges benefits to cardholders and provides an incentive for cardholders to stay more often at Choice mid-scale brands.
- July* • Choice releases the Customer Information System (CIS) for storing and tracking its brands’ customers with the goal of helping Choice know more about its guests, leading to enhanced customer service and customer loyalty.
• Choice forms a new subsidiary, Choice Hotels Mexico, headquartered in Mexico City, to begin a direct franchising effort to introduce the Choice brands to hotel owners and developers in the country.
- August* • Choice’s online guest satisfaction survey is officially named the Guest Insight System (GIS) to reflect the additional insights provided by guests that will help enhance Choice properties.
- September* • Air Canada Aeroplan becomes Choice’s 10th airline partner, allowing Aeroplan members to earn Aeroplan Miles when staying at any of Choice’s properties.
• The Comfort Inn brand introduces its re-imaged logo at Fall Regional Meetings (held in Ocean City, Md., Atlanta, Las Vegas and Chicago), revealing a vibrant new design that is part of a broader improvement strategy of the Comfort Inn brand.
• With the re-branding of 138 Flag properties to the Comfort, Quality and Clarion brands in Australia, Flag Choice Hotels changes its corporate name to Choice Hotels Australasia.
- October* • Choice partners with The Mark Travel Corporation, a leading provider of hotel and airline branded vacation packages, to create an e-wholesale relationship that allows travelers to book rooms at Choice’s eight brands via Mark Travel’s Funjet Vacations and United Vacations.
• Choice enters into an agreement with Preferred Hotels & Resorts Worldwide that allows Choice Privileges members to redeem points for free nights at luxurious Preferred properties in 21 countries.
- November* • Choice Hotels Mexico opens its first Mexican hotel, the Comfort Inn hotel of Atlacomulco. The 50-room hotel includes six suites and features two restaurants.
• Econo Lodge hotels receive promotional materials launching the new Breakfast by Econo Lodge, an enhanced offering for economy guests.
- December* • The Choice Privileges rewards program hits one million members for the year: the Sleep Inn hotel of Memphis, Tenn., signed up the one-millionth member, putting the program’s total membership above 3.2 million.

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Financial Highlights

As of or for the years ended December 31,					
	2004	2003	2002	2001	2000
	(in millions, except per share data)				
Company Results					
Total Revenues	\$ 428.8	\$ 386.1	\$ 365.6	\$ 341.4	\$ 352.8
Net Income	74.3	71.9	60.8	14.3	42.4
Net Cash Provided by Operating Activities	107.8	115.5	99.0	101.7	53.9
Basic Earnings per Share	2.24	2.01	1.55	0.32	0.80
Diluted Earnings per Share	2.15	1.96	1.52	0.32	0.80
Total Assets	262.4	267.3	316.8	321.2	484.1
Long-Term Debt	\$ 328.7	\$ 246.7	\$ 307.8	\$ 281.3	\$ 297.2
Franchise System Results (Unaudited)					
Domestic:					
Revenues (estimated in millions)	\$ 3,861	\$ 3,518	\$ 3,412	\$ 3,383	\$ 3,423
Franchised Hotels	3,834	3,636	3,482	3,327	3,244
Franchised Hotels Under Development	460	401	310	462	493
Franchised Rooms	309,586	294,268	282,423	270,514	265,962
Revenue Per Available Room	\$ 35.95	\$ 34.21	\$ 34.48	\$ 35.83	\$ 36.72
Total (Domestic and International)					
Franchised Hotels	4,977	4,810	4,664	4,545	4,392
Franchised Hotels Under Development	569	491	474	689	703
Franchised Rooms	403,806	388,618	373,722	362,549	350,351

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 4,977 hotels open and 569 hotels under development as of December 31, 2004, with 403,806 rooms and 45,167 rooms, respectively, in 49 states and more than 40 countries and territories outside the United States. Our brand names include Comfort Inn, Comfort Suites, Quality, Clarion, Sleep Inn, Econo Lodge, Rodeway Inn, MainStay Suites, Cambria Suites and Flag Hotels. The Company's franchises operate in 49 states and more than 40 countries and territories outside of the United States. 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 32.5 million shares of common stock at a total cost of \$663 million, or an average price of \$20.38 per share since the program's inception. Our cash flows from operations support our ability to complete the repurchase of approximately 1.8 million shares presently remaining under our current board of director's 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 on our common stock. During 2004, we paid dividends totaling approximately \$27.7 million and 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 \$29.0 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 Operation: Royalty fees, operating income, net income and diluted earnings per share represent key measurements of these value drivers. In 2004, royalty fees revenue and operating income totaled approximately \$167.2 million and \$125.0 million respectively, increases of approximately 10% from 2003. Net income for the year ended December 31, 2004 increased to \$74.3 million, an increase of \$2.4 million over the year ended December 31, 2003. Diluted earnings per share were \$2.15, a 10% improvement over 2003 resulting from increased net income and a reduction in the number of shares outstanding attributable to our share repurchase program. Net income and diluted earnings per share in 2004 include a loss on extinguishment of debt of approximately \$0.7 million (\$0.4 million, net of the related tax effect) related to the refinancing of the Company's senior credit facility. Net income and diluted earnings per share for the year ended December 31, 2003 include a \$3.4 million gain and \$4.5 million (\$2.8 million, net of the related tax effect) of interest income attributable to a note receivable from Sunburst Hospitality Corporation ("Sunburst"), which was repaid to the Company in December 2003. These measurements will continue to be a key management focus in 2005 and beyond.

Refer to MD&A heading "Operations Review" for additional analysis of our results.

Liquidity and Capital Resources: The Company generates significant cash flows from operations. In 2004 and 2003, net cash provided by operating activities was \$107.8 million and \$115.5 million, respectively. Since our business does not require significant reinvestment of capital, we utilize cash in ways that management believes provide 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 franchises. 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 2004 Operating Results and 2003 Operating Results

The Company recorded net income of \$74.3 million for the year ended December 31, 2004, an increase of \$2.4 million from \$71.9 million for the year ended December 31, 2003. The increase in net income for the year is primarily attributable to an \$11.0 million improvement in operating income partially offset by an \$8.9 million increase in other income and expenses. Interest and other investment income in 2003 included \$4.5 million of interest income and a \$3.4 million gain on the prepayment attributable to the Sunburst note receivable. As a result of Sunburst's prepayment, these items did not recur in 2004. Operating income increased as a result of a \$16.7 million increase in franchising revenues (total revenues excluding marketing and reservation revenues and hotel operations) and a decrease in depreciation and amortization expense partially offset by an increase in selling, general and administrative expense. Net other income and expenses for 2004 increased primarily as a result of a \$0.7 million loss on extinguishment of debt, a reduction of the \$3.4 million prepayment gain and \$4.5 million of interest income attributable to the December 2003 repayment of a note receivable from Sunburst and reductions in investment income attributable to non-qualified benefit plan assets.

Summarized financial results for the years ended December 31, 2004 and 2003 are as follows:

	2004	2003
	(In thousands)	
REVENUES:		
Royalty fees	\$167,151	\$151,326
Initial franchise and relicensing fees	20,112	16,799
Partner services	12,524	13,227
Marketing and reservation	221,313	195,420
Hotel operations	3,729	3,565
Other	3,977	5,767
Total revenues	<u>428,806</u>	<u>386,104</u>
OPERATING EXPENSES:		
Selling, general and administrative	69,654	62,860
Depreciation and amortization	9,947	11,225
Marketing and reservation	221,313	195,420
Hotel operations	2,892	2,616
Total operating expenses	<u>303,806</u>	<u>272,121</u>
Operating income	<u>125,000</u>	<u>113,983</u>
Interest expense	11,605	11,597
Interest and other investment income	(1,093)	(6,185)
Gain on prepayment of note receivable from Sunburst	—	(3,383)
Equity in net (income) losses of affiliates	(722)	(582)
Loss on extinguishment of debt	696	—
Other	(10)	129
Total other income and expenses	<u>10,476</u>	<u>1,576</u>
Income before income taxes	<u>114,524</u>	<u>112,407</u>
Income taxes	<u>40,179</u>	<u>40,544</u>
Net income	<u>\$ 74,345</u>	<u>\$ 71,863</u>
Weighted average shares outstanding-diluted	<u>34,500</u>	<u>36,674</u>
Diluted earnings per share	<u>\$ 2.15</u>	<u>\$ 1.96</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 \$203.8 million for the year ended December 31, 2004 compared to \$187.1 million for the year ended December 31, 2003. Royalty fees increased \$15.9 million to \$167.2 million from \$151.3 million in 2003, an increase of 10.5%. The increase in royalties is attributable to a combination of factors including a 5.2% increase in the number of domestic franchised hotel rooms, a 5.1% increase in RevPAR and an increase in the effective royalty rate of the domestic hotel system to 4.04% from 4.01%. Domestic initial fee revenue, included in initial franchise and relicensing fees caption above, generated from executed franchise agreements increased 17.7% to \$13.3 million for the year ended December 31, 2004 from \$11.3 million for the year ended December 31, 2003. The increase reflects domestic franchise agreements executed in 2004 of 552 compared to 470 agreements executed in 2003. Relicensing fees increased 23.6% to \$6.8 million for the year ended December 31, 2004 from \$5.5 million for the year ended December 31, 2003. 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. Other revenues declined from \$5.8 million for the year ended December 31, 2003 to \$4.0 million for the year ended December 31, 2004, primarily as the result of reduced termination awards revenue, which are generated when franchises exist the system prior to contractually agreed-upon dates. Other revenues for the year ended December 31, 2003, included approximately \$1.7 million of liquidated damages received from Sunburst for the termination of certain franchises.

The number of domestic rooms on-line increased to 309,586 from 294,268, an increase of 5.2% for the year ended December 31, 2004. For 2004, the total number of domestic hotels on-line grew 5.4% to 3,834 from 3,636 for 2003. International rooms on-line declined slightly to 94,220 as of December 31, 2004 from 94,350 as of December 31, 2003, a 0.1% decline. The total number of international hotels on-line also decreased from 1,174 to 1,143, a decline of 2.6% for the year ended December 31, 2004. As of December 31, 2004, the Company had 460 franchised hotels with 35,652 rooms either in design or under construction in its domestic system. The Company has an additional 109 franchised hotels with 9,515 rooms under development in its international system as of December 31, 2004.

Franchise Expenses: The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative expenses were \$69.7 million for the year ended December 31, 2004, an increase of \$6.8 million from the year ended December 31, 2003 total of \$62.9 million. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 34.2% for the year ended December 31, 2004 compared to 33.6% for 2003. The increase is attributable to increased costs associated with performance based incentive compensation for sales and other management personnel, costs related to retirement of a board member, adoption of the fair value method of accounting for stock compensation and increased professional fees related to Sarbanes-Oxley compliance efforts.

Marketing and Reservations: The Company's franchise agreements require the payment of franchise fees, which include marketing and reservation fees. The 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 reservations revenues were \$221.3 million and \$195.4 million for the years ended December 31, 2004 and 2003, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$9.1 million and \$12.1 million for the years ended December 31, 2004 and 2003, respectively. Interest expense attributable to reservation activities was \$1.5 million and \$1.3 million for the years ended December 31, 2004 and 2003, respectively. Marketing and reservations activities provided positive cash flow of \$19.7 million and \$24.7 million for the years ended December 31, 2004 and 2003, respectively. As of December 31, 2004 and 2003,

the Company's balance sheet includes a receivable of \$21.7 million and \$32.4 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 reservations activities. The Company's current franchisees are legally obligated 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.

Other Income and Expenses: Interest expense was \$11.6 million for each of the years ended December 31, 2004 and 2003. The Company's weighted average interest rate as of December 31, 2004 was 4.58% compared to 4.29% as of December 31, 2003. Other income and expense includes a loss on extinguishment of debt of approximately \$0.7 million attributable to the refinancing of the Company's senior credit facility during the third quarter. Other income and expenses for the year ended December 31, 2003 also includes approximately a \$3.4 million gain on prepayment and \$4.5 million of interest income earned on a note receivable from Sunburst, which was repaid in December 2003. Interest and other investment income for the year ended December 31, 2004 also reflects the reduction of investment income attributable to non-qualified employee benefit plan assets.

Income Taxes: The Company's effective income tax provision rate was 35.08% for the year ended December 31, 2004, a decrease of 99 basis points from the effective income tax provision rate of 36.07% for the year ended December 31, 2003. The reduction in the effective income tax provision rate resulted partially from an increase in foreign income, which is taxed at lower income tax rates than the statutory U.S. income tax rates. Also, the favorable resolution of several state income tax issues in the current year and the increase in taxable income over non-tax deductible items between the two periods decreased the effective income tax provision rate.

Income tax expense for 2004 includes approximately \$1.2 million of income tax benefits resulting from the reversal of income tax contingencies. Income tax expense for 2003 includes \$1.5 million of provisions for income tax contingencies. Depending upon the outcome of certain income tax contingencies during 2005, up to \$6.6 million of income tax benefits may be reflected in our 2005 results of operations.

Net income for fiscal 2004 increased by 3.5% to \$74.3 million, and diluted earnings per share increased 9.7% to \$2.15 in 2004 from \$1.96 reported for 2003. A portion of the increase in diluted earnings per share is attributable to stock repurchases made by the Company in 2004 and prior years.

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:

	2003	2002
	(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	<u>113,983</u>	<u>104,700</u>
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
Total other income and expenses	<u>1,576</u>	<u>8,882</u>
Income before income taxes	<u>112,407</u>	<u>95,818</u>
Income taxes	40,544	34,974
Net income	<u>\$ 71,863</u>	<u>\$ 60,844</u>
Weighted average shares outstanding-diluted	<u>36,674</u>	<u>40,057</u>
Diluted earnings per share	<u>\$ 1.96</u>	<u>\$ 1.52</u>

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 had 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: 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 obligated 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.

Income Taxes: The Company's effective income tax provision rate was 36.07% for the year ended December 31, 2003, a decrease of 43 basis points from the effective income tax provision rate of 36.50% for the year ended December 31, 2002. The reduction in the effective income tax provision rate resulted partially from an increase in foreign income which are taxed at lower income tax rates than the statutory U.S. income tax rates. Also, the increase in taxable income over non-tax deductible items between the two periods decreased the effective income tax rate.

Net income for fiscal 2003 increased by 18.1% to \$71.9 million, and diluted earnings per share increased 28.9% to \$1.96 in 2003 from \$1.52 reported for 2002. A portion of the increase in diluted earnings per share is attributable to stock repurchases made by the Company in 2003 and prior years.

Liquidity and Capital Resources

Net cash provided by operating activities was \$107.8 million and \$115.5 million for the years ended December 31, 2004 and 2003, respectively. The decrease is attributable to higher payments related to income taxes and lower cash flow from marketing and reservation activities partially offset by improvements in operating results.

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 \$19.7 million during the year ended December 31, 2004, compared to net repayments of \$24.7 million during the year ended December 31, 2003. The decline in cash flows from marketing and reservation activities is attributable to an increase in advertising and promotional costs during the year. The Company expects marketing and reservation activities to generate positive cash flows of between \$18.0 million and \$21.0 million in 2005.

Cash provided by (used in) investing activities for the years ended December 31, 2004, 2003 and 2002 was (\$13.7 million), \$27.8 million and (\$14.7 million), respectively. As a lodging franchisor, Choice has relatively low capital expenditure requirements. During the years ended December 31, 2004, 2003 and 2002, capital expenditures totaled \$6.9 million, \$8.5 million, and \$12.2 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. 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, treasury stock purchases and dividends. In June 2001, the Company entered into a five-year \$265 million competitive advance and multi-currency credit facility ("Old Credit Facility"). The Old Credit Facility provided for a term loan of \$115 million and a revolving credit facility of \$150 million. The term loan was scheduled to partially amortize over the three years ending June 30, 2006. The unamortized balance of the term loan and all outstanding revolving loans were scheduled to mature in June 2006. Borrowings under the Old Credit Facility bore 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. The Old Credit Facility required the Company to pay annual fees ranging, based upon the credit rating of the Company, between 1/15 of 1% to 1/2 of 1% of the aggregate available commitment under the revolving credit facility.

In July 2004, the Company entered into a \$265 million senior unsecured revolving credit facility (the “Revolver”) with a syndicate of lenders. The proceeds from the Revolver were used to refinance and terminate the revolving credit facility and term loan outstanding under the Company’s Old Credit Facility. The Revolver permits the Company to borrow, repay and reborrow revolving loans until the scheduled maturity date in July 2009. Borrowings pursuant to the Revolver bear interest, at one of several rates selected by the Company, based upon the credit rating of the Company and include LIBOR plus 62 ½ basis points to 125 basis points; prime rate; and prime rate minus 175 basis points. 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 Revolver. On February 28, 2005, Standard & Poor’s Rating Services raised its rating of the Company’s debt from BBB- to BBB. This rating and any other ratings by other rating organizations, may be subject to revision or withdrawal at any time by the assigning rating organization. Each rating should be evaluated independently of any other rating. The Revolver requires the Company to pay a commitment fee ranging, based upon the credit rating of the Company, between 12 ½ basis points and 25 basis points of the average daily-unused portion of the aggregate available commitment. The Revolver also provides for the issuances of letters of credit on behalf of the Company. The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. As of December 31, 2004 the Company was in compliance with all covenants under the Revolver. The Revolver restricts the Company’s ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. As of December 31, 2004, the Company had \$218.2 million of revolving loans outstanding pursuant to the Revolver.

The proceeds from the Revolver are used for general corporate purposes, including working capital, debt repayment, stock repurchases and investments.

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 Notes contain a call provision that would require the Company to pay a premium if the Notes were redeemed prior to their maturity. At December 31, 2004, the call provision would have resulted in a premium of \$12.4 million.

The Company has a line of credit with a bank providing up to an aggregate of \$10 million of borrowings which is due upon demand. The line of credit ranks pari-pasu (or equally) with the Revolver. Borrowings under the line of credit bear interest at rates established at the time of the borrowings based on prime minus 175 basis points. As of December 31, 2004, \$10.0 million was outstanding pursuant to this line of credit.

As of December 31, 2004, the total long-term debt outstanding for the Company was \$328.7 million, of which \$10.1 million was scheduled to mature in the next twelve months ending December 31, 2005.

Through December 31, 2004, the Company had purchased 32.5 million shares of its common stock at a total cost of \$663 million, including 3.2 million shares at a cost of \$148.3 million during the year ended December 31, 2004. At December 31, 2004, the Company had approximately 32.3 million shares of common stock outstanding. As of December 31, 2004, the Company had remaining authorization to purchase up to 1.8 million shares. Subsequent to December 31, 2004 through March 10, 2005, the Company had repurchased an additional 0.2 million shares of its common stock at a total cost of \$13.5 million.

In the fourth quarter of 2003, the Company initiated a cash dividend on its common stock. In September 2004, the Company’s board of directors increased the quarterly dividend rate to \$0.225, a 12.5% increase from the previous quarterly rate of \$0.20. This increase raises the annual dividend rate on the Company’s common stock from \$0.80 to \$0.90 per share. Dividends paid in 2004 were approximately \$27.7 million.

The Company expects to continue to return value to its shareholders through a combination of share repurchases and dividends. Market conditions and our financial performance will dictate the amounts and allocation between these vehicles.

The following table summarizes our contractual obligations as of December 31, 2004

<u>Contractual Obligations</u>	<u>Payment due by period</u>				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 years</u>	<u>3-5 years</u>	<u>More than 5 years</u>
			(in millions)		
Long-term debt (1)	\$352.5	\$17.3	\$14.6	\$320.6	\$ —
Operating lease obligations	43.0	10.8	10.3	7.8	14.1
Purchase obligations	2.2	2.2	—	—	—
Other long-term liabilities	38.8	—	19.1	2.0	17.7
Total contractual cash obligations	<u>\$436.5</u>	<u>\$30.3</u>	<u>\$44.0</u>	<u>\$330.4</u>	<u>\$31.8</u>

(1) Long-term debt amounts include interest on fixed rate debt obligations.

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.

Off Balance Sheet Arrangements: The Company has a \$3.0 million letter of credit issued as support for construction and permanent financing of a franchisee's Sleep Inn and Mainstay Suites located in Atlanta, Georgia. No amounts were drawn against this letter of credit as of December 31, 2004. The letter of credit expires in April 2005.

Inflation: Inflation has been moderate in recent years and has not had a significant impact on our 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 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 dispersed group of franchisees.

Choice Privileges is our frequent guest incentive marketing program. Choice Privileges enables members to earn points based on their spending levels at participating brands and, to a lesser degree, through participation in affiliated partners' programs, such as those offered by credit card companies. The points may be redeemed for free accommodations or other benefits. Points cannot be redeemed for cash.

The Company collects a percentage of program members' room revenue from participating franchises. Revenues are deferred equal to the fair value of the future redemption obligation. A third-party actuary estimates the eventual redemption rates and point values using various actuarial methods. These judgmental factors determine the required liability for outstanding points. Upon redemption of the points, the Company recognizes the previously deferred revenue as well as the corresponding expense relating to the cost of the awards redeemed. Revenues in excess of the estimated future redemption obligation are recognized when earned to reimburse the Company for costs incurred to operate the program, including administrative costs, marketing, promotion and performing member services. Costs to operate the program, excluding estimated redemption values, are expensed when incurred.

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 non-current 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, 2004 is set forth in Note 1 to our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. Effective, January 1, 2003, the Company adopted 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. SFAS No. 123R will require the Company to apply fair value recognition provisions to all unvested equity awards as of the first interim reporting period starting after June 15, 2005, which is the Company's third quarter beginning July 1, 2005. The adoption of SFAS No. 123R is not expected to have a material effect on the Company's results of operations or financial condition.

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.

The Company does not provide additional United States income taxes on undistributed earnings of consolidated foreign subsidiaries included in retained earnings. Such earnings could become taxable upon the sale or liquidation of these foreign subsidiaries or upon dividend repatriation. The Company's intent is for such earnings to be reinvested by the subsidiaries or to be repatriated only when required for domestic business operations, tax or cash reasons. On October 22, 2004, the American Jobs Creation Act of 2004 ("AJCA") was signed into law. The AJCA includes a temporary incentive for United States multinational corporations to repatriate accumulated income of foreign subsidiaries by providing an 85 percent dividends received deduction for qualifying dividends from controlled foreign corporations. Our income tax expense does not reflect the impact of the AJCA. We have begun an evaluation of the effects of the repatriation provisions and expect to complete the analysis prior to the end of the third quarter 2005.

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 contained in this annual report, including those in the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operation, 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 us and potential hotel owners to fund investments 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 this annual report. 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.

Management's Report on Internal Control Over Financial Reporting

The management of Choice Hotels International, Inc. and its subsidiaries (together "the Company") is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on management's assessment under those criteria, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2004.

Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2004 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Report of Independent Registered Public Accounting Firm

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

We have completed an integrated audit of Choice Hotels International, Inc. and subsidiaries' 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of shareholders' deficit and comprehensive income and of cash flows present fairly, in all material respects, the financial position of Choice Hotels International, Inc. and subsidiaries (the "Company") at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 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 the standards of the Public Company Accounting Oversight Board (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 of financial statements 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.

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

Internal control over financial reporting

Also, in our opinion, management's assessment, included in the accompanying "Management's Report on Internal Control Over Financial Reporting", that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in

accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

McLean, Virginia
March 14, 2005

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

	Years Ended December 31,		
	2004	2003	2002
	(In thousands, except per share amounts)		
REVENUES:			
Royalty fees	\$167,151	\$151,326	\$142,943
Initial franchise and relicensing fees	20,112	16,799	12,881
Partner services	12,524	13,227	11,860
Marketing and reservation	221,313	195,420	190,145
Hotel operations	3,729	3,565	3,331
Other	3,977	5,767	4,402
Total revenues	428,806	386,104	365,562
OPERATING EXPENSES:			
Selling, general and administrative	69,654	62,860	56,520
Depreciation and amortization	9,947	11,225	11,251
Marketing and reservation	221,313	195,420	190,145
Hotel operations	2,892	2,616	2,946
Total operating expenses	303,806	272,121	260,862
Operating income	125,000	113,983	104,700
OTHER INCOME AND EXPENSES:			
Interest expense	11,605	11,597	13,136
Interest and other investment income	(1,093)	(6,185)	(4,549)
Gain on prepayment of note receivable from Sunburst	—	(3,383)	—
Equity in net (income) losses of affiliates	(722)	(582)	71
Loss on extinguishment of debt	696	—	—
Other	(10)	129	224
Total other income and expenses	10,476	1,576	8,882
Income before income taxes	114,524	112,407	95,818
Income taxes	40,179	40,544	34,974
Net income	\$ 74,345	\$ 71,863	\$ 60,844
Weighted average shares outstanding-basic	33,203	35,699	39,333
Weighted average shares outstanding-diluted	34,500	36,674	40,057
Basic earnings per share	\$ 2.24	\$ 2.01	\$ 1.55
Diluted earnings per share	\$ 2.15	\$ 1.96	\$ 1.52
Cash dividends declared per share	\$ 0.85	\$ 0.20	\$ —

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31, 2004	December 31, 2003
	(In thousands, except share amounts)	
ASSETS		
Current assets		
Cash and cash equivalents	\$ 27,554	\$ 20,031
Receivables (net of allowance for doubtful accounts of \$5,956 and \$6,743, respectively)	34,611	33,631
Deferred income taxes	2,252	1,957
Other current assets	4,212	3,613
Total current assets	68,629	59,232
Property and equipment, at cost, net	47,492	54,253
Goodwill	60,620	60,620
Franchise rights, net	32,102	35,383
Receivable—marketing and reservation fees	21,683	32,368
Other assets	31,862	25,416
Total assets	\$ 262,388	\$ 267,272
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities		
Current portion of long-term debt	\$ 10,146	\$ 23,829
Accounts payable	30,718	29,740
Accrued expenses and other	59,238	46,065
Income taxes payable	989	2,577
Total current liabilities	101,091	102,211
Long-term debt	318,557	222,823
Deferred income taxes	6,974	21,562
Other liabilities	38,819	38,863
Total liabilities	465,441	385,459
Commitments and Contingencies		
SHAREHOLDERS' DEFICIT		
Common stock, \$0.01 par value; 160,000,000 shares authorized; 62,755,708 shares issued; 32,312,433 and 34,745,853 shares outstanding at December 31, 2004 and 2003, respectively	323	347
Additional paid-in-capital	83,303	74,496
Accumulated other comprehensive income	1,400	1,138
Deferred compensation	(8,034)	(2,641)
Treasury stock (30,443,275 and 28,009,855 shares at December 31, 2004 and 2003, respectively), at cost	(631,312)	(496,510)
Retained earnings	351,267	304,983
Total shareholders' deficit	(203,053)	(118,187)
Total liabilities and shareholders' deficit	\$ 262,388	\$ 267,272

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,		
	2004	2003	2002
	(In thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 74,345	\$ 71,863	\$ 60,844
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	9,947	11,225	11,251
Gain on prepayment of note receivable from Sunburst	—	(3,383)	—
Provision for bad debts	(157)	(189)	1,256
Non-cash stock compensation	4,019	2,226	1,666
Non-cash interest and other investment income	(463)	(886)	(1,521)
Loss on extinguishment of debt	696	—	—
Equity in net (income) losses of affiliates	(722)	(582)	71
Changes in assets and liabilities, net of acquisitions:			
Receivables	(735)	(887)	(5,538)
Receivable—marketing and reservation fees, net	19,743	24,726	17,219
Accounts payable	978	6,439	(4,958)
Accrued expenses and other	12,802	7,616	1,063
Income taxes payable	2,854	(2,675)	7,807
Deferred income taxes	(14,883)	(7,970)	12,575
Other current assets	(599)	383	(2,416)
Other liabilities	(26)	7,579	(301)
Net cash provided by operating activities	107,799	115,485	99,018
CASH FLOWS FROM INVESTING ACTIVITIES			
Investment in property and equipment	(6,859)	(8,480)	(12,233)
Proceeds from prepayment of note receivable from Sunburst	—	44,701	—
(Purchases) sales of investments, net	(4,157)	(2,673)	191
Issuance of notes receivable	(2,264)	(4,433)	(3,440)
Acquisition of Flag	—	(1,211)	(2,173)
Proceeds from disposition of property	—	498	—
Other items, net	(436)	(618)	2,972
Net cash (used in) provided by investing activities	(13,716)	27,784	(14,683)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from long-term debt	192,000	—	—
Principal payments of long-term debt	(267,739)	(17,404)	(13,820)
Net borrowings (repayments) pursuant to revolving credit facility	157,725	(43,800)	40,000
Debt issuance costs	(1,010)	—	—
Purchase of treasury stock	(148,273)	(80,358)	(120,931)
Dividends paid	(27,690)	—	—
Proceeds from exercise of stock options	8,427	6,097	5,772
Net cash used in financing activities	(86,560)	(135,465)	(88,979)
Net change in cash and cash equivalents	7,523	7,804	(4,644)
Cash and cash equivalents at beginning of period	20,031	12,227	16,871
Cash and cash equivalents at end of period	\$ 27,554	\$ 20,031	\$ 12,227
Supplemental disclosure of cash flow information:			
Cash payments during the year for:			
Income taxes, net of refunds	\$ 53,622	\$ 49,559	\$ 14,674
Interest	\$ 12,639	\$ 13,357	\$ 14,132
Non-cash investing activities:			
Conversion of note receivable into Flag equity interest	—	—	\$ 1,061
Non-cash financing activities:			
Declaration of dividends	\$ 28,061	\$ 6,899	—
Non-cash financing activities related to employee stock exercises:			
Income tax benefit realized	\$ 4,442	\$ 1,770	\$ 1,762
Treasury shares received for employee tax withholding obligations	\$ 58	\$ 98	—
Issuance of restricted shares of common stock	\$ 7,973	\$ 180	\$ 2,301
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' 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, 2001	41,997,637	\$420	\$70,130	\$ (354)	\$(2,857)	\$(311,053)		\$179,175	\$ (64,539)
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							\$61,240		
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	37,163,216	\$371	\$73,100	\$ 42	\$(3,492)	\$(423,839)		\$240,019	\$(113,799)
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							\$72,959		
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	34,745,853	\$347	\$74,496	\$1,138	\$(2,641)	\$(496,510)		\$304,983	\$(118,187)
Comprehensive income									
Net income	—	—	—	—	—	—	\$74,345	74,345	74,345
Other comprehensive income:									
Foreign currency translation adjustments	—	—	—	—	—	—	188	—	188
Amortization of deferred gain on hedge, net of taxes	—	—	—	—	—	—	(67)	—	(67)
Unrealized gain on available for sale securities, net of taxes	—	—	—	—	—	—	141	—	141
Other comprehensive income	—	—	—	262	—	—	262	—	—
Comprehensive income							\$74,607		
Exercise of stock options	557,107	6	7,332	—	—	5,564		—	12,902
Issuance and cancellation of restricted stock	202,405	2	(43)	—	(7,894)	7,935		—	—
Stock compensation related to stock options	—	—	1,518	—	—	—		—	1,518
Amortization of deferred compensation related to restricted stock grants	—	—	—	—	2,501	—		—	2,501
Dividends declared	—	—	—	—	—	—		(28,061)	(28,061)
Treasury purchases	(3,192,932)	(32)	—	—	—	(148,301)		—	(148,333)
Balance as of December 31, 2004	32,312,433	\$323	\$83,303	\$1,400	\$(8,034)	\$(631,312)		\$351,267	\$(203,053)

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, 2004, the Company had franchise agreements representing 4,977 open hotels and 569 hotels under development in 49 states and more than 40 countries and territories outside the United States 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 Choice Hotels Australasia Pty. Ltd. (formerly Flag Choice Hotels) (“Flag”). Flag, based in Melbourne, Australia, is a franchisor of hotels in Australia, Papua New Guinea, American Samoa, 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 with no effect on previously reported net income or shareholders’ deficit.

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. An estimate of uncollectible royalty fees is charged to bad debt expense and 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 franchise 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.

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

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.

Choice Privileges is our frequent guest loyalty program. Choice Privileges enables members to earn points based on their spending levels at participating brands and, to a lesser degree, through participation in affiliated partners' programs, such as those offered by credit card companies. The points, which we accumulate and track on the members' behalf, may be redeemed for free accommodations, airline frequent flier program miles or other benefits. Points cannot be redeemed for cash.

We provide Choice Privileges as a marketing program to participating hotels. The cost of operating the program, including the estimated cost of award redemptions, are charged to the participating hotels by collecting a percentage of program members' room revenue from participating franchises. Revenues are deferred and included within accrued expenses and other in the accompanying consolidated balance sheet equal to the estimated fair value of the future redemption obligation. A third-party actuary estimates redemption rates and point values using various actuarial methods. These judgmental factors determine the required liability for unredeemed points. Upon redemption of the points, the Company recognizes the previously deferred revenue as well as the corresponding expense relating to the cost of the awards redeemed. Revenues in excess of the estimated future redemption obligation are recognized when earned to reimburse the Company for costs incurred to operate the program, including administrative costs, marketing, promotion and performing member services. Costs to operate the program, excluding estimated redemption values, are expensed when incurred.

Accounts Receivable and Credit Risk.

Accounts receivable consist primarily of franchise and related fees due from hotel franchises and are recorded at the invoiced amount. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance considering historical write-off experience and review of aged receivable balances. 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.

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

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 \$58.5 million, \$51.0 million and \$50.7 million for the years ended December 31, 2004, 2003 and 2002, respectively. Prepaid advertising at December 31, 2004 and 2003 totaled \$1.6 million and \$0.1 million, respectively and is included within other current assets in the accompanying consolidated balance sheet. 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, 2004 and 2003, \$7.4 million and \$5.6 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 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 impairment on long-lived assets during the three years ended December 31, 2004.

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. The Company did not record any impairment of goodwill during the three years ended December 31, 2004, 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

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

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 has not recorded any material impairment charges related to notes receivable during the three years ended December 31, 2004.

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, 2004 and 2003, unamortized deferred financing costs were \$1.4 million and \$1.5 million, respectively, and are included in other non-current assets in the accompanying consolidated balance sheets.

In July 2004, the Company entered into a \$265 million senior unsecured revolving credit facility ("Revolver"). The proceeds were used to refinance and terminate the Company's existing senior credit facility ("Old Credit Facility"). The Company accounted for the refinancing of the Old Credit Facility in accordance with Emerging Issues Task Force ("EITF") Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," and EITF No. 98-14, "Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements." Pursuant to these pronouncements, the Company recorded a loss on extinguishment of debt of approximately \$0.7 million.

Investments.

The Company accounts for its investment 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, 2004 the Company had no derivative financial instruments.

Stock-based compensation.

The Company has stock-based employee compensation plans, which are described more fully in Note 14. Prior to January 1, 2003, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion 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.

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

Therefore, the cost related to stock-based employee compensation included in the determination of net income for each of the three years ended December 31, 2004 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.

	Years Ended December 31,		
	2004	2003	2002
	(In millions, except per share amounts)		
Net income, as reported	\$74.3	\$71.9	\$60.8
Stock-based employee compensation expense included in reported net income, net of related tax effects	2.2	1.4	1.2
Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(3.5)	(2.9)	(3.8)
Pro forma, net income	\$73.0	\$70.4	\$58.2
Earnings per share:			
Basic, as reported	\$2.24	\$2.01	\$1.55
Basic, pro forma	\$2.20	\$1.97	\$1.48
Diluted, as reported	\$2.15	\$1.96	\$1.52
Diluted, pro forma	\$2.12	\$1.92	\$1.45

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 3 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, 2004 and 2003, other non-current assets included \$8.7 million and \$7.6 million, respectively, net of allowance, related to the unamortized balance of these notes. As of December 31, 2004 and 2003, other non-current assets include an allowance for doubtful accounts related to these notes of \$0.9 million and \$0.8 million, respectively. Amortization expense included in the accompanying consolidated statements of income related to the notes was \$1.2 million, \$0.8 million and \$0.4 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Income Taxes.

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for 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.

The Company does not provide additional United States income taxes on undistributed earnings of consolidated foreign subsidiaries included in retained earnings. Such earnings could become taxable upon the sale or liquidation of these foreign subsidiaries or upon dividend repatriation. The Company's intent is for such earnings to be reinvested by the subsidiaries or to be repatriated only when required for domestic business operations, tax or cash reasons. On October 22, 2004, the American Jobs Creation Act of 2004 ("AJCA") was signed into law. The AJCA creates a temporary incentive for United States multinational corporations to

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

repatriate accumulated income of foreign subsidiaries by providing an 85 percent dividends received deduction for qualifying dividends from controlled foreign corporations. In December 2004, the Financial Accounting Standards Board ("FASB") issued a FASB Staff Position ("FSP") regarding "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the AJCA" ("FSP 109-2"). FSP 109-2 allows the Company time beyond the fourth quarter of 2004, the period of enactment, to evaluate the effect of the AJCA on our plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS No. 109. We have begun an evaluation of the effects of the repatriation provision and expect to complete the analysis prior to the end of the third quarter of 2005.

The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Judgment is required in determining our worldwide income tax provision. In the ordinary course of global business, there are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements among related entities. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters will not be different than that which is reflected in our historical income tax provisions and accruals. Resolution of these uncertainties in a manner inconsistent with the Company's expectations could have a material impact on the Company's results of operations. The Company accounts for income tax contingencies in accordance with SFAS No. 5, "Accounting for Contingencies."

Tax savings resulting from deductions greater than compensation cost reflected in net income, if any, for stock-based employee compensation is credited directly to additional paid-in-capital when realization of such benefit is fully assured.

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. Other Current Assets

Other current assets consist of the following at:

	December 31,	
	2004	2003
	(In thousands)	
Prepaid expenses	\$3,911	\$3,260
Other current assets	301	353
Total	<u>\$4,212</u>	<u>\$3,613</u>

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

3. Property and Equipment

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

	December 31,	
	2004	2003
	(In thousands)	
Land and land improvements	\$ 2,628	\$ 2,617
Land held for sale	1,540	1,556
Facilities in progress	2,862	2,313
Computer equipment and software	92,491	88,051
Buildings and improvements	36,241	35,330
Furniture, fixtures and equipment	14,142	13,262
	<u>149,904</u>	<u>143,129</u>
Less: Accumulated depreciation and amortization	(102,412)	(88,876)
Property and Equipment, at cost, net	<u>\$ 47,492</u>	<u>\$ 54,253</u>

On February 3, 2005, the land held for sale was sold for \$1.7 million resulting in a gain on disposition of property totaling \$0.1 million.

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, 2004, 2003 and 2002 was \$5.0 million, \$6.5 million and \$5.6 million, respectively. Depreciation has been computed for financial reporting purposes 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	3-7 years
Buildings and improvements	10-40 years
Furniture, fixtures and equipment	3-15 years

4. Goodwill, Franchise Rights and Other Intangibles

Goodwill relates to the purchase price of a minority interest in the Company for consideration in excess of the recorded minority interest. Pursuant to SFAS No. 142, the Company is not required to amortize goodwill.

Franchise rights represent the unamortized purchase price assigned to acquire long-term franchise contracts. As of December 31, 2004 and 2003, 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 17 years. Amortization expense for the years ended December 31, 2004, 2003 and 2002 amounted to \$3.4 million, \$3.4 million and \$3.1 million, respectively. Franchise rights are net of accumulated amortization of \$42.1 million and \$38.6 million at December 31, 2004 and 2003, respectively. The estimated annual amortization expense related to the Company's franchise rights for each of the years ending December 31, 2005 through 2009 is \$3.4 million.

Other non-current assets include approximately \$2.7 million of unamortized intangible assets related to trademarks at December 31, 2004 and 2003, respectively. The trademarks are being amortized over ten years. Amortization expense for the years ended December 31, 2004, 2003 and 2002 amounted to \$0.4 million, \$0.3 million and \$0.4 million, respectively. Trademarks are net of accumulated amortization of \$3.3 million and \$2.9 million at December 31, 2004 and 2003, respectively. The estimated annual amortization expense related to the Company's trademarks for each of the years ending December 31, 2005 through 2009 is \$0.4 million.

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

5. 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 obligated 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, 2004 and 2003 was \$21.7 million and \$32.4 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the years ended December 31, 2004, 2003 and 2002 was \$9.1 million, \$12.1 million and \$13.0 million, respectively. Interest expense attributable to reservation activities was \$1.5 million, \$1.3 million and \$1.4 million for the years ended December 31, 2004, 2003 and 2002, respectively.

6. 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, 2004, Sunburst operates 27 hotels under franchise with the Company.

In January 2001, the Company received certain consideration including a \$35 million seven-year senior subordinated note bearing interest at 11³/₈% (the "New Note") in conjunction with the restructuring and cancellation of a subordinated term note from Sunburst received pursuant to the spin-off. The New Note accrued interest up until June 2002, at which point interest became payable semi-annually in arrears.

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

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

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 related to the note prepayment. 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.

As a result of the December 2003 repayment of the New Note by Sunburst, no interest income was recognized related to the note in 2004. The Company recognized interest income related to the New Note of \$4.5 million and \$4.6 million for the years ended December 31, 2003 and 2002, respectively.

Total franchise fees, including royalty, marketing and reservation fees, paid by Sunburst to the Company, net of royalty fee credits, included in the accompanying consolidated financial statements were \$5.3 million, \$5.3 million and \$6.1 million for the years ended December 31, 2004, 2003 and 2002, respectively. As of December 31, 2004 and 2003, accounts receivable included \$0.9 million and \$1.1 million due from Sunburst, respectively.

7. Restructuring Programs

During 2002, the Company recognized a restructuring charge expense of \$1.6 million pursuant to SFAS 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

8. Accrued Expenses and Other

Accrued expenses and other consisted of the following at:

	<u>December 31,</u>	
	<u>2004</u>	<u>2003</u>
	(In thousands)	
Deferred loyalty program revenue	\$20,317	\$11,770
Accrued salaries and benefits	20,095	17,219
Dividends payable	7,271	6,899
Deferred revenue	2,029	4,475
Accrued interest	1,261	1,392
Other liabilities and contingencies	8,265	4,310
Total	<u>\$59,238</u>	<u>\$46,065</u>

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

9. Long-Term Debt

Debt consisted of the following at:

	<u>December 31,</u>	
	<u>2004</u>	<u>2003</u>
	(In thousands)	
\$265 million senior unsecured revolving credit facility with an effective rate of 3.42% at December 31, 2004	\$218,200	—
\$265 million competitive advance and multi-currency revolving credit facility with an effective rate of 2.29% at December 31, 2003	—	\$143,458
\$100 million senior notes with an effective rate of 7.22% at December 31, 2004 and 2003	99,785	99,720
Line(s) of credit (\$10 million and \$20 million of aggregate borrowing capacity as of December 31, 2004 and 2003, respectively) with an effective rate of 3.50% and 2.25% at December 31, 2004 and 2003, respectively	10,000	2,600
Other notes with an average effective rate of 3.50% and 2.89% at December 31, 2004 and 2003, respectively	718	874
Total debt	<u>\$328,703</u>	<u>\$246,652</u>

Scheduled principal maturities of debt as of December 31, 2004 were as follows:

<u>Year</u>	<u>(In thousands)</u>
2005	\$ 10,146
2006	146
2007	146
2008	99,931
2009	218,334
Total	<u>\$328,703</u>

In June 2001, the Company entered into a five-year competitive advance and multi-currency credit facility (“Old Credit Facility”). The Old Credit Facility originally provided for a term loan of \$150 million and a

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

revolving credit facility of \$110 million. On September 29, 2001, the Company signed an amendment to the Old 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 was \$150 million. The term loan was scheduled to partially amortize over the three years ending June 30, 2006. The unamortized balance of the term loan and all outstanding revolving loans were scheduled to mature in June 2006. Borrowings under the Old Credit Facility bore 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 Old Credit Facility required the Company to pay annual fees ranging, based upon the credit rating of the Company, between 1/15 of 1% to 1/2 of 1% of the aggregate available commitment under the revolving credit facility.

In July 2004, the Company entered into a \$265 million senior unsecured revolving credit facility (the “Revolver”) with a syndicate of lenders. The proceeds from the Revolver were used to refinance and terminate the revolving credit facility and term loan outstanding under the Company’s Old Credit Facility. The Revolver permits the Company to borrow, repay and reborrow revolving loans until the scheduled maturity date in July 2009. Borrowings pursuant to the Revolver bear interest, at one of several rates selected by the Company, based upon the credit rating of the Company and include LIBOR plus 62 ½ basis points to 125 basis points; prime rate; and prime rate minus 175 basis points. 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 Revolver. The Revolver requires the Company to pay a commitment fee ranging, based upon the credit rating of the Company, between 12 ½ basis points and 25 basis points of the average daily-unused portion of the aggregate available commitment. The Revolver also provides for the issuance of letters of credit on behalf of the Company. The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. As of December 31, 2004 the Company was in compliance with all covenants under the Revolver. The Revolver restricts the Company’s ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. As of December 31, 2004, the Company had \$218.2 million of revolving loans outstanding pursuant to the Revolver.

The proceeds from the Revolver are used for general corporate purposes, including working capital, debt repayment, stock repurchases and investments.

In 1998, the Company completed a \$100 million senior unsecured note offering (“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, 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 Notes contain a call provision that would require the Company to pay a premium if the Notes were redeemed prior to their maturity. At December 31, 2004, the call provision would have resulted in a premium of \$12.4 million.

The Company has a line of credit with a bank providing up to an aggregate of \$10 million of borrowings which is due upon demand. The line of credit ranks pari-pasu (or equally) with the Revolver. Borrowings under the line of credit bear interest at rates established at the time of borrowing based on prime minus 175 basis points. As of December 31, 2004, \$10.0 million was outstanding pursuant to this line of credit.

10. 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

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

fees, for the years ended December 31, 2004, 2003 and 2002 were \$22.0 million, \$19.1 million and \$14.2 million, respectively. Net income, including equity in the income and (loss) of equity method investments, attributable to the Company's foreign operations was \$4.8 million, \$4.4 million and \$3.0 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Choice Hotels Australasia (formerly Flag Choice Hotels)

On July 1, 2002, the Company acquired a controlling interest in Choice Hotels Australasia Pty. Ltd. (formerly Flag Choice Hotels) ("Flag") (the "Flag Transaction"). Flag, based in Melbourne, Australia, is a franchisor of certain hotel brands in Australia, Papua New Guinea, American Samoa, 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, American Samoa 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	4,115	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 2002 would not be materially different from the Company's reported results for that period.

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

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

included in other non-current assets in the accompanying consolidated balance sheets at fair value. As of December 31, 2004 and 2003, the fair value of the Company's investment in CHS was \$1.0 million and \$0.7 million, respectively, based on quoted market prices. During the years ended December 31, 2004, 2003 and 2002, the Company recognized approximately \$0.2 million, \$0.1 million and \$0.1 million, respectively, of unrealized gains attributable to this investment as a component of other comprehensive income.

Choice Hotels Canada, Inc.

The Company has a 50% interest in Choice Hotels Canada, Inc. ("CHC"), a joint venture with a third party. During 2004, 2003 and 2002, the Company recorded \$0.7 million, \$0.6 million and \$0.5 million, respectively, based on CHC's results for the twelve months ended November 30, 2004, 2003 and 2002 of equity method income related to this investment pursuant to APB Opinion No. 18 in the accompanying consolidated statements of income. The Company received dividends from CHC of \$0.8 million, and \$0.4 million for the years ended December 31, 2004 and 2003, respectively. During 2004, 2003 and 2002, the Company recognized in the accompanying consolidated statements of income, revenues of \$7.1 million, \$6.2 million and \$4.7 million, respectively, including royalty, marketing, reservation fees and other franchise revenues from CHC.

11. Pension, Profit Sharing, and Incentive Plans

The Company sponsors a 401(k) retirement plan for all eligible employees. For the years ended December 31, 2004, 2003 and 2002, the Company recorded compensation expense of \$2.8 million, \$1.7 million and \$1.5 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 an unfunded non-qualified defined benefit plan ("SERP") for certain senior executives. No assets are held with respect to the plan, therefore benefits are funded as paid to participants. The Company accounts for the SERP in accordance with SFAS No. 87, "Employers Accounting for Pensions." For the years ended December 31, 2004, 2003 and 2002, the Company recorded \$0.7 million, \$0.4 million and \$0.3 million, respectively, of expense related to the SERP which was included in selling, general and administrative expense in the accompanying consolidated statements of income. Based on the plan retirement age of 65 years old, no benefit payments are anticipated over the next ten years. The following table presents the components of net periodic benefit costs for the three years ended December 31, 2004.

	<u>Years ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
	<u>(In thousands)</u>		
Components of net periodic pension cost:			
Service cost	\$ 416	\$ 259	\$ 219
Interest cost	205	139	68
Amortizations			
Prior service cost	51	52	19
(Gain)/Loss	28	—	(1)
Net periodic pension	<u>\$ 700</u>	<u>\$ 450</u>	<u>\$ 305</u>
Weighted average assumptions:			
Discount rate	6.25%	7.00%	7.00%
Average compensation increase	4.50%	4.50%	4.50%

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

As of December 31, 2004 and 2003, a liability of \$2.4 million and \$1.7 million, respectively, related to the SERP was included in other non-current liabilities in the accompanying consolidated balance sheets. The components of the benefit obligation are as follows:

	December 31,	
	2004	2003
	(In thousands)	
Projected benefit obligation	\$ 4,365	\$3,283
Unrecognized prior service cost	(1,000)	(931)
Unrecognized net (gain)/loss	(1,170)	(858)
Net amount recognized	2,195	1,494
Intangible asset	192	237
Accumulated benefit obligation	<u>\$ 2,387</u>	<u>\$1,731</u>

The following is a reconciliation of the changes in the projected benefit obligation for the years ended December 31, 2004 and 2003:

	December 31,	
	2004	2003
	(In thousands)	
Projected benefit obligation, beginning	\$3,283	\$1,980
Service cost	416	259
Interest cost	205	139
Amendments	121	—
Actuarial (gain)/loss	340	905
Projected benefit obligation, ending	<u>\$4,365</u>	<u>\$3,283</u>

The Company sponsors two non-qualified retirement savings and investment plans for certain employees and 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 acquirer, 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, 2004 and 2003, the Company had recorded a deferred compensation liability of \$19.0 million and \$13.3 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 \$17.2 million and \$12.1 million as of December 31, 2004 and 2003, 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)

12. Income Taxes

Income before income taxes was derived from the following:

	Years ended December 31,		
	2004	2003	2002
	(In thousands)		
Income before income taxes:			
Domestic operations	\$109,424	\$108,760	\$93,418
Foreign operations	5,100	3,647	2,400
Income before income taxes	<u>\$114,524</u>	<u>\$112,407</u>	<u>\$95,818</u>

The provisions for income taxes were as follows:

	Years ended December 31,		
	2004	2003	2002
	(In thousands)		
Current tax expense			
Federal	\$ 52,334	\$44,040	\$21,374
State	4,288	3,979	631
Foreign	(315)	758	661
Deferred tax (benefit) expense			
Federal	(15,308)	(7,306)	11,297
State	(794)	(942)	1,012
Foreign	(26)	15	(1)
Income taxes	<u>\$ 40,179</u>	<u>\$40,544</u>	<u>\$34,974</u>

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

	December 31,	
	2004	2003
	(In thousands)	
Depreciation and amortization	\$(12,543)	\$(16,554)
Prepaid expenses	(7,327)	(11,478)
Foreign Operations	(57)	—
Other	(2,871)	(5,510)
Gross deferred tax liabilities	<u>(22,798)</u>	<u>(33,542)</u>
Foreign operations	—	2,553
Accrued expenses	9,277	7,894
Accrued compensation	7,338	1,982
Other	1,461	1,508
Gross deferred tax assets	<u>18,076</u>	<u>13,937</u>
Net deferred tax liability	<u>\$ (4,722)</u>	<u>\$(19,605)</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Included in the accompanying consolidated balance sheet as follows:

	December 31,	
	2004	2003
	(In thousands)	
Current net deferred tax assets	\$ 2,252	\$ 1,957
Non-current net deferred tax liabilities	(6,974)	(21,562)
Net deferred tax liability	<u>\$ (4,722)</u>	<u>\$ (19,605)</u>

No provision has been made for U.S. federal income taxes on approximately \$22.3 million of accumulated and undistributed earnings of foreign subsidiaries at December 31, 2004 since these earnings are considered to be permanently invested in foreign operations.

On October 22, 2004, the American Jobs Creation Act of 2004 (“AJCA”) was signed into law. The AJCA includes a temporary incentive for United States multinational corporations to repatriate undistributed earnings of foreign subsidiaries by providing an 85 percent dividends received deduction for qualifying dividends from controlled foreign corporations, as defined in the AJCA, at an effective tax cost of 5.25 percent on any such repatriated foreign earnings. The Company may elect to apply this provision to qualifying earnings repatriations in 2005. We have begun an evaluation of the effects of the repatriation provisions and expect to complete the analysis prior to the end of the third quarter 2005. The range of possible amounts that the Company is considering for repatriation under this provision is between zero and \$22.3 million. The related potential range of income tax is between zero and \$1.2 million.

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,		
	2004	2003	2002
	(In thousands, except Federal income tax rate)		
Federal income tax rate	35%	35%	35%
Federal taxes at statutory rate	\$40,083	\$39,342	\$33,536
State income taxes, net of federal tax benefit	1,933	1,974	1,068
Unrealized tax benefits	(144)	(617)	—
Other	(1,693)	(155)	370
Income tax expense	<u>\$40,179</u>	<u>\$40,544</u>	<u>\$34,974</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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

13. Other Non-Current Liabilities

Other non-current liabilities consist of the following at:

	December 31,	
	2004	2003
	(In thousands)	
Deferred compensation and retirement plan obligations	\$21,387	\$15,058
Deferred revenue	1,614	2,645
Other liabilities and contingencies	15,818	21,160
Total	<u>\$38,819</u>	<u>\$38,863</u>

Other liabilities and contingencies include 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.

14. 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 9.5 million shares of the Company's common stock, of which 0.7 million shares remain available for grant as of December 31, 2004. Restricted stock and stock options may be granted to officers, key employees and non-employee directors.

Restricted Stock.

The following table is a summary of activity related to restricted stock grants to non-employee directors and key employees for the year ended December 31,

	2004	2003	2002
Restricted Shares Granted	204,460	7,428	109,894
Weighted Average Grant Date Fair Value per share	\$ 39.00	\$ 24.23	\$ 20.94
Aggregate Grant Date Fair Value (\$000)	\$ 7,973	\$ 180	\$ 2,301
Restricted Shares Forfeited	2,055	—	—
Vesting Period of Shares Granted	3-5 years	3 years	5 years

The Company incurred compensation expense totaling \$2.5 million, \$0.9 million and \$1.7 million related to the vesting of restricted stock during the years ended December 31, 2004, 2003 and 2002, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock Options.

A summary of the stock option activity under the Company's stock option plan is as follows as of December 31, 2004, 2003 and 2002:

<u>Fixed Options</u>	<u>2004</u>		<u>2003</u>		<u>2002</u>	
	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding at beginning of year . . .	3,295,740	\$16.34	3,111,991	\$15.03	3,095,589	\$13.56
Granted	10,000	\$41.49	686,967	\$20.52	601,895	\$21.53
Exercised	(557,107)	\$15.13	(462,522)	\$13.58	(442,869)	\$13.01
Cancelled	(28,426)	\$19.11	(40,696)	\$18.79	(142,624)	\$16.83
Outstanding at end of year	<u>2,720,207</u>	<u>\$16.65</u>	<u>3,295,740</u>	<u>\$16.34</u>	<u>3,111,991</u>	<u>\$15.03</u>
Options exercisable at year end	<u>1,634,075</u>	<u>\$14.49</u>	<u>1,673,129</u>	<u>\$13.71</u>	<u>1,533,471</u>	<u>\$12.96</u>
Weighted average fair value of options granted during the year . .		<u>\$13.99</u>		<u>\$ 8.65</u>		<u>\$ 8.95</u>

The following table summarizes information about stock options outstanding at December 31, 2004:

<u>Range of Exercise Prices</u>	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number Outstanding at 12/31/04</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Number Exercisable at 12/31/04</u>	<u>Weighted Average Exercise Price</u>
\$ 5.01 to \$ 9.00	12,000	5.7 years	\$ 7.82	—	—
\$ 9.01 to \$13.00	896,634	3.2 years	\$12.09	877,259	\$12.12
\$13.01 to \$17.65	712,440	4.6 years	\$15.64	523,905	\$15.54
\$17.66 to \$30.00	1,089,133	7.5 years	\$20.94	232,911	\$21.04
\$30.01 to \$41.49	10,000	9.1 years	\$41.49	—	—
	<u>2,720,207</u>	<u>5.3 years</u>	<u>\$16.65</u>	<u>1,634,075</u>	<u>\$14.49</u>

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 2004, 2003 and 2002:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Risk-free interest rate	3.03%	2.57%	3.58%
Volatility	37.97%	39.69%	35.43%
Expected Lives	6 years	6 years	6 years
Dividend Yield	1.93%	0%	0%

Stock Repurchase Program.

The Company announced a stock repurchase program on June 25, 1998 to increase returns to its shareholders. Treasury stock activity is recorded at cost in the accompanying consolidated financial statements.

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

Through December 31, 2004, the Company had repurchased 32.5 million shares of its common stock at a total cost of \$663 million, including 3.2 million shares of common stock at a total cost of \$148.3 million during the year ended December 31, 2004. Subsequent to December 31, 2004 through March 10, 2005, the Company had repurchased an additional 0.2 million shares of its common stock at a total cost of \$13.5 million, including 0.1 million at a total cost of \$6.0 million from one of the Company's largest shareholders.

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 1/100th 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 acquirer having a value of twice the exercise price of the right. On February 14, 2005, the Company's board of directors voted to terminate this rights agreement.

15. Comprehensive Income

The components of accumulated other comprehensive income are as follows:

	December 31,		
	2004	2003	2002
	(In thousands)		
Unrealized gains (losses) on available-for-sale securities	\$ 123	\$ (18)	\$ (80)
Foreign currency translation adjustments	1,054	866	(235)
Deferred gain on hedging activity	223	290	357
Total accumulated other comprehensive income	<u>\$1,400</u>	<u>\$1,138</u>	<u>\$ 42</u>

The components of other comprehensive income are as follows:

	Amount Before Taxes	Income Tax (Expense)/Benefit	Amount Net of Taxes
2004			
Net unrealized gains	\$ 225	\$ (84)	\$ 141
Foreign currency translation adjustment, net	188	—	188
Amortization of deferred gain on hedge	(110)	43	(67)
Total other comprehensive income	<u>\$ 303</u>	<u>\$ (41)</u>	<u>\$ 262</u>
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)
	<u>\$ 426</u>	<u>\$ (30)</u>	<u>\$ 396</u>

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

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 original life of the related debt as a reduction of interest expense. In each of 2004, 2003 and 2002, the Company recorded approximately \$67,000, net of taxes, of amortization related to this deferred gain.

16. 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,		
	2004	2003	2002
	(In millions, except per share amounts)		
Computation of Basic Earnings Per Share:			
Net income	<u>\$74.3</u>	<u>\$71.9</u>	<u>\$60.8</u>
Weighted average shares outstanding-basic	<u>33.2</u>	<u>35.7</u>	<u>39.3</u>
Basic earnings per share	<u>\$2.24</u>	<u>\$2.01</u>	<u>\$1.55</u>
Computation of Diluted Earnings Per Share:			
Net income for diluted earnings per share	<u>\$74.3</u>	<u>\$71.9</u>	<u>\$60.8</u>
Weighted average shares outstanding-basic	<u>33.2</u>	<u>35.7</u>	<u>39.3</u>
Effect of Dilutive Securities:			
Employee stock option and restricted stock plan	<u>1.3</u>	<u>1.0</u>	<u>0.8</u>
Weighted average shares outstanding-diluted	<u>34.5</u>	<u>36.7</u>	<u>40.1</u>
Diluted earnings per share	<u>\$2.15</u>	<u>\$1.96</u>	<u>\$1.52</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.

17. Leases

The Company enters into operating leases primarily for office space and computer equipment. Rental expense under non-cancelable operating leases was approximately \$12.8 million, \$15.2 million and \$12.9 million for the years ended December 31, 2004, 2003 and 2002, respectively. The Company received sublease rental income related to computer equipment leased to franchisees totaling \$8.8 million, \$10.2 million and \$9.1 million during the years ended December 31, 2004, 2003 and 2002, respectively. Future minimum lease payments are as follows:

	2005	2006	2007	2008	2009	Thereafter	Total
	(In thousands)						
Minimum lease payments	\$10,842	\$ 6,429	\$3,878	\$3,884	\$3,943	\$14,056	\$43,032
Minimum sublease rentals	(7,171)	(2,642)	(45)	—	—	—	(9,858)
	<u>\$ 3,671</u>	<u>\$ 3,787</u>	<u>\$3,833</u>	<u>\$3,884</u>	<u>\$3,943</u>	<u>\$14,056</u>	<u>\$33,174</u>

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

18. 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 operations. Except as described in Note 5, the Company does not allocate interest and dividend income, interest expense or income taxes to its franchising segment.

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

Year Ended December 31, 2004				
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	\$425,077	\$ 3,729	—	\$428,806
Operating income (loss)	161,564	(36,564)	—	125,000
Depreciation and amortization	11,429	7,576	(9,058)	9,947
Capital expenditures	5,376	1,483	—	6,859
Total assets	186,746	75,642	—	262,388
Year Ended December 31, 2003				
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	\$382,539	\$ 3,565	—	\$386,104
Operating income (loss)	150,490	(36,507)	—	113,983
Depreciation and amortization	14,671	8,631	(12,077)	11,225
Capital expenditures	7,342	1,138	—	8,480
Total assets	195,106	72,166	—	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)	140,256	(35,556)	—	104,700
Depreciation and amortization	14,925	9,352	(13,026)	11,251
Capital expenditures	7,562	4,671	—	12,233
Total assets	221,668	95,105	—	316,773

Long-lived assets related to international operations were \$9.2 million, \$9.9 million and \$8.1 million as of December 31, 2004, 2003 and 2002, respectively. All other long-lived assets of the Company are associated with domestic activities.

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

19. 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. No amounts were drawn against this letter of credit as of December 31, 2004. The letter of credit expires in April 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 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.

20. 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, 2004 and 2003 of \$109.0 million and \$111.7 million, respectively, based on quoted market prices.

21. Related Party Transactions

During 2003 and 2002, the Company repurchased 1.0 million shares and 1.7 million shares of its common stock at a total cost of \$24.8 million and \$41.7 million, respectively from the Company's largest shareholder, affiliates and related parties. No shares were repurchased from related parties during 2004. On March 10, 2005, the Company purchased 0.1 million shares at a cost of \$6.0 million from one of the Company's largest shareholders.

During 2004, the Company recognized stock compensation expense of approximately \$0.3 million resulting from acceleration of vesting of stock options and restricted stock held by a retiring board member who is a member of the family of the Company's largest shareholder.

The Company paid approximately \$187,028 to and received approximately \$121,040 from corporations owned or controlled by family members of the Company's largest shareholder related to the lease of personal and real property during 2004. During 2003, the Company paid approximately \$298,385 and received approximately \$121,040. During 2002, the Company paid approximately \$41,000 and received approximately \$104,000.

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

22. Impact of Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. Effective, January 1, 2003, the Company adopted 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. SFAS No. 123R will require the Company to apply fair value recognition provisions to all unvested equity awards as of the first interim reporting period starting after June 15, 2005, which is the Company's third quarter beginning July 1, 2005. The adoption of SFAS No. 123R is not expected to have a material effect on the Company's results of operations or financial condition.

23. Selected Quarterly Financial Data – (Unaudited)

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>2004</u>
	(In thousands, except per share data)				
Revenues	\$87,235	\$107,175	\$127,510	\$106,886	\$428,806
Operating income	\$18,899	\$ 32,136	\$ 42,489	\$ 31,476	\$125,000
Income before income taxes	\$16,849	\$ 29,498	\$ 38,971	\$ 29,206	\$114,524
Net income	\$10,594	\$ 18,503	\$ 24,916	\$ 20,332	\$ 74,345
Per basic share:					
Net income	\$ 0.31	\$ 0.55	\$ 0.76	\$ 0.63	\$ 2.24
Per diluted share:					
Net income	\$ 0.30	\$ 0.53	\$ 0.73	\$ 0.60	\$ 2.15
	<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

The matters which effect the comparability of our quarterly results include seasonality, the loss on extinguishment of debt in the third quarter 2004 and the gain related to the fourth quarter 2003 note prepayment by Sunburst.

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CORPORATE INFORMATION

BOARD OF DIRECTORS

Stewart Bainum Jr.
Chairman of the Board,
Sunburst Hospitality Corporation

Fiona Dias
Senior Vice President,
Circuit City Stores, Inc., and
President, Circuit City Direct

Charles A. Ledsinger, Jr.
President and Chief Executive Officer:
Choice Hotels International
Director:
FelCor Lodging Trust, Inc.
TBC Corporation

Larry R. Levitan
IRS Oversight Board
Retired Managing Partner,
Andersen Consulting
Worldwide Communications
Industry Group
Trustee, FBR Funds

Raymond E. Schultz
Chairman,
RES Investments, LLC
Director:
Equity Inns, Inc.
TBC Corporation

Ervin R. Shames
Independent Management Consultant
Lecturer, University of Virginia
Darden Graduate School of Business
Director:
OnLine Resources Corporation
Select Comfort Corporation

Gordon A. Smith
President, Consumer Card Services Group
American Express Travel Related
Services, Inc.

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

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

CORPORATE EXECUTIVE OFFICERS

Stewart Bainum Jr.
Chairman of the Board

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

Joseph M. Squeri
Executive Vice President,
Chief Financial Officer and Treasurer

Wayne W. Wielgus
Executive Vice President
and Chief Marketing Officer

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

David Goldberg
Senior Vice President,
Corporate and Brand Strategy

Bruce N. Haase
Senior Vice President, International

Thomas Mirgon
Senior Vice President, Human Resources
and Administration

Janna Morrison
Senior Vice President, Franchise Services

David A. Pepper
Senior Vice President, Franchise Development

Daniel K. Rothfeld
Senior Vice President, Partner Services Group

Gary R. Thomson
Senior Vice President
and Chief Information Officer

ANNUAL MEETING

Choice Hotels International will hold its Annual Meeting of Stockholders on Tuesday, May 3, 2005, at 9:00 a.m. in The Chesapeake Room of the Learning Center, 10720 Columbia Pike, Silver Spring, Maryland.

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 Registered Public Accounting Firm
PricewaterhouseCoopers LLP
Washington, D.C.

Certifications
Choice Hotels has included as Exhibit 31 to its Annual Report on Form 10-K for fiscal year 2004 filed with the Securities and Exchange Commission certificates of the Company's Chief Executive Officer and Chief Financial Officer certifying the quality of the company's public disclosure. The Company's Chief Executive Officer has also submitted to the New York Stock Exchange (NYSE) a certificate certifying that he is not aware of any violations by Choice Hotels International of the NYSE corporate governance listing standards.

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. Click on "Investor Info," then on "SEC Filings."

Corporate Headquarters
Choice Hotels International
10750 Columbia Pike
Silver Spring, MD 20901

General Inquiries: (301) 592-5000
Franchise Sales: (800) 547-0007
Investor Inquiries: (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 Board of Directors committee charters are available on www.choicehotels.com under the "Investor Info" link.

* Retiring in May 2005

