

2005 ANNUAL REPORT



C H O I C E H O T E L S I N T E R N A T I O N A L

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ON THE COVER



In January 2005, Choice expanded into the upscale, select-service lodging segment with the launch of its newest brand, Cambria Suites. An all-suites hotel, with stylish contemporary design elements and guest amenities that meet the needs of business and leisure travelers, each hotel will typically offer 100 to 150 rooms – each 25 percent larger than industry standard. In-room features include separate living/work environments, luxury bedding and linens; a refrigerator and microwave; movable, ergonomic desk; high speed wireless Internet access; flat panel televisions and premium cable channels with Pay-Per-View options.

ABOUT CHOICE

Choice Hotels International was founded as a marketing cooperative by a group of Florida motor court owners in 1941. Operating under the name Quality Courts United – the nation’s first hotel chain – the owners sought to refer business to each other’s hotels, as well as establish quality and service standards for their properties, in order to better meet the needs and expectations of their guests.

Over the years, more hotels joined the Quality Courts system, which had become an influential force in the lodging industry and had established a reputation for providing quality, affordable lodging in convenient and popular locations.

In 1990, in order to better reflect its growing number of brands and its presence in other countries, the company changed its name to Choice Hotels International, and in 1996, Choice became a public company trading on the New York Stock Exchange under the symbol CHH.

Today, Choice Hotels International is one of the largest and most successful lodging companies in the world. With a commitment to serving the traveling public by offering high-standard accommodations at an affordable price and to ensuring an outstanding return on investment for its hotel owners and shareholders, Choice currently franchises more than 5,200 hotels, representing more than 425,000 rooms, in the United States and more than 40 countries and territories.

Choice hotels, which include Cambria Suites, Clarion, Quality, Comfort Suites, Comfort Inn, Sleep Inn, MainStay Suites, Suburban Extended Stay Hotel, Econo Lodge and Rodeway Inn, are among the world’s most recognized brands. Ranging from limited service to full service hotels in the economy, midscale and upscale segments, Choice-branded properties provide business and leisure travelers with a range of high-quality, high-value lodging options throughout the United States and internationally.

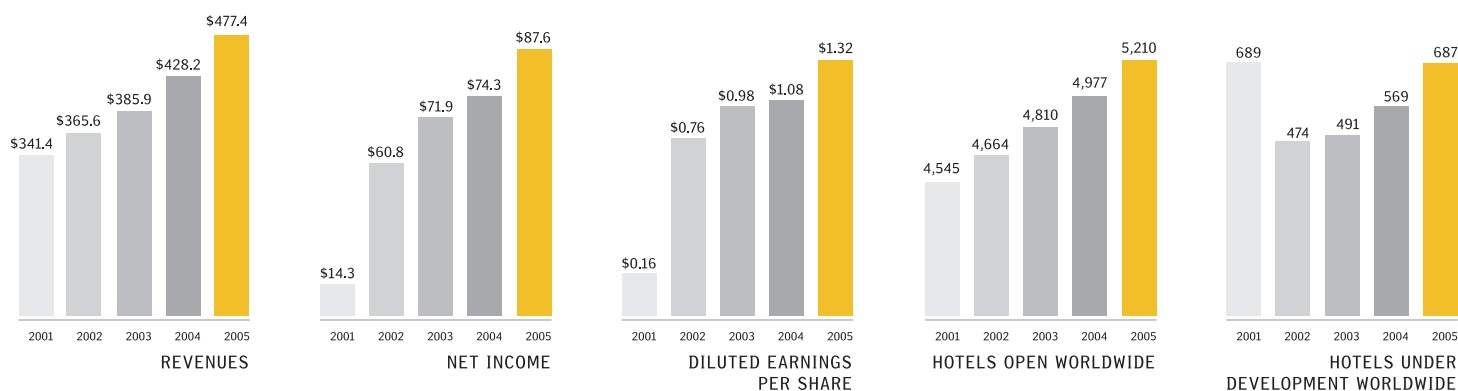


FINANCIAL HIGHLIGHTS

(amounts in millions, except unit and share data)

COMPANY RESULTS	2005	2004	2003	2002	2001
Total Revenues	\$ 477.4	\$ 428.2	\$ 385.9	\$ 365.6	\$ 341.4
Net Income	\$ 87.6	\$ 74.3	\$ 71.9	\$ 60.8	\$ 14.3
Basic Earnings per Share ¹	\$ 1.36	\$ 1.12	\$ 1.01	\$ 0.78	\$ 0.16
Diluted Earnings per Share ¹	\$ 1.32	\$ 1.08	\$ 0.98	\$ 0.76	\$ 0.16
Cash Dividends Declared per Share	\$ 0.485	\$ 0.425	\$ 0.10	—	—
DOMESTIC FRANCHISE SYSTEM					
Hotels Open and Operating	4,048	3,834	3,636	3,482	3,327
Hotels Under Development	603	460	401	310	462
Rooms Open and Operating	329,353	309,586	294,268	282,423	270,514
TOTAL FRANCHISE SYSTEM (Domestic and International)					
Hotels Open and Operating	5,210	4,977	4,810	4,664	4,545
Hotels Under Development	687	569	491	474	689
Rooms Open and Operating	427,056	403,806	388,618	373,722	362,549

¹ Per share amounts have been retroactively adjusted for the two-for-one stock split effected in the form of a stock dividend distributed on October 21, 2005, to shareholders of record on October 7, 2005.



LETTER FROM THE PRESIDENT AND CEO

DEAR SHAREHOLDER:

A high-performing business model and a well-executed strategy combined to produce another record year for Choice Hotels International in 2005. By ending the year with almost 690 hotels in our worldwide development pipeline, we solidified our position as a leading franchisor in the lodging industry.

Our financial results were stellar once again, with diluted earnings per share up 22% for the year to \$1.32 and net income growing 18% to \$87.6 million. Total revenues increased 11% to \$477.4 million while the company's 4,048 domestic franchisees generated system-wide revenues of \$4.3 billion.

As a company that thrives on unit growth, Choice experienced another record year in franchise development, with new domestic hotel franchise contracts increasing 16% to 639. During the year, we achieved a significant milestone with the opening of our 5,000th hotel, and our total number of rooms exceeding 425,000.

This performance is testament to the dedication and drive for excellence of our more than 1,500 associates and the commitment of our franchisees to help build an even stronger Choice system.

In a year marked with many milestones, the most significant was the addition of two new brands in two dynamic segments to our hotel brand portfolio. In January, we launched a new construction, upscale all-suites brand, Cambria Suites, to meet growing demand from hotel developers and business travelers for such a product. By offering the style and select service that today's guests demand, with lower development costs and ongoing fees than the competition, we were able to secure 13 franchise contracts, and broke ground on the first Cambria Suites hotel in Boise, Idaho.

Then in September, we acquired the Suburban Extended Stay Hotel brand, marking Choice's entry into the economy extended stay segment which has strong growth potential and has shown a solid track record for providing above-average returns for hotel owners. As a result of the acquisition, we immediately became the segment leader with 67 hotels, representing nearly 9,000 rooms.

The addition of these brands comes at a time when the lodging industry is enjoying strong fundamentals. According to industry forecasts, in 2006 demand is projected to rise more than 3% while supply is expected to rise a modest 1.4%. As a result, our franchised hotels will have greater pricing power and the opportunity to further drive revenue per available room (RevPAR), which rose 6.1% domestically in 2005.

This time last year, I told you that Choice's key goals had four main areas of focus: (1) guest satisfaction; (2) building brand equity; (3) system growth; and (4) owner profitability. In each of these areas, we made substantial progress as evidenced in our year-end results and our record performance in franchise development.

GUEST SATISFACTION: Our intensified focus on guest satisfaction was reflected in the more than 1.3 million Guest Insight System (GIS) surveys distributed to our guests, along with more than 400,000 of the online guest satisfaction surveys returned to us. Results from these surveys show that the majority of guests at our hotels rate their overall experiences positively and that we are focused on the key drivers of customer satisfaction. In addition, these surveys produced valuable data on our guests' preferences as well as on the performance of individual properties.

BRAND EQUITY: We continued to build brand equity, not only through the addition of our new brands, but also through a number of initiatives to strengthen our eight established brands, including upgrades to bedding, bath and breakfast standards for our midscale brands. In addition, the successful re-imaging of our flagship Comfort Inn brand provided a great contribution to keeping that brand fresh and moving forward.



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



SYSTEM GROWTH: Choice enjoyed yet another record year for system growth, due in no small measure to the excellence of our franchise sales team. Comfort Suites brands enjoyed strong growth while the Quality and Rodeway Inn brands proved most successful among our conversion brands.

OWNER PROFITABILITY: The focus on owner profitability is best reflected in our corporate vision: *To generate the highest return on investment of any hotel franchise.* Our franchise services staff, working at the hotel level with our owners, provides a significant resource to identify areas where hotel operators can improve topline revenue performance as well as profitability.

Each of these four areas remains a major focus for us moving forward in 2006. Industry prospects are bright, with the preliminary outlook for average daily rate (ADR) to rise another 5% or better, and for industry revenue to exceed 8% growth for the third consecutive year.

So what does this all mean for Choice in 2006? To leverage the opportunities, we have to focus on strategically growing our eight established brands while achieving growth in our two new market segments. We have to deliver to our franchisees a high return on investment by continuing to improve our brands and our property level performance. And, we have to provide the attributes most important to our franchisees: brand recognition and business delivery at the lowest cost. We believe that focusing on these strategic areas best positions us to further maximize financial and shareholder returns.

STRATEGICALLY GROW OUR EXISTING BRANDS AND ACHIEVE GROWTH IN NEW MARKET SEGMENTS

Our Comfort Inn, Comfort Suites, Sleep Inn, Quality, Clarion, Econo Lodge and Rodeway Inn brands continue to provide an outstanding value to our franchisees and guests, and an integral part of our strategy is to continue to improve our portfolio of properties by leveraging our world-class sales team with brands that provide strong growth potential and a compelling value proposition for hotel owners.

The introduction of Cambria Suites is successfully underway, with the first Cambria Suites hotel scheduled to come on line this winter and several more to follow.

The integration of the Suburban Extended Stay Hotel brand into our system is moving swiftly and smoothly. Coupled with our mid-scale MainStay Suites extended stay brand, we now have two outstanding products to offer developers in a dynamic part of the lodging industry.

On the international front, we continue to work with our partners in opening up new markets while building our existing base of operations in Canada, Latin America, Asia, Europe, and Australasia. In 2006, we aim to achieve market entry into China and to reinvigorate our Continental European business.

IMPROVE OUR BRANDS AND PROPERTY PERFORMANCE

In addition to the brand initiatives underway to improve and strengthen our existing brands by offering what guests value most, we are working with our franchisees to ensure they have the property management systems that can link effectively to our central reservations system (CRS) and deliver management information that can drive business improvement.

We are also introducing new tools to our hotel owners to help them better manage and focus their efforts on successful business practices. These tools include a property ranking system, which provides owners a valuable perspective on how their property measures up against other hotels in their brand with respect to quality

assurance and guest satisfaction; revenue management support to help our properties establish competitive rates; and enhanced support from our reservation call centers in order to help maximize occupancy levels.

IMPROVE BRAND RECOGNITION AND BUSINESS DELIVERY

We will continue to leverage the strength of our multi-brand marketing strategy and use single-branded messaging where it makes sense. In total our marketing approach has significantly enhanced our brand recognition as we have made inroads not only in national television advertising but also in a variety of programs including Internet marketing, corporate partnerships, special promotions and our Choice Privileges frequent traveler program which now has more than 4.4 million members.

MAXIMIZE FINANCIAL AND SHAREHOLDER RETURNS

These strategic initiatives will aid us in our overall drive to continue to build shareholder value. In the past year, we have taken several key steps to deliver more value to you, our shareholders. Foremost among these was the decision by the Board of Directors to undertake a two-for-one stock split. At the same time, the Board elected to raise the dividend by more than 15% to a post-split payout of 13 cents per share per quarter.

The Board also authorized an additional three million shares of common stock for the share repurchase program first begun in 1998. Since it was first authorized in June of that year, the company has purchased more than 33 million shares of common stock at an average price of \$21.16 per share and a total cost of \$711.9 million.

Our management team remains committed to returning value to shareholders through a combination of dividends and share repurchases, as market conditions allow.

Since I arrived at Choice in the fall of 1998, I have had the good fortune of having a strong Board of Directors to rely on for guidance and support. In the past year, we strengthened the Board with the addition of John T. Schweiters, and recently we announced that lodging industry veteran David Sullivan joined the Board and that health care executive William Jews has returned to our Board.

I would also like to take this opportunity to thank Raymond Schultz, who announced his retirement from the board effective May 2006, for the contributions he has made to Choice over the years. We appreciate the counsel he provided to us, and we wish him all the best.

In December 2005, the Board announced the extension of my employment agreement for four years. I appreciate their confidence in my leadership and in the strategy we have established to guide the company. We've been able to achieve great progress for Choice during my tenure, thanks to the support of the Board, a very talented senior management team and dedicated associates whose pride in their work is demonstrated every day, as well as a vibrant and growing base of hotel owners.

Choice has enormous potential for even greater growth ahead. A sound economy, growing travel demand and our ability to offer more rooms, in more places at many price points positions us extremely well for another great year in 2006. I look forward to the future as Choice continues to evolve into a global franchising powerhouse.



Charles A. Ledsinger, Jr.
President and Chief Executive Officer
March 2006





A CHOICE YEAR IN REVIEW

JANUARY

- Choice launches the Cambria Suites brand, a select-service all-suites hotel. The product is designed to maximize return on investment for developers, as well as to build brand loyalty in a highly competitive consumer marketplace.

FEBRUARY

- In response to the deadly tsunami that killed more than 200,000 people when it crashed into the coasts of nearly a dozen countries on Dec. 26, 2004, Choice franchisees and associates around the world raise more than \$110,000 for relief efforts, which includes a \$50,000 match from the Choice Hotels International Foundation.
- Choice begins displaying real-time rate information for its properties in the global distribution systems (GDS), giving travel agents more accurate rate and room availability information.

MARCH

- Choice Hotels Scandinavia announces the conversion of more than 30 hotels to the Clarion Collection. Sixteen Clarion Collection hotels throughout Sweden join the system, along with 13 in Norway and two in Denmark.
- Choice Hotels Canada revamps its Web site, www.choicehotels.ca, with a new look featuring enhanced navigation and search functions, making it easier for travelers to move around the site.

APRIL

- Choice redesigns its sports marketing Web site, choicesportstravel.com, to offer teams, athletes and fans enhanced, real-time sports headlines on college sports, youth sports, golf, baseball, soccer and basketball. The company also launches two online sweepstakes with two of its sports partners: Little League Baseball and the Ladies Professional Golf Association (LPGA).
- As a further enhancement to the company Web site, Choice adds Japanese language booking capability.

MAY

- Choice signs a global preferred third-party partner agreement with Expedia and Hotels.com, giving its 5,000 hotels greater exposure to potential travelers worldwide.
- The company joins forces with the National Park Foundation (NPF) to support programs, promotions and initiatives that foster visits to and volunteerism at America's national parks. Choice contributes \$100,000 from the Choice Hotels International Foundation to support volunteer initiatives within the national parks.

JUNE

- Reservations booked via choicehotels.com top \$1 million in revenues per day for a total of 110 days to date in 2005, with the daily average for the year totaling \$1.3 million. Revenues exceed \$1.5 million per day for a total of 43 days thus far in 2005.
- As part of its ongoing diversity marketing efforts aimed at attracting a broader array of customers, Choice begins sponsoring select Radio One events across the country targeting African American and urban listeners.
- Continuing to build long-term guest loyalty, Choice focuses on its key relationships with Bank of America and Southwest Airlines for the year's summer promotions.

JULY

- *ChoiceCaribbean.com*, once maintained by a Caribbean-based company, receives a redesign and is brought in-house to be hosted and maintained by Choice.
- The Endorsed Vendor Directory is reorganized into more descriptive categories to assist hotels in finding the right company for their specific needs.

AUGUST

- In an effort to drive more business to its hotels, Choice partners with the American Express Corporate Card division to be the exclusive mid-scale hotel chain in the American Express *Savings at Work* program.
- In response to the hurricanes that hit the Gulf Coast region, Choice establishes a program for relief efforts, which results in Choice, its associates, and franchisees contributing nearly \$300,000 to the American Red Cross, as well as providing an additional \$160,000 in contributions from Choice and its franchisee associations for relief to employees of the company's franchised hotels affected by the hurricanes.

SEPTEMBER

- Choice acquires Suburban Franchise Holding Company Inc., and its subsidiary, Suburban Franchise Systems Inc. With the addition of the 67 properties in the Suburban Extended Stay Hotels chain, Choice enters the economy extended-stay lodging segment and immediately becomes its largest franchisor with nearly 9,000 rooms online.
- The company celebrates the grand opening of its 5,000th franchised hotel as Choice President and Chief Executive Officer Charles A. Ledsinger Jr. presides at ceremonies for the Comfort Suites hotel of Lake Geneva, Wisconsin.
- Choice's Board of Directors names John T. Schweiters, a prominent Washington D. C. businessman, as a director, replacing long-time member Dr. Jerry Robertson.
- The Board also announces a two-for-one stock split, effected in the form of a stock dividend, and also raises the dividend more than 15% to a post-split payout of 13 cents per share per quarter.

OCTOBER

- The Summit Group breaks ground for the first Cambria Suites hotel, which will be located in Boise, Idaho.
- The Rodeway Inn brand launches a new fee structure that greatly enhances ease of entry into the Rodeway Inn system, and jumpstarts the brand's growth potential in the burgeoning budget hotel segment.

NOVEMBER

- In a survey of AAA travel agents, Choice receives a 92% rating – the highest score received by a hotel brand in the mid-scale segment – when respondents say they are “Satisfied” or “Very Satisfied” with Choice as a hotel partner.

DECEMBER

- Choice's Board authorizes a three million share increase in the share repurchase program.
- The Board also extends the employment agreement with Charles A. Ledsinger Jr., president and chief executive officer, for four years. Under the extension, his contract runs until December 2009.
- Choice Club Plus, the frequency program for Choice Hotels Canada, becomes part of the Choice Privileges rewards program, offering Choice Privileges members in the United States the ability to earn points at Choice hotels in Canada, and Canadian residents the ability to earn points at both mid-scale hotels in the United States and Canada.



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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 5,210 hotels open and 687 hotels under development as of December 31, 2005, with 427,056 rooms and 54,075 rooms, respectively, in 49 states, the District of Columbia and more than 45 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, Suburban Extended Stay Hotel and Flag Hotels. Approximately 95% of the Company's revenues are derived from hotels franchised in the United States.

During 2005, the Company acquired 100% of the stock of Suburban Franchise Holding Company, Inc. ("Suburban") and its wholly owned subsidiary, Suburban Franchise Systems, Inc for \$12.8 million. Suburban is the franchisor of Suburban Extended Stay Hotel and at acquisition had 67 units (8,942 rooms) operating in the economy extended stay segment primarily in the southeastern United States. The acquisition allowed the Company to enter, on an accelerated basis, the economy extended stay segment, a market in which it did not previously compete. The results of Suburban have been consolidated with the Company since September 28, 2005.

On September 14, 2005, the Company's board of directors declared a two-for one stock split effected in the form of a stock dividend. The stock dividend was distributed on October 21, 2005 to shareholders of record on October 7, 2005. Share data and earnings per share data included in MD&A reflect the stock split, applied retroactively, to all periods presented.

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 our customer's profitability by providing our customers with hotel franchises that generate the highest return on investment of any hotel franchise. 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. We strive every day to continuously improve our franchise offerings to enhance our customer's profitability and 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, increasing our system size by selling additional hotel franchises and effective royalty rate improvement. 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 and raise royalty rates. 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, growing the system through additional franchise sales and improving franchise agreement pricing 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 33.6 million shares (including 33.0 million prior to the 2 for 1 stock split effected in October 2005) of common stock at a total cost of \$711.9 million, or an average price of \$21.16 per share since the program's inception. On December 8, 2005, the board of directors authorized a 3 million share increase in the number of shares available for repurchase under the program. Our cash flows from operations support our ability to complete the repurchase of approximately 5.1 million shares presently remaining under our current board of directors' authorization. The Company expects to continue to return value to its shareholders through a combination of dividends and share repurchases, subject to market and other conditions and upon completion of the current authorization we will evaluate the propriety of additional share repurchases with our board of directors. During 2005, we paid cash dividends totaling approximately \$30.2 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 \$33.8 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 ("EPS") represent key measurements of these value drivers. In 2005, royalty fees revenue totaled approximately \$187.3 million, a 12% increase from 2004. Operating income totaled \$143.8 million for the year ended December 31, 2005, a 15% increase from 2004. Net income for the year ended December 31, 2005 increased to \$87.6 million, an increase of \$13.2 million over the year ended December 31, 2004, an 18% increase. Diluted earnings per share were \$1.32, a 22% improvement over 2004 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 2005 included additional income tax expense of approximately \$1.2 million related to the Company's repatriation of foreign earnings pursuant to the American Jobs Creation Act and a reduction of income tax expense related to the resolution of certain tax contingencies of approximately \$4.9 million. Those items represent diluted EPS of \$0.06, net, for the year ended December 31, 2005. 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 and a reduction of income tax expense related to the resolution of certain tax contingencies of approximately \$1.2 million. Those items represented diluted EPS of \$0.01 per share, net, for the year ended December 31, 2004. These measurements will continue to be a key management focus in 2006 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 2005 and 2004, net cash provided by operating activities was \$132.9 million and \$108.1 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 2005 Operating Results and 2004 Operating Results

The Company recorded net income of \$87.6 million for the year ended December 31, 2005, an increase of \$13.3 million, or 18% from \$74.3 million for the year ended December 31, 2004. The increase in net income for the year is primarily attributable to an \$18.8 million improvement in operating income and a decline in the effective income tax rate from 35.1% to 33.0% partially offset by a \$2.5 million expense increase in other income and expenses. The effective income tax rate declined primarily due to the resolution of tax contingencies of approximately \$4.9 million in 2005 compared to \$1.2 million in 2004 offset by additional income tax expense of \$1.2 million in 2005 related to the Company's repatriation of foreign earnings. The increase in net other income and expenses was primarily related to a \$3.7 million increase in interest expense offset by the loss on extinguishment of debt of \$0.7 million incurred during 2004. Operating income increased as a result of a \$26.2 million, or 12.9% 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 \$8.7 million increase in selling, general and administrative expense.

Summarized financial results for the years ended December 31, 2005 and 2004 are as follows:

	<u>2005</u>	<u>2004</u>
	(In thousands)	
REVENUES:		
Royalty fees	\$187,340	\$167,135
Initial franchise and relicensing fees	25,388	20,112
Partner services	13,382	12,524
Marketing and reservation	243,123	220,732
Hotel operations	4,293	3,729
Other	3,873	3,976
Total revenues	<u>477,399</u>	<u>428,208</u>
OPERATING EXPENSES:		
Selling, general and administrative	78,250	69,542
Depreciation and amortization	9,051	9,947
Marketing and reservation	243,123	220,732
Hotel operations	3,225	3,004
Total operating expenses	<u>333,649</u>	<u>303,225</u>
Operating income	<u>143,750</u>	<u>124,983</u>
Interest expense	15,325	11,605
Interest and other investment income	(1,094)	(1,110)
Equity in net income of affiliates	(803)	(722)
Loss on extinguishment of debt	—	696
Other	(420)	(10)
Other income and expenses, net	<u>13,008</u>	<u>10,459</u>
Income before income taxes	<u>130,742</u>	<u>114,524</u>
Income taxes	<u>43,177</u>	<u>40,179</u>
Net income	<u>\$ 87,565</u>	<u>\$ 74,345</u>
Weighted average shares outstanding-diluted	<u>66,336</u>	<u>69,000</u>
Diluted earnings per share	<u>\$ 1.32</u>	<u>\$ 1.08</u>

Management analyzes its business based on franchising 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.

Franchising Revenues: Franchising revenues were \$230.0 million for the year ended December 31, 2005 compared to \$203.7 million for the year ended December 31, 2004. The growth in franchising revenues is primarily due to increases in royalty revenues and initial and relicensing fees of approximately 12% and 26%, respectively.

Royalty fees increased \$20.2 million to \$187.3 million from \$167.1 million in 2004, an increase of 12.1%. Excluding the franchises obtained in the acquisition of Suburban, the increase in royalties is attributable to a combination of factors including a 3.6% increase in the number of domestic franchised hotel rooms, a 6.1% increase in RevPAR and an increase in the effective royalty rate of the domestic hotel system to 4.08% from 4.04%. The acquisition of Suburban contributed approximately \$0.7 million of royalty fees in 2005.

Including franchises acquired from Suburban, the number of domestic rooms on-line increased to 329,353 from 309,586, an increase of 6.4% for the year ended December 31, 2005. For 2005, the total number of domestic hotels on-line grew 5.6% to 4,048 from 3,834 for 2004. International rooms on-line increased to 97,703

as of December 31, 2005 from 94,220 as of December 31, 2004, a 3.7% increase. The total number of international hotels on-line also increased from 1,143 to 1,162, an increase of 1.7% for the year ended December 31, 2005. As of December 31, 2005, the Company had 603 franchised hotels with 46,464 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 460 hotels and 35,652 rooms at December 31, 2004. The Company had an additional 84 franchised hotels with 7,611 rooms under development in its international system as of December 31, 2005 compared to 109 hotels and 9,515 rooms at December 31, 2004.

Net domestic franchise additions during 2005 were 214 compared to 198 for the same period a year ago. Excluding the acquisition of Suburban, net franchise additions totaled 149. Net domestic franchise additions, excluding Suburban, declined as a result of franchise terminations increasing from 144 in 2004 to 190 in 2005. During 2005, the Company executed a strategy to replace franchised hotels that did not meet our brand standards or were underperforming in their market. This strategy resulted in a slightly lower annual growth rate in our domestic franchised rooms than historically achieved. Existing competition is getting stronger and more focused on franchising new and existing brands. As the competition gets stronger and more focused on limited service franchising, the Company will continue to focus on improving its system hotels. A strong RevPAR market is expected to continue in 2006 and many competitors are focused on improving brand consistency and quality through higher quality amenities and more aggressive brand compliance efforts. The number of domestic hotels under development provides a strong platform for continued system growth.

Domestic initial fee revenue, included in the initial franchise and relicensing fees caption above, generated from executed franchise agreements increased 13.5% to \$15.1 million for the year ended December 31, 2005 from \$13.3 million for the year ended December 31, 2004. The increase reflects domestic franchise agreements executed in 2005 of 639 new contracts representing 52,862 rooms compared to 552 agreements representing 47,227 rooms executed in 2004, increases of 16% and 12%, respectively. During 2005, 237 of the executed agreements were for new construction hotel franchises, representing 18,096 rooms, compared to 182 contracts, representing 12,799 rooms for the same period a year ago, increases of approximately 30% and 41%, respectively.

Relicensing fees increased 51.5% to \$10.3 million for the year ended December 31, 2005 from \$6.8 million for the year ended December 31, 2004. 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.

Despite rising interest rates and construction costs, we are optimistic about the prospects for a continuing rise in the supply of midscale hotels to meet demand. In addition, some of our competitors are terminating franchising agreements on mature properties. These factors should provide a healthy supply of new construction and conversion hotel opportunities in 2006.

Franchise Expenses: The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative expenses were \$78.3 million for the year ended December 31, 2005, an increase of \$8.8 million from the year ended December 31, 2004 total of \$69.5 million. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 34.0% for the year ended December 31, 2005 compared to 34.1% for 2004. Expenses increased primarily due to higher compensation costs including variable franchise sales and key management incentive compensation and increased travel and entertainment expenses related to the expansion of the franchise sales force.

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 \$243.1 million and \$220.7 million for the years ended December 31, 2005 and 2004, respectively. Depreciation and amortization attributable to marketing and reservation activities was \$7.6 million and \$9.1 million for the years ended December 31, 2005 and 2004, respectively. Interest expense attributable to reservation activities was \$1.1 million and \$1.5 million for the years ended December 31, 2005 and 2004, respectively. Marketing and reservations activities provided positive cash flow of \$19.4 million and \$19.7 million for the years ended December 31, 2005 and 2004, respectively. As of December 31, 2005, the Company's balance sheet includes a receivable of \$13.2 million for marketing fees and a payable of \$3.6 million for reservation fees. At December 31, 2004, the Company's balance sheet contained a receivable for marketing and reservation fees of \$21.7 million. 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. Cumulative reservation and marketing fees not expended are recorded as a payable in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

Other Income and Expenses: Other income and expense, net increased \$2.5 million to an expense of \$13.0 million for the year ended December 31, 2005 from \$10.5 million for the same period in 2004. This increase resulted from a \$3.7 million increase in interest expense to \$15.3 million for the twelve months ended December 31, 2005 resulting from higher average interest rates and outstanding borrowings on the Company's variable rate debt. The Company's weighted average interest rate as of December 31, 2005 was 5.96% compared to 4.58% as of December 31, 2004. The increase in interest expense was partially offset by 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 of 2004.

Income Taxes: The Company's effective income tax provision rate was 33.0% for the year ended December 31, 2005, a decrease of 210 basis points from the effective income tax provision rate of 35.1% for the year ended December 31, 2004. The effective income tax rate for 2005 declined due to the reversal of reserves resulting from the resolution of certain tax contingencies of approximately \$4.9 million offset by additional income tax expense of \$1.2 million related to the Company's repatriation of foreign earnings. The 2004 effective income tax rate reflects the resolution of certain tax contingencies totaling approximately \$1.2 million. Depending upon the outcome of certain income tax contingencies during 2006 up to \$14.1 million of additional income tax benefits may be reflected in our 2006 results of operations from the reversal of reserves.

Net income for 2005 increased by 17.8% to \$87.6 million, and diluted earnings per share increased 22.2% to \$1.32 in 2005 from \$1.08 reported for 2004. A portion of the increase in diluted earnings per share is attributable to stock repurchases made by the Company in 2005 and 2004.

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	\$167,135	\$151,324
Initial franchise and relicensing fees	20,112	16,799
Partner services	12,524	13,227
Marketing and reservation	220,732	195,219
Hotel operations	3,729	3,565
Other	3,976	5,732
Total revenues	<u>428,208</u>	<u>385,866</u>
OPERATING EXPENSES:		
Selling, general and administrative	69,542	62,753
Depreciation and amortization	9,947	11,225
Marketing and reservation	220,732	195,219
Hotel operations	3,004	2,723
Total operating expenses	<u>303,225</u>	<u>271,920</u>
Operating income	<u>124,983</u>	<u>113,946</u>
Interest expense	11,605	11,597
Interest and other investment income	(1,110)	(6,222)
Gain on prepayment of note receivable from Sunburst	—	(3,383)
Equity in net income of affiliates	(722)	(582)
Loss on extinguishment of debt	696	—
Other	(10)	129
Other income and expenses, net	<u>10,459</u>	<u>1,539</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>69,000</u>	<u>73,349</u>
Diluted earnings per share	<u>\$ 1.08</u>	<u>\$ 0.98</u>

Franchising Revenues: Franchising 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 \$15.8 million to \$167.1 million from \$151.3 million in 2003, an increase of 10.4%. 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%.

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 under construction, awaiting conversion or approved for development in its domestic system as compared to 401 hotels and 31,409 rooms at December 31, 2003. The Company had an additional 109 franchised hotels with 9,515 rooms under development in its international system as of December 31, 2004 as compared to 90 hotels and 8,468 rooms at December 31, 2003.

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 new contracts representing 47,227 rooms compared to 470 agreements representing 41,039 rooms executed in 2003, increases of 17% and 15%, respectively. During 2004, 182 of the executed agreements were for new construction hotel franchises, representing 12,799 rooms, compared to 128 contracts, representing 8,649 rooms for the same period a year ago, increases of approximately 42% and 48%, respectively.

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 \$5.7 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 exit 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.

Franchise Expenses: The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative expenses were \$69.5 million for the year ended December 31, 2004, an increase of \$6.7 million from the year ended December 31, 2003 total of \$62.8 million. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 34.1% for the year ended December 31, 2004 compared to 33.5% 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: Total marketing and reservations revenues were \$220.7 million and \$195.2 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.

Other Income and Expenses: Other income and expense, net increased \$9.0 million to an expense of \$10.5 million for the year ended December 31, 2004 from \$1.5 million for the same period in 2003. 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 35.1% for the year ended December 31, 2004, a decrease of 100 basis points from the effective income tax provision rate of 36.1% 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.

Net income for fiscal 2004 increased by 3.5% to \$74.3 million, and diluted earnings per share increased 10.2% to \$1.08 in 2004 from \$0.98 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 2003.

Liquidity and Capital Resources

Net cash provided by operating activities was \$132.9 million and \$108.1 million for the years ended December 31, 2005 and 2004, respectively. The increase primarily reflects improvements in operating income and timing differences related to payments for income taxes.

Net cash repayments related to marketing and reservation activities totaled \$19.4 million during the year ended December 31, 2005, compared to net repayments of \$19.7 million during the year ended December 31, 2004. The Company expects marketing and reservation activities to generate positive cash flows of between \$9.0 million and \$13.0 million in 2006.

Cash provided by (used in) investing activities for the years ended December 31, 2005, 2004 and 2003 was (\$23.9 million), (\$13.7 million), and \$27.8 million, respectively. As a lodging franchisor, Choice has relatively low capital expenditure requirements. During the years ended December 31, 2005, 2004 and 2003, capital expenditures totaled \$11.5 million, \$6.9 million, and \$8.5 million, respectively. Capital expenditures include the installation and upgrades of system-wide property and yield management systems and upgrades to disaster recovery hardware and financial and reservation systems. During 2005, investing cash flows included the payment of \$7.3 million related to the Company's acquisition of Suburban. 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 July 2004, the Company entered into a \$265 million senior unsecured revolving credit facility (the "Revolver") with a syndicate of lenders. In April 2005, the Company increased the available credit under the Revolver from \$265 million to \$350 million. 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 62½ 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 12½ 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, 2005 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, 2005, the Company had \$173.7 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, 2005, the call provision would have resulted in a premium of \$6.0 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, 2005, no amounts were outstanding pursuant to this line of credit.

As of December 31, 2005, the total long-term debt outstanding for the Company was \$274.1 million, of which \$0.1 million was scheduled to mature in the twelve months ending December 31, 2006.

On September 14, 2005, the Company's board of directors declared a two-for-one stock split effected in the form of a stock dividend. The stock split shares were distributed on October 21, 2005 to shareholders of record on October 7, 2005. Share data and earnings per share data referenced in MD&A reflect the stock split, applied retroactively, to all periods presented.

Through December 31, 2005, the Company had purchased 33.6 million shares (including 33.0 million prior to the 2 for 1 stock split effected in October 2005) of its common stock under its share repurchase program at a total cost of \$711.9 million, including 1.1 million shares (including 0.5 million prior to the 2 for 1 stock split) at a cost of \$49.2 million during the year ended December 31, 2005. At December 31, 2005, the Company had approximately 65.2 million shares of common stock outstanding. As of December 31, 2005, the Company had remaining authorization to purchase up to 5.1 million shares.

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 \$0.1125, a 12.5% increase from the previous quarterly rate of \$0.10. This increase raised the annual dividend rate on the Company's common stock from \$0.40 to \$0.45 per share. In September 2005, the Company's board of directors again increased the quarterly dividend rate to \$0.13, a 15.6% increase from the previous quarter rate of \$0.1125. This increase raised the annual dividend rate on the Company's common stock from \$0.45 to \$0.52 per share. Dividends paid in 2005 were approximately \$30.2 million.

The Company expects to continue to return value to its shareholders through a combination of dividends and share repurchases, subject to market conditions.

The following table summarizes our contractual obligations as of December 31, 2005

<u>Contractual Obligations</u>	<u>Payment due by period</u>				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 years (in millions)</u>	<u>3-5 years</u>	<u>More than 5 years</u>
Long-term debt ⁽¹⁾	\$290.8	\$ 7.3	\$109.7	\$173.8	\$ —
Operating lease obligations	31.2	5.1	7.9	8.1	10.1
Purchase obligations	1.4	1.4	—	—	—
Other long-term liabilities	38.2	—	11.9	2.9	23.4
Total contractual cash obligations	<u>\$361.6</u>	<u>\$13.8</u>	<u>\$129.5</u>	<u>\$184.8</u>	<u>\$33.5</u>

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

Contingent cash payments related to the acquisition of Suburban during 2005 have been excluded from the table above since no liabilities have been recorded. However, contingent cash payments, of up to \$5 million, may be required upon the satisfaction of the following conditions:

- \$2.5 million payable if at any time prior to the 3rd anniversary of closing at least 84 Suburban franchises are open or under construction and at least 79 are open on that date;
- An additional \$2.5 million payable if at any time prior to the 3rd anniversary of closing, but in no event prior to the 2nd anniversary of closing, at least 100 Suburban franchises are open or under construction and at least 90 are open on that date;
- Both contingent payments are subject to at least 51 of the existing Suburban franchises open at the acquisition date remaining open when the contingent payment is otherwise earned.

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: In March 2006, the Company guaranteed \$1 million of a bank loan funding a franchisee's construction of a Cambria Suites in Green Bay, Wisconsin. The guaranty expires at the earliest of 48 months from the date on which construction begins or June 30, 2010.

Inflation: Inflation has been moderate in recent years and has not had a significant impact on our business.

Seasonality: The hotel industry is seasonal in nature. For most of the Company's franchised hotels, demand is lower in December through March than during the remainder of the year. Our principal source of revenues is franchise fees based on the gross room revenues of our franchised properties. The Company's franchise fee revenues and operating income reflect the industry's seasonality and historically have been lower in the first quarter than in the second, third or fourth quarters.

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 and relicensing fees are non-refundable and the Company has no continuing obligations related to the franchisee. We defer the initial franchise and relicensing 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 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 in an amount 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. During the year ended December 31, 2005, the Company recognized impairment charges on notes receivable totaling approximately \$0.2 million based on the credit condition of the note holders.

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, 2005 is set forth in Note 1 to our consolidated financial statements.

SFAS No. 123 (Revised 2004), "Share-Based Payment" ("SFAS No. 123R") was issued in December 2004. 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 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 annual reporting period starting after June 15, 2005, which is the Company's fiscal year beginning January 1, 2006. 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 included a temporary one time 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. The Company repatriated earnings pursuant to AJCA totaling approximately \$23.5 million in the fourth quarter of 2005 resulting in an income tax provision of \$1.2 million.

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; 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 ("SEC"), including those set forth under Item 1A "Risk Factors" in the Company's Form 10-K filed with the SEC on March 16, 2006. 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, 2005. 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, 2005.

Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005 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 integrated audits of Choice Hotels International, Inc. and subsidiaries' 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of 2005, and an audit of its 2003 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, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 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.

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, 2005 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, 2005, 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, 2006

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

	Years Ended December 31,		
	2005	2004	2003
	(In thousands, except per share amounts)		
REVENUES:			
Royalty fees	\$187,340	\$167,135	\$151,324
Initial franchise and relicensing fees	25,388	20,112	16,799
Partner services	13,382	12,524	13,227
Marketing and reservation	243,123	220,732	195,219
Hotel operations	4,293	3,729	3,565
Other	3,873	3,976	5,732
Total revenues	477,399	428,208	385,866
OPERATING EXPENSES:			
Selling, general and administrative	78,250	69,542	62,753
Depreciation and amortization	9,051	9,947	11,225
Marketing and reservation	243,123	220,732	195,219
Hotel operations	3,225	3,004	2,723
Total operating expenses	333,649	303,225	271,920
Operating income	143,750	124,983	113,946
OTHER INCOME AND EXPENSES:			
Interest expense	15,325	11,605	11,597
Interest and other investment income	(1,094)	(1,110)	(6,222)
Gain on prepayment of note receivable from Sunburst	—	—	(3,383)
Equity in net income of affiliates	(803)	(722)	(582)
Loss on extinguishment of debt	—	696	—
Other	(420)	(10)	129
Other income and expenses, net	13,008	10,459	1,539
Income before income taxes	130,742	114,524	112,407
Income taxes	43,177	40,179	40,544
Net income	\$ 87,565	\$ 74,345	\$ 71,863
Weighted average shares outstanding-basic	64,429	66,406	71,398
Weighted average shares outstanding-diluted	66,336	69,000	73,349
Basic earnings per share	\$ 1.36	\$ 1.12	\$ 1.01
Diluted earnings per share	\$ 1.32	\$ 1.08	\$ 0.98
Cash dividends declared per share	\$ 0.485	\$ 0.425	\$ 0.10

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31, 2005	December 31, 2004
	(In thousands, except share amounts)	
ASSETS		
Current assets		
Cash and cash equivalents	\$ 16,921	\$ 28,518
Receivables (net of allowance for doubtful accounts of \$5,111 and \$5,956, respectively)	37,155	34,611
Deferred income taxes	2,616	2,252
Other current assets	6,308	4,212
Total current assets	63,000	69,593
Property and equipment, at cost, net	46,281	47,492
Goodwill	65,828	60,620
Franchise rights and other identifiable intangibles, net	38,267	34,795
Receivable—marketing and reservation fees	13,225	21,683
Investments, employee benefit plans, at fair value	23,337	17,247
Deferred income taxes	3,289	—
Other assets	11,873	11,922
Total assets	\$ 265,100	\$ 263,352
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities		
Current portion of long-term debt	\$ 146	\$ 10,146
Accounts payable	34,413	30,718
Accrued expenses and other	50,956	36,893
Deferred revenue	32,131	23,309
Income taxes payable	2,499	989
Total current liabilities	120,145	102,055
Long-term debt	273,972	318,557
Deferred compensation and retirement plan obligations	28,987	21,387
Deferred income taxes	—	6,974
Other liabilities	9,172	17,432
Total liabilities	432,276	466,405
Commitments and Contingencies		
SHAREHOLDERS' DEFICIT		
Common stock, \$0.01 par value; 160,000,000 shares authorized; 95,345,362 and 62,755,708 shares issued at December 31, 2005 and 2004, respectively; 65,219,641 and 32,312,433 shares outstanding at December 31, 2005 and 2004, respectively	652	323
Additional paid-in-capital	86,870	83,303
Accumulated other comprehensive income	859	1,400
Deferred compensation	(12,428)	(8,034)
Treasury stock (30,125,721 and 30,443,275 shares at December 31, 2005 and 2004, respectively), at cost	(650,551)	(631,312)
Retained earnings	407,422	351,267
Total shareholders' deficit	(167,176)	(203,053)
Total liabilities and shareholders' deficit	\$ 265,100	\$ 263,352

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,		
	2005	2004	2003
	(In thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 87,565	\$ 74,345	\$ 71,863
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	9,051	9,947	11,225
Gain on sale of assets	(386)	—	—
Gain on prepayment of note receivable from Sunburst	—	—	(3,383)
Provision for bad debts	391	(157)	(189)
Non-cash stock compensation	5,288	4,019	2,226
Non-cash interest and other investment income	(294)	(463)	(886)
Loss on extinguishment of debt	—	696	—
Equity in net income of affiliates	(803)	(722)	(582)
Changes in assets and liabilities, net of acquisitions:			
Receivables	(2,415)	(735)	(887)
Receivable—marketing and reservation fees, net	19,393	19,743	24,726
Accounts payable	1,923	978	6,439
Accrued expenses and other	12,894	6,702	289
Income taxes payable	11,250	2,854	(2,675)
Deferred income taxes	(13,318)	(14,883)	(7,970)
Deferred revenue	8,822	6,381	7,146
Other current assets	(2,040)	(599)	383
Other liabilities	(4,414)	(26)	7,579
Net cash provided by operating activities	132,907	108,080	115,304
CASH FLOWS FROM INVESTING ACTIVITIES			
Investment in property and equipment	(11,504)	(6,859)	(8,480)
Acquisition of Suburban, net of cash acquired	(7,314)	—	—
Proceeds from prepayment of note receivable from Sunburst	—	—	44,701
Purchases of investments	(8,929)	(8,664)	(5,272)
Proceeds from sales of investments	3,539	4,506	2,599
Issuance of notes receivable	(2,667)	(2,264)	(4,433)
Acquisition of Flag	—	—	(1,211)
Proceeds from disposition of assets	2,811	—	498
Other items, net	214	(435)	(618)
Net cash (used in) provided by investing activities	(23,850)	(13,716)	27,784
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from long-term debt	—	192,000	—
Principal payments of long-term debt	(150)	(267,739)	(17,404)
Net (repayments) borrowings pursuant to revolving credit facility	(55,129)	157,725	(43,800)
Debt issuance costs	(193)	(1,010)	—
Purchase of treasury stock	(49,154)	(148,273)	(80,358)
Dividends paid	(30,241)	(27,690)	—
Proceeds from exercise of stock options	14,213	8,427	6,097
Net cash used in financing activities	(120,654)	(86,560)	(135,465)
Net change in cash and cash equivalents	(11,597)	7,804	7,623
Cash and cash equivalents at beginning of period	28,518	20,714	13,091
Cash and cash equivalents at end of period	\$ 16,921	\$ 28,518	\$ 20,714
Supplemental disclosure of cash flow information:			
Cash payments during the year for:			
Income taxes, net of refunds	\$ 50,173	\$ 53,622	\$ 49,559
Interest	\$ 16,053	\$ 12,639	\$ 13,357
Non-cash investing activities:			
Acquisition of Suburban, liabilities assumed	\$ 5,526	—	—
Non-cash financing activities:			
Declaration of dividends	\$ 31,410	\$ 28,061	\$ 6,899
Income tax benefit realized related to stock options exercised	\$ 9,872	\$ 4,442	\$ 1,770
Issuance of restricted shares of common stock	\$ 8,491	\$ 7,973	\$ 180

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, 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)
Comprehensive income									
Net income	—	—	—	—	—	—	\$87,565	87,565	87,565
Other comprehensive income:									
Foreign currency translation adjustments	—	—	—	—	—	—	(351)	—	(351)
Amortization of deferred gain on hedge, net of taxes	—	—	—	—	—	—	(67)	—	(67)
Unrealized loss on available for sale securities, net of taxes	—	—	—	—	—	—	(25)	—	(25)
Reclassification adjustment for gains on available for sale securities included in net income	—	—	—	—	—	—	(98)	—	(98)
Other comprehensive income	—	—	—	(541)	—	—	(541)	—	—
Comprehensive income							\$87,024		
Exercise of stock options	1,275,737	13	2,087	—	—	21,997		—	24,097
Issuance and cancellation of restricted stock	149,283	1	—	—	(7,876)	7,875		—	—
Stock compensation related to stock options	—	—	1,806	—	—	—		—	1,806
Amortization of deferred compensation related to restricted stock grants	—	—	—	—	3,482	—		—	3,482
Dividends declared	—	—	—	—	—	—		(31,410)	(31,410)
Treasury purchases	(1,107,466)	(11)	—	—	—	(49,111)		—	(49,122)
Two-for-one common stock split	32,589,654	326	(326)	—	—	—		—	—
Balance as of December 31, 2005	65,219,641	\$652	\$86,870	\$ 859	\$(12,428)	\$(650,551)		\$407,422	\$(167,176)

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, 2005, the Company had franchise agreements representing 5,210 open hotels and 687 hotels under development in 49 states, the District of Columbia and more than 45 countries and territories outside the United States under the brand names: Comfort Inn, Comfort Suites, Cambria Suites, Quality, Clarion, Sleep Inn, Econo Lodge, Rodeway Inn, MainStay Suites, Suburban Extended Stay Hotel 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.

During 2005, the Company acquired 100% of the stock of Suburban Franchise Holding Company, Inc. (“Suburban”) (the “Suburban Transaction”) and its wholly owned subsidiary, Suburban Franchise Systems, Inc. The results of Suburban have been consolidated since September 28, 2005.

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, relicensing 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 up to twenty years with provisions permitting franchisees to terminate after five, ten, or fifteen years under certain circumstances. In most instances, initial franchise and relicensing fees are recognized upon execution of the franchise agreement because the initial franchise and relicensing fees are non-refundable and the Company has no continuing obligations related to the franchisee. The initial franchise and relicensing 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 principal 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 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.

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

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

expense was \$62.0 million, \$58.5 million and \$51.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. Prepaid advertising at December 31, 2005 and 2004 totaled \$2.3 million and \$1.6 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, 2005 and 2004, \$7.5 million and \$7.4 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, 2005.

The Company evaluates the impairment of goodwill and trademarks with indefinite lives in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," which requires intangible assets 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, 2005, based on assessments performed by the Company. In addition, the Company did not record any impairment of trademarks during the three years ended December 31, 2005.

The Company evaluates the collectibility of notes receivable in accordance with SFAS No. 114, "Accounting by Creditors For Impairment of a Loan." SFAS No. 114 states that a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. The Company reviews outstanding notes receivable on a periodic basis to ensure that each is fully collectible. If the Company concludes that it will be unable to collect all amounts due, the Company will record an impairment charge based on the present value of expected future cash

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

flows, discounted at the loan's effective interest rate. The Company recorded \$0.2 million of impairment charges related to notes receivable during the year ended December 31, 2005 and no amounts in the prior two 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, 2005 and 2004, unamortized deferred financing costs were \$1.2 million and \$1.4 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 during the year ended December 31, 2004.

Investments.

The Company accounts for its investment in Choice Hotels Canada, Inc. ("CHC") and Choice Hospitality (India) Private Ltd ("CHN") in accordance with Accounting Principles Board Opinion ("APB") No. 18, "The Equity Method of Accounting for Investments in Common Stock." The Company accounted 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" until the sale of this investment in August 2005.

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, 2005 and 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 16. 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 was 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

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

Compensation,” for all employee awards granted, modified, or settled after January 1, 2003. Therefore, the cost related to stock-based employee compensation included in the determination of net income for each of the three years ended December 31, 2005 is less than that which would have been recognized if the fair value based method had been applied to all awards since the original issuance 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,		
	2005	2004	2003
	(In millions, except per share amounts)		
Net income, as reported	\$87.6	\$74.3	\$71.9
Stock-based employee compensation expense included in reported net income, net of related tax effects	2.9	2.2	1.4
Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(4.7)	(3.5)	(2.9)
Pro forma, net income	\$85.8	\$73.0	\$70.4
Earnings per share:			
Basic, as reported	\$1.36	\$1.12	\$1.01
Basic, pro forma	\$1.33	\$1.10	\$0.99
Diluted, as reported	\$1.32	\$1.08	\$0.98
Diluted, pro forma	\$1.29	\$1.06	\$0.96

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, 2005 and 2004, other non-current assets included \$9.4 million and \$8.7 million, respectively, net of allowance, related to the unamortized balance of these notes. As of December 31, 2005 and 2004, other non-current assets include an allowance for doubtful accounts related to these notes of \$1.0 million and \$0.9 million, respectively. Amortization expense included in the accompanying consolidated statements of income related to the notes was \$1.3 million, \$1.2 million and \$0.8 million for the years ended December 31, 2005, 2004 and 2003, 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

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

signed into law. The AJCA created a temporary one-time 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, resulting in an effective tax rate of 5.25% on any such repatriated foreign earnings. The Company elected to apply this one-time provision to qualifying earnings repatriations in 2005. During the fourth quarter of 2005, the Company repatriated earnings totaling approximately \$23.5 million, resulting in the recordation of an income tax provision totaling approximately \$1.2 million.

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 exclude dilution and are 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. Stock Split

On September 14, 2005, the Company's board of directors declared a two-for-one stock split effected in the form of a stock dividend. The stock dividend was distributed on October 21, 2005 to shareholders of record on October 7, 2005. As a result of the stock dividend, the accompanying consolidated financial statements reflect an increase in the number of outstanding shares of common stock and the transfer of the par value of these additional shares from paid in capital. Treasury shares were not split. Share data and earnings per share data in these consolidated financial statements reflect the stock split, applied retroactively, to all periods presented. Previously awarded stock options and restricted stock awards payable in the Company's common stock have been adjusted to reflect the stock dividend.

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

3. Other Current Assets

Other current assets consist of the following at:

	December 31,	
	2005	2004
	(In thousands)	
Prepaid expenses	\$5,972	\$3,911
Other current assets	336	301
Total	<u>\$6,308</u>	<u>\$4,212</u>

4. Property and Equipment

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

	December 31,	
	2005	2004
	(In thousands)	
Land and land improvements	\$ 2,642	\$ 2,628
Land held for sale	—	1,540
Facilities in progress and software under development	3,833	2,862
Computer equipment and software	101,243	92,491
Buildings and improvements	37,302	36,241
Furniture, fixtures and equipment	14,587	14,142
	<u>159,607</u>	<u>149,904</u>
Less: Accumulated depreciation and amortization	(113,326)	(102,412)
Property and Equipment, at cost, net	<u>\$ 46,281</u>	<u>\$ 47,492</u>

On February 3, 2005, a parcel of 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, 2005, 2004 and 2003 was \$4.0 million, \$5.0 million and \$6.5 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

5. 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 and the Suburban Transaction. The components of goodwill are as follows:

	December 31,	
	2005	2004
	(In thousands)	
Minority interest	\$60,620	\$60,620
Suburban Transaction (See Note 12)	5,208	—
Total	<u>\$65,828</u>	<u>\$60,620</u>

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

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, 2005 and 2004, the unamortized balance relates primarily to the Econo Lodge, Suburban Extended Stay Hotel 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, 2005, 2004 and 2003 amounted to \$3.6 million, \$3.4 million and \$3.4 million, respectively. Franchise rights are net of accumulated amortization of \$45.6 million and \$42.1 million at December 31, 2005 and 2004, respectively. The estimated annual amortization expense related to the Company's franchise rights for each of the years ending December 31, 2006 through 2010 is as follows:

<u>Year</u>	<u>(In millions)</u>
2006	\$4.0
2007	3.9
2008	3.8
2009	3.8
2010	3.8

Franchise rights and other identifiable intangible assets include approximately \$3.8 million and \$2.7 million of unamortized intangible assets related to trademarks at December 31, 2005 and 2004, respectively. Trademarks acquired in the Suburban acquisition have an indefinite life and therefore pursuant to SFAS 142 no amounts have been amortized. The costs of registering and renewing existing trademarks are being amortized over ten years. Amortization expense for the years ended December 31, 2005, 2004 and 2003 amounted to \$0.5 million, \$0.4 million and \$0.3 million, respectively. Trademarks are net of accumulated amortization of \$3.7 million and \$3.3 million at December 31, 2005 and 2004, respectively. The estimated annual amortization expense related to the Company's trademarks for each of the years ending December 31, 2006 through 2010 is as follows;

<u>Year</u>	<u>(In millions)</u>
2006	\$0.5
2007	0.5
2008	0.5
2009	0.4
2010	0.4

6. Receivable-Marketing and Reservation Fees

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

Under the terms of these agreements, the Company has the legally enforceable right to assess and collect from its current franchisees fees sufficient to pay for the marketing and reservation services the Company has procured for the benefit of the franchise system, including fees to reimburse the Company for past services rendered. The Company has the contractual authority to require that the franchisees in the system at any given

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

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. Cumulative reservation and marketing fees not expended are recorded as a payable in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

The marketing fees receivable at December 31, 2005 and 2004 was \$13.2 million and \$15.6 million, respectively. The reservation fees receivable was \$6.1 million at December 31, 2004. As of December 31, 2005, cumulative reservation fees collected exceeded expenses by \$3.6 million and the excess has been reflected as a long-term liability in the accompanying consolidated balance sheets. Depreciation and amortization expense attributable to marketing and reservation activities for the years ended December 31, 2005, 2004 and 2003 was \$7.6 million, \$9.1 million and \$12.1 million, respectively. Interest expense attributable to reservation activities was \$1.1 million, \$1.5 million and \$1.3 million for the years ended December 31, 2005, 2004 and 2003, respectively.

7. Transactions with Sunburst

Effective October 15, 1997, Choice Hotels International, Inc. ("CHI"), which at that point included both the franchising business and owned hotel business, separated the businesses via spin-off of the Company. CHI changed its name to Sunburst Hospitality Corporation (referred to hereafter as "Sunburst"). As part of the spin-off, Sunburst and the Company entered into a strategic alliance agreement. Among other things, the strategic alliance agreement, as amended, provided for the determination of liquidated damages related to termination of Choice branded Sunburst properties and certain franchise fee credits. The liquidated damage provisions extend through the life of existing Sunburst 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, 2005, Sunburst operates 26 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 11⅜% (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 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.

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

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 or 2005. The Company recognized interest income related to the New Note of \$4.5 million for the year ended December 31, 2003.

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 for each of the years ended December 31, 2005, 2004 and 2003. As of December 31, 2005 and 2004, accounts receivable included \$1.0 million and \$0.9 million due from Sunburst, respectively.

8. Deferred Revenue

Deferred revenue consist of the following at:

	December 31,	
	2005	2004
	(In thousands)	
Loyalty programs	\$29,406	\$20,316
Initial, relicensing and franchise fees	1,983	2,089
Partner services fees	742	904
Total	<u>\$32,131</u>	<u>\$23,309</u>

9. Accrued Expenses and Other

Accrued expenses and other consisted of the following at:

	December 31,	
	2005	2004
	(In thousands)	
Accrued salaries and benefits	\$25,044	\$20,095
Dividends payable	8,439	7,271
Accrued interest	1,302	1,261
Other liabilities and contingencies	16,171	8,266
Total	<u>\$50,956</u>	<u>\$36,893</u>

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

10. Long-Term Debt

Debt consisted of the following at:

	December 31,	
	2005	2004
	(In thousands)	
\$350 million senior unsecured revolving credit facility with an effective rate of 5.24% and 3.42% at December 31, 2005 and December 31, 2004, respectively	\$173,700	\$218,200
\$100 million senior notes with an effective rate of 7.22% at December 31, 2005 and 2004	99,849	99,785
\$10 million line of credit with an effective rate of 3.50% at December 31, 2004	—	10,000
Other notes with an average effective rate of 4.90% and 3.50% at December 31, 2005 and 2004, respectively	569	718
Total debt	<u>\$274,118</u>	<u>\$328,703</u>

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

Scheduled principal maturities of debt as of December 31, 2005 were as follows:

<u>Year</u>	<u>(In thousands)</u>
2006	\$ 146
2007	146
2008	99,995
2009	173,831
2010	—
Total	<u>\$274,118</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 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. In April 2005, the Company increased the available credit under the Revolver from \$265 million to \$350 million. 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 62½ 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 12½ 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, 2005 and 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.

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, 2005, the call provision would have resulted in a premium of \$6.0 million.

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

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.

In conjunction with the Company's merger with Suburban, the Company assumed a bank loan with an outstanding balance of \$0.6 million and a maturity date of October 13, 2005. The Company repaid this loan at maturity.

11. Foreign Operations

The Company accounts for foreign currency translation in accordance with SFAS No. 52, "Foreign Currency Translation." Revenues generated by foreign operations, including royalty, marketing and reservations fees, for the years ended December 31, 2005, 2004 and 2003 were \$24.0 million, \$22.0 million and \$19.1 million, respectively. Net income, including equity in the income of equity method investments, attributable to the Company's foreign operations was \$6.7 million, \$5.4 million and \$2.9 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Choice Hotels Australasia

On July 1, 2002, the Company acquired a controlling interest in Choice Hotels Australasia Pty. Ltd. ("CHA") ("the CHA transaction"). Pursuant to the CHA Transaction, the Company converted an existing \$1.1 million convertible note due from CHA into an additional 15% of CHA's equity (beyond the 15% equity interest held prior to the CHA Transaction) and purchased an additional 25% of CHA's equity for approximately \$1.6 million increasing the Company's total ownership in CHA to 55% as of July 1, 2002.

Pursuant to the CHA Transaction, the Company gave the seller the right to "put" the remaining 45% equity interest in CHA 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 seller exercised the put right in January 2003. The put transaction closed in February 2003, at which time CHA became a wholly owned subsidiary.

The Company accounted for the CHA 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 was allocated to identifiable intangible assets as follows:

	<u>Estimated Fair Value</u>	<u>Estimated</u>
	(in thousands)	Useful Lives
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 CHA on July 1, 2002. Based in Melbourne, Australia, CHA is a franchisor of certain hotel brands in Australia, Papua New Guinea, American Samoa, Fiji and New Zealand.

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

Choice Hotels Scandinavia

The Company accounted 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. During 2005, the Company sold its investment in CHS for approximately \$1.0 million resulting in a realized gain of \$0.2 million. At December 31, 2004 the investment was included in other non-current assets in the accompanying consolidated balance sheets at its fair value of \$1.0 million based on quoted market prices. During the years ended December 31, 2004 and 2003, the Company recognized approximately \$0.2 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 2005, 2004 and 2003, the Company recorded \$0.8 million, \$0.7 million and \$0.6 million, respectively, based on CHC’s results for the twelve months ended November 30, 2005, 2004 and 2003 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 \$0.7 million, \$0.8 million and \$0.4 million for the years ended December 31, 2005, 2004 and 2003, respectively. During 2005, 2004 and 2003, the Company recognized in the accompanying consolidated statements of income, revenues of \$7.7 million, \$7.1 million and \$6.2 million, respectively, including royalty, marketing, reservation fees and other revenues from CHC.

12. Acquisition of Suburban Franchise Holding Company, Inc.

During 2005, the Company acquired 100% of the stock of Suburban Franchise Holding Company, Inc. (“Suburban”) (the “Suburban Transaction”) and its wholly owned subsidiary, Suburban Franchise Systems, Inc. The initial purchase price for Suburban was \$12.8 million, which consisted of cash paid, net of cash acquired, of \$7.3 million, liabilities assumed of \$4.5 million and direct acquisition and exit costs totaling \$1.0 million. Included in the purchase price was a working capital look-back adjustment escrow totaling \$0.5 million, which is payable on March 28, 2006. The merger provides for contingent cash payments, of up to \$5 million, to be made upon the satisfaction of the following conditions:

- \$2.5 million payable if at any time prior to the 3rd anniversary of closing, at least 84 Suburban franchises are open or under construction and at least 79 are open on that date;
- An additional \$2.5 million payable if at any time prior to the 3rd anniversary of closing, but in no event prior to the 2nd anniversary of closing, at least 100 Suburban franchises are open or under construction and at least 90 are open on that date;
- Both contingent payments are subject to at least 51 of the existing Suburban franchises open at the acquisition date, remaining open when the contingent payment is otherwise earned.

No liabilities have been recorded related to the contingent cash payments. If the contingent consideration is earned, the purchase price of Suburban will be adjusted at that time. The results of operations for Suburban have been included in the Company’s results of operations since September 28, 2005.

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

The Company accounted for the Suburban Transaction in accordance with SFAS No. 141, "Business Combinations". The Company allocated the purchase price based upon a preliminary assessment of the fair value of assets acquired and liabilities assumed as of September 28, 2005. The total purchase price was allocated based on a preliminary analysis by management of the respective fair values of the acquired assets and liabilities as follows:

	<u>Estimated Fair Value</u> (\$000)
Tangible assets	\$ 431
Intangible assets	7,201
Goodwill	5,208
Total assets acquired	12,840
Liabilities assumed	(5,526)
Cash paid, net of cash acquired	<u>\$ 7,314</u>

Suburban is the franchisor of Suburban Extended Stay Hotel, a 67-unit, 8,942 room (at the date of consolidation) lodging chain operating in the economy extended stay segment primarily in the southeastern United States. The acquisition of Suburban allowed the Company to enter, on an accelerated basis, the economy extended stay segment, a market in which it did not previously compete. The purchase price of Suburban was based on the projected business growth and cash flows of Suburban over the next several years and indicated a value that was in excess of the current net book value of the business, resulting in the recognition of various identifiable intangible assets and goodwill as follows:

	<u>Estimated Fair Value</u> (\$000)	<u>Estimated Useful Lives</u>
Franchise Contracts	\$ 6,187	10 years
Trademarks and Tradenames	1,014	Indefinite life
Goodwill	5,208	Indefinite life
	<u>\$12,409</u>	

Goodwill and intangible assets are not deductible for tax purposes. The allocations of the purchase price are preliminary and subject to revision as analyses are finalized. The Company continues to gather information concerning the valuation of assets acquired and liabilities assumed (including the identified intangible assets and their associated lives). The pro forma results of operations as if Suburban had been combined at the beginning of 2004 and 2005, would not be materially different from the Company's reported results for those periods.

13. Pension, Profit Sharing, and Incentive Plans

The Company sponsors a 401(k) retirement plan for all eligible employees. For the years ended December 31, 2005, 2004 and 2003, the Company recorded compensation expense of \$3.2 million, \$2.8 million and \$1.7 million, respectively, representing matching contributions for plan participants. In accordance with the plan, the Company will make its 2005 matching contribution with Company stock in the first quarter of 2006. The Company will purchase shares with a fair value equal to the Company's matching contribution and deposit the shares in the participant's accounts with the plan investment custodian. Effective January 1, 2006, the Company invoked the safe harbor matching contribution set forth in its 401(k) retirement plan. As a result, beginning with 2006 plan contributions, the Company will begin matching plan participant contributions in cash as bi-weekly deductions are made.

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

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, 2005, 2004 and 2003, the Company recorded \$0.9 million, \$0.7 million and \$0.4 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 five years and approximately \$0.4 million are expected in the five years thereafter. The following table presents the components of net periodic benefit costs for the three years ended December 31, 2005.

	Years ended December 31,		
	2005	2004	2003
	(In thousands)		
Components of net periodic pension cost:			
Service cost	\$ 511	\$ 416	\$ 259
Interest cost	262	205	139
Amortization			
Prior service cost	58	51	52
(Gain)/Loss	37	28	—
Net periodic pension cost	<u>\$ 868</u>	<u>\$ 700</u>	<u>\$ 450</u>
Weighted average assumptions:			
Discount rate	6.00%	6.25%	7.00%
Average compensation increase	4.50%	4.50%	4.50%

As of December 31, 2005 and 2004, a liability of \$3.4 million and \$2.4 million, respectively, related to the SERP was included in deferred compensation and retirement plan obligations in the accompanying consolidated balance sheets. The components of the benefit obligation are as follows:

	December 31,	
	2005	2004
	(In thousands)	
Projected benefit obligation	\$ 6,073	\$ 4,365
Unrecognized prior service cost	(942)	(1,000)
Unrecognized net (gain)/loss	(2,068)	(1,170)
Net amount recognized	3,063	2,195
Intangible asset	362	192
Accumulated benefit obligation	<u>\$ 3,425</u>	<u>\$ 2,387</u>

The following is a reconciliation of the changes in the projected benefit obligation for the years ended December 31, 2005 and 2004:

	December 31,	
	2005	2004
	(In thousands)	
Projected benefit obligation, beginning of year	\$4,365	\$3,283
Service cost	511	416
Interest cost	262	205
Amendments	—	121
Actuarial (gain)/loss	935	340
Projected benefit obligation, end of year	<u>\$6,073</u>	<u>\$4,365</u>

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

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, 2005 and 2004, the Company had recorded a deferred compensation liability of \$25.6 million and \$19.0 million, respectively. 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 \$23.3 million and \$17.2 million as of December 31, 2005 and 2004, respectively, and are recorded at their fair value, based on quoted market prices. 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) and is included in other income and expenses, net in the accompanying statements of income.

14. Income Taxes

Income before income taxes was derived from the following:

	Years ended December 31,		
	2005	2004	2003
	(In thousands)		
Income before income taxes:			
Domestic operations	\$123,769	\$109,424	\$108,760
Foreign operations	6,973	5,100	3,647
Income before income taxes	<u>\$130,742</u>	<u>\$114,524</u>	<u>\$112,407</u>

The provisions for income taxes were as follows:

	Years ended December 31,		
	2005	2004	2003
	(In thousands)		
Current tax expense			
Federal	\$ 54,770	\$ 52,334	\$44,040
State	5,476	4,288	3,979
Foreign	685	(315)	758
Deferred tax (benefit) expense			
Federal	(16,133)	(15,308)	(7,306)
State	(1,209)	(794)	(942)
Foreign	(412)	(26)	15
Income taxes	<u>\$ 43,177</u>	<u>\$ 40,179</u>	<u>\$40,544</u>

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

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

	December 31,	
	2005	2004
	(In thousands)	
Depreciation and amortization	\$(13,999)	\$(12,543)
Prepaid expenses	(2,882)	(7,327)
Foreign Operations	—	(57)
Other	(3,185)	(2,871)
Gross deferred tax liabilities	(20,066)	(22,798)
Foreign operations	358	—
Accrued expenses	12,347	9,277
Accrued compensation	11,497	7,338
Other	1,769	1,461
Gross deferred tax assets	25,971	18,076
Net deferred tax asset (liability)	\$ 5,905	\$ (4,722)

Included in the accompanying consolidated balance sheet as follows:

	December 31,	
	2005	2004
	(In thousands)	
Current net deferred tax assets	\$2,616	\$ 2,252
Non-current net deferred tax assets (liabilities)	3,289	(6,974)
Net deferred tax asset (liability)	\$5,905	\$(4,722)

No provision has been made for U.S. federal income taxes on approximately \$9 million of accumulated and undistributed earnings of foreign subsidiaries at December 31, 2005 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 included a temporary one-time 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 elected to apply this provision to qualifying earnings repatriations in 2005. During the fourth quarter of 2005, the Company repatriated earnings totaling approximately \$23.5 million, resulting in the recordation of additional income tax totaling approximately \$1.2 million.

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

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,		
	2005	2004	2003
	(In thousands, except Federal income tax rate)		
Federal income tax rate	35%	35%	35%
Federal taxes at statutory rate	\$45,760	\$40,083	\$39,342
State income taxes, net of federal tax benefit	2,436	1,933	1,974
Foreign income taxed at different rates	(1,932)	(1,718)	(659)
Unrealized tax benefits	199	(144)	(617)
Other	(3,286)	25	504
Income tax expense	<u>\$43,177</u>	<u>\$40,179</u>	<u>\$40,544</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 the timing and amount of related cash flows 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.

15. Other Non-Current Liabilities

Other non-current liabilities consist of the following at:

	December 31,	
	2005	2004
	(In thousands)	
Deferred revenue	\$1,662	\$ 1,614
Reservation fees collected in excess of expenditures	3,607	—
Other liabilities and contingencies	3,903	15,818
Total	<u>\$9,172</u>	<u>\$17,432</u>

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

16. 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 18.9 million shares of the Company's common stock, of which 1.2 million shares remain available for grant as of December 31, 2005. Restricted stock and stock options may be granted to officers, key employees and non-employee directors.

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

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,

	2005	2004	2003
Restricted Shares Granted	265,589	408,920	14,856
Weighted Average Grant Date Fair Value Per Share	\$ 31.97	\$ 19.50	\$ 12.12
Aggregate Grant Date Fair Value (\$000)	\$ 8,491	\$ 7,973	\$ 180
Restricted Shares Forfeited	29,150	4,110	—
Vesting Service Period of Shares Granted	3-5 years	3-5 years	3 years

The Company incurred compensation expense totaling \$3.5 million, \$2.5 million and \$0.9 million related to the vesting of restricted stock during the years ended December 31, 2005, 2004 and 2003, respectively.

Stock Options.

A summary of the stock option activity under the Company's stock option plan is as follows as of December 31, 2005, 2004 and 2003:

Options	2005		2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year ...	5,440,414	\$ 8.32	6,591,480	\$ 8.17	6,223,982	\$ 7.52
Granted	355,384	29.92	20,000	20.75	1,373,934	10.26
Exercised	(1,928,903)	7.37	(1,114,214)	7.57	(925,044)	6.79
Cancelled	(113,894)	9.98	(56,852)	9.56	(81,392)	9.40
Outstanding at end of year	3,753,001	\$10.81	5,440,414	\$ 8.32	6,591,480	\$ 8.17
Options exercisable at year end	2,200,008	\$ 7.95	3,268,150	\$ 7.25	3,346,258	\$ 6.86
Weighted average fair value of options granted during the year (grant date price equals market)		\$10.11		\$ 7.00		\$ 4.33

The following table summarizes information about stock options outstanding at December 31, 2005:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/05	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at 12/31/05	Weighted Average Exercise Price
\$ 4.51 to \$ 6.50	803,676	2.4 years	\$ 6.10	803,676	\$ 6.10
\$ 6.51 to \$ 8.82	872,277	3.7 years	7.89	812,055	7.92
\$ 8.83 to \$15.00	1,701,664	6.5 years	10.43	580,277	10.46
\$15.01 to \$21.17	20,000	8.1 years	20.75	4,000	20.75
\$21.18 to \$30.00	355,384	9.1 years	29.92	—	—
	3,753,001	5.3 years	\$10.81	2,200,008	\$ 7.95

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

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 2005, 2004 and 2003:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Risk-free interest rate	3.70 %	3.03 %	2.57 %
Volatility	36.07 %	37.97%	39.69%
Expected Lives	6 years	6 years	6 years
Dividend Yield	1.50 %	1.93 %	0 %
Vesting Service Period	5 years	5 years	4-5 years
Contractual Life	10 years	10 years	5-10 years

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. Through December 31, 2005, the Company had repurchased 33.6 million shares of its common stock (including 33.0 million prior to the 2 for 1 stock split effected in October 2005) at a total cost of \$712 million, including 1.1 million shares of common stock (including 0.5 million prior to the 2 for 1 stock split effected in October 2005) at a total cost of \$49.2 million during the year ended December 31, 2005.

17. Comprehensive Income

The components of accumulated other comprehensive income are as follows:

	<u>December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
	(In thousands)		
Unrealized gains (losses) on available-for-sale securities	\$ —	\$ 123	\$ (18)
Foreign currency translation adjustments	703	1,054	866
Deferred gain on hedging activity	156	223	290
Total accumulated other comprehensive income	<u>\$ 859</u>	<u>\$1,400</u>	<u>\$1,138</u>

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

The components of other comprehensive income are as follows:

	<u>Amount Before Taxes</u>	<u>Income Tax (Expense)/Benefit</u>	<u>Amount Net of Taxes</u>
2005			
Net unrealized loss	\$ (40)	\$ 15	\$ (25)
Reclassification adjustment for gains included in net income	(98)	—	(98)
Foreign currency translation adjustment, net	(351)	—	(351)
Amortization of deferred gain on hedge	(110)	43	(67)
Total other comprehensive income	<u>\$ (599)</u>	<u>\$ 58</u>	<u>\$ (541)</u>
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>

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 through 2008 as a reduction of interest expense. In each of 2005, 2004 and 2003, the Company recorded approximately \$67,000, net of taxes, of amortization related to this deferred gain.

18. Earnings Per Share

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

	<u>Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
	(In millions, except per share amounts)		
Computation of Basic Earnings Per Share:			
Net income	\$87.6	\$74.3	\$71.9
Weighted average shares outstanding-basic	64.4	66.4	71.4
Basic earnings per share	<u>\$1.36</u>	<u>\$1.12</u>	<u>\$1.01</u>
Computation of Diluted Earnings Per Share:			
Net income for diluted earnings per share	\$87.6	\$74.3	\$71.9
Weighted average shares outstanding-basic	64.4	66.4	71.4
Effect of Dilutive Securities:			
Stock options and restricted stock	1.9	2.6	1.9
Weighted average shares outstanding-diluted	66.3	69.0	73.3
Diluted earnings per share	<u>\$1.32</u>	<u>\$1.08</u>	<u>\$0.98</u>

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

The effect of dilutive securities is computed using the treasury stock method and average market prices during the period.

19. Leases

The Company enters into operating leases primarily for office space and computer equipment. Rental expense under non-cancelable operating leases was approximately \$8.0 million, \$12.6 million and \$15.2 million for the years ended December 31, 2005, 2004 and 2003, respectively. The Company received sublease rental income related to computer equipment leased to franchisees totaling \$4.1 million, \$8.8 million and \$10.2 million during the years ended December 31, 2005, 2004 and 2003, respectively. Future minimum lease payments are as follows:

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Thereafter</u>	<u>Total</u>
	(In thousands)						
Minimum lease payments	\$ 5,055	\$3,990	\$3,956	\$4,016	\$4,110	\$10,082	\$31,209
Minimum sublease rentals	(1,330)	(241)	(229)	(236)	(60)	—	(2,096)
	<u>\$ 3,725</u>	<u>\$3,749</u>	<u>\$3,727</u>	<u>\$3,780</u>	<u>\$4,050</u>	<u>\$10,082</u>	<u>\$29,113</u>

20. 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 6, 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, 2005			
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	\$473,106	\$ 4,293	—	\$477,399
Operating income (loss)	185,525	(41,775)	—	143,750
Depreciation and amortization	9,595	7,085	(7,629)	9,051
Capital expenditures	8,973	2,531	—	11,504
Total assets	190,517	74,583	—	265,100

	Year Ended December 31, 2004			
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	\$424,479	\$ 3,729	—	\$428,208
Operating income (loss)	161,564	(36,581)	—	124,983
Depreciation and amortization	11,429	7,576	(9,058)	9,947
Capital expenditures	5,376	1,483	—	6,859
Total assets	187,710	75,642	—	263,352

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

	Year Ended December 31, 2003			
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	\$382,301	\$ 3,565	—	\$385,866
Operating income (loss)	150,490	(36,544)	—	113,946
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

Long-lived assets related to international operations were \$6.9 million, \$9.2 million and \$9.9 million as of December 31, 2005, 2004 and 2003, respectively. All other long-lived assets of the Company are associated with domestic activities.

21. 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.

In March 2006, the Company guaranteed \$1 million of a bank loan funding a franchisee's construction of a Cambria Suites in Green Bay, Wisconsin. The guaranty expires at the earliest of 48 months from the date on which construction begins or June 30, 2010.

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.

22. 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, 2005 and 2004 of \$104.0 million and \$109.0 million, respectively, based on quoted market prices.

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

23. Related Party Transactions

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

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 \$315,409 to and received approximately \$166,954 from corporations owned or controlled by family members of the Company's largest shareholder related to the lease of personal and real property during 2005. During 2004, the Company paid approximately \$187,028 and received approximately \$121,040. During 2003, the Company paid approximately \$298,385 and received approximately \$121,040.

24. 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 annual reporting period starting after June 15, 2005, which is the Company's first quarter beginning January 1, 2006.

The Company believes the pro forma disclosures in Note 1 under the sub heading "Stock Based Compensation" provide an appropriate short-term indicator of the level of expense that will be recognized in accordance with SFAS No. 123R. However, the total expense recorded in future periods will depend on several variables, including the number of share-based awards that vest and the fair value of those vested awards.

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

25. Selected Quarterly Financial Data – (Unaudited)

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>	<u>2005</u>
	(In thousands, except per share data)				
Revenues	\$91,168	\$122,295	\$141,951	\$121,985	\$477,399
Operating income	\$22,299	\$ 37,417	\$ 47,787	\$ 36,247	\$143,750
Income before income taxes	\$18,893	\$ 34,157	\$ 45,157	\$ 32,535	\$130,742
Net income	\$11,999	\$ 21,548	\$ 32,466	\$ 21,552	\$ 87,565
Per basic share:					
Net income	\$ 0.19	\$ 0.33	\$ 0.50	\$ 0.33	\$ 1.36
Per diluted share:					
Net income	\$ 0.18	\$ 0.32	\$ 0.48	\$ 0.32	\$ 1.32

	<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	\$87,167	\$107,018	\$127,350	\$106,673	\$428,208
Operating income	\$18,899	\$ 32,130	\$ 42,488	\$ 31,466	\$124,983
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	\$ 0.15	\$ 0.28	\$ 0.38	\$ 0.31	\$ 1.12
Per diluted share:					
Net income	\$ 0.15	\$ 0.27	\$ 0.36	\$ 0.30	\$ 1.08

Quarterly revenues reported in the table above have been reclassified from prior quarter Form 10-Q filings to reflect the reclassification of certain marketing and reservation fund revenues. The reclassification of revenues had no effect on reported operating income, income before income taxes, net income or earnings per share.

The matters which effect the comparability of our quarterly results include seasonality, the reversal of reserves for income tax contingencies in the third and fourth quarter of 2005 and 2004, tax provisions for the repatriation of foreign earnings in the third quarter of 2005 and the loss on extinguishment of debt in the third quarter 2004.

CORPORATE AND INVESTOR INFORMATION

BOARD OF DIRECTORS

Stewart Bainum Jr.

Chairman of the Board
Choice Hotels International

Director:

Sunburst Hospitality Corporation
Realty Investment Company, Inc.

Fiona Dias

*Executive Vice President
and Chief Marketing Officer*
Circuit City Stores, Inc.

Charles A. Ledsinger, Jr.

President and Chief Executive Officer
Choice Hotels International

Director:

Darden Restaurants, Inc.
FelCor Lodging Trust, Inc.

William L. Jews

President and Chief Executive Officer
CareFirst, Inc.

Director:

The Ryland Group, Inc.

Larry R. Levitan

Retired Managing Partner
Andersen Consulting Worldwide Communications
Industry Group

Trustee:

FBR Funds

Raymond E. Schultz

Chairman
RES Investments, LLC
Retirement from the board May 2006

Director:

Equity Inns, Inc.

John T. Schwieters

Vice Chairman

Perseus LLC

Director:

Danaher Corporation
Manor Care, Inc.
Smithfield Foods, Inc.

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

Global Commerical Card Group
American Express Travel Related Services, Inc.

David Sullivan

Chairman

Advisory Board for the Kemmons Wilson School
of Hospitality and Resort Management
University of Memphis

Director:

Winston Hotels

EXECUTIVE OFFICERS

Stewart Bainum Jr.

Chairman of the Board

Charles A. Ledsinger, Jr.

President and Chief Executive Officer

Joseph M. Squeri

*Executive Vice President, Operations,
and Chief Financial Officer*

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, Brand Value

Bruce N. Haase

Senior Vice President, International

Daniel M. Head

*Senior Vice President, Business Intelligence
and Strategy*

Thomas Mirgon

*Senior Vice President, Human Resources
and Administration*

Janna Morrison

*Senior Vice President, Customer Care
and Technology Services*

David A. Pepper

*Senior Vice President, Franchise Growth
and Performance*

Gary R. Thomson

*Senior Vice President and
Chief Information Officer*

CORPORATE HEADQUARTERS

Choice Hotels International
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Silver Spring, Maryland 20901
301.592.5000
www.choicehotels.com

STOCK EXCHANGE 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, Georgia 30302-4625
800.568.3476

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

PricewaterhouseCoopers LLP
McLean, Virginia

CERTIFICATIONS

Choice Hotels International has included as Exhibits 31 and 32 to its Annual Report on Form 10-K for fiscal year 2005 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

Shareholders may receive without charge a copy of the Form 10-K and other publications 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" and then "SEC Filings."

In addition, 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 choicehotels.com under "Investor Info."

ANNUAL MEETING

Choice Hotels International will hold its Annual Meeting of Stockholders on May 1, 2006, at 9:00 a.m. in Silver Spring, Maryland:

Choice Hotels International
The Learning Center
Chesapeake Room
10720 Columbia Pike
Silver Spring, Maryland 20901

INQUIRIES

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