

CHOICE HOTELS INTERNATIONAL INC /DE  
Form 10-Q  
August 09, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED June 30, 2013  
OR  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
COMMISSION FILE NO. 001-13393

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CHOICE HOTELS INTERNATIONAL, INC.  
(Exact name of registrant as specified in its charter)

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DELAWARE (State or other jurisdiction of incorporation or organization) 1 CHOICE HOTELS CIRCLE, SUITE 400 ROCKVILLE, MD 20850 (Address of principal executive offices) (Zip Code) (301) 592-5000 (Registrant's telephone number, including area code)	52-1209792 (I.R.S. Employer Identification No.)
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(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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CLASS	SHARES OUSTANDING AT JUNE 30, 2013
Common Stock, Par Value \$0.01 per share	58,535,024

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF INCOME  
 (UNAUDITED, IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
<b>REVENUES:</b>				
Royalty fees	\$68,379	\$66,064	\$118,115	\$113,917
Initial franchise and relicensing fees	4,416	3,178	8,193	5,706
Procurement services	7,546	6,836	11,496	10,151
Marketing and reservation	99,645	94,633	176,085	165,562
Hotel operations	1,334	1,224	2,290	2,202
Other	2,258	1,686	4,271	5,252
Total revenues	183,578	173,621	320,450	302,790
<b>OPERATING EXPENSES:</b>				
Selling, general and administrative	30,180	24,554	57,096	48,903
Depreciation and amortization	2,520	1,977	4,695	3,994
Marketing and reservation	99,645	94,633	176,085	165,562
Hotel operations	911	867	1,786	1,676
Total operating expenses	133,256	122,031	239,662	220,135
Operating income	50,322	51,590	80,788	82,655
<b>OTHER INCOME AND EXPENSES, NET:</b>				
Interest expense	10,807	3,540	21,577	6,657
Interest income	(659)	(394)	(1,303)	(731)
Other (gains) and losses	147	377	(563)	(1,626)
Equity in net (income) loss of affiliates	(60)	128	81	183
Total other income and expenses, net	10,235	3,651	19,792	4,483
Income before income taxes	40,087	47,939	60,996	78,172
Income taxes	11,853	16,077	17,239	26,313
Net income	\$28,234	\$31,862	\$43,757	\$51,859
Basic earnings per share	\$0.48	\$0.55	\$0.75	\$0.89
Diluted earnings per share	\$0.48	\$0.55	\$0.74	\$0.89

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(UNAUDITED, IN THOUSANDS)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Net income	\$28,234	\$31,862	\$43,757	\$51,859
Other comprehensive income (loss), net of tax:				
Amortization of loss on cash flow hedge	216	216	431	431
Foreign currency translation adjustment, net	(2,080	) (432	) (2,312	) (20
Amortization of pension related costs, net of tax:				
Actuarial loss (net of income tax of \$12 and \$24 for the three and six months ended June 30, 2012, respectively)	—	20	—	40
Other comprehensive income (loss), net of tax	(1,864	) (196	) (1,881	) 451
Comprehensive income	\$26,370	\$31,666	\$41,876	\$52,310

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(UNAUDITED, IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	June 30, 2013	December 31, 2012
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 143,790	\$ 134,177
Receivables (net of allowance for doubtful accounts of \$10,540 and \$10,820, respectively)	70,951	52,270
Income taxes receivable	928	2,732
Deferred income taxes	4,136	4,136
Investments, employee benefit plans, at fair value	377	3,486
Other current assets	35,522	36,669
Total current assets	255,704	233,470
Property and equipment, at cost, net	69,648	51,651
Goodwill	65,813	65,813
Franchise rights and other identifiable intangibles, net	11,573	13,473
Receivable – marketing and reservation fees	54,786	42,179
Investments, employee benefit plans, at fair value	14,114	12,755
Deferred income taxes	11,187	15,418
Other assets	79,887	76,013
Total assets	\$ 562,712	\$ 510,772
<b>LIABILITIES AND SHAREHOLDERS' DEFICIT</b>		
Current liabilities		
Accounts payable	\$ 54,572	\$ 38,714
Accrued expenses	47,719	55,552
Deferred revenue	67,757	71,154
Deferred compensation and retirement plan obligations	2,393	2,522
Current portion of long-term debt	8,205	8,195
Total current liabilities	180,646	176,137
Long-term debt	858,273	847,150
Deferred compensation and retirement plan obligations	20,114	20,399
Other liabilities	23,700	15,990
Total liabilities	1,082,733	1,059,676
Commitments and Contingencies		
<b>SHAREHOLDERS' DEFICIT</b>		
Common stock, \$0.01 par value, 160,000,000 shares authorized; 95,345,362 shares issued at June 30, 2013 and December 31, 2012 and 58,535,024 and 58,171,059 shares outstanding at June 30, 2013 and December 31, 2012, respectively	585	582
Additional paid-in-capital	111,580	110,246
Accumulated other comprehensive loss	(6,097	) (4,216
Treasury stock (36,810,338 and 37,174,303 shares at June 30, 2013 and December 31, 2012, respectively), at cost	(920,355	) (927,776
Retained earnings	294,266	272,260
Total shareholders' deficit	(520,021	) (548,904
Total liabilities and shareholders' deficit	\$ 562,712	\$ 510,772

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



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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED, IN THOUSANDS)

	Six Months Ended	
	June 30,	
	2013	2012
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$43,757	\$51,859
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,695	3,994
Provision for bad debts, net	1,420	1,236
Non-cash stock compensation and other charges	5,581	4,868
Non-cash interest and other (income) loss	967	(820)
Deferred income taxes	4,169	(194)
Dividends received from equity method investments	535	399
Equity in net loss of affiliates	81	183
Changes in assets and liabilities:		
Receivables	(21,156)	(12,258)
Receivable – marketing and reservation fees, net	(2,945)	(2,389)
Forgivable notes receivable, net	(3,595)	(1,537)
Accounts payable	9,893	6,330
Accrued expenses	(18,463)	(17,659)
Income taxes payable/receivable	1,729	11,808
Deferred revenue	(3,318)	(4,404)
Other assets	(1,664)	(4,331)
Other liabilities	7,271	(820)
Net cash provided by operating activities	28,957	36,265
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Investment in property and equipment	(21,005)	(6,236)
Equity method investments	(1,851)	(6,315)
Issuance of mezzanine and other notes receivable	—	(4,136)
Collections of mezzanine and other notes receivable	201	63
Purchases of investments, employee benefit plans	(1,580)	(969)
Proceeds from sales of investments, employee benefit plans	3,934	8,969
Other items, net	(304)	(226)
Net cash used in investing activities	(20,605)	(8,850)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net borrowings pursuant to revolving credit facilities	15,200	—
Proceeds from issuance of long-term debt	—	393,444
Principal payments on long-term debt	(4,095)	(333)
Purchase of treasury stock	(3,651)	(22,173)
Dividends paid	(11,261)	(21,396)
Excess tax benefits from stock-based compensation	1,146	641
Debt issuance costs	—	(153)
Proceeds from exercise of stock options	5,973	445
Net cash provided by financing activities	3,312	350,475
Net change in cash and cash equivalents	11,664	377,890
Effect of foreign exchange rate changes on cash and cash equivalents	(2,051)	443
Cash and cash equivalents at beginning of period	134,177	107,057



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Cash and cash equivalents at end of period	\$ 143,790	\$ 485,390
Supplemental disclosure of cash flow information:		
Cash payments during the period for:		
Income taxes, net of refunds	\$ 11,652	\$ 14,391
Interest	\$ 22,033	\$ 7,699
Non-cash investing and financing activities:		
Dividends declared but not paid	\$ 10,766	\$ 10,658
Issuance of restricted shares of common stock	\$ 8,096	\$ 9,267
Issuance of performance vested restricted stock units	\$ 1,298	\$ —
Investment in property and equipment acquired in accounts payable	\$ 6,096	\$ —
Debt issuance costs	\$ —	\$ 6,556

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

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

1. Company Information and Significant Accounting Policies

The accompanying unaudited consolidated financial statements of Choice Hotels International, Inc. and subsidiaries (together the "Company") have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). These unaudited consolidated financial statements include all adjustments that are necessary, in the opinion of management, to fairly present our financial position and results of operations. Except as otherwise disclosed, all adjustments are of a normal recurring nature.

Certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been omitted. The year-end balance sheet information was derived from audited financial statements, but does not include all disclosures required by GAAP. The Company believes the disclosures made are adequate to make the information presented not misleading.

The consolidated financial statements should be read in conjunction with the consolidated financial statements for the year ended December 31, 2012 and notes thereto included in the Company's Form 10-K, filed with the SEC on February 28, 2013 (the "10-K"). Interim results are not necessarily indicative of the entire year results because of seasonal variations. All inter-company transactions and balances between Choice Hotels International, Inc. and its subsidiaries have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revision to Prior Period Financial Statements

In connection with the preparation of the consolidated financial statements for the second quarter of 2013, a misapplication of GAAP was identified related to the presentation of cash flows pursuant to forgivable notes receivable. Previously, the Company applied Accounting Standards Codification ("ASC") 230 "Statement of Cash Flows" paragraphs 12 and 13 when reporting cash outflows and cash collections related to these notes receivable and as a result reported these items as cash flows from investing activities. During the current period, the Company revised its presentation of these cash flows in accordance with ASC 230 paragraphs 22 and 23 to reclassify them to operating activities on the Company's Consolidated Statements of Cash Flows.

In conjunction with brand and development programs, the Company issues forgivable notes receivable to qualifying franchisees for property improvements and other purposes. Under the terms of the forgivable promissory notes, the Company ratably reduces the outstanding principal balance and related interest over the term of the loan contingent upon the franchisee remaining within the franchise system and operating in accordance with the terms of the franchise agreement including credit, quality and brand standards. Therefore, the predominant reduction of these notes receivable is through non-cash operating expenses and not cash collections of note receivable amounts. As a result, the Company revised the cash flow classification of these forgivable notes receivable from investing activities to operating activities.

In accordance with Accounting Standards Codification ("ASC") 250 (SEC's Staff Accounting Bulletin 99, "Materiality"), the Company assessed the materiality of the misapplication of GAAP and concluded that the reclassification of these cash flows was not material to any of our previously issued annual or interim financial statements. In accordance with the accounting guidance in ASC 250 (SEC Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements"), the Company will revise its previously issued financial statements to correct the presentation of these cash flows in future quarterly and annual filings beginning with the financial statements contained in this Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2013. These revisions did not impact the Company's previously reported net income, comprehensive income, assets, liabilities or shareholders' deficit.



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The following tables present the effect of the correction of the classification of the cash flows related to forgivable notes receivable on selected line items included in the Company's Consolidated Statements of Cash Flows for all periods affected:

	Year Ended December 31, 2012 (In thousands)			Year Ended December 31, 2011			Year Ended December 31, 2010			
	As Previously Reported	Adjustment	As Revised	As Previously Reported	Adjustment	As Revised	As Previously Reported	Adjustment	As Revised	
Forgivable notes receivable, net	\$—	\$ (10,898 )	\$(10,898)	\$—	\$ (3,475 )	\$(3,475)	\$—	\$ (1,120 )	\$(1,120)	
Net cash provided by operating activities	161,020	(10,898 )	150,122	134,844	(3,475 )	131,369	144,935	(1,120 )	143,815	
Issuance of mezzanine and other notes receivable	(34,925 )	11,189	(23,736 )	(12,766 )	3,539	(9,227 )	(11,786 )	1,203	(10,583 )	
Collections of mezzanine and other notes receivable	3,561	(291 )	3,270	4,754	(64 )	4,690	5,083	(83 )	5,000	
Net cash used in investing activities	(57,999 )	10,898	(47,101 )	(23,804 )	3,475	(20,329 )	(32,155 )	1,120	(31,035 )	
	Three Months Ended March 31, 2013 (In thousands)						Three Months Ended March 31, 2012			
	As Previously Reported	Adjustment	As Revised	As Previously Reported	Adjustment	As Revised	As Previously Reported	Adjustment	As Revised	
Forgivable notes receivable, net	\$—	\$(1,729 )	\$(1,729 )	\$—	\$(475 )	\$(475 )				
Net cash provided by operating activities	1,874	(1,729 )	145	4,412	(475 )	3,937				
Issuance of mezzanine and other notes receivable	(1,729 )	1,729	—	(3,719 )	583	(3,136 )				
Collections of mezzanine and other notes receivable	19	—	19	151	(108 )	43				
Net cash used in investing activities	(13,816 )	1,729	(12,087 )	(1,496 )	475	(1,021 )				
	Six Months Ended June 30, 2012 (In thousands)						Nine Months Ended September 30, 2012			
		Adjustment	As Revised		Adjustment	As Revised				

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	As Previously Reported			As Previously Reported				
Forgivable notes receivable, net	\$—	\$(1,537	) \$(1,537	)	\$—	\$(2,853	) \$(2,853	)
Net cash provided by operating activities	37,802	(1,537	) 36,265	)	121,276	(2,853	) 118,423	)
Issuance of mezzanine and other notes receivable	(5,820	) 1,684	(4,136	)	(7,305	) 3,069	(4,236	)
Collections of mezzanine and other notes receivable	210	(147	) 63	)	326	(216	) 110	)
Net cash used in investing activities	(10,387	) 1,537	(8,850	)	(19,562	) 2,853	(16,709	)
Cash and Cash Equivalents								

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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 June 30, 2013 and December 31, 2012, \$3.6 million and \$5.0 million respectively, of book overdrafts representing outstanding checks in excess of funds on deposit are included in accounts payable in the accompanying consolidated balance sheets.

The Company maintains cash balances in domestic banks, which at times, may exceed the limits of amounts insured by the Federal Deposit Insurance Corporation. In addition, the Company also maintains cash balances in international banks which do not provide deposit insurance.

### Recently Adopted Accounting Guidance

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income" ("ASU 2013-02"). This update requires companies to present either in a single note or parenthetically on the face of the financial statements the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and the income statement line items affected by the reclassification. If a component is not required to be reclassified to net income in its entirety companies would instead cross reference to the related footnote for additional information. ASU 2013-02 became effective for interim and annual periods beginning after December 15, 2012 and the Company adopted this ASU during the first quarter of 2013. The Company has elected to present the required disclosures in a single note rather than on the face of the financial statement. See Note 8 for additional information.

### Future Adoption of Recently Announced Accounting Guidance

In February 2013, the FASB issued ASU No. 2013-04, "Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date" ("ASU 2013-04"). The ASU requires entities to measure obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this guidance is fixed at the reporting date, as the sum of the following: (a) The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and (b) any additional amount the reporting entity expects to pay on behalf of its co-obligors. Required disclosures include a description of the joint-and-several arrangement and the total outstanding amount of the obligation for all joint parties. The ASU permits entities to aggregate disclosures (as opposed to providing separate disclosures for each joint-and-several obligation). ASU 2013-04 is effective for all interim and annual periods beginning after December 15, 2013. The ASU should be applied retrospectively to obligations with joint-and-several liabilities existing at the beginning of an entity's fiscal year of adoption. Early adoption is permitted. The Company is currently evaluating the impact the adoption of this statement will have on its financial statement presentation, if any, and will adopt the provision of this ASU on January 1, 2014.

In March 2013, the FASB issued ASU No. 2013-05, "Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity" ("ASU 2013-05"). ASU 2013-05 clarifies that when a reporting entity ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business within a foreign entity, the parent is required to apply the guidance in ASC 830 "Foreign Currency Matters" Subtopic 830-30 to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The provisions of ASU 2013-05 are effective prospectively for reporting periods beginning after December 15, 2013. The Company does not currently believe that the adoption of this update will have a material impact on its financial statements and will adopt the provisions of this ASU on January 1, 2014.

## 2. Other Current Assets

Other current assets consist of the following:

June 30, 2013

		December 31, 2012
	(In thousands)	
Notes receivable (See Note 3)	\$14,511	\$14,415
Prepaid expenses	11,900	10,694
Land held for sale	6,077	8,541
Other current assets	3,034	3,019
Total	\$35,522	\$36,669

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Land held for sale represents the Company's purchase of real estate as part of its program to incent franchise development in strategic markets for certain brands. The Company has acquired this real estate with the intent to resell it to third-party developers for the construction of hotels operated under the Company's brands. The real estate is accounted for as assets held for sale and therefore is carried at the lower of its carrying value or its estimated fair value (based on comparable sales), less estimated costs to sell.

## 3. Notes Receivable and Allowance for Losses

The Company segregates its notes receivable for the purposes of evaluating allowances for credit losses between two categories: Mezzanine and Other Notes Receivable and Forgivable Notes Receivable. The Company utilizes the level of security it has in the various notes receivable as its primary credit quality indicator (i.e. senior, subordinated or unsecured) when determining the appropriate allowances for uncollectible loans within these categories.

The following table shows the composition of our notes receivable balances:

Credit Quality Indicator	June 30, 2013 (\$ in thousands)			December 31, 2012 (\$ in thousands)		
	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable	Total	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable	Total
Senior	\$—	\$27,796	\$27,796	\$—	\$27,549	\$27,549
Subordinated	—	14,840	14,840	—	15,019	15,019
Unsecured	17,979	1,817	19,796	16,235	1,265	17,500
Total notes receivable	17,979	44,453	62,432	16,235	43,833	60,068
Allowance for losses on non-impaired loans	1,863	1,303	3,166	1,623	638	2,261
Allowance for losses on receivables specifically evaluated for impairment	—	8,453	8,453	—	8,289	8,289
Total loan reserves	1,863	9,756	11,619	1,623	8,927	10,550
Net carrying value	\$16,116	\$34,697	\$50,813	\$14,612	\$34,906	\$49,518
Current portion, net	\$583	\$13,928	\$14,511	\$420	\$13,995	\$14,415
Long-term portion, net	15,533	20,769	36,302	14,192	20,911	35,103
Total	\$16,116	\$34,697	\$50,813	\$14,612	\$34,906	\$49,518

The Company classifies notes receivable due within one year as other current assets and notes receivable with a maturity greater than one year as other assets in the Company's consolidated balance sheets.

The following table summarizes the activity related to the Company's Forgivable Notes Receivable and Mezzanine and Other Notes Receivable allowance for losses from December 31, 2012 through June 30, 2013:

Forgivable Notes Receivable	Mezzanine & Other Notes Receivable
(In thousands)	(In thousands)



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Balance, December 31, 2012	\$1,623	\$8,927
Provisions	380	829
Recoveries	(14)	) —
Write-offs	(98)	) —
Other <sup>(1)</sup>	(28)	) —
Balance, June 30, 2013	\$1,863	\$9,756

(1) Consists of default rate assumption changes

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## Forgivable Notes Receivable

As of June 30, 2013 and December 31, 2012, the unamortized balance of the Company's forgivable notes receivable totaled \$18.0 million and \$16.2 million, respectively. The Company recorded an allowance for credit losses on these forgivable notes receivable of \$1.9 million and \$1.6 million at June 30, 2013 and December 31, 2012, respectively. At June 30, 2013 and December 31, 2012, the Company did not have any forgivable unsecured notes that were past due. Amortization expense included in the accompanying consolidated statements of income related to the notes for the three and six months ended June 30, 2013 was \$1.0 million and \$2.0 million, respectively. Amortization expense for the three and six months ended June 30, 2012 was \$0.6 million and \$1.3 million, respectively.

## Mezzanine and Other Notes Receivable

The Company determined that approximately \$13.2 million and \$13.3 million of its mezzanine and other notes receivable were impaired at June 30, 2013 and December 31, 2012, respectively. The Company recorded allowance for credit losses on these impaired loans at June 30, 2013 and December 31, 2012 totaling \$8.5 million and \$8.3 million, respectively, resulting in a carrying value of impaired loans of \$4.7 million and \$5.0 million, respectively. The Company recognized approximately \$73 thousand and \$139 thousand of interest income on impaired loans during the three and six months ended June 30, 2013, respectively, on the cash basis. The Company recognized approximately \$31 thousand and \$62 thousand of interest income on impaired loans during the three and six months ended June 30, 2012, respectively, on the cash basis. The Company provided loan reserves on non-impaired loans totaling \$1.3 million and \$0.6 million at June 30, 2013 and December 31, 2012, respectively.

Past due balances of mezzanine and other notes receivable by credit quality indicators are as follows:

	30-89 days Past Due	> 90 days Past Due	Total Past Due	Current	Total Notes Receivable
	(\$ in thousands)				
As of June 30, 2013					
Senior	\$—	\$—	\$—	\$27,796	\$27,796
Subordinated	—	9,629	9,629	5,211	14,840
Unsecured	—	47	47	1,770	1,817
	\$—	\$9,676	\$9,676	\$34,777	\$44,453
As of December 31, 2012					
Senior	\$—	\$—	\$—	\$27,549	\$27,549
Subordinated	619	9,629	10,248	4,771	15,019
Unsecured	—	47	47	1,218	1,265
	\$619	\$9,676	\$10,295	\$33,538	\$43,833

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## Loans Acquired with Deteriorated Credit Quality

On December 2, 2011, the Company acquired an \$11.5 million mortgage, held on a franchisee hotel asset, from a financial institution for \$7.9 million. At the time of acquisition, the Company determined that it would be unable to collect all contractually required payments under the original mortgage terms. The contractually required payments receivable, including principal and interest, under the terms of the acquired mortgage totaled \$12.0 million. The Company expects to collect \$9.7 million of these contractually required payments. No prepayments were considered in the determination of contractual cash flows and cash flows expected to be collected. At both June 30, 2013 and December 31, 2012, the carrying amount of this loan, which is reported under senior mezzanine and other notes receivables, was \$7.9 million and there was no allowance for uncollectable amounts. The Company's accretable yield at acquisition was \$1.8 million or 7.36% and a reconciliation of the accretable yield for the six months ended June 30, 2013 is as follows:

	Accretable Yield (\$ in thousands)
Balance, December 31, 2012	\$ 1,161
Additions	—
Accretion	(286 )
Disposals	—
Reclassifications from nonaccretable yield	—
Balance, June 30, 2013	\$ 875

## 4. Receivable – Marketing and Reservation Fees

The marketing fees receivable from cumulative marketing expenses incurred in excess of cumulative marketing fees earned at June 30, 2013 and December 31, 2012 was \$16.1 million and \$7.9 million, respectively. As of June 30, 2013 and December 31, 2012, the reservation fees receivable related to cumulative reservation expenses incurred in excess of cumulative reservation fees earned was \$38.7 million and \$34.2 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the three months ended June 30, 2013 and 2012 was \$4.1 million and \$3.5 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the six months ended June 30, 2013 and 2012 was \$8.1 million and \$7.0 million, respectively. Interest expense attributable to marketing and reservation activities was \$0.9 million and \$1.0 million for the three months ended June 30, 2013 and 2012, respectively. Interest expense attributable to marketing and reservation activities was \$1.8 million and \$2.2 million for the six months ended June 30, 2013 and 2012, respectively.

The Company evaluates the receivable for marketing and reservation costs in excess of cumulative marketing and reservation system revenues earned on a periodic basis for collectibility. The Company will record an allowance when, based on current information and events, it is probable that it will be unable to collect all amounts due for marketing and reservation activities according to the contractual terms of the franchise agreements. The receivables are considered to be uncollectible if the expected net, undiscounted cash flows from marketing and reservation activities are less than the carrying amount of the asset. Based on the Company's analysis of projected net cash flows from marketing and reservation activities for all periods presented, the Company concluded that the receivable for marketing and reservation activities was fully collectible and as a result no allowance for possible losses was recorded.

## 5. Other Assets

Other assets consist of the following:

	June 30, 2013	December 31, 2012
	(In thousands)	
Notes receivable (see Note 3)	\$36,302	\$35,103
Equity method investments	28,636	27,453

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Deferred financing fees, net	10,064	11,174
Land held for sale	4,020	1,300
Other assets	865	983
Total	\$79,887	\$76,013

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## Variable Interest Entities

Equity method investments include investments in joint ventures totaling \$25.0 million and \$24.3 million at June 30, 2013 and December 31, 2012, respectively, that the Company determined to be variable interest entities. These investments relate to the Company's program to offer equity support to qualified franchisees to develop and operate Cambria Suites hotels in strategic markets. Based on an analysis of who has the power to direct the activities that most significantly impact these entities performance and who has an obligation to absorb losses of these entities or a right to receive benefits from these entities that could potentially be significant to the entity, the Company determined that it is not the primary beneficiary of any of its joint venture investments. The Company based its quantitative analysis on the forecasted cash flows of the entity and its qualitative analysis on its review of the design of the entity, its organizational structure including decision-making ability and the relevant development, operating management and financial agreements. As a result, the Company's investment in these entities is accounted for under the equity method. For the three and six months ended June 30, 2013, the Company recognized losses totaling \$7 thousand and \$72 thousand, respectively. For the three and six months ended June 30, 2012, the Company recognized income totaling \$9 thousand from these investments.

## 6. Deferred Revenue

Deferred revenue consists of the following:

	June 30, 2013	December 31, 2012
	(In thousands)	
Loyalty programs	\$60,696	\$64,636
Initial, relicensing and franchise fees	3,993	4,994
Procurement service fees	1,940	1,225
Other	1,128	299
Total	\$67,757	\$71,154

## 7. Debt

Debt consists of the following at:

	June 30, 2013	December 31, 2012
	(In thousands)	
\$400 million senior unsecured notes with an effective interest rate of 5.94% at June 30, 2013 and December 31, 2012	\$400,000	\$400,000
\$250 million senior unsecured notes with an effective interest rate of 6.19% less discount of \$0.5 million at June 30, 2013 and December 31, 2012	249,540	249,508
\$350 million senior secured credit facility with an effective interest rate of 2.60% and 2.66% at June 30, 2013 and December 31, 2012, respectively	214,700	203,250
Capital lease obligations due 2016 with an effective interest rate of 3.18% at June 30, 2013 and December 31, 2012	2,184	2,519
Other notes payable	54	68
Total debt	\$866,478	\$855,345
Less current portion	8,205	8,195
Total long-term debt	\$858,273	\$847,150

## Senior Unsecured Notes Due 2022

On June 27, 2012, the Company issued unsecured notes in the principal amount of \$400 million ("the 2012 Senior Notes") at par, bearing a coupon of 5.75% with an effective rate of 5.94%. The 2012 Senior Notes will mature on July 1, 2022, with interest to be paid semi-annually on January 1st and July 1st. The Company used the net proceeds of this offering, after deducting underwriting discounts and commissions and other offering expenses, together with a

portion of the proceeds from a new credit facility, to pay a special cash dividend totaling approximately \$600.7 million paid to shareholders on August 23, 2012. The Company's 2012 Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations by eight 100%-owned domestic subsidiaries.

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### Senior Unsecured Notes Due 2020

On August 25, 2010, the Company issued unsecured senior notes in the principal amount of \$250 million (“the 2010 Senior Notes”) at a discount of \$0.6 million, bearing a coupon of 5.7% with an effective rate of 6.19%. The 2010 Senior Notes will mature on August 28, 2020, with interest to be paid semi-annually on February 28<sup>th</sup> and August 28<sup>th</sup>. The Company used the net proceeds from the offering, after deducting underwriting discounts and other offering expenses, to repay outstanding borrowings and for other general corporate purposes. The Company's 2010 Senior Notes are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations by eight 100%-owned domestic subsidiaries.

### Revolving Credit Facilities

On July 25, 2012, the Company entered into a \$350 million senior secured credit facility, comprised of a \$200 million revolving credit tranche (the "New Revolver") and a \$150 million term loan tranche (the "Term Loan") with Deutsche Bank AG New York Branch, as administrative agent, Wells Fargo Bank, National Association, as administrative agent and a syndication of lenders (the "New Credit Facility"). The New Credit Facility has a final maturity date of July 25, 2016, subject to an optional one-year extension provided certain conditions are met. Up to \$25 million of the borrowings under the New Revolver may be used for letters of credit, up to \$10 million of borrowings under the New Revolver may be used for swing-line loans and up to \$35 million of borrowings under the New Revolver may be used for alternative currency loans. The Term Loan requires quarterly amortization payments (a) during the first two years, in equal installments aggregating 5% of the original principal amount of the Term Loan per year, (b) during the second two years, in equal installments aggregating 7.5% of the original principal amount of the Term Loan per year, and (c) during the one-year extension period (if exercised), equal installments aggregating 10% of the original principal amount of the Term Loan.

The Company utilized the proceeds from the Term Loan and borrowings from the New Revolver, together with the net proceeds from the Company's 2012 Senior Notes, to pay a special cash dividend of approximately \$600.7 million in the aggregate to the Company's stockholders on August 23, 2012.

The New Credit Facility is unconditionally guaranteed, jointly and severally, by certain of the Company's domestic subsidiaries. The subsidiary guarantors currently include all subsidiaries that guarantee the obligations under the Company's Indenture governing the terms of its 2010 and 2012 Senior Notes.

The New Credit Facility is secured by first priority pledges of (i) 100% of the ownership interests in certain domestic subsidiaries owned by the Company and the guarantors, (ii) 65% of the ownership interests in (a) Choice Netherlands Antilles N.V. (“Choice NV”), the top-tier foreign holding company of the Company's foreign subsidiaries, and (b) the domestic subsidiary that owns Choice NV and (iii) all presently existing and future domestic franchise agreements (the “Franchise Agreements”) between the Company and individual franchisees, but only to the extent that the Franchise Agreements may be pledged without violating any law of the relevant jurisdiction or conflicting with any existing contractual obligation of the Company or the applicable franchisee. At the time that the maximum total leverage ratio is required to be no greater than 4.0 to 1.0 (beginning of year 4 of the New Credit Facility), the security interest in the Franchise Agreements will be released.

The Company may at any time prior to the final maturity date increase the amount of the New Credit Facility by up to an additional \$100 million to the extent that any one or more lenders commit to being a lender for the additional amount and certain other customary conditions are met. Such additional amounts may take the form of an increased Revolver or Term Loan.

The Company may elect to have borrowings under the New Credit Facility bear interest at a rate equal to (i) LIBOR, plus a margin ranging from 200 to 425 basis points based on the Company's total leverage ratio or (ii) a base rate plus a margin ranging from 100 to 325 basis points based on the Company's total leverage ratio.

The New Credit Facility requires the Company to pay a fee on the undrawn portion of the New Revolver, calculated on the basis of the average daily unused amount of the New Revolver multiplied by 0.30% per annum.

The Company may reduce the New Revolver commitment and/or prepay the Term Loan in whole or in part at any time without penalty, subject to reimbursement of customary breakage costs, if any. Any Term Loan prepayments

made by the Company shall be applied to reduce the scheduled amortization payments in direct order of maturity. Additionally, the New Credit Facility requires that the Company and its restricted subsidiaries comply with various covenants, including with respect to restrictions on liens, incurring indebtedness, making investments, paying dividends or repurchasing stock, and effecting mergers and/or asset sales. With respect to dividends, the Company may not make any payment if there is an existing event of default or if the payment would create an event of default. In addition, if the Company's total leverage



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ratio exceeds 4.50 to 1.00, the Company is generally restricted from paying aggregate dividends in excess of \$50.0 million during any calendar year.

The New Credit Facility also imposes financial maintenance covenants requiring the Company to maintain:

- a total leverage ratio of not more than 5.75 to 1.00 in year 1, 5.00 to 1.00 in year 2, 4.50 to 1.00 in year 3 and 4.00 to 1.00 thereafter,
- a maximum secured leverage ratio of not more than 2.50 to 1.00 in year 1, 2.25 to 1.00 in year 2, 2.00 to 1.00 in year 3 and 1.75 to 1.00 thereafter, and
- a minimum fixed charge coverage ratio of not less than 2.00 to 1.00 in years 1 and 2, 2.25 to 1.00 in year 3 and 2.50 to 1.00 thereafter.

At June 30, 2013, the Company maintained a total leverage ratio of approximately 3.68x, a maximum secured leverage ratio of 0.92x and a minimum fixed charge coverage ratio of approximately 5.52x. At June 30, 2013, the Company was in compliance with all covenants under the New Credit Facility.

The New Credit Facility includes customary events of default, the occurrence of which, following any applicable cure period, would permit the lenders to, among other things, declare the principal, accrued interest and other obligations of the Company under the New Credit Facility to be immediately due and payable. At June 30, 2013, the Company was in compliance with all covenants under the New Credit Facility.

At June 30, 2013, the Company had \$142.5 million and \$72.2 million outstanding under the Term Loan and New Revolver, respectively. At December 31, 2012, the Company had \$146.3 million and \$57.0 million outstanding under the Term Loan and New Revolver, respectively.

In connection with the entering into the New Credit Facility, the Company's \$300 million senior unsecured revolving credit agreement, dated as of February 24, 2011, among the Company, Wells Fargo Bank, National Association, as administrative agent, and a syndicate of lenders (the "Old Credit Facility"), was terminated and replaced by the New Credit Facility. Borrowings under the Old Credit Facility bore interest at (i) a base rate plus a margin ranging from 5 to 80 basis points based on the Company's credit rating or (ii) LIBOR plus a margin ranging from 105 to 180 basis points based on the Company's credit rating. In addition, the Old Credit Facility required the Company to pay a quarterly facility fee on the full amount of the commitments under the Old Credit Facility (regardless of usage) ranging from 20 to 45 basis points based upon the credit rating of the Company.

#### 8. Accumulated Other Comprehensive Income (Loss)

The following represents the changes in accumulated other comprehensive loss, net of tax, by component for the six months ended June 30, 2013:

	Loss on Cash Flow Hedge	Foreign Currency Items	Total
	(\$ in thousands)		
Balance, December 31, 2012	\$ (6,607	) \$ 2,391	\$ (4,216 )
Other comprehensive income (loss) before reclassification	—	(2,312	) (2,312 )
Amounts reclassified from accumulated other comprehensive income (loss)	431	—	431
Net current period other comprehensive income (loss)	431	(2,312	) (1,881 )
Balance, June 30, 2013	\$ (6,176	) \$ 79	\$ (6,097 )



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The amounts reclassified from other accumulated other comprehensive income (loss) during the three and six months ended June 30, 2013 were reclassified to the following line items in the Company's Consolidated Statements of Income.

Component	Amount Reclassified from Accumulated Other Comprehensive Income(Loss)		Affected Line Item in the Consolidated Statement of Net Income
	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013	
	(\$ in thousands)		
Loss on cash flow hedge			
Interest rate contract	\$ 216	\$ 431	Interest expense
	—	—	Tax (expense) benefit
	\$ 216	\$ 431	Net of tax

#### 9. Non-Qualified Retirement, Savings and Investment Plans

The Company sponsors two non-qualified retirement savings and investment plans for certain employees and senior executives. 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.

In 2002, the Company adopted the Choice Hotels International, Inc. Executive Deferred Compensation Plan ("EDCP") which became effective January 1, 2003. Under the EDCP, certain executive officers may defer a portion of their salary into an irrevocable trust. Prior to January 1, 2010, participants could elect an investment return of either the annual yield of the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points, or a return based on a selection of available diversified investment options. Effective January 1, 2010, the Moody's Average Corporate Bond Rate Yield Index plus 300 basis points is no longer an investment option for salary deferrals made on compensation earned after December 31, 2009. The Company recorded current and long-term deferred compensation liabilities of \$10.4 million and \$11.7 million, as of June 30, 2013 and December 31, 2012, respectively, related to these deferrals and credited investment returns. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. Compensation expense recorded in SG&A for each of the three months ended June 30, 2013 and 2012 was \$0.1 million. Compensation expense recorded in SG&A for the six months ended June 30, 2013 and 2012 was \$0.4 million and \$0.5 million, respectively. In addition, the EDCP Plan held shares of the Company's common stock with a market value of \$0.2 million and \$0.1 million at June 30, 2013 and December 31, 2012, respectively, which were recorded as a component of shareholders' deficit. The Company has invested the employee salary deferrals in diversified long-term investments which are intended to provide investment returns that partially offset the earnings credited to the participants. The diversified investments held in the trusts totaled \$3.5 million and \$6.0 million as of June 30, 2013 and December 31, 2012, respectively, and are recorded at their fair value, based on quoted market prices. At June 30, 2013, the Company expects \$0.4 million of the assets held in the trusts to be distributed to participants during the next twelve months. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other gains and losses in the accompanying consolidated statements of income. The Company recorded investment losses during the three months ended June 30, 2013 and 2012 of approximately \$36 thousand and \$24 thousand, respectively. The Company recorded investment gains during the six months ended June 30, 2013 and 2012 of approximately \$0.1 million and \$1.1 million, respectively.

In 1997, the Company adopted the Choice Hotels International, Inc. Non-Qualified Retirement Savings and Investment Plan (“Non-Qualified Plan”). The Non-Qualified Plan allows certain employees who do not participate in the EDCP to defer a portion of their salary and invest these amounts in a selection of available diversified investment options. As of June 30, 2013 and December 31, 2012, the Company had recorded a deferred compensation liability of \$12.1 million and \$11.2 million, respectively, related to these deferrals. Compensation expense is recorded in SG&A expense on the Company's consolidated statements of income based on the change in the deferred compensation obligation related to earnings credited to participants as well as changes in the fair value of diversified investments. The net decrease in compensation expense recorded in SG&A for the three months ended June 30, 2013 and 2012 was \$0.2 million and \$0.3 million, respectively. The net increase in

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compensation expense recorded in SG&A for the six months ended June 30, 2013 and 2012 was \$0.7 million and \$0.6 million, respectively.

The diversified investments held in the trusts were \$11.0 million and \$10.2 million as of June 30, 2013 and December 31, 2012, respectively, and are recorded at their fair value, based on quoted market prices. These investments are considered trading securities and therefore the changes in the fair value of the diversified assets is included in other gains and losses in the accompanying consolidated statements of income. The Company recorded investment losses during the three months ended June 30, 2013 and 2012 of approximately \$0.1 million and \$0.3 million, respectively. The Company recorded investment gains during the six months ended June 30, 2013 and 2012 of approximately \$0.5 million and \$0.6 million, respectively. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of \$1.1 million and \$1.0 million at June 30, 2013 and December 31, 2012, respectively, which are recorded as a component of shareholders' deficit.

## 10. Fair Value Measurements

The Company estimates the fair value of its financial instruments utilizing a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. The following summarizes the three levels of inputs, as well as the assets that the Company values using those levels of inputs.

Level 1: Quoted prices in active markets for identical assets and liabilities. The Company's Level 1 assets consist of marketable securities (primarily mutual funds) held in the Company's EDCP and Non-Qualified Plan deferred compensation plans.

Level 2: Observable inputs, other than quoted prices in active markets for identical assets and liabilities, such as quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable. The Company's Level 2 assets consist of money market funds held in the Company's EDCP and Non-Qualified Plan deferred compensation plans and those recorded in cash and cash equivalents.

Level 3: Unobservable inputs, supported by little or no market data available, where the reporting entity is required to develop its own assumptions to determine the fair value of the instrument. The Company does not currently have any assets whose fair value was determined using Level 3 inputs.

As of June 30, 2013 and December 31, 2012, the Company had the following assets measured at fair value on a recurring basis:

	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Assets (in thousands)				
As of June 30, 2013				
Money market funds, included in cash and cash equivalents	\$50,001	\$—	\$50,001	\$—
Mutual funds <sup>(1)</sup>	13,515	13,515	—	—
Money market funds <sup>(1)</sup>	976	—	976	—
	\$64,492	\$13,515	\$50,977	\$—
As of December 31, 2012				
Money market funds, included in cash and cash equivalents	\$20,001	\$—	\$20,001	\$—
Mutual funds <sup>(1)</sup>	11,884	11,884	—	—
Money market funds <sup>(1)</sup>	4,357	—	4,357	—
	\$36,242	\$11,884	\$24,358	\$—

(1)Included in Investments, employee benefit plans fair value on the consolidated balance sheets.

The Company's policy is to recognize transfers in and transfers out of the three levels of the fair value hierarchy as of the end of each quarterly reporting period. There were no transfers between Level 1 and 2 assets during the three and

six months ended June 30, 2013.

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## Other Financial Instruments

The Company believes that the fair value of its current assets and current liabilities approximate their reported carrying amounts due to the short-term nature of these items. In addition, the interest rates of the Company's New Credit Facility adjust frequently based on current market rates; accordingly its carrying amount approximates fair value.

The Company estimates the fair value of notes receivable which approximate their carrying value, utilizing an analysis of future cash flows and credit worthiness for similar types of arrangements. Based upon the availability of market data, we have classified these notes receivables as Level 3 inputs. The primary sensitivity in these calculations is based on the selection of appropriate interest and discount rates. For further information on the notes receivables see Note 3.

The Company estimates the fair value of the Company's \$250 million and \$400 million senior notes using quoted market prices, which are directly observable Level 1 inputs. At June 30, 2013 and December 31, 2012, the \$250 million senior notes had an approximate fair value of \$263.8 million and \$271.6 million, respectively. At June 30, 2013 and December 31, 2012, the \$400 million senior notes had an approximate fair value of \$418.0 million and \$442.0 million, respectively.

Fair values estimated are made at a specific point in time, are subjective in nature and involve uncertainties and matters of significant judgment. Settlement of such fair value amounts may not be possible and may not be a prudent management decision.

## 11. Income Taxes

The effective income tax rates were 29.6% and 33.5% for the three months ended June 30, 2013 and 2012, respectively. The effective income tax rates were 28.3% and 33.7% for the six months ended June 30, 2013 and 2012, respectively.

The effective income tax rate for the three and six months ended June 30, 2013 and June 30, 2012, were lower than the U.S federal income tax rate of 35% due to the recurring impact of foreign operations, partially offset by state taxes. The effective income tax rate for the three and six months ended June 30, 2013 reflects the release of a valuation allowance on local country tax refunds received by our foreign subsidiary. The effective income tax rate for the six months ended June 30, 2013 was further reduced by settlements of unrecognized tax positions and by legislation retroactively extending the U.S. controlled foreign corporation look-through rule.

## 12. Share-Based Compensation and Capital Stock

## Stock Options

No stock options were granted during the three month periods ended June 30, 2013 and 2012. The Company granted 0.2 million and 0.2 million options to certain employees of the Company at a fair value of \$1.7 million and \$1.6 million for the six months ended June 30, 2013 and 2012, respectively. The stock options granted by the Company had an exercise price equal to the market price of the Company's common stock on the date of grant. The fair value of the options granted was estimated on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2013 Grants	2012 Grants	
Risk-free interest rate	0.73	% 0.78	%
Expected volatility	38.14	% 40.15	%
Expected life of stock option	4.5 years	4.4 years	
Dividend yield	2.01	% 2.08	%
Requisite service period	4 years	4 years	
Contractual life	7 years	7 years	
Weighted average fair value of options granted	\$9.89	\$9.98	

The expected life of the options and volatility are based on historical data and are not necessarily indicative of exercise patterns or actual volatility that may occur. Historical volatility is calculated based on a period that corresponds to the expected life of the stock option. The dividend yield and the risk-free rate of return are calculated on the grant date based on the then current dividend rate and the risk-free rate of return for the period corresponding to the expected life of the stock option. Compensation expense related to the fair value of these awards is recognized straight-line over the requisite service period based on those awards that ultimately vest.



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The aggregate intrinsic value of the stock options outstanding and exercisable at June 30, 2013 was \$23.9 million and \$19.3 million, respectively. The total intrinsic value of options exercised during the three months ended June 30, 2013 and 2012 was approximately \$0.6 million and \$0.1 million, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2013 and 2012 was approximately \$2.9 million and \$0.5 million, respectively.

The Company received approximately \$0.6 million and \$0.1 million in proceeds from the exercise of 29,742 and 4,988 employee stock options during the three month periods ended June 30, 2013 and 2012, respectively. The Company received approximately \$6.0 million and \$0.4 million in proceeds from the exercise of 234,065 and 25,204 employee stock options during the six month periods ended June 30, 2013 and 2012, respectively.

**Restricted Stock**

The following table is a summary of activity related to restricted stock grants:

	Three Months Ended		Six Months Ended	
	June 30, 2013	2012	June 30, 2013	2012
Restricted share grants	20,858	20,468	215,399	258,487
Weighted average grant date fair value per share	\$45.32	\$37.62	\$37.59	\$35.85
Aggregate grant date fair value (\$000)	\$945	\$770	\$8,097	\$9,267
Restricted shares forfeited	6,429	5,974	27,928	10,302
Vesting service period of shares granted	12 - 48 months	12 - 36 months	12 - 48 months	12 - 68 months
Grant date fair value of shares vested (\$000)	\$660	\$1,605	\$7,659	\$6,618

Compensation expense related to the fair value of these awards is recognized straight-line over the requisite service period based on those restricted stock grants that ultimately vest. The fair value of grants is measured by the market price of the Company's stock on the date of grant. Restricted stock awards generally vest ratably over the service period beginning with the first anniversary of the grant date. Awards granted to retirement eligible non-employee directors are recognized over the shorter of the requisite service period or the length of time until retirement since the terms of the grant provide that the awards will vest upon retirement.

**Performance Vested Restricted Stock Units**

The Company has granted performance vested restricted stock units ("PVRSU") to certain employees. The fair value is measured by the market price of the Company's common stock on the date of the grant. The vesting of these stock awards is contingent upon the Company achieving performance targets at the end of specified performance periods and the employees' continued employment. The performance conditions affect the number of shares that will ultimately vest. The range of possible stock-based award vesting is generally between 0% and 200% of the initial target. If minimum performance targets are not attained then no awards will vest under the terms of the various PVRSU agreements. Compensation expense related to these awards is recognized over the requisite service period based on the Company's estimate of the achievement of the various performance targets. The Company has currently estimated that between 100% and 160% of the various award targets will be achieved. Compensation expense is recognized ratably over the requisite service period only on those PVRSUs that ultimately vest.

The following table is a summary of activity related to PVRSU grants:

	Three Months Ended		Six Months Ended	
	June 30, 2013	2012	June 30, 2013	2012
Performance vested restricted stock units granted at target	—	55,433	58,902	93,909
Weighted average grant date fair value per share	\$—	\$36.08	\$36.76	\$35.88
Aggregate grant date fair value (\$000)	\$—	\$2,000	\$2,165	\$3,370
Stock units forfeited	—	57,176	—	57,176
Requisite service period	—	48-60 months	22-36 months	36-60 months



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During the three months ended June 30, 2013 and 2012, no PVRSU grants vested. During the six months ended June 30, 2013, a total of 39,816 PVRSU grants vested at a fair value of \$1.3 million. These PVRSU grants were initially granted at a target of 30,624 units. However, since the Company exceeded targeted performance conditions contained in the stock awards granted in prior periods by 130%, an additional 9,192 shares were earned and issued. No PVRSU grants vested during the six months ended June 30, 2012. During the three and six months ended June 30, 2013, no PVRSU stock units were forfeited. During the three months ended June 30, 2012, PVRSU grants totaling 57,176 units were terminated in accordance with an amended and restated employment agreement. A summary of stock-based award activity as of June 30, 2013 and changes during the six months ended are presented below:

	Stock Options			Restricted Stock		Performance Vested Restricted Stock Units	
	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Outstanding at January 1, 2013	1,934,034	\$25.80		606,547	\$35.17	170,116	\$35.56
Granted	173,413	36.76		215,399	37.59	58,902	36.76
Performance based leveraging <sup>(1)</sup>	—	—		—	—	9,192	32.60
Exercised/Vested	(234,065 )	25.52		(225,575 )	33.95	(39,816 )	32.60
Expired	(75,473 )	36.99		—	—	—	—
Forfeited	—	—		(27,928 )	35.31	—	—
Outstanding at June 30, 2013	1,797,909	\$26.42	4.1 years	568,443	\$36.56	198,394	\$36.37
Options exercisable at June 30, 2013	1,287,654	\$24.71	2.8 years				

<sup>(1)</sup>PVRSU shares have been increased by 9,192 units due to the Company exceeding the targeted performance conditions contained in PVRSUs granted in prior periods during the six months ended June 30, 2013.

The components of the Company's pretax stock-based compensation expense and associated income tax benefits are as follows for the three and six months ended June 30, 2013 and 2012:

(in millions)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Stock options	\$0.5	\$0.5	\$1.0	\$1.1
Restricted stock	1.8	1.9	3.6	3.9
Performance vested restricted stock units	0.6	0.3	1.2	0.5
Total	\$2.9	\$2.7	\$5.8	\$5.5
Income tax benefits	\$1.1	\$1.0	\$2.1	\$2.0
Dividends				

The Company currently maintains the payment of a quarterly dividend on its common shares outstanding of \$0.185 per share, however the declaration of future dividends are subject to the discretion of the board of directors. In the fourth quarter of 2012, the Company's board of directors elected to pay prior to December 31, 2012 the regular quarterly dividend initially scheduled to be paid in the first quarter of 2013. During the three and six months ended June 30, 2013, the Company declared dividends totaling \$0.185 and \$0.37 per share or approximately \$10.8 million and \$21.5 million in the aggregate, respectively,

During the three and six months ended June 30, 2012, the Company declared dividends totaling \$0.185 and \$0.37 per share or approximately \$10.7 million and \$21.4 million in the aggregate, respectively. In addition, during the six months ended June 30, 2013, the Company paid previously declared dividends totaling \$0.5 million that were contingent upon the vesting of performance vested restricted units. No dividends on performance vested restricted

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units were paid during the three months ended June 30, 2013. No dividends on performance vested restricted units were paid during the three and six months ended June 30, 2012.

## Share Repurchases and Redemptions

No shares of common stock were purchased by the Company under the share repurchase program during the three and six months ended June 30, 2013. During the three and six months ended June 30, 2012, the Company purchased 0.2 million and 0.5 million shares of common stock under the share repurchase program at a total cost of \$7.0 million and \$19.9 million, respectively.

During the three and six months ended June 30, 2013, the Company redeemed 410 and 97,387 shares of common stock at a total cost of approximately \$16 thousand and \$3.7 million from employees to satisfy statutory minimum tax requirements from the vesting of restricted stock and performance vested restricted stock unit grants. During the three and six months ended June 30, 2012, the Company redeemed 7,350 and 62,512 shares of common stock at a total cost of approximately \$0.3 million and \$2.3 million from employees to satisfy statutory minimum tax requirements from the vesting of restricted stock grants. These redemptions were outside the share repurchase program initiated in June 1998.

## 13. Earnings Per Share

The computation of basic and diluted earnings per common share is as follows:

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30, 2013	2012	June 30, 2013	2012
Computation of Basic Earnings Per Share:				
Net income	\$28,234	\$31,862	\$43,757	\$51,859
Income allocated to participating securities	(275)	(346)	(442)	(547)
Net income available to common shareholders	\$27,959	\$31,516	\$43,315	\$51,312
Weighted average common shares outstanding – basic	57,953	57,357	57,837	57,489
Basic earnings per share	\$0.48	\$0.55	\$0.75	\$0.89
Computation of Diluted Earnings Per Share:				
Net income	\$28,234	\$31,862	\$43,757	\$51,859
Income allocated to participating securities	(274)	(346)	(440)	(546)
Net income available to common shareholders	\$27,960	\$31,516	\$43,317	\$51,313
Weighted average common shares outstanding – basic	57,953	57,357	57,837	57,489
Diluted effect of stock options and PVRsUs	386	101	376	101
Weighted average shares outstanding – diluted	58,339	57,458	58,213	57,590
Diluted earnings per share	\$0.48	\$0.55	\$0.74	\$0.89

The Company's unvested restricted shares contain rights to receive non-forfeitable dividends, and thus are participating securities requiring the two-class method of computing earnings per share (“EPS”). The calculation of EPS for common stock shown above excludes the income attributable to the unvested restricted share awards from the numerator and excludes the dilutive impact of those awards from the denominator.

At June 30, 2013 and 2012, the Company had 1.8 million and 1.7 million outstanding stock options, respectively. Stock options are included in the diluted earnings per share calculation using the treasury stock method and average market prices during the period, unless the stock options would be anti-dilutive. For the three and six month periods ended June 30, 2013, the Company did not exclude any anti-dilutive stock options from the diluted earnings per share calculation. For each the three and six month periods ended June 30, 2012, the Company excluded 0.4 million of anti-dilutive stock options from the diluted earnings per share calculation.

PVRsUs are also included in the diluted earnings per share calculation assuming the performance conditions have been met at the reporting date. However, at June 30, 2013 and 2012, PVRsUs totaling 198,394 and 146,502, respectively, were excluded from the computation since the performance conditions had not been met.



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## 14. Condensed Consolidating Financial Statements

The Company's Senior Notes due 2020 and 2022 are guaranteed jointly, severally, fully and unconditionally, subject to certain customary limitations, by eight 100%-owned domestic subsidiaries. There are no legal or regulatory restrictions on the payment of dividends to Choice Hotels International, Inc. from subsidiaries that do not guarantee the Senior Notes. As a result of the guarantee arrangements, the following condensed consolidating financial statements are presented. Investments in subsidiaries are accounted for under the equity method of accounting.

Certain revisions have been made to correct immaterial errors in the condensed consolidating statement of income for the three and six months ended June 30, 2012 and condensed consolidating statement of cash flows for the six months ended June 30, 2012. The revisions to the condensed consolidating statement of income decreased the Guarantor's marketing and reservation expense and total operating expenses by \$1.0 million and \$2.1 million for the three and six months ended June 30, 2012, respectively. The revisions also increased the Guarantor's interest expense and total other income and expenses, net by \$1.0 million and \$2.1 million for the three and six months ended June 30, 2012, respectively. These revisions had offsetting adjustments to the same items in the Eliminations column. The following tables present the effect of the correction of these immaterial errors on selected line items in the Company's Guarantor Condensed Consolidating Statements of Income for the three and six months ended June 30, 2012.

	For the Three Months Ended June 30, 2012			For the Six Months Ended June 30, 2012		
	(in thousands) As Previously Reported	Adjustment	As Revised	As Previously Reported	Adjustment	As Revised
Marketing and reservation expense	\$84,463	\$(974 )	\$83,489	\$155,363	\$(2,111 )	\$153,252
Total operating expenses	107,591	(974 )	106,617	203,220	(2,111 )	201,109
Operating income	4,029	974	5,003	8,282	2,111	10,393
Interest expense	(972)	) 974	2	(2,075)	) 2,111	36
Total other income and expenses, net	(595)	) 974	379	(3,701)	) 2,111	(1,590 )

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The condensed consolidating statements of cash flows for the six months ended June 30, 2012 has been revised from prior filings to reflect the reclassification of certain operating, investing and financing cash flows related to inter-company investment transactions between wholly-owned subsidiaries. The revisions to the condensed consolidating statement of cash flows increased the Guarantors net cash provided (used) by operating activities and decreased investment in affiliates and net cash used in investing activities by \$6.3 million and decreased the Non-Guarantor's net cash provided (used) by operating activities and increased proceeds from contributions from affiliates and net cash provided (used) by financing activities by \$6.3 million for the six months ended June 30, 2012, with corresponding offsetting adjustments to the same items in the Eliminations column. In addition, as described in Note 1 to the Company's Consolidated Financial Statements, the consolidated statements of cash flows have been revised for the correction of the misapplication of GAAP related to the presentation of cash flows from the Company's forgivable notes receivable. As a result of this revision, the Guarantors net cash provided (used) by operating activities and net cash used in investing activities were each decreased by \$1.5 million for the six months ended June 30, 2012. The following tables present the effect of the correction for the aforementioned items on selected line items included in the Company's Condensed Consolidating Statement of Cash Flows for the six months ended June 30, 2012:

	For the Six Months Ended June 30, 2012						
	Guarantor (in thousands)			Non-Guarantor			
	As Previously Reported	Adjustment	As Revised	As Previously Reported	Adjustment	As Revised	
Net cash provided (used) by operating activities	\$(2,711	) \$4,802	\$2,091	\$12,115	\$(6,339	) \$5,776	
Investing Activities:							
Issuance of mezzanine and other notes receivable	(1,684	) 1,684	—	—	—	—	
Collection of mezzanine and other notes receivable	147	(147	) —	—	—	—	
Advances to and investments in affiliates	—	(6,339	) (6,339	) —	—	—	
Net cash provided (used) in investing activities	2,418	(4,802	) (2,384	) (6,468	) —	(6,468	)
Financing Activities:							
Proceeds from contributions from affiliates	—	—	—	—	6,339	6,339	
Net cash provided (used) by financing activities	127	—	127	(9	) 6,339	6,330	

The Company assessed the materiality of the revisions noted above and concluded that they are not material to any of our previously issued annual or interim condensed consolidating financial statements.



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Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Three Months Ended June 30, 2013  
(Unaudited, in Thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>REVENUES:</b>					
Royalty fees	\$62,182	\$35,111	\$10,978	\$(39,892 )	\$68,379
Initial franchise and relicensing fees	4,087	—	329	—	4,416
Procurement services	7,384	—	162	—	7,546
Marketing and reservation	88,215	94,551	4,794	(87,915 )	99,645
Other items, net	2,015	1,334	243	—	3,592
Total revenues	163,883	130,996	16,506	(127,807 )	183,578
<b>OPERATING EXPENSES:</b>					
Selling, general and administrative	34,992	31,974	3,106	(39,892 )	30,180
Marketing and reservation	92,003	91,224	4,333	(87,915 )	99,645
Other items, net	759	2,469	203	—	3,431
Total operating expenses	127,754	125,667	7,642	(127,807 )	133,256
Operating income	36,129	5,329	8,864	—	50,322
<b>OTHER INCOME AND EXPENSES, NET:</b>					
Interest expense	10,783	17	7	—	10,807
Equity in earnings of consolidated subsidiaries	(11,919 )	—	—	11,919	—
Other items, net	(564 )	147	(155 )	—	(572 )
Total other income and expenses, net	(1,700 )	164	(148 )	11,919	10,235
Income before income taxes	37,829	5,165	9,012	(11,919 )	40,087
Income taxes	9,595	2,115	143	—	11,853
Net income	\$28,234	\$3,050	\$8,869	\$(11,919 )	\$28,234

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Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Three Months Ended June 30, 2012  
(Unaudited, in Thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>REVENUES:</b>					
Royalty fees	\$59,550	\$26,055	\$9,798	\$(29,339 )	\$66,064
Initial franchise and relicensing fees	3,030	—	148	—	3,178
Procurement services	6,712	—	124	—	6,836
Marketing and reservation	83,505	84,341	4,722	(77,935 )	94,633
Other items, net	1,526	1,224	160	—	2,910
Total revenues	154,323	111,620	14,952	(107,274 )	173,621
<b>OPERATING EXPENSES:</b>					
Selling, general and administrative	28,536	21,191	4,166	(29,339 )	24,554
Marketing and reservation	83,551	83,489	4,554	(76,961 )	94,633
Other items, net	705	1,937	202	—	2,844
Total operating expenses	112,792	106,617	8,922	(106,300 )	122,031
Operating income	41,531	5,003	6,030	(974 )	51,590
<b>OTHER INCOME AND EXPENSES, NET:</b>					
Interest expense	4,510	2	2	(974 )	3,540
Equity in earnings of consolidated subsidiaries	(8,165 )	—	—	8,165	—
Other items, net	(287 )	377	21	—	111
Total other income and expenses, net	(3,942 )	379	23	7,191	3,651
Income before income taxes	45,473	4,624	6,007	(8,165 )	47,939
Income taxes	13,611	2,252	214	—	16,077
Net income	\$31,862	\$2,372	\$5,793	\$(8,165 )	\$31,862

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Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Six Months Ended June 30, 2013  
(Unaudited, in Thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>REVENUES:</b>					
Royalty fees	\$106,418	\$59,316	\$20,173	\$(67,792 )	\$118,115
Initial franchise and relicensing fees	7,655	—	538	—	8,193
Procurement services	11,184	—	312	—	11,496
Marketing and reservation	153,374	170,682	9,376	(157,347 )	176,085
Other items, net	3,803	2,290	468	—	6,561
Total revenues	282,434	232,288	30,867	(225,139 )	320,450
<b>OPERATING EXPENSES:</b>					
Selling, general and administrative	64,074	54,412	6,402	(67,792 )	57,096
Marketing and reservation	159,701	164,360	9,371	(157,347 )	176,085
Other items, net	1,473	4,605	403	—	6,481
Total operating expenses	225,248	223,377	16,176	(225,139 )	239,662
Operating income	57,186	8,911	14,691	—	80,788
<b>OTHER INCOME AND EXPENSES, NET:</b>					
Interest expense	21,519	50	8	—	21,577
Equity in earnings of consolidated subsidiaries	(19,886 )	—	—	19,886	—
Other items, net	(1,112 )	(564 )	(109 )	—	(1,785 )
Total other income and expenses, net	521	(514 )	(101 )	19,886	19,792
Income before income taxes	56,665	9,425	14,792	(19,886 )	60,996
Income taxes	12,908	4,006	325	—	17,239
Net income	\$43,757	\$5,419	\$14,467	\$(19,886 )	\$43,757

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Choice Hotels International, Inc.  
Condensed Consolidating Statement of Income  
For the Six Months Ended June 30, 2012  
(Unaudited, in Thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
<b>REVENUES:</b>					
Royalty fees	\$101,676	\$52,275	\$16,856	\$(56,890 )	\$113,917
Initial franchise and relicensing fees	5,463	—	243	—	5,706
Procurement services	9,860	—	291	—	10,151
Marketing and reservation	143,158	157,025	9,109	(143,730 )	165,562
Other items, net	4,967	2,202	285	—	7,454
Total revenues	265,124	211,502	26,784	(200,620 )	302,790
<b>OPERATING EXPENSES:</b>					
Selling, general and administrative	53,023	44,019	8,751	(56,890 )	48,903
Marketing and reservation	145,105	153,252	8,824	(141,619 )	165,562
Other items, net	1,411	3,838	421	—	5,670
Total operating expenses	199,539	201,109	17,996	(198,509 )	220,135
Operating income	65,585	10,393	8,788	(2,111 )	82,655
<b>OTHER INCOME AND EXPENSES, NET:</b>					
Interest expense	8,726	36	6	(2,111 )	6,657
Equity in earnings of consolidated subsidiaries	(15,046 )	—	—	15,046	—
Other items, net	(489 )	(1,626 )	(59 )	—	(2,174 )
Total other income and expenses, net	(6,809 )	(1,590 )	(53 )	12,935	4,483
Income before income taxes	72,394	11,983	8,841	(15,046 )	78,172
Income taxes	20,535	5,310	468	—	26,313
Net income	\$51,859	\$6,673	\$8,373	\$(15,046 )	\$51,859



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Choice Hotels International, Inc.  
 Condensed Consolidating Statement of Comprehensive Income  
 For the Three Months Ended June 30, 2013  
 (Unaudited, in Thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net income	\$28,234	\$3,050	\$ 8,869	\$(11,919 )	