CHOICE HOTELS INTERNATIONAL INC /DE
Form 10-Q
November 12, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

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

DELAWARE	52-1209792
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

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)

(Former name, former address and former fiscal year, if changed since last report)

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 x   No o
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 x   No o
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	x	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	o

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

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CLASS	SHARES OUSTANDING AT SEPTEMBER 30, 2013
Common Stock, Par Value $0.01 per share	58,570,858

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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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
REVENUES:				
Royalty fees	$83,107	$80,845	$201,222	$194,762
Initial franchise and relicensing fees	4,650	3,247	12,843	8,953
Procurement services	4,708	3,839	16,204	13,990
Marketing and reservation	126,296	119,062	302,381	284,624
Hotel operations	1,310	1,238	3,600	3,440
Other	3,091	2,182	7,362	7,434
Total revenues	223,162	210,413	543,612	513,203
OPERATING EXPENSES:				
Selling, general and administrative	26,982	23,170	84,078	72,073
Depreciation and amortization	2,379	1,995	7,074	5,989
Marketing and reservation	126,296	119,062	302,381	284,624
Hotel operations	956	933	2,742	2,609
Total operating expenses	156,613	145,160	396,275	365,295
Operating income	66,549	65,253	147,337	147,908
OTHER INCOME AND EXPENSES, NET:				
Interest expense	10,757	10,166	32,334	16,823
Interest income	(676)	(425)	(1,979)	(1,156)
Loss on extinguishment of debt	—	526	—	526
Other (gains) and losses	(703)	(511)	(1,266)	(2,137)
Equity in net (income) loss of affiliates	(421)	(171)	(340)	12
Total other income and expenses, net	8,957	9,585	28,749	14,068
Income before income taxes	57,592	55,668	118,588	133,840
Income taxes	16,080	11,291	33,319	37,604
Net income	$41,512	$44,377	$85,269	$96,236
Basic earnings per share	$0.71	$0.77	$1.46	$1.66
Diluted earnings per share	$0.70	$0.76	$1.45	$1.65

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	$41,512	$44,377	$85,269	$96,236
Other comprehensive income (loss), net of tax:				
Amortization of loss on cash flow hedge	215	215	646	646
Foreign currency translation adjustment	512	211	(1,800)	191
Amortization of pension related costs, net of tax:				
Actuarial loss (net of income tax of $12 and $36 for the three and nine months ended September 30, 2012, respectively)	—	20	—	60
Other comprehensive income (loss), net of tax	727	446	(1,154)	897
Comprehensive income	$42,239	$44,823	$84,115	$97,133

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)

	September 30, 2013	December 31, 2012
ASSETS		
Current assets		
Cash and cash equivalents	$161,138	$134,177
Receivables (net of allowance for doubtful accounts of $10,324 and $10,820, respectively)	62,605	52,270
Income taxes receivable	—	2,732
Deferred income taxes	4,136	4,136
Investments, employee benefit plans, at fair value	386	3,486
Other current assets	30,002	36,669
Total current assets	258,267	233,470
Property and equipment, at cost, net	65,540	51,651
Goodwill	65,813	65,813
Franchise rights and other identifiable intangibles, net	10,875	13,473
Advances, marketing and reservation activities	32,564	42,179
Investments, employee benefit plans, at fair value	14,950	12,755
Deferred income taxes	19,496	15,418
Other assets	88,204	76,013
Total assets	$555,709	$510,772
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	$40,758	$38,714
Accrued expenses	43,475	55,552
Deferred revenue	61,401	71,154
Current portion of long-term debt	9,132	8,195
Deferred compensation and retirement plan obligations	2,439	2,522
Income taxes payable	21,906	—
Total current liabilities	179,111	176,137
Long-term debt	815,957	847,150
Deferred compensation and retirement plan obligations	21,219	20,399
Other liabilities	24,146	15,990
Total liabilities	1,040,433	1,059,676
Commitments and Contingencies		
SHAREHOLDERS' DEFICIT		
Common stock, $0.01 par value, 160,000,000 shares authorized; 95,345,362 shares issued at September 30, 2013 and December 31, 2012 and 58,570,858 and 58,171,059 shares outstanding at September 30, 2013 and December 31, 2012, respectively	586	582
Additional paid-in-capital	114,571	110,246
Accumulated other comprehensive loss	(5,370)	(4,216)
Treasury stock (36,774,504 and 37,174,303 shares at September 30, 2013 and December 31, 2012, respectively), at cost	(919,516)	(927,776)
Retained earnings	325,005	272,260
Total shareholders' deficit	(484,724)	(548,904)
Total liabilities and shareholders' deficit	$555,709	$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)

	Nine Months Ended September 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$85,269	$96,236
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,074	5,989
Provision for bad debts, net	2,054	1,802
Non-cash stock compensation and other charges	8,638	7,306
Non-cash interest and other (income) loss	1,057	(633)
Deferred income taxes	(4,118)	(1,627)
Loss on extinguishment of debt	—	526
Dividends received from equity method investments	1,109	855
Equity in net (income) loss of affiliates	(340)	12
Changes in assets and liabilities:		
Receivables	(13,699)	(17,405)
Advances to/from marketing and reservation activities, net	23,756	20,811
Forgivable notes receivable, net	(5,722)	(2,853)
Accounts payable	1,280	5,980
Accrued expenses	(22,757)	(10,309)
Income taxes payable/receivable	24,638	12,786
Deferred revenue	(9,686)	8,018
Other assets	(2,395)	(7,458)
Other liabilities	8,851	(1,613)
Net cash provided by operating activities	105,009	118,423
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment in property and equipment	(26,442)	(12,525)
Equity method investments	(3,761)	(9,454)
Issuance of mezzanine and other notes receivable	—	(4,236)
Collections of mezzanine and other notes receivable	224	110
Purchases of investments, employee benefit plans	(1,845)	(1,191)
Proceeds from sales of investments, employee benefit plans	4,052	10,909
Other items, net	(578)	(322)
Net cash used in investing activities	(28,350)	(16,709)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings (repayments) pursuant to revolving credit facilities	(27,500)	16,725
Proceeds from issuance of long-term debt	3,360	543,500
Principal payments on long-term debt	(6,158)	(502)
Purchase of treasury stock	(3,684)	(22,227)
Dividends paid	(22,026)	(632,751)
Excess tax benefits from stock-based compensation	1,216	793
Debt issuance costs	—	(4,753)
Proceeds from exercise of stock options	6,677	4,695
Net cash used in financing activities	(48,115)	(94,520)
Net change in cash and cash equivalents	28,544	7,194
Effect of foreign exchange rate changes on cash and cash equivalents	(1,583)	813

Cash and cash equivalents at beginning of period	134,177	107,057
Cash and cash equivalents at end of period	$161,138	$115,064
Supplemental disclosure of cash flow information:		
Cash payments during the period for:		
Income taxes, net of refunds	$12,990	$25,700
Interest	$42,244	$15,666
Non-cash investing and financing activities:		
Dividends declared but not paid	$10,773	$10,677
Issuance of restricted shares of common stock	$8,397	$9,517
Issuance of performance vested restricted stock units	$1,298	$—
Investment in property and equipment acquired in accounts payable	$763	$—
Debt issuance costs	$—	$6,500

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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. 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. In second quarter of 2013 and the following periods, the Company has 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 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 its 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 has revised its previously issued financial statements to correct the presentation of these cash flows in both the current and future quarterly and annual filings beginning with the financial statements in the Quarterly Report on Form 10-Q filed on August 9, 2013 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
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

	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)

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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 September 30, 2013 and December 31, 2012, $3.4 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, as of September 30, 2013, the Company maintains cash balances of $149.8 million 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 provisions 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.

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" ("ASU 2013-11"). ASU

2013-11 requires an entity to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss ("NOL") carryforward, or similar tax loss or tax credit carryforward, rather than as a liability when (1) the uncertain tax position would reduce the NOL or other carryforward under the tax law of the applicable jurisdiction and (2) the entity intends to use the deferred tax asset for that purpose. The ASU does not require new recurring disclosures. The provisions of ASU 2013-11 are effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption and retrospective application are permitted. 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.

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2. Other Current Assets

Other current assets consist of the following:

	September 30, 2013	December 31, 2012
	(In thousands)	
Notes receivable (See Note 3)	$14,126	$14,415
Prepaid expenses	12,740	10,694
Land held for sale	—	8,541
Other current assets	3,136	3,019
Total	$30,002	$36,669

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 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, which is no longer classified as land held for sale, was accounted for as assets held for sale and therefore was 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:

	September 30, 2013 ($ in thousands)			December 31, 2012 ($ in thousands)		
Credit Quality Indicator	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable	Total	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable	Total
Senior	$—	$27,548	$27,548	$—	$27,549	$27,549
Subordinated	—	14,841	14,841	—	15,019	15,019
Unsecured	19,018	1,812	20,830	16,235	1,265	17,500
Total notes receivable	19,018	44,201	63,219	16,235	43,833	60,068
Allowance for losses on non-impaired loans	1,902	1,443	3,345	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	1,902	9,896	11,798	1,623	8,927	10,550
Net carrying value	$17,116	$34,305	$51,421	$14,612	$34,906	$49,518
Current portion, net	$425	$13,701	$14,126	$420	$13,995	$14,415
Long-term portion, net	16,691	20,604	37,295	14,192	20,911	35,103
Total	$17,116	$34,305	$51,421	$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.

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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 September 30, 2013:

	Forgivable Notes Receivable	Mezzanine & Other Notes Receivable
	(In thousands)	
Balance, December 31, 2012	$1,623	$8,927
Provisions	598	969
Recoveries	(25)	—
Write-offs	(147)	—
Other[1]	(147)	—
Balance, September 30, 2013	$1,902	$9,896

(1) Consists of default rate assumption changes

Forgivable Notes Receivable

As of September 30, 2013 and December 31, 2012, the unamortized balance of the Company's forgivable notes receivable totaled $19.0 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 September 30, 2013 and December 31, 2012, respectively. At September 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 nine months ended September 30, 2013 was $1.1 million and $3.0 million, respectively. Amortization expense for the three and nine months ended September 30, 2012 was $0.7 million and $2.0 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 September 30, 2013 and December 31, 2012, respectively. The Company recorded allowance for credit losses on these impaired loans at September 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 $81 thousand and $0.2 million of interest income on impaired loans during the three and nine months ended September 30, 2013, respectively, on the cash basis. The Company recognized approximately $38 thousand and $100 thousand of interest income on impaired loans during the three and nine months ended September 30, 2012, respectively, on the cash basis. The Company provided loan reserves on non-impaired loans totaling $1.4 million and $0.6 million at September 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 September 30, 2013					
Senior	$9,500	$—	$9,500	$18,048	$27,548
Subordinated	—	10,268	10,268	4,573	14,841
Unsecured	—	47	47	1,765	1,812
	$9,500	$10,315	$19,815	$24,386	$44,201
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

Subsequent to September 30, 2013, the amounts reflected in the 30-89 past due column for senior mezzanine notes receivable totaling $9.5 million were repaid in full.

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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 September 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 nine months ended September 30, 2013 is as follows:

	Accretable Yield ($ in thousands)
Balance, December 31, 2012	$ 1,161
Additions	—
Accretion	(433)
Disposals	—
Reclassifications from nonaccretable yield	—
Balance, September 30, 2013	$ 728

4. Advances, Marketing and Reservation Activities

At September 30, 2013 and December 31, 2012, the Company had incurred cumulative marketing and reservation system expenses in excess of cumulative marketing and reservation system fees earned totaling $32.6 million and $42.2 million, respectively. These costs incurred in excess of fees collected have been deferred and recorded as an asset in the financial statements as the Company has the contractual authority to recover the deficits incurred related to marketing and reservation activities from the franchisees in the system at any given point in time.

Depreciation and amortization expense attributable to marketing and reservation activities for the three months ended September 30, 2013 and 2012 was $3.9 million and $3.7 million, respectively. Depreciation and amortization expense attributable to marketing and reservation activities for the nine months ended September 30, 2013 and 2012 was $12.0 million and $10.7 million, respectively. Interest expense attributable to marketing and reservation activities was $0.9 million for both the three months ended September 30, 2013 and 2012, respectively. Interest expense attributable to marketing and reservation activities was $2.8 million and $3.0 million for the nine months ended September 30, 2013 and 2012, respectively.

The Company evaluates the recoverability of marketing and reservation costs incurred in excess of cumulative marketing and reservation system revenues earned on a periodic basis. The Company will record a reserve when, based on current information and events, it is probable that it will be unable to recover the cumulative amounts advanced for marketing and reservation activities according to the contractual terms of the franchise agreements. These advances are considered to be unrecoverable 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 cumulative advances for marketing and reservation activities recorded as an asset on the balance sheet were fully recoverable and as a result no reserves were necessary.

5. Other Assets

Other assets consist of the following:

	September 30, 2013	December 31, 2012
	(In thousands)	

Notes receivable (see Note 3)	$37,295	$35,103
Equity method investments	30,404	27,453
Deferred financing fees, net	9,509	11,174
Land	10,097	1,300
Other assets	899	983
Total	$88,204	$76,013

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Land 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 either resell it to third-party developers for the construction of hotels operated under the Company’s brands or contribute the land into joint ventures for the same purpose. The real estate is carried at the lower of its carrying value or its estimated fair value (based on comparable sales), less estimated costs to sell.

Variable Interest Entities

Equity method investments include investments in joint ventures totaling $27.0 million and $24.3 million at September 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 nine months ended September 30, 2013, the Company recognized income totaling $81 thousand and $9 thousand, respectively, from these investments. For the three and nine months ended September 30, 2012, the Company recognized income totaling $75 thousand and $84 thousand, respectively, from these investments.

6. Deferred Revenue

Deferred revenue consists of the following:

	September 30, 2013	December 31, 2012
	(In thousands)	
Loyalty programs	$55,106	$64,636
Initial, relicensing and franchise fees	4,369	4,994
Procurement service fees	1,197	1,225
Other	729	299
Total	$61,401	$71,154

7. Debt

Debt consists of the following at:

	September 30, 2013	December 31, 2012
	(In thousands)	
$400 million senior unsecured notes with an effective interest rate of 5.94% at September 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 $0.4 million and $0.5 million at September 30, 2013 and December 31, 2012	249,556	249,508
$350 million senior secured credit facility with an effective interest rate of 2.52% and 2.66% at September 30, 2013 and December 31, 2012, respectively	170,125	203,250
Economic development loans with an effective interest rate of 3.00% at September 30, 2013	3,360	—
	2,017	2,519

Capital lease obligations due 2016 with an effective interest rate of 3.18% at September 30, 2013 and December 31, 2012		
Other notes payable	31	68
Total debt	825,089	$855,345
Less current portion	9,132	8,195
Total long-term debt	815,957	$847,150

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Senior Notes Due 2022

On June 27, 2012, the Company issued unsecured senior 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 wholly-owned domestic subsidiaries.

Senior 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 28th and August 28th. 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 wholly-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 the eight wholly-owned 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.

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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 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 September 30, 2013, the Company maintained a total leverage ratio of approximately 3.46x, a maximum secured leverage ratio of 0.72x and a minimum fixed charge coverage ratio of approximately 5.52x.

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 September 30, 2013, the Company was in compliance with all covenants under the New Credit Facility.

At September 30, 2013, the Company had $140.6 million and $29.5 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 was terminated and replaced by the New Credit Facility.

Economic Development Loans

The Company entered into economic development agreements with various governmental entities in conjunction with the relocation of its corporate headquarters in April 2013. In accordance with these agreements, the governmental entities agreed to advance approximately $4.4 million to the Company to offset a portion of the corporate headquarter relocation and tenant improvement costs in consideration of the employment of permanent, full-time employees within the jurisdictions. At September 30, 2013, the Company had been advanced approximately $3.4 million pursuant to these agreements and expects to receive the remaining $1 million over the next several years, subject to annual appropriations by the governmental entities. These advances bear interest at a rate of 3% per annum. Repayment of the advances is contingent upon the Company achieving certain performance conditions. Performance conditions are measured annually on December 31st and primarily relate to maintaining certain levels of employment within the various jurisdictions. If the Company fails to meet an annual performance condition, the Company may be required to repay a portion or all of the advances including accrued interest by April 30th following the measurement date. Any outstanding advances at the expiration of the Company's ten year corporate headquarter lease in 2023 will be forgiven in full. The advances will be included in long-term debt in Company's consolidated balance sheets until the Company determines that the future performance conditions will be met over the entire term of the agreement and the Company will not be required to repay the advances. The Company accrues interest on the portion of the advances that it expects to repay. The Company was in compliance with all current performance conditions as of September 30, 2013.

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8. Accumulated Other Comprehensive Income (Loss)

The following represents the changes in accumulated other comprehensive loss, net of tax, by component for the nine months ended September 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	—	(1,800)	(1,800)
Amounts reclassified from accumulated other comprehensive income (loss)	646	—	646
Net current period other comprehensive income (loss)	646	(1,800)	(1,154)
Balance, September 30, 2013	$(5,961)	$591	$(5,370)

The amounts reclassified from other accumulated other comprehensive income (loss) during the three and nine months ended September 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 September 30, 2013	Nine Months Ended September 30, 2013	
	($ in thousands)		
Loss on cash flow hedge			
Interest rate contract	$215	$646	Interest expense
	—	—	Tax (expense) benefit
	$215	$646	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 $10.9 million and $11.7 million, as of September 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 related to the EDCP for the three months ended

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September 30, 2013 and 2012 was $0.3 million and $0.2 million, respectively. Compensation expense recorded in SG&A related to the EDCP for the nine months ended September 30, 2013 and 2012 was $0.7 million for both periods.
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 $3.8 million and $6.0 million as of September 30, 2013 and December 31, 2012, respectively, and are recorded at their fair value, based on quoted market prices. At September 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 gains related to the EDCP during the three months ended September 30, 2013 and 2012 of approximately $0.2 million and $0.1 million, respectively. The Company recorded investment gains related to the EDCP during the nine months ended September 30, 2013 and 2012 of approximately $0.3 million and $1.2 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 September 30, 2013 and December 31, 2012, respectively, which were recorded as a component of shareholders' deficit.
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 September 30, 2013 and December 31, 2012, the Company had recorded a deferred compensation liability of $12.8 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 increase in compensation expense recorded in SG&A related to the Non-Qualified Plan for the three months ended September 30, 2013 and 2012 was $0.6 million and $0.2 million, respectively. The net increase in compensation expense recorded in SG&A related to the Non-Qualified Plan for the nine months ended September 30, 2013 and 2012 was $1.3 million and $0.8 million, respectively.
The diversified investments held in the trusts were $11.6 million and $10.2 million as of September 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 gains related to the Non-Qualified Plan during the three months ended September 30, 2013 and 2012 of approximately $0.5 million and $0.4 million, respectively. The Company recorded investment gains related to the Non-Qualified Plan during the nine months ended September 30, 2013 and 2012 of approximately $1.1 million and $1.0 million, respectively. In addition, the Non-Qualified Plan held shares of the Company's common stock with a market value of $1.2 million and $1.0 million at September 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.

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As of September 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 September 30, 2013				
Money market funds, included in cash and cash equivalents	$50,001	$—	$50,001	$—
Mutual funds[(1)]	13,201	13,201	—	—
Money market funds[(1)]	2,135	—	2,135	—
	$65,337	$13,201	$52,136	$—
As of December 31, 2012				
Money market funds, included in cash and cash equivalents	$20,001	$—	$20,001	$—
Mutual funds[(1)]	11,884	11,884	—	—
Money market funds[(1)]	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, 2 and 3 assets during the three and nine months ended September 30, 2013.

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 fair value of the Company's $250 million and $400 million senior notes are classified as Level 2 as the significant inputs are observable in an active market. At September 30, 2013 and December 31, 2012, the $250 million senior notes had an approximate fair value of $256.9 million and $271.6 million, respectively. At September 30, 2013 and December 31, 2012, the $400 million senior notes had an approximate fair value of $412.0 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 27.9% and 20.3% for the three months ended September 30, 2013 and 2012, respectively. The effective income tax rates were 28.1% for both the nine months ended September 30, 2013 and 2012, respectively.

The effective income tax rate for the three and nine months ended September 30, 2013 and 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,

and reflect adjustments to our federal accruals. Additionally, the effective income tax rate for the nine months ended September 30, 2013 was further reduced by the release of a valuation allowance on local country tax refunds received by our foreign subsidiary, settlements of unrecognized tax positions and by legislation retroactively extending the U.S. controlled foreign corporation look-through rule. The effective income tax rates for the three and nine months ended September 30, 2012 also reflect a nonrecurring favorable adjustment of $4.5 million related to foreign operations.

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12. Share-Based Compensation and Capital Stock

Stock Options

No stock options were granted during the three month periods ended September 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 nine months ended September 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.

The aggregate intrinsic value of the stock options outstanding and exercisable at September 30, 2013 was $29.6 million and $23.4 million, respectively. The total intrinsic value of options exercised during the three months ended September 30, 2013 and 2012 was approximately $0.5 million and $0.5 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2013 and 2012 was approximately $3.4 million and $1.0 million, respectively.

The Company received approximately $0.7 million and $4.3 million in proceeds from the exercise of 29,008 and 109,996 employee stock options during the three month periods ended September 30, 2013 and 2012, respectively. The Company received approximately $6.7 million and $4.7 million in proceeds from the exercise of 263,073 and 135,200 employee stock options during the nine month periods ended September 30, 2013 and 2012, respectively.

Restricted Stock

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Restricted share grants	7,646	7,672	223,045	266,159
Weighted average grant date fair value per share	$39.24	$32.59	$37.65	$35.76
Aggregate grant date fair value ($000)	$300	$250	$8,397	$9,517
Restricted shares forfeited	25	13,619	27,953	23,921
Vesting service period of shares granted	36 months	36 months	12 - 48 months	12 - 68 months
Grant date fair value of shares vested ($000)	$94	$75	$8,569	$6,693

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

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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 81% and 165% 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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Performance vested restricted stock units granted at target	—	6,137	58,902	100,046
Weighted average grant date fair value per share	$—	$32.59	$36.76	$35.68
Aggregate grant date fair value ($000)	$—	$200	$2,165	$3,570
Stock units forfeited	—	—	—	57,176
Requisite service period	—	41 months	22-36 months	36-60 months

During the three months ended September 30, 2013 and 2012, no PVRSU grants vested. During the nine months ended September 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. During the nine months ended September 30, 2012, PVRSU grants totaling 57,176 units were terminated in accordance with an amended and restated employment agreement.

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A summary of stock-based award activity as of September 30, 2013 and changes during the nine 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		223,045	37.65	58,902	36.76
Performance based leveraging [(1)]	—	—		—	—	9,192	32.60
Exercised/Vested	(263,073)	25.38		(227,890)	33.94	(39,816)	32.60
Expired	(75,473)	36.99		—	—	—	—
Forfeited	—	—		(27,953)	35.30	—	—
Outstanding at September 30, 2013	1,768,901	$26.46	3.2 years	573,749	$36.61	198,394	$36.37
Options exercisable at September 30, 2013	1,265,481	$24.70	2.4 years				

[(1)]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 nine months ended September 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 nine months ended September 30, 2013 and 2012:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2013	2012	2013	2012
Stock options	$0.3	$0.5	$1.3	$1.6
Restricted stock	2.1	1.8	5.7	5.7
Performance vested restricted stock units	0.5	0.8	1.7	1.3
Total	$2.9	$3.1	$8.7	$8.6
Income tax benefits	$1.1	$1.1	$3.2	$3.2

Dividends

The Company currently pays a quarterly dividend on its common stock 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 nine months ended September 30, 2013, the Company declared dividends totaling $0.185 and $0.56 per share or approximately $10.8 million and $32.3 million in the aggregate, respectively.

In addition, during the nine months ended September 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 units were paid during the three months ended September 30, 2013. No dividends on performance vested restricted units were paid during the three and nine months ended September 30, 2012.

During the three and nine months ended September 30, 2012, the Company declared regular quarterly cash dividends totaling $0.185 and $0.56 per share or approximately $10.7 million and $32.1 million in the aggregate, respectively. In addition, during the three and nine months ended September 30, 2012, the Company's board of directors declared a

special cash dividend to common shareholders in the amount of $10.41 per share or approximately $600.7 million.

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Share Repurchases and Redemptions

No shares of common stock were purchased by the Company under the share repurchase program during the three and nine months ended September 30, 2013 and no shares of common stock were repurchased under the program during the three months ended September 30, 2012. During the nine months ended September 30, 2012, the Company purchased 0.5 million shares of common stock under the share repurchase program at a total cost of $19.9 million. During the three and nine months ended September 30, 2013, the Company redeemed 795 and 98,182 shares of common stock at a total cost of approximately $32 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 nine months ended September 30, 2012, the Company redeemed 1,525 and 64,037 shares of common stock at a total cost of approximately $0.1 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:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands, except per share amounts)	2013	2012	2013	2012
Computation of Basic Earnings Per Share:				
Net income	$41,512	$44,377	$85,269	$96,236
Income allocated to participating securities	(404)	(470)	(851)	(1,016)
Net income available to common shareholders	$41,108	$43,907	$84,418	$95,220
Weighted average common shares outstanding – basic	57,978	57,388	57,884	57,455
Basic earnings per share	$0.71	$0.77	$1.46	$1.66
Computation of Diluted Earnings Per Share:				
Net income	$41,512	$44,377	$85,269	$96,236
Income allocated to participating securities	(402)	(493)	(848)	(1,032)
Net income available to common shareholders	$41,110	$43,884	$84,421	$95,204
Weighted average common shares outstanding – basic	57,978	57,388	57,884	57,455
Diluted effect of stock options and PVRSUs	394	225	383	157
Weighted average shares outstanding – diluted	58,372	57,613	58,267	57,612
Diluted earnings per share	$0.70	$0.76	$1.45	$1.65

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 September 30, 2013 and 2012, the Company had 1.8 million and 2.1 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 nine month periods ended September 30, 2013, the Company did not exclude any anti-dilutive stock options from the diluted earnings per share calculation. For each the three and nine month periods ended September 30, 2012, the Company excluded 0.3 million of anti-dilutive stock options from the diluted earnings per share calculation. PVRSUs are also included in the diluted earnings per share calculation when the performance conditions have been met at the reporting date. However, at September 30, 2013 and 2012, PVRSUs totaling 198,394 and 152,639, 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 nine months ended September 30, 2012 and condensed consolidating statement of cash flows for the nine months ended September 30, 2012. The revisions to the condensed consolidating statement of income decreased the Guarantor's marketing and reservation expense and total operating expenses by $0.8 million and $3.0 million for the three and nine months ended September 30, 2012, respectively. The revisions also increased the Guarantor's interest expense and total other income and expenses, net by $0.8 million and $3.0 million for the three and nine months ended September 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 nine months ended September 30, 2012.

	For the Three Months Ended September 30, 2012 (in thousands)			For the Nine Months Ended September 30, 2012		
	As Previously Reported	Adjustment	As Revised	As Previously Reported	Adjustment	As Revised
Marketing and reservation expense	$89,498	$(843)	$88,655	$244,861	$(2,954)	$241,907
Total operating expenses	111,041	(843)	110,198	314,261	(2,954)	311,307
Operating income (loss)	(2,470)	843	(1,627)	5,812	2,954	8,766
Interest expense	(839)	843	4	(2,914)	2,954	40
Total other income and expenses, net	(1,350)	843	(507)	(5,051)	2,954	(2,097)

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The condensed consolidating statements of cash flows for the nine months ended September 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 $9.7 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 $9.7 million for the nine months ended September 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 $2.9 million for the nine months ended September 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 nine months ended September 30, 2012:

	For the Nine Months Ended September 30, 2012					
	Guarantor			Non-Guarantor		
	(in thousands)					
	As Previously Reported	Adjustment	As Revised	As Previously Reported	Adjustment	As Revised
Net cash provided (used) by operating activities	$(1,928)	$6,869	$4,941	$36,131	$(9,721)	$26,410
Investing Activities:						
Issuance of mezzanine and other notes receivable	(3,068)	3,068	—	—	—	—
Collection of mezzanine and other notes receivable	216	(216)	—	—	—	—
Advances to and investments in affiliates	—	(9,721)	(9,721)	—	—	—
Net cash provided (used) in investing activities	1,649	(6,869)	(5,220)	(9,636)	—	(9,636)
Financing Activities:						
Proceeds from contributions from affiliates	—	—	—	—	9,721	9,721
Net cash provided (used) by financing activities	122	—	122	(14)	9,721	9,707

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 September 30, 2013
(Unaudited, in Thousands)

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
REVENUES:					
Royalty fees	$76,645	$25,161	$11,279	$(29,978)	$83,107
Initial franchise and relicensing fees	4,419	—	231	—	4,650
Procurement services	4,375	—	333	—	4,708
Marketing and reservation	114,117	96,626	5,577	(90,024)	126,296
Other items, net	2,778	1,310	313	—	4,401
Total revenues	202,334	123,097	17,733	(120,002)	223,162
OPERATING EXPENSES:					
Selling, general and administrative	30,619	22,867	3,474	(29,978)	26,982
Marketing and reservation	119,002	92,747	4,571	(90,024)	126,296
Other items, net	828	2,285	222		