

CHOICE HOTELS INTERNATIONAL INC /DE
Form 10-Q
August 11, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED June 30, 2014
OR
 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 (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)

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 OUTSTANDING AT JUNE 30, 2014
Common Stock, Par Value \$0.01 per share	58,433,234

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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,	
	2014	2013	2014	2013
REVENUES:		(Restated)		(Restated)
Royalty fees	\$77,670	\$72,638	\$136,210	\$128,746
Initial franchise and relicensing fees	4,722	4,416	8,462	8,193
Procurement services	8,020	7,546	12,798	11,496
Marketing and reservation	103,766	104,072	193,372	186,395
Other	3,486	2,258	6,558	4,271
Total revenues	197,664	190,930	357,400	339,101
OPERATING EXPENSES:				
Selling, general and administrative	31,413	29,731	58,093	56,399
Depreciation and amortization	2,332	2,388	4,610	4,429
Marketing and reservation	103,766	104,072	193,372	186,395
Total operating expenses	137,511	136,191	256,075	247,223
Operating income	60,153	54,739	101,325	91,878
OTHER INCOME AND EXPENSES, NET:				
Interest expense	10,710	10,807	20,881	21,577
Interest income	(347)	(659)	(850)	(1,303)
Other (gains) and losses	(474)	147	(533)	(563)
Equity in net (income) loss of affiliates	30	(60)	65	81
Total other income and expenses, net	9,919	10,235	19,563	19,792
Income from continuing operations before income taxes	50,234	44,504	81,762	72,086
Income taxes	14,955	12,880	25,014	20,686
Income from continuing operations, net of income taxes	35,279	31,624	56,748	51,400
Income from discontinued operations, net of income taxes	121	183	1,762	150
Net income	\$35,400	\$31,807	\$58,510	\$51,550
Basic earnings per share				
Continuing operations	\$0.61	\$0.54	\$0.97	\$0.88
Discontinued operations	—	—	0.03	—
	\$0.61	\$0.54	\$1.00	\$0.88
Diluted earnings per share				
Continuing operations	\$0.60	\$0.54	\$0.96	\$0.88
Discontinued operations	—	—	0.03	—
	\$0.60	\$0.54	\$0.99	\$0.88

Cash dividends declared per share	\$0.185	\$0.185	\$0.37	\$0.37
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The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED, IN THOUSANDS)

	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2014	2013	2014	2013
Net income	\$35,400	\$31,807	\$58,510	\$51,550
Other comprehensive income (loss), net of tax:		(Restated)		(Restated)
Amortization of loss on cash flow hedge	216	216	431	431
Foreign currency translation adjustment	509	(2,082	) 1,030	(2,327
Other comprehensive income (loss), net of tax	725	(1,866	) 1,461	(1,896
Comprehensive income	\$36,125	\$29,941	\$59,971	\$49,654

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, 2014	December 31, 2013
ASSETS		
Current assets		
Cash and cash equivalents	\$211,542	\$167,795
Receivables (net of allowance for doubtful accounts of \$13,188 and \$12,187, respectively)	119,763	82,385
Deferred income taxes	29,733	26,684
Investments, employee benefit plans, at fair value	176	400
Other current assets	23,789	29,710
Total current assets	385,003	306,974
Property and equipment, at cost, net	58,238	67,852
Goodwill	65,813	65,813
Franchise rights and other identifiable intangibles, net	8,389	9,953
Advances, marketing and reservation activities	—	5,844
Notes receivable, net of allowances	34,492	31,872
Investments, employee benefit plans, at fair value	17,270	15,950
Deferred income taxes	1,121	—
Other assets	58,116	52,164
Total assets	\$628,442	\$556,422
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	\$50,892	\$41,663
Accrued expenses	52,398	56,625
Deferred revenue	67,365	61,188
Current portion of long-term debt	11,970	10,088
Deferred compensation and retirement plan obligations	579	2,492
Income taxes payable	17,459	2,282
Total current liabilities	200,663	174,338
Long-term debt	777,536	783,471
Deferred compensation and retirement plan obligations	23,260	22,527
Deferred income taxes	—	5,149
Other liabilities	39,493	23,808
Total liabilities	1,040,952	1,009,293
Commitments and Contingencies		
Common stock, \$0.01 par value, 160,000,000 shares authorized; 95,065,638 shares issued at June 30, 2014 and December 31, 2013 and 58,433,234 and 58,638,863 shares outstanding at June 30, 2014 and December 31, 2013, respectively	584	586
Additional paid-in-capital	118,976	117,768
Accumulated other comprehensive loss	(4,756	) (6,217)
Treasury stock (36,632,404 and 36,426,775 shares at June 30, 2014 and December 31, 2013, respectively), at cost	(916,893	) (918,031)
Retained earnings	389,579	353,023
Total shareholders' deficit	(412,510	) (452,871)
Total liabilities and shareholders' deficit	\$628,442	\$556,422

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	
	2014	2013
		(Restated)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$58,510	\$51,550
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,610	4,695
Gain on sale of assets	(2,849)) —
Provision for bad debts, net	1,383	1,753
Non-cash stock compensation and other charges	4,711	5,566
Non-cash interest and other (income) loss	719	967
Deferred income taxes	(9,273)	) 8,236
Dividends received from equity method investments	546	535
Equity in net loss of affiliates	65	81
Changes in assets and liabilities:		
Receivables	(39,518)	) (40,349)
Advances to/from marketing and reservation activities, net	31,522	5,631
Forgivable notes receivable, net	(6,692)	) (3,595)
Accounts payable	8,316	9,893
Accrued expenses	(5,247)	) (18,463)
Income taxes payable/receivable	15,198	1,198
Deferred revenue	6,231	(3,318)
Other assets	(1,102)	) (1,664)
Other liabilities	(1,298)	) 7,271
Net cash provided by operating activities	65,832	29,987
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment in property and equipment	(7,314)	) (22,035)
Proceeds from sales of assets	12,216	—
Equity method investments	(6,946)	) (1,851)
Purchases of investments, employee benefit plans	(1,220)	) (1,580)
Proceeds from sales of investments, employee benefit plans	641	3,934
Issuance of mezzanine and other notes receivable	(2,223)) —
Collections of mezzanine and other notes receivable	9,743	201
Other items, net	(296)	) (304)
Net cash provided (used) in investing activities	4,601	(21,635)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings pursuant to revolving credit facility	—	15,200
Principal payments on long-term debt	(4,112)	) (4,095)
Proceeds from the issuance of long-term debt	26	—
Purchases of treasury stock	(4,544)	) (3,651)
Dividends paid	(21,957)	) (11,261)
Excess tax benefits from stock-based compensation	1,319	1,146
Proceeds from exercise of stock options	1,547	5,973
Net cash provided (used) by financing activities	(27,721)) 3,312
Net change in cash and cash equivalents	42,712	11,664

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Effect of foreign exchange rate changes on cash and cash equivalents	1,035	(2,051)
Cash and cash equivalents at beginning of period	167,795	134,177	
Cash and cash equivalents at end of period	\$211,542	\$143,790	
Supplemental disclosure of cash flow information:			
Cash payments during the period for:			
Income taxes, net of refunds	\$19,594	\$11,652	
Interest	\$20,595	\$22,033	
Non-cash investing and financing activities:			
Dividends declared but not paid	\$10,810	\$10,766	
Issuance of common stock pursuant to share based compensation plans	\$8,024	\$9,395	
Investment in property and equipment acquired in accounts payable	\$688	\$6,096	
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 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, 2013 and notes thereto included in the Company's Form 10-K, filed with the SEC on March 3, 2014 (the "10-K") as well as the information provided below under the heading "Revision to Prior Annual Financial Statements and Restatement of Prior Interim Financial Statements". The Company intends to amend its 10-K as soon as administratively practical to revise its previously issued audited financial statements and amend its report on internal control over financial reporting. 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 Annual Financial Statements and Restatement of Prior Interim Financial Statements

In connection with the preparation of the consolidated financial statements for the second quarter of 2014, the Company reviewed its accounting policies and practices, including the historical practice of reporting royalty and certain marketing and reservation fees one month in arrears as compared to when the gross room revenues (on which the fees are based) are earned by the Company's franchisees. The Company previously determined that the impact of the revenue recognition timing related to these revenues on its annual financial statements was not material and therefore reported these revenues one month in arrears despite the fact that these fees meet the definition of being earned and realizable in the same period that the underlying gross room revenues are earned by its franchisees. However, during the current period, the Company reassessed the impact of reporting these revenues one month in arrears on interim periods and determined that this revenue recognition practice, which was not in accordance with GAAP, was material to interim periods due to the seasonality of the Company's business. As a result, the Company has corrected its revenue recognition method to recognize royalty and certain marketing and reservation system fees as revenue in the same period as the gross room revenues are earned by its franchisees.

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 restatement of revenues was not material to any of its previously issued annual financial statements but was material to certain interim periods. 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 restate its previously issued interim financial statements for the periods ended March 31, 2014 and 2013 and September 30, 2013 and 2012 through the filing of amended quarterly filings on Form 10-Q and has restated the interim financial periods for June 30, 2013 in this interim financial report. In addition, the Company will revise its previously issued audited financial statements for the years ended December 31, 2011, 2012, and 2013 to correct the presentation of revenues and amend its report on internal control over financial reporting.

The following tables present the effect of this and other immaterial errors for the financial statement line items impacted in the affected periods included within this interim financial report. In addition, these amounts have been adjusted to reflect the Company's discontinued operations reported in the first quarter of 2014.

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Consolidated Statements of Income

	Three Months Ended June 30, 2013				Six Months Ended June 30, 2013			
	As Previously Reported	Discontinued Operations	Adjustment	As Restated	As Previously Reported	Discontinued Operations	Adjustment	As Restated
	(in thousands, except per share amounts)							
Royalty fees	\$68,379	\$—	\$4,259	\$72,638	\$118,115	\$—	\$10,631	\$128,746
Marketing and reservation revenues	99,645	—	4,427	104,072	176,085	—	10,310	186,395
Hotel operations	1,334	(1,334)	) —	—	2,290	(2,290)) —	—
Total revenues	183,578	(1,334)	) 8,686	190,930	320,450	(2,290)	) 20,941	339,101
Selling, general and administrative	30,180	—	(449)	) 29,731	57,096	—	(697)	) 56,399
Depreciation and amortization	2,520	(132)	) —	2,388	4,695	(266)	) —	4,429
Marketing and reservation expenses	99,645	—	4,427	104,072	176,085	—	10,310	186,395
Hotel operations	911	(911)	) —	—	1,786	(1,786)) —	—
Total operating expenses	133,256	(1,043)	) 3,978	136,191	239,662	(2,052)	) 9,613	247,223
Operating income	50,322	(291)	) 4,708	54,739	80,788	(238)	) 11,328	91,878
Income from continuing operations before income taxes	40,087	(291)	) 4,708	44,504	60,996	(238)	) 11,328	72,086
Income taxes	11,853	(108)	) 1,135	12,880	17,239	(88)	) 3,535	20,686
Income from continuing operations, net of income taxes	28,234	(183)	) 3,573	31,624	43,757	(150)	) 7,793	51,400
Basic earnings per share, continuing operations	\$0.48	\$—	\$0.06	\$0.54	\$0.75	\$—	\$0.13	\$0.88
Diluted earnings per share, continuing operations	\$0.48	\$—	\$0.06	\$0.54	\$0.74	\$—	\$0.14	\$0.88

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	Six Months Ended June 30, 2013		
	As		As
	Previously	Adjustment	As
	Reported		Restated
Consolidated Statement of Cash Flows	(in thousands)		
Net income	\$43,757	\$7,793	\$51,550
Provision for bad debts, net	1,420	333	1,753
Non-cash stock compensation and other charges	5,581	(15	) 5,566
Deferred income taxes	4,169	4,067	8,236
Change in assets and liabilities			
Receivables	(21,156	) (19,193	) (40,349)
Advances to/from marketing and reservation activities, net	(2,945	) 8,576	5,631
Income taxes payable/receivable	1,729	(531	) 1,198
Net cash provided by operating activities	28,957	1,030	29,987
Investment in property and equipment	(21,005	) (1,030	) (22,035)
Net cash used in investing activities	(20,605	) (1,030	) (21,635)

	As of December 31, 2013		
	As		As
	Previously	Adjustment	Revised
	Reported		As
Consolidated Balance Sheet	(in thousands)		
Receivables	\$53,521	\$28,864	\$82,385
Deferred income taxes	7,220	19,464	26,684
Total current assets	258,646	48,328	306,974
Property and equipment, at cost, net	66,092	1,760	67,852
Advances, marketing and reservation activities	19,127	(13,283	) 5,844
Deferred income taxes	20,282	(20,282) —
Total assets	539,899	16,523	556,422
Deferred income taxes	—	5,149	5,149
Total liabilities	1,004,144	5,149	1,009,293
Retained earnings	341,649	11,374	353,023
Total shareholders' deficit	(464,245	) 11,374	(452,871)

The following tables present the effect of this and other immaterial errors for the financial statement line items impacted in the Company's quarterly reports on Form 10-Q which will be amended for the interim periods ended March 31, 2014 and September 30, 2013 and corresponding prior year periods. These amended reports will be filed with the SEC as soon as administratively possible. In addition, these amounts have been adjusted to reflect the Company's discontinued operations reported in the first quarter of 2014.

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Consolidated Statements of Income

	Three Months Ended March 31, 2014			Three Months Ended March 31, 2013		
	As Previously Reported	Adjustment	As Restated	As Previously Reported	Adjustment	As Restated
	(in thousands, except per share amounts)					
Royalty fees	\$51,681	\$6,859	\$58,540	\$49,736	\$6,372	\$56,108
Marketing and reservation revenues	84,012	5,594	89,606	76,440	5,883	82,323
Total revenues	147,283	12,453	159,736	135,916	12,255	148,171
Selling, general and administrative	26,463	217	26,680	26,916	(248)	26,668
Depreciation and amortization	2,122	156	2,278	2,041	—	2,041
Marketing and reservation expenses	84,012	5,594	89,606	76,440	5,883	82,323
Total operating expenses	112,597	5,967	118,564	105,397	5,635	111,032
Operating income	34,686	6,486	41,172	30,519	6,620	37,139
Income from continuing operations before income taxes	25,042	6,486	31,528	20,962	6,620	27,582
Income taxes	7,711	2,348	10,059	5,406	2,400	7,806
Income from continuing operations, net of income taxes	17,331	4,138	21,469	15,556	4,220	19,776
Basic earnings per share, continuing operations	\$0.30	\$0.07	\$0.37	\$0.27	\$0.07	\$0.34
Diluted earnings per share, continuing operations	\$0.29	\$0.07	\$0.36	\$0.26	\$0.08	\$0.34
	Three Months Ended March 31, 2014			Three Months Ended March 31, 2013		
Consolidated Statements of Cash Flow	As Previously Reported	Adjustment	As Restated	As Previously Reported	Adjustment	As Restated
	(in thousands)					
Net cash provided by operating activities	\$5,264	\$—	\$5,264	\$145	\$450	\$595
Investment in property and equipment	(3,015)	—	(3,015)	(13,645)	(450)	(14,095)
Net cash provided (used) by investing activities	1,027	—	1,027	(12,087)	(450)	(12,537)

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	As of March 31, 2014							
	As Previously Reported	Adjustment	As Restated					
	(in thousands)							
Consolidated Balance Sheet								
Receivables	\$59,241	\$40,906	\$100,147					
Deferred income taxes	7,220	21,202	28,422					
Total current assets	277,714	62,108	339,822					
Property and equipment, at cost, net	56,664	1,604	58,268					
Advances, marketing and reservation activities	18,856	(18,696)	) 160					
Deferred income taxes	20,321	(20,321)) —					
Total assets	554,900	24,695	579,595					
Deferred income taxes	—	9,196	9,196					
Total liabilities	1,009,533	9,196	1,018,729					
Retained earnings	349,458	15,511	364,969					
Total shareholders' deficit	(454,633)	) 15,499	(439,134))			
Consolidated Statements of Income								
	Three Months Ended September 30, 2013				Nine Months Ended September 30, 2013			
	As Previously Reported	Discontinued Operations	Adjustment	As Restated	As Previously Reported	Discontinued Operations	Adjustment	As Restated
	(in thousands, except per share amounts)							
Royalty fees	\$83,107	\$—	\$(3,647)	) \$79,460	\$201,222	\$—	\$6,984	\$208,206
Marketing and reservation revenues	126,296	—	(1,487)	) 124,809	302,381	—	8,823	311,204
Hotel operations	1,310	(1,310)	) —	—	3,600	(3,600)) —	—
Total revenues	223,162	(1,310)	) (5,134)	) 216,718	543,612	(3,600)	) 15,807	555,819
Selling, general and administrative	26,982	—	(573)	) 26,409	84,078	—	(1,270)	) 82,808
Depreciation and amortization	2,379	(127)	) 20	2,272	7,074	(393)	) 20	6,701
Marketing and reservation expenses	126,296	—	(1,487)	) 124,809	302,381	—	8,823	311,204
Hotel operations	956	(956)	) —	—	2,742	(2,742)) —	—
Total operating expenses	156,613	(1,083)	) (2,040)	) 153,490	396,275	(3,135)	) 7,573	400,713
Operating income	66,549	(227)	) (3,094)	) 63,228	147,337	(465)	) 8,234	155,106
Income from continuing operations before income taxes	57,592	(227)	) (3,094)	) 54,271	118,588	(465)	) 8,234	126,357
Income taxes	16,080	(84)	) (298)	) 15,698	33,319	(172)	) 3,237	36,384
Income from continuing	41,512	(143)	) (2,796)	) 38,573	85,269	(293)	) 4,997	89,973

operations, net of
income taxes

Basic earnings per share, continuing operations	\$0.71	\$—	\$(0.05)	) \$0.66	\$1.46	\$—	\$0.08	\$1.54
Diluted earnings per share, continuing operations	\$0.70	(0.01) \$(0.04) \$0.65	\$1.45	\$—	\$0.08	\$1.53

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	Three Months Ended September 30, 2012				Nine Months Ended September 30, 2012			
	As Previously Filed	Discontinued Operations	Adjustment	As Restated	As Previously Filed	Discontinued Operations	Adjustment	As Restated
	(in thousands, except per share amounts)							
Royalty fees	\$80,845	\$—	\$(2,807)	\$78,038	\$194,762	\$—	\$8,225	\$202,987
Marketing and reservation revenues	119,062	—	(1,097)	117,965	284,624	—	9,721	294,345
Hotel operations	1,238	(1,238)	—	—	3,440	(3,440)	—	—
Total revenues	210,413	(1,238)	(3,904)	205,271	513,203	(3,440)	17,946	527,709
Selling, general and administrative	23,170	—	(98)	23,072	72,073	—	249	72,322
Depreciation and amortization	1,995	(135)	—	1,860	5,989	(401)	—	5,588
Marketing and reservation expenses	119,062	—	(1,097)	117,965	284,624	—	9,721	294,345
Hotel operations	933	(933)	—	—	2,609	(2,609)	—	—
Total operating expenses	145,160	(1,068)	(1,195)	142,897	365,295	(3,010)	9,970	372,255
Operating income	65,253	(170)	(2,709)	62,374	147,908	(430)		