CONSUMER PORTFOLIO SERVICES INC
Form S-1/A
December 08, 2010

As filed with the Securities and Exchange Commission on December 7, 2010 Reg. No. 333-168976

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Amendment No. 4 to FORM S-1

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

CONSUMER PORTFOLIO SERVICES, INC.
(Exact name of registrant as specified in its charter)

California (State or other jurisdiction of incorporation or organization)	33-0459135 (I.R.S. Employer Identification Number)

19500 Jamboree Road Irvine, California 92612 (949) 753-6800 Fax (949) 753-6897 (Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)	Charles Bradley, Jr. Chief Executive Officer 19500 Jamboree Road Irvine, California 92612 (949) 753-6800 (Name, address, including zip code, and telephone number, including area code, of agent for service)	With a copy to: Mark Harris, Esq. Andrews Kurth LLP 1717 Main Street, Suite 3700 Dallas, Texas 75201 Telephone: (214) 659-4400 Fax: (214) 659-4401

Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. [x]

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ]

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ]

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ]

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 [ ]　　Accelerated filer [ ]
Non-accelerated filer [ ]　　Smaller reporting company [X]

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to Be Registered	Amount to be Registered	Proposed Maximum Offering Price Per Unit	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee
Renewable Unsecured Subordinated Notes	$ 44 ,000,000	(1)	$ 44,000,000	$ 3565.00 (2)

(1) The Renewable Unsecured Subordinated Notes will be issued in denominations selected by the purchasers in any amount equal to or exceeding $1,000.
(2) A registration fee in the amount of $3565.00 was paid concurrently with the initial filing of this registration statement on August 20, 2010.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

$ 44,000,000
Consumer Portfolio Services, Inc.

Three and Six Month Renewable Unsecured Subordinated Notes

One, Two, Three, Four, Five and Ten Year Renewable Unsecured Subordinated Notes

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We are offering an aggregate principal amount of up to $ 44,000,000 of our renewable unsecured subordinated notes to new purchasers and existing noteholders. As of the date of this prospectus, we are offering the notes with maturities ranging from three months to ten years. However, depending on our capital needs, notes with certain terms may not always be offered. We will establish interest rates on the securities offered in this prospectus from time to time in interest rate supplements to this prospectus. Our filing such an interest rate supplement will not affect the interest rates applicable to any notes previously sold.

The notes are unsecured obligations and your right to payment is subordinated in right of payment to substantially all of our existing and future indebtedness, other than our issued and outstanding renewable unsecured subordinated notes, each of which is pari passu in right of payment with the notes offered hereby. Upon maturity, your notes will be automatically renewed for the same term as your maturing notes. The interest rate will be what we are then offering to other investors with similar aggregate note portfolios for notes of the same term, as specified in the most recently filed interest rate supplement, unless we elect not to have your notes renewed or unless you notify us within 15 days after the maturity date for your notes that you want your notes repaid. If notes of the same term are not then being offered, the interest rate upon renewal will be the rate specified by us on or before maturity or, if no such rate is specified, the rate of the existing note. The interest rate on your renewed note may differ from the interest rate applicable to your note during the prior term. After giving you thirty days' advance notice, we may redeem all or a portion of your notes for their original principal amount plus accrued and unpaid interest. You also may request us to repurchase your notes prior to maturity; however, unless the request is due to your death or total permanent disability, we are currently prohibited by contract from making any such repurchases. See "Description Of The Notes - Redemption or Repurchase Prior To Stated Maturity - Repurchase At Request of Holder."

We will market and sell the notes directly to the public. The notes will not be listed on any securities exchange or quoted on Nasdaq or any over-the-counter market. We do not intend to make a market in the notes and we do not anticipate that a market in the notes will develop. There will be significant restrictions on your ability to transfer or resell the notes. We have not requested a rating for the notes; however, third parties may independently rate them.

The notes are not certificates of deposit or similar obligations of, and are not guaranteed or insured by, any depository institution, the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation or any other governmental or private fund or entity. Investing in the notes involves risks, which are described in "Risk Factors" beginning on page 6 of this prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Note	Total
Public offering price	100.00%	100.00%
Selling agent commissions	none	none
Proceeds to CPS, before expenses	100.00%	100.00%

See “Plan of Distribution” for a description of anticipated expenses to be incurred in connection with our offering and selling the notes. There will be no underwriting discount. We are not required to sell any specific number or dollar amount of notes in order to accept subscriptions.

We will issue the notes in book-entry or uncertificated form. Subject to certain limited exceptions, you will not receive a certificated security or a negotiable instrument that evidences your notes. We will deliver written confirmations to purchasers of the notes. Wells Fargo Bank, National Association, Minneapolis, Minnesota, will act as trustee for the notes.

The date of this Prospectus is __________, 2010

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PROSPECTUS SUMMARY

This summary highlights selected information from this prospectus and from our reports filed with the SEC, and may not contain all the information that may be important to you. You should read the entire prospectus and the other information that is incorporated by reference into this prospectus before making an investment decision. Certain industry terms that we use are defined in the glossary, which begins on page 35.

CPS

We are a specialty finance company. Our business is to purchase and service retail automobile contracts originated primarily by franchised automobile dealers and, to a lesser extent, by select independent dealers in the United States in the sale of new and used automobiles, light trucks and passenger vans. Through our automobile contract purchases, we provide indirect financing to the customers of dealers who have limited credit histories, low incomes or past credit problems, who we refer to as sub-prime customers. We serve as an alternative source of financing for dealers, facilitating sales to customers who otherwise might not be able to obtain financing from traditional sources, such as commercial banks, credit unions and the captive finance companies affiliated with major automobile manufacturers. In addition to purchasing installment purchase contracts directly from dealers, we have also (i) acquired installment purchase contracts in three merger and acquisition transactions, (ii) purchased immaterial amounts of vehicle purchase money loans from non-affiliated lenders, and (iii) directly originated an immaterial amount of vehicle purchase money loans by lending money directly to consumers. In this report, we refer to all of such contracts and loans as "automobile contracts."

We were incorporated and began our operations in March 1991. From inception through December 31, 2009, we have purchased a total of approximately $8.7 billion of automobile contracts from dealers. In addition, we obtained a total of approximately $605.0 million of automobile contracts in mergers and acquisitions in 2002, 2003 and 2004. In 2004 and 2009, we were appointed as a third-party servicer for certain portfolios of automobile receivables originated and owned by entities not affiliated with us. During 2008, 2009 and 2010, unlike recent prior years, our managed portfolio decreased from the previous year due to our strategy of decreasing automobile contract purchases to conserve our liquidity in response to adverse economic conditions, as discussed further below in “Risk Factors - We Need Substantial Liquidity to Operate Our Business. Our total managed portfolio was approximately $1,194.7 million at December 31, 2009 compared to $1,664.1 million at December 31, 2008, $2,162.2 million as of December 31, 2007 and $1,565.9 million as of December 31, 2006. Our total managed portfolio was approximately $843.0 million at September 30, 2010, compared to $1197.3 million at September 30, 2009.

We have incurred net losses every quarter subsequent to the quarter ended June 30, 2008. We have been adversely affected by the economic recession affecting the United States as a whole, by increased financing costs and decreased availability of capital to fund our purchases of automobile contracts, and by a decrease in the overall level of sales of automobiles and light trucks. We expect to return to profitability at some time within the calendar year 2011; however, there can be no assurance as to that expectation. Our expectation of profitability is a forward-looking statement. We identify important factors that could cause actual results to differ, generally in the “Risk Factors” section of this prospectus, and more specifically under the caption “Forward-Looking Statements.”

We purchase automobile contracts with the intention of placing them into securitizations. Securitizations are transactions in which we sell a specified pool of automobile contracts to a special purpose entity of ours, which in turn issues asset-backed securities to fund the purchase of the pool of automobile contracts from us. Depending on the structure of the securitization, the transaction may be properly accounted for as a sale of the automobile contracts or as a secured financing. Since September 2003, we have structured our securitization transactions to be reflected as secured financings for financial accounting purposes, except that in September 2008, we securitized $198.7 million of our automobile contracts in a structure that is treated as a sale of the receivables for financial accounting purposes.

We are headquartered in Irvine, California, where most operational and administrative functions are centralized. All credit and underwriting functions are performed in our California headquarters, and we service our automobile contracts from our California headquarters and from three servicing branches in Virginia, Florida and Illinois. Our principal executive offices are located at 19500 Jamboree Road, Irvine, California 92612, and our telephone number is (949) 753-6800.

The Offering

Issuer	Consumer Portfolio Services, Inc.
Trustee	Wells Fargo Bank, National Association
Selling Agent	None
Paying Agent	Wells Fargo Bank, National Association
Securities Offered	Renewable Unsecured Subordinated Notes. The notes represent our unsecured promise to repay principal at maturity and to pay interest during the term or at maturity. By purchasing a note, you are lending money to us without any collateral security.
Method of Purchase	Prior to your purchase of notes, you will be required to complete a subscription agreement that will set forth the principal amount of your purchase, the term of the notes and certain other information regarding your ownership of the notes. The form of subscription agreement is filed as an exhibit to the registration statement of which this prospectus is a part. We will mail you written confirmation that your subscription has been accepted.
Denomination	You may choose the denomination of the notes you purchase in any principal amount of $1,000 or more, including odd amounts.
Offering Price	100% of the principal amount per note.
Rescission Right	You may rescind your investment within five business days of the postmark date of your purchase confirmation without incurring an early redemption penalty. In addition, if your subscription agreement is accepted at a time when we have determined that a post-effective amendment to the registration statement of which this prospectus is a part must be filed with the Securities and Exchange Commission, but such post-effective amendment has not yet been declared effective, you will be able to rescind your investment subject to the conditions set forth in this prospectus. See “Description of the Notes — Rescission Right” for additional information.
Maturity	You may generally choose maturities for your notes of 3 or 6 months or 1, 2, 3, 4, 5 or 10 years; however, depending on our capital requirements, we may not sell notes of all maturities at all times.
Interest Rate	The interest rate of the notes will be established at the time you purchase them, or at the time of renewal, based upon the rates we

	are offering in our latest interest rate supplement to this prospectus, and will remain fixed throughout each term. We may offer higher rates of interest to investors with larger aggregate note portfolios, as set forth in the then current interest rate supplement.
Interest Payment Dates	You may choose to receive interest payments monthly, quarterly, semiannually, annually or at maturity. If you choose to receive interest payments monthly, you may choose the day on which you will be paid. Subject to our approval, you may change the interest payment schedule or interest payment date once during each term of your notes.
Principal Payment	We will not pay principal over the term of the notes. We are obligated to pay the entire principal balance of the outstanding notes upon maturity.
Payment Method	Principal and interest payments will be made by direct deposit to the account you designate in your subscription documents.

Renewal or Redemption at Maturity	Upon maturity, the notes will be automatically renewed for the same term at the interest rate we are offering at that time to other investors with similar aggregate note portfolios for notes of the same maturity, unless we notify you prior to the maturity date that we intend to repay the notes. You may also notify us within 15 days after the maturity date that you want your notes repaid. This 15 day period will be automatically extended if you would otherwise be required to make the repayment election at a time when we have determined that a post-effective amendment to the registration statement of which this prospectus is a part must be filed with the Securities and Exchange Commission, but such post-effective amendment has not yet been declared effective. If notes with similar terms are not being offered at the time of renewal, the interest rate upon renewal will be (a) the rate specified by us on or before the maturity date or (b) if no such rate is specified, the rate of your existing notes. The interest rate being offered upon renewal may, however, differ from the interest rate applicable to your notes during the prior term. See "Description of the Notes — Renewal or Redemption on Maturity."
Optional Redemption or Repurchase	After giving you 30 days' prior notice, we may redeem some or all of your notes at a price equal to their original principal amount plus accrued but unpaid interest. You may request us to repurchase your notes prior to maturity; however, unless the request is due to your death or total permanent disability, we are currently prohibited by contract from making any such repurchases. See "Description of Notes — Redemption or Repurchase Prior To Stated Maturity- Repurchase At Request of Holder."
Consolidation, Merger or Sale	Upon any consolidation, merger or sale of our company, we will either redeem all of the notes or our successor will be required to assume our obligations to pay principal and interest on the notes pursuant to the indenture for the notes. For a description of these provisions see "Description of the Notes - Consolidation, Merger or Sale."
Ranking; No Security	The notes: • are unsecured; • rank junior to our existing and future secured debt, including the debt of our special purpose entities; • rank junior to our existing and future senior unsecured debt, including debt we may incur under our existing and future credit

facilities; and

• rank pari passu to our issued and outstanding renewable unsecured subordinated notes.

As of September 30, 2010, we had approximately $743.7 million of debt outstanding that is senior to the notes, of which approximately $716.7 million was issued by our consolidated special purpose entities. Including an additional approximately $90.5 million of debt that does not appear on our consolidated financial statements (which was issued by our off-balance sheet special purpose entities), we had approximately $855.5 million of debt outstanding that is senior to the notes. See "Capitalization."

Limited Restrictive Covenants	The indenture governing the notes contains very limited restrictive covenants. One of these covenants prohibits us from paying dividends on our capital stock if there is an event of default with respect to the notes or if payment of the dividend would result in an event of default. We are not restricted from entering into qualified sales or financing transactions or incurring additional indebtedness. The covenants set forth in the indenture are more fully described under "Description of Notes — Restrictive Covenants." These covenants have significant exceptions. We do not plan to issue any debt that is subordinate to the notes.
Use of Proceeds	If all the notes are sold, we would expect to receive up to approximately $ 43.5 million of net proceeds from this offering after paying the estimated offering expenses. To the extent that we sell the notes in exchange for outstanding notes, our net proceeds will be correspondingly reduced. The exact amount of net proceeds also may vary considerably depending on how long the notes are offered and other factors. We intend to use the net proceeds to fund the purchase of automobile contracts and for other general corporate purposes, which may include the payment of general and administrative expenses. See "Use of Proceeds."
Absence of Public Market and Restrictions on Transfers	There is no existing market for the notes. We do not anticipate that a secondary market for the notes will develop. We do not intend to apply for listing of the notes on any securities exchange or for quotation of the notes in any automated dealer quotation system, including without limitation the OTC Bulletin Board or any over-the-counter market. You will be able to transfer or pledge the notes only with our prior written consent. See "Description of the Notes - Transfers."
Book Entry	The notes will be issued in book entry or uncertificated form only. Except under limited circumstances, the notes will not be evidenced by certificated securities or negotiable instruments. See "Description of the Notes — Book Entry Registration and Transfers."

INCORPORATION OF CERTAIN INFORMATION BY REFERENCE

The SEC allows us to "incorporate by reference" the information we file with it, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference into this prospectus is an important part of this prospectus. Specifically, we are incorporating by reference the documents listed below:

- Our Annual Report on Form 10-K for the year ended December 31, 2009, including an amendment thereto filed April 30, 2010;

- Our Quarterly Reports on Form 10-Q for the quarters ended March 31, June 30, 2010 and September 30, 2010;

- Our Current Reports on Form 8-K filed with the SEC on April 1, April 7, June 3, June 16, August 30, September 7 and October 1, 2010; and

- Our definitive proxy statement filed August 2, 2010.

You should rely only on the information we include or incorporate by reference in this prospectus and any applicable prospectus supplement. We have not authorized anyone to provide you with information different from that contained or incorporated by reference in this prospectus. The information contained in this prospectus and any applicable prospectus supplement is accurate only as of the date on the front of those documents, regardless of the time of delivery of this prospectus or the applicable prospectus supplement or of any sale of our securities.

Any statement contained in this prospectus or in a document incorporated by reference in this prospectus is deemed to be modified or superseded for purposes of this prospectus to the extent that any of the following modifies or supersedes a statement in this prospectus or incorporated by reference in this prospectus:

- in the case of a statement in a previously filed document incorporated by reference in this prospectus, a statement contained in this prospectus;
- a statement contained in any accompanying prospectus supplement relating to our offering of the notes; or
- a statement contained in any other subsequently filed document that is also incorporated by reference in this prospectus.

Any modified or superseded statement will not be deemed to constitute a part of this prospectus or any accompanying prospectus supplement, except as modified or superseded. Except as provided by the above mentioned exceptions, all information appearing in this prospectus and each accompanying prospectus supplement is qualified in its entirety by the information appearing in the documents incorporated by reference.

We will provide without charge to each person to whom a copy of this prospectus is delivered, including any beneficial owner, upon his or her written or oral request, a copy of any or all of the documents incorporated in this prospectus by reference, other than exhibits to the documents, unless the exhibits are incorporated specifically by reference in the documents. We will provide those documents, including any exhibits that are incorporated by reference into those documents, without cost to the requester. Requests for copies should be directed to:

Consumer Portfolio Services, Inc.
19500 Jamboree Road
Irvine, California 92612
Attention: Corporate Secretary

(949) 753-6800
notesinfo@consumerportfolio.com

You may also obtain copies of any of such reports at our website, free of charge, at http://www.consumerportfolio.com/investorinfo.htm.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and special reports, proxy statements and other information with the SEC. You may read and copy any document we file at the SEC's Public Reference Room at 100 F Street NE, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the Public Reference Room. Our SEC filings are also available to the public at the SEC's web site at http://www.sec.gov, and at our website at http://www.consumerportfolio.com/investorinfo.htm.

We have also filed a registration statement on Form S-1 under the Securities Act with the SEC with respect to the notes offered by this prospectus. This prospectus has been filed as part of that registration statement. This prospectus does not contain all of the information set forth in the registration statement because parts of the registration statement are omitted in accordance with the rules and regulations of the SEC. The registration statement is available for inspection and copying as set forth above.

RISK FACTORS

The risks described below set forth the material risks associated with the purchase of notes and our company. Before you invest in the notes, you should carefully consider these risk factors, as well as the other information regarding the notes and the company contained in this prospectus and in the documents incorporated by reference into this prospectus.

Risk Factors Relating to the Notes

Because of their characteristics, the notes may not be a suitable investment for you.

The notes may not be a suitable investment for you, and we advise you to consult your investment, tax and other professional financial advisors prior to purchasing notes. The characteristics of the notes, including maturity, interest rate and lack of liquidity, may not satisfy your investment objectives. The notes may not be a suitable investment for you based on your ability to withstand a loss of interest or principal or other aspects of your financial situation, including your income, net worth, financial needs, investment risk profile, return objectives, investment experience and other factors. Prior to purchasing any notes, you should consider your investment allocation with respect to the amount of your contemplated investment in the notes in relation to your other investment holdings and the diversity of those holdings.

Because the notes rank junior to substantially all of our existing and future debt and other financial obligations, your notes will lack priority in payment.

Your right to receive payments on the notes is junior to substantially all of our existing indebtedness and future borrowings (including debt of our special purpose entities). Your notes will be subordinated to the prior payment in full of all of our other debt obligations, other than our issued and outstanding renewable unsecured subordinated notes, and your notes will be pari passu in right of payment with our issued and outstanding renewable unsecured subordinated notes. As of September 30, 2010, we had approximately $743.7 million of debt outstanding that is senior to your notes, of which approximately $716.7 million was issued by our consolidated special purpose entities. Including an additional approximately $90.5 million of debt that does not appear on our consolidated financial statements (which was issued by our off-balance sheet special purpose entities), we had approximately $855.5 million of debt outstanding that is senior to your notes. We may also incur substantial additional indebtedness in the future that would also rank senior to your notes. Because of the subordination provisions of the notes, in the event of our bankruptcy, liquidation or dissolution, our assets would be available to make payments to you under the notes only after all payments had been made on all of our secured and unsecured indebtedness and other obligations that are senior to the notes. Sufficient assets may not remain after all such senior payments have been made to make any payments to you under the notes, including payments of interest when due or principal upon maturity.

Because there will be no trading market for the notes and because transfers of the notes require our consent, it may be difficult to sell your notes.

Your ability to liquidate your investment is limited because of transfer restrictions, the lack of a trading market and the limitation on repurchase requests prior to maturity. Your notes may not be transferred without our prior written consent. In addition, there will be no trading market for the notes. Due to the restrictions on transfer of the notes and the lack of a market for the sale of the notes, even if we permitted a transfer, you might be unable to sell, pledge or otherwise liquidate your investment. We are currently subject to contractual restrictions that prohibit us from repurchasing notes except in the case of death or total permanent disability of the related holder. In any event, the total principal amount of notes that we would be required to repurchase in any calendar quarter, for any reason, will be limited to the greater of $1 million or 2% of the aggregate principal amount of all notes outstanding at the end of the previous quarter. See “Description of the Notes.”

Because the notes will have no sinking fund, collateral security, insurance or guarantee, you may lose all or a part of your investment in the notes if we do not have enough cash to pay the notes.

There is no sinking fund, collateral security, insurance or guarantee of our obligation to make payments on the notes. The notes are not secured by any of our assets. We will not contribute funds to a separate account, commonly known as a sinking fund, to make interest or principal payments on the notes. The notes are not certificates of deposit or similar obligations of, and are not guaranteed or insured by, any depository institution, the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation, or any other governmental or private fund or entity. Therefore, if you invest in the notes, you will have to rely only on our cash flow from operations and other sources of funds for repayment of principal at maturity or redemption and for payment of interest when due. Our cash flow from operations could be impaired under the circumstances described under "—Risks Related to Our Business". If our cash flow from operations and other sources of funds are not sufficient to pay any amounts owed under the notes, then you may lose all or part of your investment.

The notes will automatically renew unless you request repayment.

Upon maturity, the notes will be automatically renewed for the same term as your maturing note and at an interest rate that we are offering at that time to other investors with similar aggregate note portfolios for notes of the same term, unless we notify you prior to the maturity date that we intend to repay the notes or you notify us within 15 days after the maturity date that you want your notes repaid. This 15 day period will be automatically extended if you would otherwise be required to make the repayment election at a time when we have determined that a post-effective amendment to the registration statement of which this prospectus is a part must be filed with the Securities and Exchange Commission, but such post-effective amendment has not yet been declared effective. If notes with the same term are not then being offered, the interest rate upon renewal will be the rate specified by us on or before the maturity date, or the rate of the existing note if no such rate is specified. The interest rate on your renewed note may be lower than the interest rate of your original note. Any requests for repurchases after your notes are renewed will be subject to contractual restrictions that presently prohibit us from making any such repurchases and, in any event, to limitations on the amount of notes we would be willing to repurchase in any calendar quarter.

Because we have substantial indebtedness that is senior to the notes, our ability to pay the notes may be impaired.

We have now and, after we sell these notes, will continue to have a substantial amount of indebtedness. At September 30, 2010, we had approximately $855.5 million of debt outstanding, comprising (in thousands):

Warehouse lines of credit (1)	39,692	
Subordinated renewable notes	21,300	
Residual interest financing (1)	44,252	
Securitization trust debt (1)	632,783	
Senior secured debt, related party	26,950	
Total on balance sheet debt	764,977	
Off-balance sheet securitization trust debt (1)(2)		90,541
Total on and off-balance sheet debt		855,518

(1) Debt obligations of our special purpose entities
(2) Debt obligations of our special purpose entities where the securitization transactions were structured as sales for accounting purposes

Our debt to net worth ratio at September 30, 2010 was 47.6 (including all debt issued by off-balance sheet special purpose entities our debt to net worth ratio was 53.2 and excluding all securitization trust debt, our debt to net worth ratio was 8.2), and our ratio of earnings to fixed charges, including interest expense on the above-mentioned debt, was

0.77.

Our substantial indebtedness could adversely affect our financial condition and prevent us from fulfilling our obligations under the notes by, among other things:

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- increasing our vulnerability to general adverse economic and industry conditions;
- requiring us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing amounts available for working capital, capital expenditures and other general corporate purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- placing us at a competitive disadvantage compared to our competitors that have less debt; and
- limiting our ability to borrow additional funds.

Although we believe we will generate sufficient free cash flow to service this debt and our obligations under the notes, there is no assurance that we will be able to do so. If we do not generate sufficient operating profits, our ability to make required payments on our senior debt, as well as on the debt represented by the notes described in this prospectus, may be impaired.

If we incur substantially more indebtedness that is senior to your notes, our ability to pay the notes may be impaired.

Subject to limitations contained in our credit facilities and in the indenture, we may incur substantial additional indebtedness in the future. The indenture for the notes does not prohibit us from incurring additional indebtedness. Any such borrowings would be senior to the notes. If we borrow more money, the risks to noteholders described in this prospectus could intensify.

Our management has broad discretion over the use of proceeds from the offering.

We expect to use the proceeds from the offering to fund the purchase of automobile contracts and for other general corporate purposes, which may include the payment of general and administrative expenses. Because no specific allocation of the proceeds is required in the indenture, our management will have broad discretion in determining how the proceeds of the offering will be used. See “Use of Proceeds.”

Because we are subject to many restrictions in our existing credit facilities, our ability to pay the notes may be impaired.

The terms of our existing credit facilities and our securitization trust debt impose significant operating and financial restrictions on us and our subsidiaries and require us to meet certain financial tests. The indenture for the notes also imposes certain limited restrictions on our ability and that of our subsidiaries to take certain actions. Such terms and restrictions may be amended or supplemented from time to time without requiring any notice to or consent of the holders of the notes or the trustee. These restrictions may have an adverse impact on our business activities, results of operations and financial condition. These restrictions may also significantly limit or prohibit us from engaging in certain transactions, including the following:

- incurring or guaranteeing additional indebtedness;
- making capital expenditures in excess of agreed upon amounts;
- paying dividends or other distributions to our stockholders or redeeming, repurchasing or retiring our capital stock or subordinated obligations;

- making investments;
- creating or permitting liens on our assets or the assets of our subsidiaries;
- issuing or selling capital stock of our subsidiaries;
- transferring or selling our assets;
- engaging in mergers or consolidations;
- permitting a change of control of our company;
- liquidating, winding up or dissolving our company;

- changing our name or the nature of our business, or the names or nature of the business of our subsidiaries; and
- engaging in transactions with our affiliates outside the normal course of business.

These restrictions may limit our ability to obtain additional sources of capital, which may limit our ability to repay the notes. In addition, the failure to comply with any of the covenants of our existing credit facilities or the indenture or to maintain certain indebtedness ratios would cause a default under one or more of our credit facilities and may cause a default under the indenture or our other debt agreements that may be outstanding from time to time. A default, if not waived, could result in acceleration of the related indebtedness, in which case such debt would become immediately due and payable. A continuing default or acceleration of one or more of our credit facilities, the indenture or any other debt agreement, will likely cause a default under the indenture and other debt agreements that otherwise would not be in default, in which case all such related indebtedness could be accelerated. If this occurs, we may not be able to repay our debt or borrow sufficient funds to refinance our indebtedness. Even if any new financing is available, it may not be on terms that are acceptable to us or it may not be sufficient to refinance all of our indebtedness as it becomes due. Complying with these covenants may cause us to take actions that are not favorable to holders of the notes. See “Description of the Notes – Restrictive Covenants.”

Because there are limited restrictions on our activities under the indenture, you will have only limited protections under the indenture.

In comparison to the restrictive covenants that are imposed on us by our existing credit facilities and other borrowing arrangements, the indenture governing the notes contains relatively minimal restrictions on our activities. In addition, the indenture contains only limited events of default other than our failure to timely pay principal and interest on the notes. Because there are only very limited restrictions and limited events of default under the indenture, we will not be restricted from issuing additional debt senior to your notes or be required to maintain any ratios of assets to debt in order to increase the likelihood of timely payments to you under the notes. Further, if we default in the payment of the notes or otherwise under the indenture, you will likely have to rely on the trustee to exercise your remedies on your behalf. You may not be able to seek remedies against us directly. See “Description of the Notes – Events of Default.”

Because there are no financial covenants in the Indenture, we will not be required to maintain a positive net worth.

Unlike the indenture for our renewable unsecured subordinated notes issued prior to August 1, 2010, the indenture for the notes offered hereby does not contain any financial covenants relating to our net worth. Accordingly, we will not be required to maintain a positive net worth. However, if we fail to maintain a positive net worth, a majority of the holders of our renewable unsecured subordinated notes that were issued prior to August 1, 2010 will have the right to declare an event of default under the related indenture and accelerate the maturity of their notes. Any such acceleration may have a material and adverse effect on our liquidity and results of operation, which could impair our ability to make payments on the notes offered hereby.

Because we may redeem the notes at any time prior to their maturity, you may be subject to reinvestment risk.

We have the right to redeem any note at any time prior to its stated maturity upon 30 days written notice to you. The notes would be redeemed at 100% of the principal amount plus accrued but unpaid interest up to but not including the redemption date. Any such redemption may have the effect of reducing the income or return on investment that any investor may receive on an investment in the notes by reducing the term of the investment. If this occurs, you may not be able to reinvest the proceeds at an interest rate comparable to the rate paid on the notes. See “Description of the Notes – Redemption or Repurchase Prior To Stated Maturity.”

Under certain circumstances, you may be required to pay taxes on accrued interest on the notes prior to receiving a sufficient amount of cash interest payments.

If you choose to have interest on your note paid at maturity and the term of your note exceeds one year, you may be required to pay taxes on the accrued interest prior to our making any interest payments to you. You should consult your tax advisor to determine your tax obligations.

Risk Factors Relating to CPS

We remind you that there are substantial risk factors relating to our business generally, in addition to those described above relating specifically to the Notes.

Our business, operating results and financial condition could be adversely affected by any of the following specific risks. In addition to the risks described below, we may encounter risks that are not currently known to us or that we currently deem immaterial, which may also impair our business operations.

Risks Related to Our Business

We Require a Substantial Amount of Cash to Service Our Substantial Debt.

To service our existing substantial indebtedness, we require a significant amount of cash. Our ability to generate cash depends on many factors, including our successful financial and operating performance. Our financial and operational performance depends upon a number of factors, many of which are beyond our control. These factors include, without limitation:

- the economic and competitive conditions in the asset-backed securities market;
- the performance of our current and future automobile contracts;
- the performance of our residual interests from our securitizations and warehouse credit facilities;
- any operating difficulties or pricing pressures we may experience;
- our ability to obtain credit enhancement for our securitizations;
- our ability to establish and maintain dealer relationships;
- the passage of laws or regulations that affect us adversely;
- our ability to compete with our competitors; and
- our ability to acquire and finance automobile contracts.

Depending upon the outcome of one or more of these factors, we may not be able to generate sufficient cash flow from operations or obtain sufficient funding to satisfy all of our obligations. We presently find that funding in the asset-backed securities market is difficult to secure, that the credit performance of our automobile contracts has been adversely affected by general economic conditions, and that adverse effects on performance of our automobile contracts held in securitization pools result in an adverse effect on performance of residual interests. Such factors may result in our being unable to pay our debts timely or as agreed. If we were unable to pay our debts, we would be required to pursue one or more alternative strategies, such as selling assets, refinancing or restructuring our indebtedness or selling additional equity capital. These alternative strategies might not be feasible at the time, might prove inadequate or could require the prior consent of our lenders.

We Need Substantial Liquidity to Operate Our Business.

We have historically funded our operations principally through internally generated cash flows, sales of debt and equity securities, including through securitizations and warehouse credit facilities, borrowings under senior subordinated debt agreements and sales of subordinated notes. However, we may not be able to obtain sufficient funding for our future operations from such sources. As of the date of this report, our access to the capital markets is impaired with respect to long-term debt, and the terms on which we are able to access short-term debt are inferior to those available to us in years immediately prior to the commencement of the current recession. As a consequence, our results of operations, financial condition and cash flows have been and may continue to be materially and adversely affected. We require a substantial amount of cash liquidity to operate our business. Among other things, we use such cash liquidity to:

- acquire automobile contracts;
- fund overcollateralization in warehouse credit facilities and securitizations;
- pay securitization fees and expenses;
- fund spread accounts in connection with securitizations;
- satisfy working capital requirements and pay operating expenses;
- pay taxes; and
- pay interest expense.

We have to date matched our liquidity needs to our available sources of funding by reducing our acquisition of new automobile contracts, at times to merely nominal levels. There can be no assurance that we will continue to be successful with that strategy.

We Are Not Presently Profitable

We have incurred net losses every quarter subsequent to the quarter ended June 30, 2008. We have been adversely affected by the economic recession affecting the United States as a whole, by increased financing costs and decreased availability of capital to fund our purchases of automobile contracts, and by a decrease in the overall level of sales of automobiles and light trucks. We expect to return to profitability at some time within the calendar year 2011; however, there can be no assurance as to that expectation. Our expectation of profitability is a forward-looking statement. We discuss the assumptions underlying that expectation under the caption “Forward-Looking Statements” in this prospectus. We identify important factors that could cause actual results to differ, generally in the “Risk Factors” section of this prospectus, and also under the caption “Forward-Looking Statements.”

Our Results of Operations Will Depend on Our Ability to Secure and Maintain Adequate Credit and Warehouse Financing on Favorable Terms.

Our business strategy requires that warehouse credit facilities be available in order to purchase significant volumes of receivables.

Historically, our primary sources of day-to-day liquidity were our warehouse credit facilities, in which we sold and contributed automobile contracts, as often as twice a week, to special-purpose subsidiaries, where they were "warehoused" until they were securitized, at which time funds advanced under one or more warehouse credit facilities were repaid from the proceeds of the securitizations. The special-purpose subsidiaries obtained the funds to purchase these automobile contracts by pledging the automobile contracts to a trustee for the benefit of senior warehouse lenders, who advanced funds to our special-purpose subsidiaries based on the dollar amount of the automobile contracts pledged. Through November 2008, we depended substantially on two warehouse credit facilities: (i) a $200 million warehouse credit facility, which we established in November 2005 and expired by its terms in November 2008; and (ii) a $200 million warehouse credit facility, which we established in June 2004 and which was amended in December 2008 to eliminate future advances and to provide for repayment of the related debt from the cash collections on the related pledged automobile contracts, and certain other principal reductions until it was repaid in September 2009. In September 2009 we entered into a new $50 million two-year multiple-draw credit facility, which, like a warehouse facility, allows us advances against new purchases of automobile contracts, and in March 2010 we entered into a second $50 million delayed draw credit facility, which likewise allows us advances against new purchases of automobile contracts.

As stated elsewhere in this report, since the fourth quarter of 2007 we have observed adverse changes in the market for securitized pools of automobile contracts. If we are unable to maintain warehouse financing on acceptable terms, our results of operations, financial condition and cash flows could be materially and adversely affected.

Our Results of Operations Will Depend on Our Ability to Securitize Our Portfolio of Automobile Contracts.

Historically we have depended upon our ability to obtain permanent financing for pools of automobile contracts by conducting term securitization transactions. By "permanent financing" we mean financing that extends to cover the full term during which the underlying automobile contracts are outstanding and requires repayment as the underlying automobile contracts are repaid or charged off. By contrast, our warehouse credit facilities permit us to borrow against the value of such receivables only for limited periods of time. Our past practice and future plan has been and is to repay loans made to us under our warehouse credit facilities with the proceeds of securitizations. There can be no assurance that any securitization transaction will be available on terms acceptable to us, or at all. The timing of any securitization transaction is affected by a number of factors beyond our control, any of which could cause substantial delays, including, without limitation:

- market conditions;
- the approval by all parties of the terms of the securitization;
- the availability of credit enhancement on acceptable terms; and
- our ability to acquire a sufficient number of automobile contracts for securitization.

As stated elsewhere in this report, since the fourth quarter of 2007 we have observed adverse changes in the market for securitized pools of automobile contracts, which has made permanent financing in the form of securitization transactions difficult to obtain and more costly than in prior periods. These changes include reduced liquidity and reduced demand for asset-backed securities, particularly for securities carrying a financial guaranty or for securities backed by sub-prime automobile receivables. Should we choose not to securitize automobile contracts in the future or do so on the more costly terms prevalent in current market conditions, we could expect a further material adverse effect on our results of operations.

Our Results of Operations Will Depend on Cash Flows from Our Residual Interests in Our Securitization Program and Our Warehouse Credit Facilities.

When we finance our automobile contracts through securitizations and warehouse credit facilities, we receive cash and a residual interest in the assets financed. Those financed assets are owned by the special-purpose subsidiary that is formed for the related securitization. This residual interest represents the right to receive the future cash flows to be generated by the automobile contracts in excess of (i) the interest and principal paid to investors or lenders on the indebtedness issued in connection with the financing, (ii) the costs of servicing the automobile contracts and (iii) certain other costs incurred in connection with completing and maintaining the securitization or warehouse credit facility. We sometimes refer to these future cash flows as "excess spread cash flows."

Under the financial structures we have used to date in our securitizations and warehouse credit facilities, excess spread cash flows that would otherwise be paid to the holder of the residual interest are first used to increase overcollateralization or are retained in a spread account within the securitization trusts or the warehouse facility to provide liquidity and credit enhancement for the related securities.

While the specific terms and mechanics vary among transactions, our securitization and warehousing agreements generally provide that we will receive excess spread cash flows only if the amount of overcollateralization and spread account balances have reached specified levels and/or the delinquency, defaults or net losses related to the automobile contracts in the automobile contract pools are below certain predetermined levels. In the event delinquencies, defaults or net losses on automobile contracts exceed these levels, the terms of the securitization or warehouse credit facility:

- may require increased credit enhancement, including an increase in the amount required to be on deposit in the spread account to be accumulated for the particular pool;
- may restrict the distribution to us of excess spread cash flows associated with other securitized or warehoused pools; and
- in certain circumstances, may permit affected parties to require the transfer of servicing on some or all of the securitized or warehoused automobile contracts from us to an unaffiliated servicer.

We typically retain residual interests or use them as collateral to borrow cash. In any case, the future excess spread cash flow received in respect of the residual interests is integral to the financing of our operations. The amount of cash received from residual interests depends in large part on how well our portfolio of securitized and warehoused automobile contracts performs. If our portfolio of securitized and warehoused automobile contracts has higher delinquency and loss ratios than expected, then the amount of money realized from our retained residual interests, or the amount of money we could obtain from the sale or other financing of our residual interests, would be reduced. Such higher than expected losses have been incurred, which has had an adverse effect on our operations, financial condition and cash flows. Should losses continue to rise, we would expect further material adverse effects on our results of operations, financial condition and cash flows.

We May Have Rescission Liability in Connection with Sales of Our Renewable Unsecured Subordinated Notes to Certain Purchasers

We filed a registration statement on Form S-2 with respect to our renewable unsecured subordinated notes on January 7, 2005 and subsequently filed amendments to such registration statement on April 13, May 2, and May 20, 2005 and April 11, 2006 (such registration statement, as so amended, the “Former Registration Statement”). We recently discovered that, under a rule of the SEC, we are no longer permitted to offer and sell our renewable unsecured subordinated notes in reliance on the Former Registration Statement. Consequently, purchasers who acquired such notes within the past twelve months may have a statutory right to rescind their purchases. As a result, we could be required to repurchase some or all of such notes at the original sale price plus statutory interest, less the amount of any income received by the purchasers. Within the twelve months immediately preceding December 1, 2010, we sold a total of approximately $5.1 million of such notes, including renewals of previously sold notes prior to August 2010, but excluding notes that we have repaid.

Sales of such notes could also subject us to regulatory sanctions by the SEC, which might include the imposition of civil penalties. Although we do not expect any rescissions or regulatory actions to have a material adverse effect on us, we are unable to predict the full consequences of these events and regulatory actions at this time.

Our results of operations, financial condition and cash flows could be materially and adversely affected if a substantial number of purchasers of such notes seek to exercise rescission rights, or if we are assessed substantial penalties by regulatory authorities. The exercise of rescission rights would not have any direct material effect on our results of operations, as any rescission of sales of such notes would involve simultaneous and approximately equal reductions in our assets and our liabilities. However, if holders of sufficient amounts of such notes were to demand rescission, the adverse effect on our liquidity could be material, which could in turn impair our ability to conduct our business as otherwise planned. In such event, our ability to perform our obligations under the renewable unsecured subordinated notes, including those offered by this Prospectus, could also be materially and adversely affected.

If We Are Unable to Obtain Credit Enhancement for Our Securitizations Upon Favorable Terms, Our Results of Operations Would Be Impaired.

In our securitizations, we historically have utilized credit enhancement in the form of one or more financial guaranty insurance policies issued by financial guaranty insurance companies. Each of these policies unconditionally and irrevocably guarantees certain interest and principal payments on the senior classes of the securities issued in our securitizations. These guarantees enabled these securities to achieve the highest credit rating available. This form of credit enhancement reduced the costs of our securitizations relative to alternative forms of credit enhancement available to us at the time. Such financial guaranty insurance policies are not at present available to us. Due to significantly reduced investor demand for securities carrying such a financial guaranty, it is likely that this form of credit enhancement, even if it were again to become available to us, may not be economic for us in the future. As we pursue future securitizations, we may not be able to obtain:

- credit enhancement in any form on terms acceptable to us, or at all; or
- similar ratings for senior classes of securities to be issued in future securitizations.

Based on indications from market participants as to reduced investor comfort with credit ratings and financial guarantees, we believe that even if we were unable to obtain such enhancements or such ratings, we would expect to incur increased interest expense. Such increased interest expense would adversely affect our results of operations.

If We Are Unable to Successfully Compete With Our Competitors, Our Results of Operations May Be Impaired.

The automobile financing business is highly competitive. We compete with a number of national, regional and local finance companies. In addition, competitors or potential competitors include other types of financial services companies, such as commercial banks, savings and loan associations, leasing companies, credit unions providing retail loan financing and lease financing for new and used vehicles and captive finance companies affiliated with major automobile manufacturers such as Ford Motor Credit Corporation. Many of our competitors and potential competitors possess substantially greater financial, marketing, technical, personnel and other resources than we do, including greater access to capital markets for unsecured commercial paper and investment grade rated debt instruments, and to other funding sources which may be unavailable to us. Moreover, our future profitability will be directly related to the availability and cost of our capital relative to that of our competitors. Many of these companies also have long-standing relationships with automobile dealers and may provide other financing to dealers, including floor plan financing for the dealers' purchases of automobiles from manufacturers, which we do not offer. There can be no assurance that we will be able to continue to compete successfully and, as a result, we may not be able to purchase automobile contracts from dealers at a price acceptable to us, which could result in reductions in our revenues or the cash flows available to us.

If Our Dealers Do Not Submit a Sufficient Number of Suitable Automobile Contracts to Us for Purchase, Our Results of Operations May Be Impaired.

We are dependent upon establishing and maintaining relationships with a large number of unaffiliated automobile dealers to supply us with automobile contracts. During the year ended December 31, 2009, no single dealer accounted for more than 8.0% of the automobile contracts we purchased. The agreements we have with dealers to purchase automobile contracts do not require dealers to submit a minimum number of automobile contracts for purchase. The failure of dealers to submit automobile contracts that meet our underwriting criteria could result in reductions in our revenues or the cash flows available to us, and, therefore, could have an adverse effect on our results of operations.

If a Significant Number of Our Automobile Contracts Experience Defaults, Our Results of Operations May Be Impaired.

We specialize in the purchase and servicing of automobile contracts to finance automobile purchases by sub-prime customers, those who have limited credit history, low income, or past credit problems. Such automobile contracts entail a higher risk of non-performance, higher delinquencies and higher losses than automobile contracts with more creditworthy customers. While we believe that our pricing of the automobile contracts and the underwriting criteria and collection methods we employ enable us to control, to a degree, the higher risks inherent in automobile contracts with sub-prime customers, no assurance can be given that such pricing, criteria and methods will afford adequate protection against such risks. We have experienced increases in the delinquency of, and credit losses on, our automobile contracts.

If automobile contracts that we purchase and hold experience defaults to a greater extent than we have anticipated, this could materially and adversely affect our results of operations, financial condition, cash flows and liquidity. Our results of operations, financial condition, cash flows and liquidity, depend, to a material extent, on the performance of automobile contracts that we purchase, warehouse and securitize. A portion of the automobile contracts acquired by us will default or prepay. In the event of payment default, the collateral value of the vehicle securing an automobile contract realized by us in a repossession will most likely not cover the outstanding principal balance on that automobile contract and the related costs of recovery. We maintain an allowance for credit losses on automobile contracts held on our balance sheet, which reflects our estimates of probable credit losses that can be reasonably estimated for securitizations that are accounted for as financings and warehoused automobile contracts. If the allowance is inadequate, then we would recognize the losses in excess of the allowance as an expense and our results of operations could be adversely affected. In addition, under the terms of our warehouse credit facilities, we are not able to borrow against defaulted automobile contracts, including automobile contracts that are, at the time of default, funded under our warehouse credit facilities, which will reduce the overcollateralization of those warehouse credit facilities and possibly reduce the amount of cash flows available to us.

If We Lose Servicing Rights on Our Portfolio of Automobile Contracts, Our Results of Operations Would Be Impaired.

We are entitled to receive servicing fees only while we act as servicer under the applicable sale and servicing agreements governing our warehouse facilities and securitizations. Under such agreements, we may be terminated as servicer upon the occurrence of certain events, including:

- our failure generally to observe and perform covenants and agreements applicable to us;
- certain bankruptcy events involving us; or
- the occurrence of certain events of default under the documents governing the facilities.

We have received waivers regarding the potential breach of certain covenants relating to minimum net worth and maintenance of active warehouse credit facilities. Without such waivers, certain credit enhancement providers would have had the right to terminate us as servicer with respect to certain of outstanding securitization pools. Although such rights have been waived, such waivers are temporary, and there can be no assurance as to their future extension. We do, however, believe that we will obtain such future extensions because it is generally not in the interest of any party to the securitization transaction to transfer servicing. Nevertheless, there can be no assurance as to our belief being correct. The loss of our servicing rights could materially and adversely affect our results of operations, financial condition and cash flows. Our results of operations, financial condition and cash flows, would be materially and adversely affected if we were to be terminated as servicer with respect to a material portion of the automobile contracts for which we are receiving servicing fees.

If We Lose Key Personnel, Our Results of Operations May Be Impaired.

Our senior management team averages thirteen years of service with us. Charles E. Bradley, Jr., our President and CEO, has been our President since our formation in 1991. Our future operating results depend in significant part upon the continued service of our key senior management personnel, none of whom is bound by an employment agreement. Our future operating results also depend in part upon our ability to attract and retain qualified management, technical, sales and support personnel for our operations. Competition for such personnel is intense. We cannot assure you that we will be successful in attracting or retaining such personnel. Layoffs that we have implemented since 2008 may have reduced employee loyalty, which may in turn result in decreased employee performance. Conversely, adverse general economic conditions may have had a countervailing effect. The loss of any key employee, the failure of any key employee to perform in his or her current position or our inability to attract and retain skilled employees, as needed, could materially and adversely affect our results of operations, financial condition and cash flows.

If We Fail to Comply with Regulations, Our Results of Operations May Be Impaired.

Failure to materially comply with all laws and regulations applicable to us could materially and adversely affect our ability to operate our business. Our business is subject to numerous federal and state consumer protection laws and regulations, which, among other things:

• require us to obtain and maintain certain licenses and qualifications;
• limit the interest rates, fees and other charges we are allowed to charge;
• limit or prescribe certain other terms of our automobile contracts;
• require specific disclosures to our customers;
• define our rights to repossess and sell collateral; and
• maintain safeguards designed to protect the security and confidentiality of customer information.

We believe that we are in compliance in all material respects with all such laws and regulations, and that such laws and regulations have had no material adverse effect on our ability to operate our business. However, we may be materially and adversely affected if we fail to comply with:

• applicable laws and regulations;
• changes in existing laws or regulations;
• changes in the interpretation of existing laws or regulations; or
• any additional laws or regulations that may be enacted in the future.

Recent Legislation and Proposed Regulations May Have an Adverse Effect on Our Business.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") mandates the most wide-ranging overhaul of financial industry regulation in decades. Dodd-Frank was signed into law on July 21, 2010, and is now in the implementation stage. The law provides a regulatory framework and requires that regulators, some of which are new regulatory bodies created by Dodd-Frank, draft, review and approve more than 200 implementing regulations and conduct numerous studies that are likely to lead to more regulations. In addition, the Commission has recently proposed amendments to regulations first adopted in 2005 known as Regulation AB. The amendments to Regulation AB have yet to be adopted and are expected to be significantly modified from the form initially proposed, however, the final form of the amendments to Regulation AB when adopted are expected to adversely affect CPS’s ability to complete securitization transactions without increased expense.

Compliance with these new laws and regulations may be or likely will be costly and can affect operating results. Compliance requires forms, processes, procedures, controls and the infrastructure to support these requirements. Compliance may create operational constraints and place limits on pricing. Laws in the financial services industry are designed primarily for the protection of consumers. The failure to comply could result in significant statutory civil and criminal penalties, monetary damages, attorneys’ fees and costs, possible revocation of licenses and damage to reputation, brand and valued customer relationships.

At this time, it is difficult to predict the extent to which the Dodd-Frank Act or the resulting regulations or the Regulation AB amendments will affect our business. However, compliance with these new laws and regulations may result in additional cost and expenses, which may adversely affect our results of operations, financial condition or liquidity.

If We Experience Unfavorable Litigation Results, Our Results of Operations May Be Impaired.

Unfavorable outcomes in any of our current or future litigation proceedings could materially and adversely affect our results of operations, financial conditions and cash flows. As a consumer finance company, we are subject to various consumer claims and litigation seeking damages and statutory penalties based upon, among other things, disclosure inaccuracies and wrongful repossession, which could take the form of a plaintiff's class action complaint.

We, as the assignee of finance automobile contracts originated by dealers, may also be named as a co-defendant in lawsuits filed by consumers principally against dealers. We are also subject to other litigation common to the automobile industry and businesses in general. The damages and penalties claimed by consumers and others in these types of matters can be substantial. The relief requested by the plaintiffs varies but includes requests for compensatory, statutory and punitive damages.

While we intend to vigorously defend ourselves against such proceedings, there is a chance that our results of operations, financial condition and cash flows could be materially and adversely affected by unfavorable outcomes.

If We Experience Problems with Our Originations, Accounting or Collection Systems, Our Results of Operations May Be Impaired.

We are dependent on our receivables originations, accounting and collection systems to service our portfolio of automobile contracts. Such systems are vulnerable to damage or interruption from natural disasters, power loss, telecommunication failures, terrorist attacks, computer viruses and other events. A significant number of our systems are not redundant, and our disaster recovery planning is not sufficient for every eventuality. Our systems are also subject to break-ins, sabotage and intentional acts of vandalism by internal employees and contractors as well as third parties. Despite any precautions we may take, such problems could result in interruptions in our services, which could harm our reputation and financial condition. We do not carry business interruption insurance sufficient to compensate us for losses that may result from interruptions in our service as a result of system failures. Such systems problems could materially and adversely affect our results of operations, financial conditions and cash flows.

We Have Substantial Indebtedness.

We have and will continue to have a substantial amount of indebtedness. At September 30, 2010, we had approximately $765.0 million of debt outstanding. Such debt consisted primarily of $632.8 million of securitization trust debt, and also included $39.7 million of warehouse lines of credit, $44.3 million of residual interest financing, $27.0 million of senior secured related party debt, and $21.3 million owed to holders of our renewable unsecured subordinated notes. We have offered our renewable unsecured subordinated notes to the public on a continuous basis from May 2005 through July 2010, and those notes have maturities that range from three months to ten years.

Our substantial indebtedness could adversely affect our financial condition by, among other things:

- increasing our vulnerability to general adverse economic and industry conditions;
- requiring us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing amounts available for working capital, capital expenditures and other general corporate purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- placing us at a competitive disadvantage compared to our competitors that have less debt; and
- limiting our ability to borrow additional funds.

Although we believe we are able to service and repay such debt, there is no assurance that we will be able to do so. If we do not generate sufficient operating profits, our ability to make required payments on our debt would be impaired. Failure to pay our indebtedness when due could have a material adverse effect.

Because We Are Subject to Many Restrictions in Our Existing Credit Facilities and Securitization Transactions, Our Ability to Pay Dividends or Engage in Specified Transactions May Be Impaired.

The terms of our existing credit facilities, term securitizations and our other outstanding debt impose significant operating and financial restrictions on us and our subsidiaries and require us to meet certain financial tests. These restrictions may have an adverse effect on our business activities, results of operations and financial condition. These restrictions may also significantly limit or prohibit us from engaging in certain transactions, including the following:

- incurring or guaranteeing additional indebtedness;
- making capital expenditures in excess of agreed upon amounts;

- paying dividends or other distributions to our stockholders or redeeming, repurchasing or retiring our capital stock or subordinated obligations;
- making investments;
- creating or permitting liens on our assets or the assets of our subsidiaries;
- issuing or selling capital stock of our subsidiaries;
- transferring or selling our assets;
- engaging in mergers or consolidations;
- permitting a change of control of our company;
- liquidating, winding up or dissolving our company;
- changing our name or the nature of our business, or the names or nature of the business of our subsidiaries; and
- engaging in transactions with our affiliates outside the normal course of business.

These restrictions may limit our ability to obtain additional sources of capital, which may limit our ability to generate earnings. In addition, the failure to comply with any of the covenants of one or more of our debt agreements could cause a default under other debt agreements that may be outstanding from time to time. A default, if not waived, could result in acceleration of the related indebtedness, in which case such debt would become immediately due and payable. A continuing default or acceleration of one or more of our credit facilities or any other debt agreement, would likely cause a default under other debt agreements that otherwise would not be in default, in which case all such related indebtedness could be accelerated. If this occurs, we may not be able to repay our debt or borrow sufficient funds to refinance our indebtedness. Even if any new financing is available, it may not be on terms that are acceptable to us or it may not be sufficient to refinance all of our indebtedness as it becomes due.

In addition, the transaction documents for our securitizations restrict our securitization subsidiaries from declaring or making payment to us of (i) any dividend or other distribution on or in respect of any shares of their capital stock, or (ii) any payment on account of the purchase, redemption, retirement or acquisition of any option, warrant or other right to acquire shares of their capital stock unless (in each case) at the time of such declaration or payment (and after giving effect thereto) no amount payable under any transaction document with respect to the related securitization is then due and owing, but unpaid. These restrictions may limit our ability to receive distributions in respect of the residual interests from our securitization facilities, which may limit our ability to generate earnings.

Risks Related to General Factors

If The Economy of All or Certain Regions of the United States Continues to Slow Down or the Current Recession Worsens, Our Results of Operations May Be Impaired.

Our business is directly related to sales of new and used automobiles, which are sensitive to employment rates, prevailing interest rates and other domestic economic conditions. Delinquencies, repossessions and losses generally increase during economic slowdowns or recessions. Because of our focus on sub-prime customers, the actual rates of delinquencies, repossessions and losses on our automobile contracts could be higher under adverse economic conditions than those experienced in the automobile finance industry in general, particularly in the states of Texas, California, Ohio, Florida, Pennsylvania and Louisiana, states in which our automobile contracts are geographically concentrated. Any sustained period of economic slowdown or recession could adversely affect our ability to acquire suitable automobile contracts, or to securitize pools of such automobile contracts. The timing of any economic changes is uncertain, and weakness in the economy could have an adverse effect on our business and that of the dealers from which we purchase automobile contracts and result in reductions in our revenues or the cash flows available to us.

Our Results Of Operations May Be Impaired As a Result of Natural Disasters.

Our automobile contracts are geographically concentrated in the states of California, Texas, and Florida. Such states may be particularly susceptible to natural disasters: earthquake in the case of California, and hurricanes and flooding in the states of Florida and Texas. Natural disasters, in those states or others, could cause a material number of our vehicle purchasers to lose their jobs, or could damage or destroy vehicles that secure our automobile contracts. In either case, such events could result in our receiving reduced collections on our automobile contracts, and could thus result in reductions in our revenues or the cash flows available to us.

If an Increase in Interest Rates Results in a Decrease in Our Cash Flow from Excess Spread, Our Results of Operations May Be Impaired.

Our profitability is largely determined by the difference, or "spread," between the effective interest rate received by us on the automobile contracts that we acquire and the interest rates payable under warehouse credit facilities and on the asset-backed securities issued in our securitizations. Recent disruptions in the market for asset-backed securities are likely to result in an increase in the interest rates we would pay on asset-backed securities that we may issue in future securitizations. Although we have the ability to partially offset increases in our cost of funds by increasing fees we charge to dealers when purchasing automobile contracts, or by demanding higher interest rates on automobile contracts we purchase, there is no assurance that such actions will materially offset increases in interest we pay to finance our managed portfolio.

Several factors affect our ability to manage interest rate risk. Specifically, we are subject to interest rate risk during the period between when automobile contracts are purchased from dealers and when such automobile contracts are sold and financed in a securitization. Interest rates on warehouse credit facilities are typically adjustable while the interest rates on the automobile contracts are fixed. Therefore, if interest rates increase, the interest we must pay to the lenders under warehouse credit facilities is likely to increase while the interest realized by us from those warehoused automobile contracts remains the same, and thus, during the warehousing period, the excess spread cash flow received by us would likely decrease. Additionally, automobile contracts warehoused and then securitized during a rising interest rate environment may result in less excess spread cash flow realized by us under those securitizations as, historically, our securitization facilities pay interest to security holders on a fixed rate basis set at prevailing interest rates at the time of the closing of the securitization, which may be several months after the securitized automobile contracts were originated and entered the warehouse, while our customers pay fixed rates of interest on the automobile contracts, set at the time they purchase the underlying vehicles. A decrease in excess spread cash flow could adversely affect our earnings and cash flow.

To mitigate, but not eliminate, the short-term risk relating to interest rates payable by us under the warehouse facilities, we have historically held automobile contracts in the warehouse credit facilities for less than four months. To mitigate, but not eliminate, the long-term risk relating to interest rates payable by us in securitizations, we have in the past, and intend to continue to, structure some of our securitization transactions to include pre-funding structures, whereby the amount of securities issued exceeds the amount of automobile contracts initially sold into the securitization. In pre-funding, the proceeds from the pre-funded portion are held in an escrow account until we sell the additional automobile contracts into the securitization in amounts up to the balance of the pre-funded escrow account. In pre-funded securitizations, we effectively lock in our borrowing costs with respect to the automobile contracts we subsequently sell into the securitization. However, we incur an expense in pre-funded securitizations equal to the difference between the money market yields earned on the proceeds held in escrow prior to subsequent delivery of automobile contracts and the interest rate paid on the securities issued in the securitization. The amount of such expense may vary. Despite these mitigation strategies, an increase in prevailing interest rates would cause us to receive less excess spread cash flows on automobile contracts, and thus could adversely affect our earnings and cash flows.

RECENT DEVELOPMENTS

Non-compliance with Nasdaq Listing Requirement

On August 24, 2010, we received from Nasdaq a staff deficiency letter indicating that we have failed to comply with the minimum bid price requirement for continued listing on the Nasdaq Global Market. A minimum bid price of $1.00 per share is required by Nasdaq Rule 5450(a)(1). Our common stock remains listed on the Nasdaq Global Market during the 180-day grace period following such notification of noncompliance. We have until February 22, 2011 to regain compliance with the minimum price rule; otherwise our common stock would be subject to delisting.

We are considering several steps that could be taken to maintain public trading of our common stock. Such steps include (i) proposing and submitting to our shareholders for approval a reverse stock split, (ii) transferring the listing of our common stock to the Nasdaq Capital Market, or (iii) arranging for the quotation of trades in respect of our common stock through market makers on the OTCQB market. It should be noted that alternative (ii), transfer to the Nasdaq Capital Market, does no more than extend the grace period for 180 days following transfer of listing.

Waivers and Amendments of Financial and Performance Covenants

Certain of our securitization transactions and our warehouse credit facilities contain various financial covenants requiring certain minimum financial ratios and results. Such covenants include (i) maintaining minimum levels of liquidity or warehouse financing availability, (ii) maintaining minimum levels of adjusted net worth, (iii) not exceeding maximum leverage levels, and (iv) not exceeding maximum financial losses. In addition, certain of our securitization and non-securitization related debt contains cross-default provisions which would allow certain of our creditors to declare a default if a default were declared under a different facility. As a result of waivers and amendments to these covenants and cross-default provisions throughout 2009 and during the first and second quarter of 2010, we were in compliance with all such covenants and cross-default provisions as of each monthly or quarterly measurement date and as of date of this prospectus.

There can be no assurance that we will remain in compliance with any of the covenants and cross-default provisions in our securitization transactions or our warehouse credit facilities (as the same have been and/or may be amended from time to time) or that we will be able to obtain waivers or amendments to any such covenants and cross default provisions from our senior lenders in the future. If we are unable to remain in compliance with any such covenants and cross-default provisions and we are not able to obtain waivers or amendments to any such covenants and cross-default provisions, we could be terminated as servicer under the terms of the related securitization transactions and warehouse credit facilities.

As of September 30, 2010, we were in compliance with all applicable financial covenants, in part by reason of having received waivers of compliance as summarized in the table below. All such waivers relate to securitization trust debt issued by our consolidated subsidiaries.

Financial covenant	Applicable Standard	Status Requiring Waiver (as of or for the quarter ended September 30, 2010)
Warehouse financing capacity	\$200 million of warehouse capacity	\$50 million of warehouse capacity
Adjusted net worth (I)	\$87.6 million	\$16.1 million
Leverage (I)	Not greater than 4.5:1	7.1:1
Adjusted net worth (II)	\$95.3 million	\$16.1 million

The covenant regarding warehouse financing capacity is a covenant to maintain one or more credit facilities that allow us to finance acquisition of automobile contracts on a revolving basis, with a minimum aggregate capacity of \$200 million. The adjusted net worth covenants are covenants to maintain minimum levels of adjusted net worth, defined in each case as our consolidated book value under GAAP with the exclusion of intangible assets such as goodwill. The two separate adjusted net worth covenants run in favor of two separate financial guaranty insurers of classes of our outstanding securitization trust debt. The leverage covenant requires that we not exceed the specified ratio of debt over the defined adjusted net worth. Debt is defined in this covenant to mean consolidated liabilities less warehouse lines of credit and securitization trust debt; using this definition at September 30, 2010, we had debt of \$113.4 million.

See "Risk Factors – Risk Factors Relating To CPS – Risks Related to Our Business – If We Lose Servicing Rights on Our Portfolio of Automobile Contracts, Our Results of Operations Would be Impaired."

Availability of Funding

Since the fourth quarter of 2007, we have observed unprecedented adverse changes in the market for securitized pools of automobile contracts. These changes include reduced liquidity, and reduced demand for asset-backed securities, particularly for securities carrying a financial guaranty and for securities backed by sub-prime receivables. Moreover, many of the firms that previously provided financial guarantees, which were an integral part of our securitizations, are no longer offering such guarantees. In November 2008, we lost the ability to draw against available warehouse facilities, causing us to conserve liquidity by reducing our purchases of automobile contracts to nominal levels. However, in September 2009 we entered into a $50 million revolving credit facility that allows advances against new purchases of automobile contracts, and in March 2010 we entered into another $50 million delayed draw credit facility, which also allows us advances against new purchases of automobile contracts. These facilities have provided us the liquidity to gradually increase our automobile contract purchases from dealers. Moreover, during 2009 and to date in 2010 we have observed an increase in demand for asset-backed securities, including, securities backed by sub-prime automobile receivables. Nevertheless, if the current adverse circumstances that have affected the capital markets should worsen, we may again curtail or cease our purchases of new automobile contracts, which could lead to a material adverse effect on our operations.

Contingent Rescission Liability

We filed a registration statement on Form S-2 with respect to our renewable unsecured subordinated notes on January 7, 2005 and subsequently filed amendments to such registration statement on April 13, May 2, and May 20, 2005 and April 11, 2006 (such registration statement, as so amended, the "Former Registration Statement"). We recently discovered that, under a rule of the SEC, we are no longer permitted to offer and sell our renewable unsecured subordinated notes in reliance upon the Former Registration Statement. Consequently, purchasers who acquired such notes within the immediately preceding twelve months may have a statutory right to rescind their purchases. As a result, we could be required to repurchase some or all of such notes at the original sale price plus statutory interest, less the amount of any income received by the purchasers. Within the twelve months immediately preceding December 1, 2010, we sold a total of approximately $5.1 million of such notes, including renewals of previously sold notes prior to August 2010, but excluding notes that we have repaid.

Sales of such notes could also subject us to regulatory sanctions by the SEC, which might include the imposition of civil penalties. Although we do not expect any rescissions or regulatory actions to have a material adverse effect on us, we are unable to predict the full consequences of these events and regulatory actions at this time.

Our results of operations, financial condition and cash flows could be materially and adversely affected if a substantial number of purchasers of such notes seek to exercise rescission rights, or if we are assessed substantial penalties by regulatory authorities. The exercise of rescission rights would not have any direct material effect on our results of operations, as any rescission of sales would involve simultaneous and approximately equal reductions in our assets and our liabilities. However, if holders of sufficient amounts of such notes were to demand rescission, the adverse effect on our liquidity could be material, which could in turn impair our ability to conduct our business as otherwise planned. In such event, our ability to perform our obligations under the renewable unsecured subordinated notes, including those offered by this Prospectus, could also be materially and adversely affected.

Not Presently Profitable

We have incurred net losses every quarter subsequent to the quarter ended June 30, 2008. Our pretax loss for the third quarter of 2010 was $(3.5) million, compared to a pretax loss of $(4.3) million in the third quarter of 2009. Our net loss for the third quarter of 2010 was $(4.5) million, or $(0.26) per diluted share, compared to a net loss of $(4.3) million, or $(0.23) per diluted share, for the year-ago quarter. Net loss for the third quarter of 2010 includes a charge to income tax expense of $(1.0) million, or $(0.06) per diluted share, related to an addition to the valuation allowance against our deferred tax asset. Our pretax loss for the nine months ended September 30, 2010 was $(14.7) million, compared to a pretax loss of $(10.8) million for the nine months ended September 30, 2009. Our net loss for the nine months ended September 30, 2010 was $(19.3) million, or $(1.10) per diluted share, compared to a net loss of $(10.8) million, or $(0.57) per diluted share, for the nine months ended September 30, 2009. Net loss for the first nine months of 2010 includes a charge to income tax expense of $(4.6) million, or $(0.26) per diluted share, related to additions to the valuation allowance against our deferred tax asset.

FORWARD-LOOKING STATEMENTS

This prospectus contains certain statements of a forward-looking nature relating to future events or our future performance. These forward-looking statements are based on our current expectations, assumptions, estimates and projections about us and our industry. When used in this prospectus, the words “expects,” “believes,” “anticipates,” “estimates,” “intends” and similar expressions are intended to identify forward-looking statements. These statements include, but are not limited to, statements of our plans, strategies and prospects under the captions “Prospectus Summary,” “Risk Factors,” “Use of Proceeds,” and other statements contained elsewhere in this prospectus. In particular, but without limitation, our statement that we expect to return to profitability within the calendar year 2011 is a forward-looking statement. That expectation is dependent on our ability to avoid or to mitigate the risks inherent in our business, which risks we have described above.

These forward-looking statements are only predictions and are subject to risks and uncertainties that could cause actual events or results to differ materially from those projected. The cautionary statements made in this prospectus should be read as being applicable to all related forward-looking statements wherever they appear in this prospectus. We assume no obligation to update these forward-looking statements publicly for any reason. Actual results could differ materially from those anticipated in these forward-looking statements.

The risk factors discussed above could cause our actual results to differ materially from those expressed in any forward-looking statements, including, without limitation, our statement that we expect to return to profitability within the calendar year 2011. Factors that we believe are especially important with respect to that particular statement are those discussed above under the captions "We Require a Substantial Amount of Cash to Service Our Substantial Debt," "We Need Substantial Liquidity to Operate Our Business," "Our Results of Operations Will Depend on Our Ability to Secure and Maintain Adequate Credit and Warehouse Financing on Favorable Terms," "Our Results of Operations Will Depend on Our Ability to Securitize Our Portfolio of Automobile Contracts," "If We Lose Servicing Rights on Our Portfolio of Automobile Contracts, Our Results of Operations Would Be Impaired," "If We Experience Unfavorable Litigation Results, Our Results of Operations May Be Impaired," and "If The Economy of All or Certain Regions of the United States Continues to Slow Down or the Current Recession Worsens, Our Results of Operations May Be Impaired."

RATIOS OF EARNINGS TO FIXED CHARGES

	Year Ended					Nine Months Ended
	December 31, 2005	December 31, 2006	December 31, 2007	December 31, 2008	December 31, 2009	September 30, 2010
Ratio of earnings to fixed charges1	1.06	1.14	1.17	0.72	0.56	0.77
Deficiency2 ($000s)	--	--	--	(43,455)	(49,407)	(14,684)

1 For purposes of computing our ratios of earnings to fixed charges, we calculated earnings by adding fixed charges to income before income taxes. Fixed charges consist of gross interest expenses and one-third of our rent expense, which is the amount we believe is representative of the interest factor component of our rent expense.

2 The deficiency is the amount by which the sum of earnings plus fixed charges, as calculated above, fell short of fixed charges. It is thus equal to our pre-tax loss recorded in the years ended December 31, 2008 and 2009, and the nine-month period ended September 30, 2010.

USE OF PROCEEDS

If all of the notes are sold for cash, we would expect to receive approximately $ 43.5 million of net proceeds from this offering after payment of estimated offering expenses. Because we may sell the notes for cash or in exchange for surrender of outstanding notes (or surrender of other renewable subordinated notes issued prior to the date of this Prospectus), our actual cash proceeds will be less than that amount, to the extent of such sales in exchange. At September 30, 2010, there were $21.3 million of such other renewable subordinated notes outstanding, Although we have no specific plan to allocate the proceeds, the general purpose of the offering is to raise capital to purchase automobile contracts and for other general corporate purposes, which may include payment of general and administrative expenses.

CAPITALIZATION

The following table sets forth our capitalization, as of September 30, 2010, and as adjusted assuming sale of all of the notes for cash. To the extent that we sell the notes in exchange for surrender of previously outstanding notes (or surrender of other renewable subordinated notes issued prior to the date of this Prospectus), the adjustments to the table below would be reduced, dollar-for-dollar. For a description of the application of the net proceeds see “Use of Proceeds” and “Risk Factors – Risk Factors Relating to the Notes – Our management has broad discretion over the use of proceeds from the offering.”

	As of September 30, 2010 (in 000’s)	
	Actual	As adjusted
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Liabilities		
Accounts payable and accrued expenses	$20,932	$20,932
Warehouse lines of credit	39,692	39,692
Residual interest financing	44,252	44,252
Securitization trust debt	632,783	632,783
Senior secured debt	26,950	26,950
Renewable Subordinated Notes Subordinated debt	21,300	65 ,300
	785,909	829 ,909
Shareholders’ Equity		
Preferred stock, $1 par value;		
authorized 5,000,000 shares; none issued	--	--
Series A preferred stock, $1 par value;		
authorized 5,000,000 shares;		
None issued; none outstanding	--	--
Common stock, no par value; authorized		
75,000,000 shares; 18,034,909		
shares issued and outstanding at September 30, 2010	54,352	54,352
Additional paid-in capital, warrants	9,141	9,141
Retained earnings (accumulated deficit)	(41,788)	(41,788)
Accumulated other comprehensive loss	(5,636)	(5,636)
Total Shareholders’ Equity	16,069	16,069
Total capitalization	$801,978	$845 ,978

DESCRIPTION OF THE NOTES

General. The renewable unsecured subordinated notes we are offering will represent subordinated, unsecured debt obligations of CPS. We will issue the notes under an indenture between us and Wells Fargo Bank, National Association, as trustee. The terms and conditions of the notes include those stated in the indenture and those made part of the indenture by reference to the Trust Indenture Act of 1939. The following is a summary of the material provisions of the indenture. For a complete understanding of the notes, you should review the definitive terms and conditions contained in the indenture, which include definitions of certain terms used below. A copy of the indenture has been filed with the SEC as an exhibit to the registration statement of which this prospectus is a part and is available from us at no charge upon request.

The notes will be subordinated in right of payment to the prior payment in full of all our secured, unsecured, senior debt and other financial obligations, whether outstanding on the date of the indenture or incurred following the date of the indenture. Subject to limited restrictions contained in the indenture discussed below, there is no limit under the indenture on the amount of additional debt we may incur. See “ – Subordination” below.

The notes are not secured by any collateral or lien and we are not required to establish or maintain a sinking fund to provide for payments on the notes. See " – No Security; No Sinking Fund" below. In addition, the notes are not bank certificates of deposit and are not insured by the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation or any other agency or company.

You may select the amount (subject to a minimum principal amount of $1,000) and term (ranging from 3 months to 10 years) of the notes you would like to purchase when you subscribe; however, depending upon our capital requirements, we may not always offer notes with the requested terms. See " – Denomination" and " – Term" below.

We will determine the rate at which we will pay you interest on the notes at the time of subscription and the rate will be fixed for the term of your note. Currently available rates will be set forth in interest rate supplements to this prospectus. The interest rate will vary based on the term to maturity of the note you purchase and the total principal amount of all notes owned by you and your immediate family. We may change the interest rates at which we are offering new or renewed notes based on market conditions, the demand for notes and other factors. See " – Interest Rate" below.

Upon acceptance of your subscription to purchase notes, we will create an account in a book-entry registration and transfer system for you, and credit the principal amount of your subscription to your account. We will send you a purchase confirmation that will indicate our acceptance of your subscription. You will have five business days from the postmark date of your purchase confirmation to rescind your subscription. If your subscription is rejected, or if you rescind your subscription during the rescission period, all funds deposited will be promptly returned to you without any interest. See " – Book-Entry Registration and Transfer" and " – Rescission Right" below. Investors whose subscriptions for notes have been accepted and anyone who subsequently acquires notes in a qualified transfer are referred to as "holders" or "registered holders" in this prospectus and in the indenture.

We may modify or supplement the terms of the notes described in this prospectus from time to time in a supplement to the indenture and a supplement to this prospectus. Except as set forth under " – Amendment, Supplement And Waiver" below, any modification or amendment will not affect notes outstanding at the time of such modification or amendment.

Denomination. You may purchase notes in the minimum principal amount of $1,000 or any amount in excess of $1,000. You will determine the original principal amount of each note you purchase when you subscribe. You may not cumulate purchases of multiple notes with principal amounts less than $1,000 to satisfy the minimum denomination requirement.

Term. We may offer notes with the following terms to maturity:

- three months
- six months
- one year
- two years
- three years
- four years
- five years
- ten years

You will select the term of each note you purchase when you subscribe. You may purchase multiple notes with different terms by filling in investment amounts for more than one term on your subscription agreement. However, we may not always sell notes with all of the above terms.

Interest Rate. The rate of interest we will offer to pay you on notes at any particular time will vary based upon market conditions, and will be determined by the length of the term of the notes, the total principal amount of all notes owned by you and your immediate family, our capital requirements and other factors described below. The interest rate on a particular note will be determined at the time of subscription or renewal, and then remain fixed for the original or renewal term of the note. We will establish and may change the interest rates payable for notes of various terms and at various investment levels in an interest rate supplement to this prospectus.

The notes will earn incrementally higher interest rates when, at the time they are purchased or renewed, the aggregate principal amount of the note portfolio of the holder. The interest rates payable at each level of investment will be set forth in an interest rate supplement to this prospectus.

Interest rates we offer on the notes may vary based on numerous factors in addition to length of the term and aggregate principal amount. These factors may include, but are not limited to:

- the desire to attract new investors;
- whether the notes exceed certain principal amounts;
- whether the notes are being renewed by existing holders; and
- whether the notes are beneficially owned by persons residing in particular geographic localities.

Computation of Interest. We will compute interest on notes on the basis of a calendar year consisting of 365 days. Interest will compound daily and accrue from the date of purchase. The date of purchase will be the date we receive and accept funds if the funds are received prior to 12:01 p.m. central time on a business day, or the next business day if the funds are received on a non-business day or at or after 12:01 p.m. central time on a business day. Our business days are Monday through Friday, except for legal holidays in the State of Minnesota.

Interest Payment Dates. Holders of notes may elect at the time a subscription agreement is completed to have interest paid either monthly, quarterly, semiannually, annually or at maturity. If you choose to have interest paid monthly, you may elect the day of the month on which interest will be paid, subject to our approval. For all other payment periods, interest will be paid on the same day of the month as the purchase date of your note. You will not earn interest on any rescinded note. See "—Rescission Right" below for additional information on your right to rescind your investment.

Place and Method of Payment. We will pay principal and interest on the notes by direct deposit to the account you specify in your subscription documents. We will not accept subscription agreements from investors who are unwilling to receive their interest payments via direct deposit. If the foregoing payment method is not available, principal and interest on the notes will be payable at our principal executive office or at such other place as we may designate for payment purposes.

Servicing Agent. We may engage a non-affiliated third party to act as our servicing agent. Such person's responsibilities as servicing agent would involve the performance of certain administrative and customer service functions for the notes that we are responsible for performing as the issuer of the notes. For example, a servicing agent may serve as our registrar and transfer agent and may manage certain aspects of the customer service function for the notes, which may include handling phone inquiries, mailing investment kits, processing subscription agreements, issuing quarterly investor statements and redeeming and repurchasing notes. In addition, we may retain a servicing agent to provide us with monthly reports and analysis regarding the status of the notes, and the amount of notes that remain available for purchase.

You may contact us with any questions about the notes at the following address and telephone number:

Consumer Portfolio Services, Inc.
19500 Jamboree Road, Fifth Floor
Irvine, CA 92612
Telephone: (888) 776-1887
Fax: (949) 753-4878

Book-Entry Registration and Transfer. The notes are issued in book entry form, which means that no physical note is created. Evidence of your ownership is provided by written confirmation. Except under limited circumstances described below, holders will not receive or be entitled to receive any physical delivery of a certificated security or negotiable instrument that evidences their notes. The issuance and transfer of notes will be accomplished exclusively through the crediting and debiting of the appropriate accounts in our book-entry registration and transfer system.

The holders of the accounts established upon the purchase or transfer of notes will be deemed to be the owners of the notes under the indenture. The holder of the notes must rely upon the procedures established by the trustee to exercise any rights of a holder of notes under the indenture. We will regularly provide the trustee with information regarding the establishment of new accounts and the transfer of existing accounts.

We will also regularly provide the trustee with information regarding the total amount of any principal and/or interest due to holders with regard to the notes on any interest payment date or upon redemption.

On each interest payment date, we will credit interest due on each account and direct payments to the holders. We will determine the interest payments to be made to the book-entry accounts and maintain, supervise and review any records relating to book-entry beneficial interests in the notes.

Book-entry notations in the accounts evidencing ownership of the notes are exchangeable for actual notes in principal denominations of $1,000 and any amount in excess of $1,000 and fully registered in those names as we direct only if:

- we, at our option, advise the trustee in writing of our election to terminate the book-entry system, or
- after the occurrence of an event of default under the indenture, holders of more than 50% of the aggregate outstanding principal amount of the notes advise the trustee in writing that the continuation of a book-entry system is no longer in the best interests of the holders of notes and the trustee notifies all registered holders of the occurrence of any such event and the availability of certificated securities that evidence the notes.

Subject to the exceptions described above, the book-entry interests in these securities will not be exchangeable for fully registered certificated notes.

Rescission Right. A purchaser of notes has the right to rescind his or her investment, without penalty, upon written request within five business days from the postmark date of the purchase confirmation (but not upon transfer or automatic renewal of a note). You will not earn interest on any rescinded note. We will promptly return any funds sent with a subscription agreement that is properly rescinded. A written request for rescission, if personally delivered or delivered via electronic transmission, must be received by us on or prior to the fifth business day following the mailing of written confirmation by us of the acceptance of your subscription. If mailed, the written request for rescission must be postmarked on or before the fifth business day following the mailing of such written confirmation by us.

In addition, if your subscription agreement is accepted at a time when we have determined that a post-effective amendment to the registration statement of which this prospectus is a part must be filed with the Securities and Exchange Commission, but such post-effective amendment has not yet been declared effective, we will send to you at your registered address a notice and a copy of the post-effective amendment once it has been declared effective. You will have the right to rescind your investment upon written request within five business days from the postmark date of the notice that the post-effective amendment has been declared effective. We will promptly return any funds sent with a subscription agreement that is properly rescinded without penalty, although any interest previously paid on the notes being rescinded will be deducted from the funds returned to you upon rescission. A written request for rescission, if personally delivered or delivered via electronic transmission, must be received on or prior to the fifth business day following the mailing of the notice that the post-effective amendment has been declared effective. If mailed, the written request for rescission must be postmarked on or before the fifth business day following the mailing of such notice.

The limitations on the amount of notes that can be redeemed early in a single calendar quarter described under "–Redemption or Repurchase Prior to Stated Maturity" below do not affect your rescission rights.

Right to Reject Subscriptions. We may reject any subscription for notes in its sole discretion. If a subscription for notes is rejected, we will promptly return any funds sent with that subscription, without interest.

Renewal or Redemption On Maturity. Approximately 15, but not less than 10 days prior to maturity of your note, we will send you a notice at your registered address indicating that your note is about to mature and whether we will allow automatic renewal of your note. If we allow you to renew your note, we will also send to you the then current form of prospectus, which will include an interest rate supplement and any other updates to the information contained in this prospectus. The interest rate supplement will set forth the interest rates then in effect. The notice will recommend that you review the then current prospectus, including any prospectus supplements, and the interest rate supplement, prior to exercising one of the below options. If we do not send you a new prospectus because the prospectus has not changed since the delivery of this prospectus in connection with your original subscription or any prior renewal, we will send you a new prospectus upon your request. Unless the election period is extended as described below, you will have until 15 days after the maturity date to exercise one of the following options:

- You can do nothing, in which case your note will automatically renew for a new term equal to the original term at the interest rate in effect at the time of renewal. If your note pays interest only at maturity, all accrued interest will be added to the principal amount of your note upon renewal. For notes with other payment options, interest will be paid on the renewed note on the same schedule as the original note.

- You can elect repayment of your note, in which case the principal amount will be repaid in full along with any accrued but unpaid interest. If you choose this option, your note will not earn interest on or after the maturity date.

- You can elect repayment of your note and use all or part of the proceeds to purchase a new note with a different term or principal amount. To exercise this option, you will need to complete a subscription agreement for the new note and mail it along with your request. The issue date of the new note will be the maturity date of the old note. Any proceeds from the old note that are not applied to the new note will be sent to you.

- If your note pays interest only at maturity, you can receive the accrued interest that you have earned during the note term just ended while allowing the principal amount of your note to roll over and renew for the same term at the interest rate then in effect. To exercise this option, you will need to call, fax or send a written request to us.

The foregoing options will be available to holders until termination or redemption under the indenture and the notes by either the holder or us. Interest will accrue from the first day of each renewed term. Each renewed note will retain all its original provisions, including provisions relating to payment, except that the interest rate payable during any renewal term will be the interest rate that is being offered at that time to other holders with similar aggregate note portfolios for notes of the same term as set forth in the interest rate supplement delivered with the maturity notice. If similar notes are not then being offered, the interest rate upon renewal will be the rate specified by us on or before the maturity date, or the rate of the existing note if no such rate is specified.

If we notify the holder of our intention to repay a note at maturity, we will pay the holder the principal amount and any accrued but unpaid interest on the stated maturity date. Similarly, if, within 15 days after a note’s stated maturity date (or during any applicable extension of the 15 day period, as described below), the holder requests repayment with respect to a note, we will pay the holder the principal amount of the note plus accrued but unpaid interest up to, but not including, the note’s stated maturity date. In the event that a holder’s regularly scheduled interest payment date falls after the maturity date of the note but before the date on which the holder requests repayment, the holder may receive interest payments that include interest for periods after the maturity date of the note. If this occurs, the excess interest will be deducted from our final payment of the principal amount of the note to the holder. We will initiate payment to any holder timely requesting repayment by the later of the maturity date or five business days after the date on which we receive such notice from the holder. Because payment is made by ACH transfer, funds may not be received in the holder’s account for 2 to 3 business days. Requests for repayment should be made in writing.

We will be required from time to time to file post-effective amendments to the registration statement of which this prospectus is a part to update the information it contains. If you would otherwise be required to elect to have your notes renewed or repaid following their stated maturity at a time when we have determined that a post-effective amendment must be filed with the Securities and Exchange Commission, but such post-effective amendment has not yet been declared effective, the period during which you can elect renewal or repayment will be automatically extended until ten days following the postmark date of a notice that will be sent to you at your registered address that the post-effective amendment has been declared effective. In the event that a holder’s regularly scheduled interest payment date falls after the maturity date of the note but before the date on which the holder requests repayment, the holder may receive an interest payment that includes interest for periods after the maturity date of the note. If this occurs, the excess interest will be deducted from our final payment of the principal amount of the note to the holder. All other provisions relating to the renewal or redemption of notes upon their stated maturity described above shall remain unchanged.

Redemption or Repurchase Prior To Stated Maturity. The notes may be redeemed prior to stated maturity only as set forth in the indenture and described below. The holder has no right to require us to prepay or repurchase any note prior to its maturity date as originally stated or as it may be extended, except as indicated in the indenture and described below.

Redemption By Us. We have the right to redeem any note at any time prior to its stated maturity upon 30 days written notice to the holder of the note. The holder of the note being redeemed will be paid a redemption price equal to the outstanding principal amount thereof plus but accrued and unpaid interest up to but not including the date of redemption without any penalty or premium. We may use any criteria we choose to determine which notes we will redeem if we choose to do so. We are not required to redeem notes on a pro rata basis.

Repurchase Election Upon Death Or Total Permanent Disability. Notes may be repurchased prior to maturity, in whole and not in part, at the election of a holder who is a natural person (including notes held in an individual retirement account), by giving us written notice within 45 days following the holder's total permanent disability, as established to our satisfaction, or at the election of the holder's estate, by giving written notice within 45 days following his or her death. Subject to the limitations described below, we will repurchase the notes within 10 days after the later to occur of the request for repurchase or the establishment to our satisfaction of the holder's death or total permanent disability. The repurchase price, in the event of such a death or total permanent disability, will be the principal amount of the notes, plus interest accrued and not previously paid up to but not including the date of repurchase. If spouses are joint registered holders of a note, the right to elect to have us repurchase will apply when either registered holder dies or suffers a total permanent disability. If the note is held jointly by two or more persons who are not legally married, none of these persons will have the right to request that we repurchase the notes unless all joint holders have either died or suffered a total permanent disability. If the note is held by a person who is not a natural person such as a trust, partnership, corporation or other similar entity, the right to request repurchase upon death or total permanent disability does not apply.

Repurchase At Request of Holder. We have agreed not to repurchase any notes other than upon maturity, or upon the death or total permanent disability of the holder. We agreed to that prohibition (subject to the exceptions stated) in order to issue and sell secured notes in the original principal amount of $10 million, subsequently increased to an aggregate principal amount of $30 million, pursuant to a Securities Purchase Agreement ("SPA") between us and Levine Leichtman Capital Partners IV, L.P. ("LLCP"), dated June 30, 2008 and as subsequently amended. Under the SPA, LLCP has purchased from us notes representing our senior secured debt. The general prohibition on our repurchase of the notes offered by this prospectus is one of several provisions of the SPA that are designed to protect LLCP as our creditor.

Limitations on Requirements to Repurchase. Our obligation to repurchase notes prior to maturity for any reason will be subject to a calendar quarter limit equal to the greater of $1 million of aggregate principal amount for all holders or 2% of the total principal amount of all notes outstanding at the end of the previous calendar quarter. This limit includes any notes we repurchase upon death or total permanent disability of the holder, and would apply even in the absence of our contractual prohibition on repurchases, noted above.

Modifications to Repurchase Policy. We may modify the policies on repurchase in the future. No modification will affect the right of repurchase applicable to any note outstanding at the time of any such modification.

Transfers. The notes are not negotiable debt instruments and, subject to certain exceptions, will be issued only in book-entry form. The purchase confirmation issued upon our acceptance of a subscription is not a certificated security or negotiable instrument, and no rights of record ownership can be transferred without our prior written consent. Ownership of notes may be transferred on the note register only as follows:

- The holder must deliver us written notice requesting a transfer signed by the holder(s) or such holder's duly authorized representative on a form to be supplied by us.

- We must provide our written consent to the proposed transfer.

- We may require a legal opinion from counsel satisfactory to us that the proposed transfer will not violate any applicable securities laws.

- We may require a signature guarantee in connection with such transfer.

Upon transfer of a note, we will provide the new holder of the note with a purchase confirmation that will evidence the transfer of the account on our records. We may charge a reasonable service charge in connection with the transfer of any note.

Quarterly Statements. We will provide holders of the notes with quarterly statements, which will indicate, among other things, the account balance at the end of the quarter, interest credited, redemptions or repurchases made, if any, and the interest rate paid during the quarter. These statements will be mailed not later than the 10th business day following the end of each calendar quarter. We may charge such holders a reasonable fee to cover the charges incurred in providing such information.

Subordination. The indebtedness evidenced by the notes, and any interest thereon, is subordinated in right of payment to all of our senior debt, including indebtedness held by our subsidiaries that are special purpose entities. “Senior debt” means all of our secured, unsecured, senior or subordinate indebtedness, as well as other financial obligations of the company, whether outstanding on the date of this prospectus or incurred after the date of this prospectus, whether such indebtedness is or is not specifically designated as being senior debt in its defining instruments, other than (i) existing outstanding unsecured subordinated indebtedness in the amount of $22.1 million, as of June 30, 2010, and (ii) any future offerings of additional renewable unsecured subordinated notes, both of which will rank equally with the notes. Any documents, agreements or instruments evidencing or relating to any senior debt may be amended, restated, supplemented and/or renewed from time to time without requiring any notice to or consent of any holder of notes or any person or entity acting on behalf of any such holder or the trustee.

The indenture does not prevent holders of senior debt from disposing of, or exercising any other rights with respect to, any or all of the collateral securing the senior debt. As of June 30, 2010, we had approximately $806.7 million of debt outstanding that is senior to the notes, of which approximately $780.0 million was issued by our consolidated special purpose entities. Including an additional approximately $68.0 million of debt that does not appear on our consolidated financial statements (which was issued by our off-balance sheet special purpose entities), we had approximately $874.7 million of debt outstanding that is senior to the notes.

Except for certain limited restrictions, the terms of the notes or the indenture do not impose any limitation on the amount of senior debt or other indebtedness we may incur, although our existing senior debt agreements may restrict us from incurring new senior debt. See "Risk Factors – Risk Factors Relating to the Notes – Because the notes rank junior to substantially all of our existing and future debt and other financial obligations, your notes will lack priority in payment."

The notes are not guaranteed by any of our subsidiaries, affiliates or control persons. Accordingly, in the event of a liquidation or dissolution of one of our subsidiaries, creditors of that subsidiary will be paid in full, or provision for such payment will be made, from the assets of that subsidiary prior to distributing any remaining assets to us as a shareholder of that subsidiary. Therefore, in the event of liquidation or dissolution of a subsidiary, no assets of that subsidiary may be used to make payment to the holders of the notes until the creditors of that subsidiary are paid in full from the assets of that subsidiary.

In the event of any liquidation, dissolution or any other winding up of us, or of any receivership, insolvency, bankruptcy, readjustment, reorganization or similar proceeding under the U.S. Bankruptcy Code or any other applicable federal or state law relating to bankruptcy or insolvency, or during the continuation of any event of default on the senior debt, no payment may be made on the notes until all senior debt has been paid in full or provision for such payment has been made to the satisfaction of the senior debt holders. If any of the above events occurs, holders of senior debt may also submit claims on behalf of holders of the notes and retain the proceeds for their own benefit until they have been fully paid, and any excess will be turned over to the holders of the notes. If any distribution is nonetheless made to holders of the notes, the money or property distributed to them must be paid over to the holders of the senior debt to the extent necessary to pay senior debt in full.

We will not make any payment, direct or indirect (whether for interest, principal, as a result of any redemption or repurchase at maturity, on default, or otherwise), on the notes and any other indebtedness being subordinated to the payment of the notes, and neither the holders of the notes nor the trustee will have the right, directly or indirectly, to sue to enforce the indenture or the notes, if a default or event of default under any senior debt has occurred and is continuing, or if any default or event of default under any senior debt would result from such payment, in each case unless and until:

- the default and event of default has been cured or waived or has ceased to exist; or

- the end of the period commencing on the date the trustee receives written notice of default from a holder of the senior debt and ending on the earlier of

— the trustee's receipt of a valid waiver of default from the holder of senior debt; or

— the trustee's receipt of a written notice from the holder of senior debt terminating the payment blockage period.

Provided, however, that if any of the blockage events described above has occurred and 179 days have passed since the trustee's receipt of the notice of default without the occurrence of the cure, waiver or termination of all blockage periods described above, the trustee may thereafter sue on and enforce the indenture and the notes as long as any funds paid as a result of any such suit or enforcement action shall be paid toward the senior debt until it is indefeasibly paid in full before being applied to the notes.

No Collateral Security; No Sinking Fund. The notes are unsecured, which means that none of our tangible or intangible assets or property, nor any of the assets or property of any of our subsidiaries, has been set aside or reserved to make payment to the holders of the notes in the event that we default on our obligations to the holders. In addition, we will not contribute funds to any separate account, commonly known as a sinking fund, to repay principal or interest due on the notes upon maturity or default. See “Risk Factors – Risk Factors Relating to the Notes – Because the notes will have no sinking fund, security, insurance or guarantee, you may lose all or a part of your investment in the notes if we do not have enough cash to pay the notes.”

Restrictive Covenants. The indenture contains certain limited restricted covenants that restrict us from certain actions as set forth below.

The indenture provides that, so long as the notes are outstanding:

- we will not declare or pay any dividends or other payments of cash or other property solely in respect of our capital stock to our stockholders (other than a dividend paid in shares of our capital stock on a pro rata basis to all our stockholders) unless no default and no event of default with respect to the notes exists or would exist immediately following the declaration or payment of the dividend or other payment;

- to the extent legally permissible, we will not at any time insist upon, plead, or in any manner whatsoever claim or take the benefit or advantage of, any stay, extension or usury law wherever enacted, now or at any time hereafter in force, which may affect the covenants or the performance of the indenture; and

- neither our board of directors nor our shareholders will adopt a plan of liquidation that provides for, contemplates or the effectuation of which is preceded by (a) the sale, lease, conveyance or other disposition of all or substantially all of our assets, otherwise than (i) substantially as an entirety, or (ii) in a qualified sales and financing transaction, and (b) the distribution of all or substantially all of the proceeds of such sale, lease, conveyance or other disposition and of our remaining assets to the holders of our capital stock, unless, prior to making any liquidating distribution pursuant to such plan, we make provision for the satisfaction of our obligations under the renewable unsecured subordinated notes.

We are not restricted from entering into qualified sale and financing transactions or incurring additional indebtedness. See “Risk Factors – Risk Factors Relating to the Notes – Because there are limited restrictions on our activities under the Indenture, you will have only limited protection under the indenture.”

Consolidation, Merger or Sale. The indenture generally permits a consolidation or merger between us and another entity. It also permits the sale or transfer by us of all or substantially all of our property and assets. These transactions are permitted if:

- the resulting or acquiring entity, if other than us, is a United States corporation, limited liability company or limited partnership and assumes all of our responsibilities and liabilities under the indenture, including the payment of all amounts due on the notes and performance of the covenants in the indenture; and

- immediately after the transaction, and giving effect to the transaction, no event of default under the indenture exists.

If we consolidate or merge with or into any other entity or sell or lease all or substantially all of our assets, according to the terms and conditions of the indenture, the resulting or acquiring entity will be substituted for us in the indenture with the same effect as if it had been an original party to the indenture. As a result, the successor entity may exercise our rights and powers under the indenture, in our name and we will be released from all our liabilities and obligations under the indenture and under the notes.

Events Of Default. The indenture provides that each of the following constitutes an event of default:

- failure to pay interest on a note within 15 days after the due date for such payment (whether or not prohibited by the subordination provisions of the indenture);

- failure to pay principal on a note within 15 days after the due date for such payment (whether or not prohibited by the subordination provisions of the indenture);

- our failure to observe or perform any material covenant, condition or agreement or our breach of any material representation or warranty, but only after we have been given notice of such failure or breach and such failure or breach is not cured within 60 days after our receipt of notice;

- defaults in certain of our other payment obligations that result in such payment obligations becoming or being declared immediately due and payable and such declaration is not rescinded or annulled within 60 days after our receipt of notice of such declaration; and

- certain events of bankruptcy or insolvency with respect to us.

If any event of default occurs and is continuing (other than an event of default involving certain events of bankruptcy or insolvency with respect to us), the trustee or the holders of at least a majority in principal amount of the then outstanding notes may by notice to us declare the unpaid principal of and any accrued interest on the notes to be due and payable immediately. So long as any senior debt is outstanding, however, and a payment blockage on the notes is in effect, a declaration of this kind will not be effective, and neither the trustee nor the holders of notes may enforce the indenture or the notes, except as otherwise set forth above in "- Subordination". In the event senior debt is outstanding and no payment blockage on the notes is in effect, a declaration of this kind will not become effective until the later of:

- the day which is five business days after the receipt by us and the holders of senior debt of such written notice of acceleration; or
- the date of acceleration of any senior debt.

In the case of an event of default arising from certain events of bankruptcy or insolvency, with respect to us, all outstanding notes will become due and payable without further action or notice.

Holders of the notes may not enforce the indenture or the notes except as provided in the indenture. Subject to certain limitations, holders of a majority in principal amount of the then outstanding notes may direct the trustee in its exercise of any trust power. The trustee may withhold from holders of the notes notice of any continuing default or event of default (except a default or event of default relating to the payment of principal or interest on the notes) if the trustee in good faith determines that withholding notice would have no material adverse effect on the holders.

The holders of a majority in aggregate principal amount of the notes then outstanding by notice to the trustee may, on behalf of the holders of all of the notes, waive any existing default or event of default and its consequences under the indenture, except:

- a continuing default or event of default in the payment of interest on, or the principal of, a note held by a non-consenting holder; or
- a waiver that would conflict with any judgment or decree.

We are required to deliver to the trustee within 120 days of the end of our fiscal year a certificate regarding compliance with the indenture, and we are required, upon becoming aware of any default or event of default, to deliver to the trustee a certificate specifying such default or event of default and what action we are taking or propose to take with respect to the default or event of default.

Amendment, Supplement and Waiver. Except as provided in this prospectus or the indenture, the terms of the indenture or the notes then outstanding may be amended or supplemented with the consent of the holders of at least a majority in principal amount of the notes then outstanding, and any existing default or compliance with any provision of the indenture or the notes may be waived with the consent of the holders of a majority in principal amount of the then outstanding notes.

Notwithstanding the foregoing, an amendment or waiver will not be effective with respect to the notes held by a holder who has not consented if it has any of the following consequences:

- reduces the aggregate principal amount of notes whose holders must consent to an amendment, supplement or waiver;
-

reduces the principal of or changes the fixed maturity of any note or alters the repurchase or redemption provisions or the price at which we shall offer to repurchase or redeem the note;

- reduces the rate of or changes the time for payment of interest, including default interest, on any note;
- waives a default or event of default in the payment of principal or interest on the notes, except a rescission of acceleration of the notes by the holders of at least a majority in aggregate principal amount of the then outstanding notes and a waiver of the payment default that resulted from such acceleration;.
- makes any note payable in money other than that stated in this prospectus;

- makes any change in the provisions of the indenture relating to waivers of past defaults or the rights of holders of notes to receive payments of principal of or interest on the notes;
- makes any change to the subordination provisions of the indenture that has a material adverse effect on holders of notes;
- modifies or eliminates the right of the estate of a holder or a holder to cause us to repurchase a note upon the death or total permanent disability of a holder; or
- makes any change in the foregoing amendment and waiver provisions.

Notwithstanding the foregoing, without the consent of any holder of the notes, we and the trustee may amend or supplement the indenture or the notes:

- to cure any ambiguity, defect or inconsistency;
- to provide for assumption of our obligations to holders of the notes in the case of a merger, consolidation or sale of all or substantially all of our assets;
- to provide for additional uncertificated or certificated notes;
- to make any change that does not adversely affect the legal rights under the indenture of any such holder, including but not limited to an increase in the aggregate dollar amount of notes which may be outstanding under the indenture;
- to modify our policy regarding repurchases elected by a holder of notes prior to maturity and our policy regarding repurchase of the notes prior to maturity upon the death or total permanent disability of any holder of the notes, but such modifications shall not materially adversely affect any then outstanding notes; or
- to comply with requirements of the SEC in order to effect or maintain the qualification of the indenture under the Trust Indenture Act.

The Trustee. Wells Fargo Bank, National Association has agreed to be the trustee under the indenture. The indenture contains certain limitations on the rights of the trustee, should it become one of our creditors, to obtain payment of claims in certain cases, or to realize on certain property received in respect of any claim as security or otherwise. The trustee will be permitted to engage in other transactions with us.

Subject to certain exceptions, the holders of a majority in principal amount of the then outstanding notes will have the right to direct the time, method and place of conducting any proceeding for exercising any remedy available to the trustee. The indenture provides that in case an event of default specified in the indenture shall occur and not be cured, the trustee will be required, in the exercise of its power, to use the degree of care of a reasonable person in the conduct of his own affairs. Subject to such provisions, the trustee will be under no obligation to exercise any of its rights or powers under the indenture at the request of any holder of notes, unless the holder shall have offered to the trustee security and indemnity satisfactory to it against any loss, liability or expense.

Resignation or Removal of the Trustee. The trustee may resign at any time, or may be removed by the holders of a majority of the aggregate principal amount of the outstanding notes. In addition, upon the occurrence of contingencies relating generally to the insolvency of the trustee or the trustee’s ineligibility to serve as trustee under the Trust Indenture Act of 1939, as amended, we may remove the trustee. However, no resignation or removal of the trustee may become effective until a successor trustee has accepted the appointment as provided in the indenture.

Reports to Trustee. We will provide the trustee with quarterly reports containing any information reasonably requested by the trustee. These quarterly reports will include information on each note outstanding during the preceding quarter, including outstanding principal balance, interest credited and paid, transfers made, any redemption or repurchase and interest rate paid.

No Personal Liability of Our Directors, Officers, Employees and Stockholders. No director, officer, employee, incorporator or stockholder of ours or any servicing agent, will have any liability for any of our obligations under the notes, the indenture or for any claim based on, in respect to, or by reason of, these obligations or their creation. Each holder of the notes waives and releases these persons from any liability, including any liability arising under applicable securities laws. The waiver and release are part of the consideration for issuance of the notes. We have been advised that the waiver may not be effective to waive liabilities under the federal securities laws and it is the view of the SEC that such a waiver is against public policy.

Service Charges. We and our servicing agent may assess service charges for changing the registration of any note to reflect a change in name of the holder, multiple changes in interest payment dates or transfers (whether by operation of law or otherwise) of a note by the holder to another person.

Additional Securities. We may offer additional classes of securities with terms and conditions different from the notes currently being offered in this prospectus. We will amend or supplement this prospectus if and when we decide to offer to the public any additional class of security under this prospectus. If we sell the entire principal amount of notes offered in this prospectus, we may register and sell additional notes by amending this prospectus, but we are under no obligation to do so.

Variations in Terms and Conditions. We may from time to time to vary the terms and conditions of the notes offered by this prospectus, including, but not limited to: minimum initial principal investment amount requirements; maximum aggregate principal amount limits; interest rates; minimum denominations; service and other fees and charges; and redemption provisions. Terms and conditions may be varied by state, locality, principal amount, type of investor — for example, new or current investor — or as otherwise permitted under the indenture governing the securities offered by this prospectus. No change in terms, however, will apply to any notes issued and outstanding.

Interest Withholding. We will withhold 28% (which rate is scheduled to increase to 31% for payments made after December 31, 2010) of any interest paid to any investor who has not provided us with a social security number, employer identification number, or other satisfactory equivalent in the subscription agreement (or another document) or where the Internal Revenue Service has notified us that backup withholding is otherwise required. Please read “Material Federal Income Tax Consequences – Reporting and Backup Withholding.”

Liquidity. There is not currently a trading market for the notes, and we do not expect that a trading market for the notes will develop.

Satisfaction and Discharge of Indenture. The indenture shall cease to be of further effect upon the payment in full of all of the outstanding notes and the delivery of an officer’s certificate to the trustee stating that we do not intend to issue additional notes under the indenture or, with certain limitations, upon deposit with the trustee of funds sufficient for the payment in full of all of the outstanding notes.

Reports. We currently publish annual reports containing financial statements and quarterly reports containing financial information for the first three quarters of each fiscal year. We will send copies of these reports, at no charge, to any holder of notes who sends a written request to:

Consumer Portfolio Services, Inc.
19500 Jamboree Road
Irvine, California 92612
Attention: Corporate Secretary
(949) 753-6800

MATERIAL FEDERAL INCOME TAX CONSEQUENCES

The following discussion is our counsel's opinion of the material federal income tax consequences relating to the ownership and disposition of the notes. The discussion is based upon the current provisions of the Internal Revenue Code of 1986, as amended, regulations issued under the Internal Revenue Code and judicial or ruling authority, all of which are subject to change that may be applied retroactively. The discussion assumes that the notes are held as capital assets and does not discuss the federal income tax consequences applicable to all categories of investors, some of which may be subject to special rules such as banks, tax-exempt organizations, insurance companies, dealers in securities or currencies, persons that will hold notes as a position in a hedging, straddle or conversion transactions, or persons that have a functional currency other than the U.S. dollar. If a partnership holds notes, the tax treatment of a partner will generally depend on the status of the partner and on the activities of the partnership. In addition, it does not deal with holders other than original purchasers. You are urged to consult your own tax advisor to determine the specific federal, state, local and any other tax consequences applicable to you relating to your ownership and disposition of the notes.

Interest Income on the Notes

Subject to the discussion below applicable to "non-U.S. holders," interest paid on the notes will generally be taxable to you as ordinary income as the income is paid if you are a cash method taxpayer or as the income accrues if you are an accrual method taxpayer.

However, a note with a term of one year or less, which we refer to in this discussion as a "short-term note," will be treated as having been issued with original issue discount or "OID" for tax purposes equal to the total payments on the note over its issue price. If you are a cash method holder of a short-term note you are not required to include this OID as income currently unless you elect to do so. Cash method holders who make that election and accrual method holders of short-term notes are generally required to recognize the OID in income currently as it accrues on a straight-line basis unless the holder elects to accrue the OID under a constant yield method. Under a constant yield method, you generally would be required to include in income increasingly greater amounts of OID in successive accrual periods.

Cash method holders of short-term notes who do not include OID in income currently will generally be taxed on stated interest at the time it is received and will treat any gain realized on the disposition of a short-term note as ordinary income to the extent of the accrued OID generally reduced by any prior payments of interest. In addition, these cash method holders will be required to defer deductions for certain interest paid on indebtedness related to purchasing or carrying the short-term notes until the OID is included in the holder's income.

There are also some situations in which a cash basis holder of a note having a term of more than one year may have taxable interest income with respect to a note before any cash payment is received with respect to the note. If you report income on the cash method and you hold a note with a term longer than one year that pays interest only at maturity, you generally will be required to include OID accrued during the original term (without regard to renewals) as ordinary gross income as the OID accrues. OID accrues under a constant yield method, as described above.

Treatment of Dispositions of Notes

Upon the sale, exchange, retirement or other taxable disposition of a note, you will recognize gain or loss in an amount equal to the difference between the amount realized on the disposition and your adjusted tax basis in the note. Your adjusted tax basis of a note generally will equal your original cost for the note, increased by any accrued but unpaid interest (including OID) you previously included in income with respect to the note and reduced by any principal payments you previously received with respect to the note. Any gain or loss will be capital gain or loss, except for gain representing accrued interest not previously included in your income. This capital gain or loss will be short-term or long-term capital gain or loss, depending on whether the note had been held for more than one year or for one year or less.

Non-U.S. Holders

Generally, if you are a nonresident alien individual or a non-U.S. corporation and do not hold the note in connection with a United States trade or business, interest paid and OID accrued on the notes will be treated as “portfolio interest” and therefore will be exempt from a 30% United States withholding tax. In that case, you will be entitled to receive interest payments on the notes free of United States federal income tax provided that you periodically provide a statement on applicable IRS forms certifying under penalty of perjury that you are not a United States person and provide your name and address. In addition, in that case you will not be subject to United

States federal income tax on gain from the disposition of a note unless you are an individual who is present in the United States for 183 days or more during the taxable year in which the disposition takes place and certain other requirements are met. Interest paid and accrued OID paid to a non-U.S. person are not subject to withholding if they are effectively connected with a United States trade or business conducted by that person and we are provided a properly executed IRS Form W-8ECI. They will, however, generally be subject to the regular United States income tax. If you are a non-U.S. corporation, that portion of your earnings and profits that is effectively connected with your U.S. trade or business also may be subject to a "branch profits tax" at a 30% rate, although an applicable income tax treaty may provide for lower rate.

Reporting and Backup Withholding

We will report annually to the Internal Revenue Service and to holders of record that are not excepted from the reporting requirements any information that may be required with respect to interest or OID on the notes.

Under certain circumstances, as a holder of a note, you may be subject to “backup withholding” at a 28% rate. After December 31, 2010, the backup withholding rate is scheduled to increase to 31%. Backup withholding may apply to you if you are a United States person and, among other circumstances, you fail to furnish on IRS Form W-9 or a substitute Form W-9 your Social Security number or other taxpayer identification number to us. Backup withholding may apply, under certain circumstances, if you are a non-U.S. person and fail to provide us with the statement necessary to establish an exemption from federal income and withholding tax on interest on the note. Backup withholding, however, does not apply to payments on a note made to certain exempt recipients, such as corporations and tax-exempt organizations, and to certain non-U.S. persons. Backup withholding is not an additional tax and may be refunded or credited against your United States federal income tax liability, provided that you furnish certain required information.

This federal tax discussion is included for general information only and may not be applicable depending upon your particular situation. You are urged to consult your own tax advisor with respect to the specific tax consequences to you of the ownership and disposition of the notes, including the tax consequences under state, local, foreign and other tax laws and the possible effects of changes in federal or other tax laws.

New Legislation

On March 18, 2010, the President signed into law the Hiring Incentives to Restore Employment Act of 2010, which imposes a U.S. withholding tax of a 30% rate on interest and proceeds of sale in respect of our notes received by U.S. holders who own their notes through foreign accounts or foreign intermediaries and certain non-U.S holders if certain due diligence and disclosure requirements related to U.S. accounts or ownership are not satisfied. If payment of withholding taxes is required, non-U.S. holders that are otherwise eligible for an exemption from, or reduction of, U.S. withholding tax with respect to such interest and proceeds will be required to seek a refund from the IRS to obtain the benefit of such exemption or reduction. We will not pay any additional amounts in respect of any amounts withheld. These new withholding rules are generally effective for notes issued after March 18, 2012.

For taxable years beginning after December 31, 2012, newly enacted legislation is scheduled to impose a 3.8 percent tax on the "net investment income" of certain individuals, and on the undistributed "net investment income" of certain estates and trusts. Among other items, net investment income generally includes gross income from interest, less certain deductions. Prospective investors are urged to consult with their tax advisors regarding the possible implications of this legislation in their particular circumstances.

PLAN OF DISTRIBUTION

Except as we may otherwise indicate in the applicable prospectus supplement, we will sell these securities directly, without an underwriter or selling agent, and the securities will be sold by our employees who, under Rule 3a4-1(a) of the Exchange Act, are deemed not to be brokers. In accordance with the provisions of Rule 3a4-1(a), our employees who sell securities will not be compensated by commission, will not be associated with any broker or dealer and will limit their activities so that, among other things, they do not engage in oral solicitations of, and comply with certain specified limitations when responding to inquiries from, potential purchasers.

We plan to market the notes directly to the public and to our existing noteholders through newspaper, radio, internet, direct mail and other advertising. We may engage an unaffiliated third party (a "servicing agent") to manage certain administrative and customer service functions relating to the notes, including handling all inquiries from potential investors, mailing investment kits, meeting with investors, processing subscription agreements and responding to all written and telephonic questions relating to the notes. We may elect to perform these duties ourselves.

We will bear the expenses incurred in connection with the offer and sale of the notes, including document fulfillment expenses, legal and accounting fees, regulatory fees, due diligence expenses and marketing costs. No one will receive a commission based on notes sold or renewed.

We may distribute the notes in one or more transactions: (1) at a fixed price or prices, which may be changed; or (2) at negotiated prices. We may also sell notes in exchange for outstanding notes held by our existing noteholders.

We may agree to pay a servicing agent an annual portfolio management fee equal to a percentage of the weighted average principal balance of the notes outstanding for its services as servicing agent. In exchange for the annual portfolio management fee, such a servicing agent would manage specified customer service functions concerning the notes and act as an agent between us and the purchasers of the notes. The annual portfolio management fee also covers costs relating to maintenance of the investor relationship after the purchase of notes. This includes, among other things, addressing ministerial investor inquiries regarding the notes, the preparation of all confirmations, notices and statements, the coordination of interest payments, the establishment and maintenance of records relating to the notes, the preparation of all reports, statements and analyses regarding the notes, and all out-of-pocket expenses for the printing and mailing of confirmations, notices and statements to the investors. The amount of this fee will depend upon a number of variables, including the pace at which notes are sold, the terms of the notes sold and whether the notes are redeemed or repurchased.

We may engage an advertising and marketing company, not affiliated with us nor with any broker-dealer, to directly provide or manage the advertising and marketing functions related to the sale of the notes. These services may include media planning, media buying, creative and copy development, direct mail services, literature fulfillment, commercial printing, list management, list brokering, advertising consulting, efficiency analyses and other similar activities. If we retain an advertising agent, such agent will be compensated directly by us or its sub-service providers for these advertising and marketing services. This compensation is consistent with accepted normal advertising and marketing industry standards for similar services.

Prior to the offering, there has been no public market for the notes. We do not intend to list the notes on any securities exchange or include them for quotation on Nasdaq. No one is obligated to make a market in the notes, and we do not anticipate that a secondary market for the notes will develop.

We may vary the terms and conditions of the offer by state, locality or as otherwise described under "Description of the Notes – Interest Rate" and "– Variations in Terms and Conditions" in this prospectus. From time to time, we also may vary the terms and conditions of the securities offered by this prospectus depending on such factors as our liquidity requirements, the interest rate environmentD VALIGN="bottom">

Total operating expenses	**333,649**	303,225

Operating income	**143,750**	124,983
Interest expense	**15,325**	11,605
Interest and other investment income	**(1,094)**	(1,110)
Equity in net income of affiliates	**(803)**	(722)
Loss on extinguishment of debt		696
Other	**(420)**	(10)
Other income and expenses, net	**13,008**	10,459
Income before income taxes		

	130,742	114,524
Income taxes	**43,177**	40,179
Net income	**$87,565**	$74,345
Weighted average shares outstanding-diluted	**66,336**	69,000
Diluted earnings per share	**$1.32**	$1.08

Management analyzes its business based on franchising revenues, which is total revenues excluding marketing and reservation revenues and hotel operations, and franchise operating expenses that are reflected as selling, general and administrative expenses.

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

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

Including franchises acquired from Suburban, the number of domestic rooms on-line increased to 329,353 from 309,586, an increase of 6.4% for the year ended December 31, 2005. For 2005, the total number of domestic hotels on-line grew 5.6% to 4,048 from 3,834 for 2004. International rooms on-line increased to 97,703 as of December 31, 2005 from 94,220 as of December 31, 2004, a 3.7% increase. The total number of international hotels on-line also increased from 1,143 to 1,162, an increase of 1.7% for the year ended December 31, 2005. As of December 31, 2005, the Company had 603 franchised hotels with 46,464 rooms under construction, awaiting conversion or approved for development in its domestic system as compared to 460 hotels and 35,652 rooms at December 31, 2004. The Company had an additional 84 franchised hotels with 7,611 rooms under development in its international system as of December 31, 2005 compared to 109 hotels and 9,515 rooms at December 31, 2004.

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

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

Relicensing fees increased 51.5% to $10.3 million for the year ended December 31, 2005 from $6.8 million for the year ended December 31, 2004. Relicensing fees are charged to the new property owner of a franchised property whenever an ownership change occurs and the property remains in the franchise system.

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

Franchise Expenses: The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative expenses were $78.3 million for the year ended

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December 31, 2005, an increase of $8.8 million from the year ended December 31, 2004 total of $69.5 million. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 34.0% for the year ended December 31, 2005 compared to 34.1% for 2004. Expenses increased primarily due to higher compensation costs including variable franchise sales and key management incentive compensation and increased travel and entertainment expenses related to the expansion of the franchise sales force.

Marketing and Reservations: The Company s franchise agreements require the payment of franchise fees, which include marketing and reservation fees. The fees, which are based on a percentage of the franchisees gross room revenues, are used exclusively by the Company for expenses associated with providing franchise services such as central reservation systems, national marketing and media advertising. The Company is contractually obligated to expend the marketing and reservation fees it collects from franchisees in accordance with the franchise agreements; as such, no income or loss to the Company is generated.

Total marketing and reservations revenues were $243.1 million and $220.7 million for the years ended December 31, 2005 and 2004, respectively. Depreciation and amortization attributable to marketing and reservation activities was $7.6 million and $9.1 million for the years ended December 31, 2005 and 2004, respectively. Interest expense attributable to reservation activities was $1.1 million and $1.5 million for the years ended December 31, 2005 and 2004, respectively. Marketing and reservations activities provided positive cash flow of $19.4 million and $19.7 million for the years ended December 31, 2005 and 2004, respectively. As of December 31, 2005, the Company s balance sheet includes a receivable of $13.2 million for marketing fees and a payable of $3.6 million for reservation fees. At December 31, 2004, the Company s balance sheet contained a receivable for marketing and reservation fees of $21.7 million. This receivable is recorded as an asset in the financial statements as the Company has the contractual authority to require that the franchisees in the system at any given point repay the Company for any deficits related to marketing and reservations activities. The Company s current franchisees are legally obligated to pay any assessment the Company imposes on its franchisees to obtain reimbursement of such deficit regardless of whether those constituents continue to generate gross room revenue. The Company has no present intention to accelerate repayment of the deficit from current franchisees. Cumulative reservation and marketing fees not expended are recorded as a payable in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

Other Income and Expenses: Other income and expense, net increased $2.5 million to an expense of $13.0 million for the year ended December 31, 2005 from $10.5 million for the same period in 2004. This increase resulted from a $3.7 million increase in interest expense to $15.3 million for the twelve months ended December 31, 2005 resulting from higher average interest rates and outstanding borrowings on the Company s variable rate debt. The Company s weighted average interest rate as of December 31, 2005 was 5.96% compared to 4.58% as of December 31, 2004. The increase in interest expense was partially offset by a loss on extinguishment of debt of approximately $0.7 million attributable to the refinancing of the Company s senior credit facility during the third quarter of 2004.

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

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

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Comparison of 2004 Operating Results and 2003 Operating Results

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

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

	2004	**2003**
	(In thousands)	
REVENUES:		
Royalty fees	**$ 167,135**	$ 151,324
Initial franchise and relicensing fees	**20,112**	16,799
Partner services	**12,524**	13,227
Marketing and reservation	**220,732**	195,219
Hotel operations	**3,729**	3,565
Other	**3,976**	5,732
Total revenues	**428,208**	385,866
OPERATING EXPENSES:		
Selling, general and administrative	**69,542**	62,753
Depreciation and amortization	**9,947**	11,225
Marketing and reservation	**220,732**	195,219
Hotel operations	**3,004**	2,723
Total operating expenses	**303,225**	271,920
Operating income	**124,983**	113,946
Interest expense	**11,605**	11,597
Interest and other investment income	**(1,110)**	(6,222)
Gain on prepayment of note receivable from Sunburst		(3,383)
Equity in net income of affiliates	**(722)**	(582)
Loss on extinguishment of debt	**696**	
Other	**(10)**	129
Other income and expenses, net	**10,459**	1,539
Income before income taxes	**114,524**	112,407
Income taxes	**40,179**	40,544

Net income	**$ 74,345**	$ 71,863
Weighted average shares outstanding-diluted	**69,000**	73,349
Diluted earnings per share	**$ 1.08**	$ 0.98

Franchising Revenues: Franchising revenues were $203.8 million for the year ended December 31, 2004 compared to $187.1 million for the year ended December 31, 2003. Royalty fees increased $15.8 million to

$167.1 million from $151.3 million in 2003, an increase of 10.4%. The increase in royalties is attributable to a combination of factors including a 5.2% increase in the number of domestic franchised hotel rooms, a 5.1% increase in RevPAR and an increase in the effective royalty rate of the domestic hotel system to 4.04% from 4.01%.

The number of domestic rooms on-line increased to 309,586 from 294,268, an increase of 5.2% for the year ended December 31, 2004. For 2004, the total number of domestic hotels on-line grew 5.4% to 3,834 from 3,636 for 2003. International rooms on-line declined slightly to 94,220 as of December 31, 2004 from 94,350 as of December 31, 2003, a 0.1% decline. The total number of international hotels on-line also decreased from 1,174 to 1,143, a decline of 2.6% for the year ended December 31, 2004. As of December 31, 2004, the Company had 460 franchised hotels with 35,652 rooms either under construction, awaiting conversion or approved for development in its domestic system as compared to 401 hotels and 31,409 rooms at December 31, 2003. The Company had an additional 109 franchised hotels with 9,515 rooms under development in its international system as of December 31, 2004 as compared to 90 hotels and 8,468 rooms at December 31, 2003.

Domestic initial fee revenue, included in initial franchise and relicensing fees caption above, generated from executed franchise agreements increased 17.7% to $13.3 million for the year ended December 31, 2004 from $11.3 million for the year ended December 31, 2003. The increase reflects domestic franchise agreements executed in 2004 of 552 new contracts representing 47,227 rooms compared to 470 agreements representing 41,039 rooms executed in 2003, increases of 17% and 15%, respectively. During 2004, 182 of the executed agreements were for new construction hotel franchises, representing 12,799 rooms, compared to 128 contracts, representing 8,649 rooms for the same period a year ago, increases of approximately 42% and 48%, respectively.

Relicensing fees increased 23.6% to $6.8 million for the year ended December 31, 2004 from $5.5 million for the year ended December 31, 2003. Relicensing fees are charged to the new property owner of a franchised property whenever an ownership change occurs and the property remains in the franchise system. Other revenues declined from $5.7 million for the year ended December 31, 2003 to $4.0 million for the year ended December 31, 2004, primarily as the result of reduced termination awards revenue, which are generated when franchises exit the system prior to contractually agreed-upon dates. Other revenues for the year ended December 31, 2003, included approximately $1.7 million of liquidated damages received from Sunburst for the termination of certain franchises.

Franchise Expenses: The cost to operate the franchising business is reflected in selling, general and administrative expenses. Selling, general and administrative expenses were $69.5 million for the year ended December 31, 2004, an increase of $6.7 million from the year ended December 31, 2003 total of $62.8 million. As a percentage of revenues, excluding marketing and reservation fees and hotel operations, total SG&A expenses were 34.1% for the year ended December 31, 2004 compared to 33.5% for 2003. The increase is attributable to increased costs associated with performance based incentive compensation for sales and other management personnel, costs related to retirement of a board member, adoption of the fair value method of accounting for stock compensation and increased professional fees related to Sarbanes-Oxley compliance efforts.

Marketing and Reservations: Total marketing and reservations revenues were $220.7 million and $195.2 million for the years ended December 31, 2004 and 2003, respectively. Depreciation and amortization attributable to marketing and reservation activities was $9.1 million and $12.1 million for the years ended December 31, 2004 and 2003, respectively. Interest expense attributable to reservation activities was $1.5 million and $1.3 million for the years ended December 31, 2004 and 2003, respectively. Marketing and reservations activities provided positive cash flow of $19.7 million and $24.7 million for the years ended December 31, 2004 and 2003, respectively. As of December 31, 2004 and 2003, the Company s balance sheet includes a receivable of $21.7 million and $32.4 million, respectively, for marketing and reservation fees.

Other Income and Expenses: Other income and expense, net increased $9.0 million to an expense of $10.5 million for the year ended December 31, 2004 from $1.5 million for the same period in 2003. Interest expense was $11.6 million for each of the years ended December 31, 2004 and 2003. The Company s weighted average

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

Income Taxes: The Company s effective income tax provision rate was 35.1% for the year ended December 31, 2004, a decrease of 100 basis points from the effective income tax provision rate of 36.1% for the year ended December 31, 2003. The reduction in the effective income tax provision rate resulted partially from an increase in foreign income, which is taxed at lower income tax rates than the statutory U.S. income tax rates. Also, the favorable resolution of several state income tax issues in the current year and the increase in taxable income over non-tax deductible items between the two periods decreased the effective income tax provision rate.

Income tax expense for 2004 includes approximately $1.2 million of income tax benefits resulting from the reversal of income tax contingencies. Income tax expense for 2003 includes $1.5 million of provisions for income tax contingencies.

Net income for fiscal 2004 increased by 3.5% to $74.3 million, and diluted earnings per share increased 10.2% to $1.08 in 2004 from $0.98 reported for 2003. A portion of the increase in diluted earnings per share is attributable to stock repurchases made by the Company in 2004 and 2003.

Liquidity and Capital Resources

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

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

Cash provided by (used in) investing activities for the years ended December 31, 2005, 2004 and 2003 was ($23.9 million), ($13.7 million), and $27.8 million, respectively. As a lodging franchisor, Choice has relatively low capital expenditure requirements. During the years ended December 31, 2005, 2004 and 2003, capital expenditures totaled $11.5 million, $6.9 million, and $8.5 million, respectively. Capital expenditures include the installation and upgrades of system-wide property and yield management systems and upgrades to disaster recovery hardware and financial and reservation systems. During 2005, investing cash flows included the payment of $7.3 million related to the Company s acquisition of Suburban. During 2003, the Company received a cash payment of $44.7 million from Sunburst related to the prepayment of a note receivable due to the Company. During 2003, approximately $4.5 million of interest income related to this note was included in net income. As a result of the prepayment, no interest income related to this note will be realized in future periods.

Financing cash flows relate primarily to the Company s borrowings under its credit lines, treasury stock purchases and dividends. In July 2004, the Company entered into a $265 million senior unsecured revolving credit facility (the Revolver) with a syndicate of lenders. In April 2005, the

Company increased the available credit under the Revolver from $265 million to $350 million. The Revolver permits the Company to borrow, repay and reborrow revolving loans until the scheduled maturity date in July 2009. Borrowings pursuant to the Revolver bear interest, at one of several rates selected by the Company, based upon the credit rating of the Company and include LIBOR plus 62 $^{1}/2$ basis points to 125 basis points; prime rate; and prime rate minus 175 basis points. In addition, the Company has the option to request participating banks to bid on loan participation at

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lower rates than those contractually provided by the Revolver. On February 28, 2005, Standard & Poor s Rating Services raised its rating of the Company s debt from BBB- to BBB. This rating and any other ratings by other rating organizations, may be subject to revision or withdrawal at any time by the assigning rating organization. Each rating should be evaluated independently of any other rating. The Revolver requires the Company to pay a commitment fee ranging, based upon the credit rating of the Company, between 12 1/2 basis points and 25 basis points of the average daily-unused portion of the aggregate available commitment. The Revolver also provides for the issuances of letters of credit on behalf of the Company. The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. As of December 31, 2005 the Company was in compliance with all covenants under the Revolver. The Revolver restricts the Company s ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions. As of December 31, 2005, the Company had $173.7 million of revolving loans outstanding pursuant to the Revolver.

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

In 1998, the Company completed a $100 million senior unsecured note offering (the Notes), bearing a coupon rate of 7.13% with an effective rate of 7.22%. The Notes will mature on May 1, 2008, with interest on the Notes to be paid semi-annually. The Company used the net proceeds from the offering of approximately $99 million to repay amounts outstanding under the Company s previous credit facility. The Notes contain a call provision that would require the Company to pay a premium if the Notes were redeemed prior to their maturity. At December 31, 2005, the call provision would have resulted in a premium of $6.0 million.

The Company has a line of credit with a bank providing up to an aggregate of $10 million of borrowings which is due upon demand. The line of credit ranks pari-pasu (or equally) with the Revolver. Borrowings under the line of credit bear interest at rates established at the time of the borrowings based on prime minus 175 basis points. As of December 31, 2005, no amounts were outstanding pursuant to this line of credit.

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

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

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

In the fourth quarter of 2003, the Company initiated a cash dividend on its common stock. In September 2004, the Company s board of directors increased the quarterly dividend rate to $0.1125, a 12.5% increase from the previous quarterly rate of $0.10. This increase raised the annual dividend rate on the Company s common stock from $0.40 to $0.45 per share. In September 2005, the Company s board of directors again increased the quarterly dividend rate to $0.13, a 15.6% increase from the previous quarter rate of $0.1125. This increase raised the annual dividend rate on the Company s common stock from $0.45 to $0.52 per share. Dividends paid in 2005 were approximately $30.2 million.

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

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

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

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

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

$2.5 million payable if at any time prior to the 3rd anniversary of closing at least 84 Suburban franchises are open or under construction and at least 79 are open on that date;

An additional $2.5 million payable if at any time prior to the 3rd anniversary of closing, but in no event prior to the 2nd anniversary of closing, at least 100 Suburban franchises are open or under construction and at least 90 are open on that date;

Both contingent payments are subject to at least 51 of the existing Suburban franchises open at the acquisition date remaining open when the contingent payment is otherwise earned.

The Company believes that cash flows from operations and available financing capacity are adequate to meet expected future operating, investing and financing needs of the business.

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

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

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

Critical Accounting Policies

Our accounting policies comply with principles generally accepted in the United States. We have described below those policies that we believe are critical and require the use of complex judgment or significant estimates in their application. Additional discussion of these policies is included in Note 1 to our consolidated financial statements.

Revenue Recognition.

We recognize continuing franchise fees, including royalty, marketing and reservations fees, when earned and receivable from our franchisees. Franchise fees are typically based on a percentage of gross room revenues of each franchisee. Our estimate of the allowance for uncollectible royalty fees is charged to selling, general and administrative expense.

Initial franchise and relicensing fees are recognized, in most instances, in the period the related franchise agreement is executed because the initial franchise and relicensing fees are non-refundable and the Company has no continuing obligations related to the franchisee. We defer the initial franchise and relicensing fee revenue related to franchise agreements which include incentives until the incentive criteria are met or the agreement is terminated, whichever occurs first.

We account for partner services revenues from endorsed vendors in accordance with Staff Accounting Bulletin No. 104, (SAB 104) Revenue Recognition. SAB 104 provides guidance on the recognition, presentation and disclosure of revenue in financial statements. Pursuant to SAB 104, the Company recognizes partner services revenues when the services are performed or the product delivered, evidence of an arrangement exists, the fee is fixed and determinable and collectibility is probable. We defer the recognition of partner services revenues related to certain upfront fees and recognize them over a period corresponding to the Company s estimate of the life of the arrangement.

Marketing and Reservation Revenues and Expenses.

The Company records marketing and reservation revenues and expenses in accordance with Emerging Issues Task Force (EITF) Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, which requires that these revenues and expenses be recorded gross. In addition, net advances to and repayments from the franchise system for marketing and reservation activities are presented as cash flows from operating activities.

Reservation fees and marketing fees not expended in the current year are carried over to the next fiscal year and expended in accordance with the franchise agreements. Shortfall amounts are similarly recovered in subsequent years. Cumulative excess or shortfall amounts from the operation of these programs are recorded as a marketing or reservation fee payable or receivable. Under the terms of the franchise agreements, the Company may advance capital as necessary for marketing and reservation activities and recover such advances through future fees. Our current assessment is that the credit risk associated with the marketing fee receivable is mitigated due to our contractual right to recover these amounts from a large geographically dispersed group of franchisees.

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

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

Impairment Policy.

We evaluate the fair value of goodwill to assess potential impairments on an annual basis, or during the year if an event or other circumstance indicates that we may not be able to recover the carrying amount of the asset. We evaluate impairment of goodwill by comparing the fair value of our net assets with the carrying amount of goodwill. We evaluate the potential impairment of property and equipment and other long-lived assets, including franchise rights whenever an event or other circumstance indicates that we may not be able to recover the carrying value of the asset. Our evaluation is based upon future cash flow projections. These projections reflect management s best assumptions and estimates. Significant management judgment is involved in developing these projections, and they include inherent uncertainties. If different projections had been used in the current period, the balances for non-current assets could have been materially impacted. Furthermore, if management uses different projections or if different conditions occur in future periods, future-operating results could be materially impacted. The Company reviews outstanding notes receivable on a periodic basis to ensure that each is fully collectible by reviewing the financial condition of its debtors. If the Company concludes that it will be unable to collect all amounts due, the Company will record an impairment charge. During the year ended December 31, 2005, the Company recognized impairment charges on notes receivable totaling approximately $0.2 million based on the credit condition of the note holders.

Stock Compensation.

Effective January 1, 2003, the Company adopted, in accordance with SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the fair value based method of accounting for stock option awards granted on or after January 1, 2003. No compensation expense related to the grant of stock options under the Company s stock compensation plans was reflected in net income for any years ended on or before December 31, 2002 because the Company accounted for grants in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and all stock options granted in those years had an exercise price equal to the market value of the underlying common stock on the date of grant. The effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 148 to all stock compensation for the three years ended December 31, 2005 is set forth in Note 1 to our consolidated financial statements.

SFAS No. 123 (Revised 2004), Share-Based Payment (SFAS No. 123R) was issued in December 2004. SFAS No. 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. Effective, January 1, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123 for all employee awards granted, modified, or settled after January 1, 2003. SFAS No. 123R will require the Company to apply fair value recognition provisions to all unvested equity awards as of the first annual reporting period starting after June 15, 2005, which is the Company s fiscal year beginning January 1, 2006. The adoption of SFAS No. 123R is not expected to have a material effect on the Company s results of operations or financial condition.

Income Taxes.

Our income tax expense and related balance sheet amounts involve significant management estimates and judgments. Judgments regarding realization of deferred tax assets and the ultimate outcome of tax-related contingencies represent key items involved in the determination of income tax expense and related balance sheet accounts.

The Company does not provide additional United States income taxes on undistributed earnings of consolidated foreign subsidiaries included in retained earnings. Such earnings could become taxable upon the sale or liquidation of these foreign subsidiaries or upon dividend repatriation. The Company s intent is for such earnings to be reinvested by the subsidiaries or to be repatriated only when required for domestic business operations, tax or cash reasons. On October 22, 2004, the American Jobs Creation Act of 2004 (AJCA) was signed into law. The AJCA included a temporary one time incentive for United States multinational corporations to repatriate accumulated income of foreign subsidiaries by providing an 85 percent dividends received deduction for qualifying dividends from controlled foreign corporations. The Company repatriated earnings pursuant to AJCA totaling approximately $23.5 million in the fourth quarter of 2005 resulting in an income tax provision of $1.2 million.

Deferred tax assets represent items to be used as a tax deduction or credit in future tax returns for which we have already properly recorded the tax benefit in our income statement. Realization of our deferred tax assets reflects our tax planning strategies. We establish valuation allowances for deferred tax assets that we do not believe will be realized.

Tax assessments and resolution of tax contingencies may arise several years after tax returns have been filed. Predicting the outcome of such tax assessments involves uncertainty; however, we believe that recorded tax liabilities adequately account for our analysis of probable outcomes.

FORWARD-LOOKING STATEMENTS

Certain statements contained in this annual report, including those in the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operation that are not historical facts constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act. Words such as believes, anticipates, expects, intends, estimates, projects, and other similar expressions, are predictions of or indicate future events and trends, typically identify forward-looking statements. Such statements are subject to a number of risks and uncertainties which could cause actual results to differ materially from those projected, including: competition; business strategies and their intended results; the balance between supply of and demand for hotel rooms; our ability to obtain new franchise agreements; our ability to develop and maintain positive relations with current and potential hotel owners; the effect of international, national and regional economic conditions and geopolitical events such as acts of god, acts of war, terrorism or epidemics; the availability of capital to allow us and potential hotel owners to fund investments and construction of hotels; the cost and other effects of legal proceedings; and other risks described from time to time in our filings with the Securities and Exchange Commission, including those set forth under Item 1A Risk Factors in this annual report. Given these uncertainties, you are cautioned not to place undue reliance on such statements. We also undertake no obligation to publicly update or revise any forward-looking statement to reflect current or future events or circumstances.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The Company is exposed to market risk from changes in interest rates and the impact of fluctuations in foreign currencies on the Company s foreign investments and operations. The Company manages its exposure to these market risks through the monitoring of its available financing alternatives including in certain circumstances the use of derivative financial instruments. The Company does not foresee any significant changes in exposure in these areas or in how such exposure is managed in the near future.

At December 31, 2005 and December 31, 2004, the Company had $274.1 million and $328.7 million of debt outstanding, at an effective interest rate of 6.0% and 4.6%, respectively. A hypothetical change of 10% in the Company s effective interest rate from December 31, 2005 levels would increase or decrease interest expense by $0.9 million. Prior to scheduled maturities, the Company expects to refinance its long-term debt obligations.

The Company does not presently have any derivative financial instruments.

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Item 8. Financial Statements and Supplementary Data.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders

of Choice Hotels International, Inc. and subsidiaries:

We have completed integrated audits of Choice Hotels International, Inc. and subsidiaries 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005 and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the accompanying index, present fairly, in all material respects, the financial position of Choice Hotels International, Inc. and subsidiaries (the Company) at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management s assessment, included in Management s Report on Internal Control Over Financial Reporting , appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control Integrated Framework* issued by the COSO. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

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

/s/ PricewaterhouseCoopers LLP

McLean, Virginia

March 14, 2006

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

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

Basic earnings per share	**$ 1.36**	$ 1.12	$ 1.01
Diluted earnings per share	**$ 1.32**	$ 1.08	$ 0.98
Cash dividends declared per share	**$ 0.485**	$ 0.425	$ 0.10

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

Additional paid-in-capital	**86,870**	83,303
Accumulated other comprehensive income	**859**	1,400
Deferred compensation	**(12,428)**	(8,034)
Treasury stock (30,125,721 and 30,443,275 shares at December 31, 2005 and 2004, respectively), at cost	**(650,551)**	(631,312)
Retained earnings	**407,422**	351,267
Total shareholders deficit	**(167,176)**	(203,053)
Total liabilities and shareholders deficit	**$ 265,100**	$ 263,352

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2005	2004	2003
		(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	**$ 87,565**	$ 74,345	$ 71,863
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**9,051**	9,947	11,225
Gain on sale of assets	**(386)**		
Gain on prepayment of note receivable from Sunburst			(3,383)
Provision for bad debts	**391**	(157)	(189)
Non-cash stock compensation	**5,288**	4,019	2,226
Non-cash interest and other investment income	**(294)**	(463)	(886)
Loss on extinguishment of debt		696	
Equity in net income of affiliates	**(803)**	(722)	(582)
Changes in assets and liabilities, net of acquisitions:			
Receivables	**(2,415)**	(735)	(887)
Receivable marketing and reservation fees, net	**19,393**	19,743	24,726
Accounts payable	**1,923**	978	6,439
Accrued expenses and other	**12,894**	6,702	289
Income taxes payable	**11,250**	2,854	(2,675)
Deferred income taxes	**(13,318)**	(14,883)	(7,970)
Deferred revenue	**8,822**	6,381	7,146
Other current assets	**(2,040)**	(599)	383
Other liabilities	**(4,414)**	(26)	7,579
Net cash provided by operating activities	**132,907**	108,080	115,304
CASH FLOWS FROM INVESTING ACTIVITIES			
Investment in property and equipment	**(11,504)**	(6,859)	(8,480)
Acquisition of Suburban, net of cash acquired	**(7,314)**		
Proceeds from prepayment of note receivable from Sunburst			44,701
Purchases of investments	**(8,929)**	(8,664)	(5,272)
Proceeds from sales of investments	**3,539**	4,506	2,599
Issuance of notes receivable	**(2,667)**	(2,264)	(4,433)
Acquisition of Flag			(1,211)
Proceeds from disposition of assets	**2,811**		498
Other items, net	**214**	(435)	(618)
Net cash (used in) provided by investing activities	**(23,850)**	(13,716)	27,784
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from long-term debt		192,000	
Principal payments of long-term debt	**(150)**	(267,739)	(17,404)
Net (repayments) borrowings pursuant to revolving credit facility	**(55,129)**	157,725	(43,800)
Debt issuance costs	**(193)**	(1,010)	
Purchase of treasury stock	**(49,154)**	(148,273)	(80,358)
Dividends paid	**(30,241)**	(27,690)	
Proceeds from exercise of stock options	**14,213**	8,427	6,097
Net cash used in financing activities	**(120,654)**	(86,560)	(135,465)

Net change in cash and cash equivalents	**(11,597)**	7,804	7,623
Cash and cash equivalents at beginning of period	**28,518**	20,714	13,091
Cash and cash equivalents at end of period	**$ 16,921**	$ 28,518	$ 20,714
Supplemental disclosure of cash flow information:			
Cash payments during the year for:			
Income taxes, net of refunds	**$ 50,173**	$ 53,622	$ 49,559
Interest	**$ 16,053**	$ 12,639	$ 13,357
Non-cash investing activities:			
Acquisition of Suburban, liabilities assumed	**$ 5,526**		
Non-cash financing activities:			
Declaration of dividends	**$ 31,410**	$ 28,061	$ 6,899
Income tax benefit realized related to stock options exercised	**$ 9,872**	$ 4,442	$ 1,770
Issuance of restricted shares of common stock	**$ 8,491**	$ 7,973	$ 180

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS DEFICIT AND COMPREHENSIVE INCOME

(In thousands, except share amounts)

	Common Stock - Shares Outstanding	Common Stock - Par Value	Additional Paid-in-Capital	Accumulated Other Comprehensive Income (Loss)	Deferred Compensation	Treasury Stock	Comprehensive Income	Retained Earnings	Total
Balance as of December 31, 2002	37,163,216	$ 371	$ 73,100	$ 42	$ (3,492)	$ (423,839)		$ 240,019	$ (113,799)
Comprehensive income									
Net income							$ 71,863	71,863	71,863
Other comprehensive income:									
Foreign currency translation adjustments							1,101		1,101
Amortization of deferred gain on hedge, net of taxes							(67)		(67)
Unrealized gain on available for sale securities, net of taxes							62		62
Other comprehensive income				1,096			1,096		
Comprehensive income							$ 72,959		
Exercise of stock options	462,522	5	198			7,845			8,048
Issuance and cancellation of restricted stock	7,428		(108)		(72)	180			
Stock compensation related to stock options			1,306						1,306
Amortization of deferred compensation related to restricted stock grants					923				923
Dividends declared								(6,899)	(6,899)
Treasury purchases	(2,887,313)	(29)				(80,696)			(80,725)
Balance as of December 31, 2003	34,745,853	$ 347	$ 74,496	$ 1,138	$ (2,641)	$ (496,510)		$ 304,983	$ (118,187)
Comprehensive income									
Net income							$ 74,345	74,345	74,345
Other comprehensive income:									
Foreign currency translation adjustments							188		188
Amortization of deferred gain on hedge, net of taxes							(67)		(67)
Unrealized gain on available for sale securities, net of taxes							141		141
Other comprehensive income				262			262		
Comprehensive income							$ 74,607		

Exercise of stock options	557,107	6	7,332			5,564			12,902
Issuance and cancellation of restricted stock	202,405	2	(43)		(7,894)	7,935			
Stock compensation related to stock options			1,518						1,518
Amortization of deferred compensation related to restricted stock grants					2,501				2,501
Dividends declared								(28,061)	(28,061)
Treasury purchases	(3,192,932)	(32)				(148,301)			(148,333)
Balance as of December 31, 2004	32,312,433	$ 323	$ 83,303	$ 1,400	$ (8,034)	$ (631,312)		$ 351,267	$ (203,053)
Comprehensive income									
Net income							**$ 87,565**	**87,565**	**87,565**
Other comprehensive income:									
Foreign currency translation adjustments							**(351)**		**(351)**
Amortization of deferred gain on hedge, net of taxes							**(67)**		**(67)**
Unrealized loss on available for sale securities, net of taxes							**(25)**		**(25)**
Reclassification adjustment for gains on available for sale securities included in net income							**(98)**		**(98)**
Other comprehensive income				**(541)**			**(541)**		
Comprehensive income							**$ 87,024**		
Exercise of stock options	**1,275,737**	**13**	**2,087**			**21,997**			**24,097**
Issuance and cancellation of restricted stock	**149,283**	**1**			**(7,876)**	**7,875**			
Stock compensation related to stock options			**1,806**						**1,806**
Amortization of deferred compensation related to restricted stock grants					**3,482**				**3,482**
Dividends declared								**(31,410)**	**(31,410)**
Treasury purchases	**(1,107,466)**	**(11)**				**(49,111)**			**(49,122)**
Two-for-one common stock split	**32,589,654**	**326**	**(326)**						
Balance as of December 31, 2005	**65,219,641**	**$ 652**	**$ 86,870**	**$ 859**	**$ (12,428)**	**$ (650,551)**		**$ 407,422**	**$ (167,176)**

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Company Information and Significant Accounting Policies

Company Information.

Choice Hotels International, Inc. and subsidiaries (together the Company) is in the business of hotel franchising. As of December 31, 2005, the Company had franchise agreements representing 5,210 open hotels and 687 hotels under development in 49 states, the District of Columbia and more than 45 countries and territories outside the United States under the brand names: Comfort Inn, Comfort Suites, Cambria Suites, Quality, Clarion, Sleep Inn, Econo Lodge, Rodeway Inn, MainStay Suites, Suburban Extended Stay Hotel and Flag Hotels.

Principles of Consolidation.

The consolidated financial statements include the accounts of Choice Hotels International, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

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

Certain amounts in the prior years financial statements have been reclassified to conform to the current year presentation with no effect on previously reported net income or shareholders deficit.

Revenue Recognition.

The Company accounts for initial, relicensing and continuing franchise fees in accordance with Statement of Financial Accounting Standards (SFAS) No. 45, Accounting for Franchise Fee Revenue. The Company enters into franchise agreements to provide franchisees with various marketing services, a centralized reservation system and limited non-exclusive rights to utilize the Company s registered tradenames and trademarks. These agreements typically have an initial term of up to twenty years with provisions permitting franchisees to terminate after five, ten, or fifteen years under certain circumstances. In most instances, initial franchise and relicensing fees are recognized upon execution of the franchise agreement because the initial franchise and relicensing fees are non-refundable and the Company has no continuing obligations related to the franchisee. The initial franchise and relicensing fees related to executed franchise agreements which include incentives, such as future potential rebates, are deferred and recognized when the incentive criteria are met or the agreement is terminated, whichever occurs first.

Royalty fees, which are typically based on a percentage of gross room revenues of each franchisee, are recorded when earned and receivable from the franchisee. An estimate of uncollectible royalty fees is charged to bad debt expense and included in selling, general and administrative expenses in the accompanying consolidated statements of income.

The Company generates partner services revenues from endorsed vendors. Partner services revenues are generally earned based on the level of goods or services purchased from endorsed vendors by hotel franchise owners and hotel guests who stay in the Company s franchised hotels. The Company accounts for partner services revenues in accordance with Staff Accounting Bulletin No. 104, (SAB 104) Revenue Recognition. SAB 104 provides guidance on the recognition, presentation and disclosure of revenue in financial statements. The Company recognizes partner services revenues when the services are performed or the product delivered, evidence of an arrangement exists, the fee is fixed and determinable and collectibility is probable. SAB 104 requires the Company to defer the recognition of partner services revenues related to upfront fees. Such upfront fees are generally recognized over a period corresponding to the Company s estimate of the life of the arrangement.

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Marketing and Reservation Revenues and Expenses.

The Company s franchise agreements require the payment of franchise fees, including marketing and reservation fees, which are used exclusively by the Company for expenses associated with providing franchise services such as national marketing, media advertising, central reservation systems and technology services. The Company is contractually obligated to expend the marketing and reservation fees it collects from franchisees in accordance with the franchise agreements; as such, no income or loss to the Company is generated. In accordance with our contracts, we include in marketing and reservation expenses an allocation of costs for certain activities, such as human resources, legal, accounting, etc., required to carry out marketing and reservation activities.

The Company records marketing and reservation revenues and expenses in accordance with Emerging Issues Task Force (EITF) Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, which requires that these revenues and expenses be recorded gross. In addition, net advances from and repayments related to marketing and reservation activities are presented as cash flows from operating activities.

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

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

Accounts Receivable and Credit Risk.

Accounts receivable consist primarily of franchise and related fees due from hotel franchises and are recorded at the invoiced amount. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance considering historical write-off experience and review of aged receivable balances. However, the Company considers its credit risk associated with trade receivables and the receivable for marketing and reservation fees to be partially mitigated due to the dispersion of these receivables across a large number of geographically diverse franchisees.

The Company records bad debt expense in selling, general and administrative expenses and marketing and reservation expenses in the accompanying consolidated statements of income based on its assessment of the ultimate realizability of receivables considering historical collection experience and the economic environment. When the Company determines that an account is not collectible, the account is written-off to the associated allowance for doubtful accounts.

Advertising Costs.

The Company expenses advertising costs as the advertising occurs in accordance with American Institute of Certified Public Accountants, Statement of Position 93-7, Reporting on Advertising Costs. Advertising

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

expense was $62.0 million, $58.5 million and $51.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. Prepaid advertising at December 31, 2005 and 2004 totaled $2.3 million and $1.6 million, respectively and is included within other current assets in the accompanying consolidated balance sheet. The Company includes advertising costs primarily in marketing and reservation expenses on the accompanying consolidated statements of income.

Cash and Cash Equivalents.

The Company considers all highly liquid investments purchased with a maturity of three months or less at the date of purchase to be cash equivalents. As of December 31, 2005 and 2004, $7.5 million and $7.4 million, respectively, of book overdrafts representing outstanding checks in excess of funds on deposit are included in accounts payable in the accompanying consolidated balance sheets.

Capitalization Policies.

Property and equipment are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Major renovations, replacements and interest incurred during construction are capitalized. Upon sale or retirement of property, the cost and related accumulated depreciation are eliminated from the accounts and any related gain or loss is recognized in the accompanying consolidated statements of income. Maintenance, repairs and minor replacements are charged to expense as incurred.

Impairment Policy.

The Company evaluates the impairment of property and equipment and other long-lived assets, including franchise rights and other definite-lived intangibles, in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 states that an impairment of long-lived assets has occurred whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability is measured based on net, undiscounted expected cash flows. Assets are considered to be impaired if the net, undiscounted expected cash flows are less than the carrying amount of the assets. Impairment charges are recorded based upon the difference between the carrying value and the fair value of the asset. The Company did not record any impairment on long-lived assets during the three years ended December 31, 2005.

The Company evaluates the impairment of goodwill and trademarks with indefinite lives in accordance with SFAS No. 142, Goodwill and Other Intangible Assets, which requires intangible assets to be assessed on at least an annual basis for impairment using a fair value basis. Because the Company has one reporting unit pursuant to SFAS No. 142 the fair value of the Company s net assets are used to determine if goodwill may be impaired. The Company did not record any impairment of goodwill during the three years ended December 31, 2005, based on assessments performed by the Company. In addition, the Company did not record any impairment of trademarks during the three years ended December 31, 2005.

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

flows, discounted at the loan s effective interest rate. The Company recorded $0.2 million of impairment charges related to notes receivable during the year ended December 31, 2005 and no amounts in the prior two years ended December 31, 2004.

Deferred Financing Costs.

Debt financing costs are deferred and amortized, using the effective interest method, over the term of the related debt. As of December 31, 2005 and 2004, unamortized deferred financing costs were $1.2 million and $1.4 million, respectively, and are included in other non-current assets in the accompanying consolidated balance sheets.

In July 2004, the Company entered into a $265 million senior unsecured revolving credit facility (Revolver). The proceeds were used to refinance and terminate the Company s existing senior credit facility (Old Credit Facility). The Company accounted for the refinancing of the Old Credit Facility in accordance with Emerging Issues Task Force (EITF) Issue No. 96-19, Debtor s Accounting for a Modification or Exchange of Debt Instruments, and EITF No. 98-14, Debtor s Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements. Pursuant to these pronouncements, the Company recorded a loss on extinguishment of debt of approximately $0.7 million during the year ended December 31, 2004.

Investments.

The Company accounts for its investment in Choice Hotels Canada, Inc. (CHC) and Choice Hospitality (India) Private Ltd (CHN) in accordance with Accounting Principles Board Opinion (APB) No. 18, The Equity Method of Accounting for Investments in Common Stock. The Company accounted for its investment in the common stock of Choice Hotels Scandinavia (CHS) in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and SFAS No. 130, Reporting Comprehensive Income until the sale of this investment in August 2005.

Derivatives.

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, establishes accounting and reporting standards for derivative instruments, including derivative instruments embedded in other contracts, and for hedging activities. SFAS No. 133 requires the recognition of the fair value of derivatives in the balance sheet, with changes in the fair value recognized either in earnings or as a component of other comprehensive income dependent upon the nature of the derivative. SFAS No. 133 also states that any deferred gain on previous hedging activity does not meet the definition of a liability, due to a lack of expected future cash flows and therefore should be included in comprehensive income. As of December 31, 2005 and 2004 the Company had no derivative financial instruments.

Stock-based compensation.

The Company has stock-based employee compensation plans, which are described more fully in Note 16. Prior to January 1, 2003, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No stock-based employee compensation cost was reflected in 2002 or prior years net income related to the grant of stock options, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2003, the Company adopted, in accordance with the prospective method prescribed by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Compensation, for all employee awards granted, modified, or settled after January 1, 2003. Therefore, the cost related to stock-based employee compensation included in the determination of net income for each of the three years ended December 31, 2005 is less than that which would have been recognized if the fair value based method had been applied to all awards since the original issuance date of SFAS 123. The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested awards in each period.

	Years Ended December 31,		
	2005	**2004**	**2003**
	(In millions, except per share amounts)		
Net income, as reported	**$ 87.6**	$ 74.3	$ 71.9
Stock-based employee compensation expense included in reported net income, net of related tax effects	**2.9**	2.2	1.4
Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	**(4.7)**	(3.5)	(2.9)
Pro forma, net income	**$ 85.8**	$ 73.0	$ 70.4
Earnings per share:			
Basic, as reported	**$ 1.36**	$ 1.12	$ 1.01
Basic, pro forma	**$ 1.33**	$ 1.10	$ 0.99
Diluted, as reported	**$ 1.32**	$ 1.08	$ 0.98
Diluted, pro forma	**$ 1.29**	$ 1.06	$ 0.96

Notes Receivable.

From time to time, the Company provides financing to franchisees for property improvements and other purposes in the form of interest free notes. The terms of the notes range from 3 to 10 years and are forgiven and amortized over that time period if the franchisee remains in the system in good standing. As of December 31, 2005 and 2004, other non-current assets included $9.4 million and $8.7 million, respectively, net of allowance, related to the unamortized balance of these notes. As of December 31, 2005 and 2004, other non-current assets include an allowance for doubtful accounts related to these notes of $1.0 million and $0.9 million, respectively. Amortization expense included in the accompanying consolidated statements of income related to the notes was $1.3 million, $1.2 million and $0.8 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Income Taxes.

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes . Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the financial statements or income tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted rates expected to apply to taxable income in the years in which those differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

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

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signed into law. The AJCA created a temporary one-time incentive for United States multinational corporations to repatriate undistributed earnings of foreign subsidiaries by providing an 85 percent dividends received deduction for qualifying dividends from controlled foreign corporations, as defined in the AJCA, resulting in an effective tax rate of 5.25% on any such repatriated foreign earnings. The Company elected to apply this one-time provision to qualifying earnings repatriations in 2005. During the fourth quarter of 2005, the Company repatriated earnings totaling approximately $23.5 million, resulting in the recordation of an income tax provision totaling approximately $1.2 million.

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

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

Earnings per Share.

Basic earnings per share exclude dilution and are computed by dividing net income by the weighted-average number of common shares outstanding. Diluted earnings per share, assumes dilution and is computed based on the weighted-average number of common shares outstanding after consideration of the dilutive effect of stock options and unvested restricted stock.

Use of Estimates.

The consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States and require management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Stock Split

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Other Current Assets

Other current assets consist of the following at:

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

4. Property and Equipment

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

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

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

As facilities in progress are completed and placed in service, they are transferred to appropriate property and equipment categories and depreciation begins. Depreciation expense, excluding amounts attributable to marketing and reservation activities, for the years ended December 31, 2005, 2004 and 2003 was $4.0 million, $5.0 million and $6.5 million, respectively. Depreciation has been computed for financial reporting purposes using the straight-line method. A summary of the ranges of estimated useful lives upon which depreciation rates are based follows:

Computer equipment and software	3-7 years
Buildings and improvements	10-40 years
Furniture, fixtures and equipment	3-15 years

5. Goodwill, Franchise Rights and Other Intangibles

Goodwill relates to the purchase price of a minority interest in the Company for consideration in excess of the recorded minority interest and the Suburban Transaction. The components of goodwill are as follows:

	December 31,	
	2005	**2004**
	(In thousands)	
Minority interest	**$ 60,620**	$ 60,620
Suburban Transaction (See Note 12)	**5,208**	
Total	**$ 65,828**	$ 60,620

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Pursuant to SFAS No. 142, the Company is not required to amortize goodwill.

Franchise rights represent the unamortized purchase price assigned to acquire long-term franchise contracts. As of December 31, 2005 and 2004, the unamortized balance relates primarily to the Econo Lodge, Suburban Extended Stay Hotel and Flag franchise rights. The franchise rights are being amortized over lives ranging from 5 to 17 years. Amortization expense for the years ended December 31, 2005, 2004 and 2003 amounted to $3.6 million, $3.4 million and $3.4 million, respectively. Franchise rights are net of accumulated amortization of $45.6 million and $42.1 million at December 31, 2005 and 2004, respectively. The estimated annual amortization expense related to the Company s franchise rights for each of the years ending December 31, 2006 through 2010 is as follows:

Year	(In millions)
2006	$ 4.0
2007	3.9
2008	3.8
2009	3.8
2010	3.8

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

Year	(In millions)
2006	$ 0.5
2007	0.5
2008	0.5
2009	0.4
2010	0.4

6. Receivable-Marketing and Reservation Fees

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

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

point repay any deficits related to marketing and reservation activities. The Company s current franchisees are legally obligated to pay any assessment the Company imposes on its franchisees to obtain reimbursement of such deficit regardless of whether those constituents continue to generate gross room revenue. The Company has no present intention to accelerate repayment of the deficit from current franchisees. Cumulative reservation and marketing fees not expended are recorded as a payable in the financial statements and are carried over to the next fiscal year and expended in accordance with the franchise agreements.

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

7. Transactions with Sunburst

Effective October 15, 1997, Choice Hotels International, Inc. (CHI), which at that point included both the franchising business and owned hotel business, separated the businesses via spin-off of the Company. CHI changed its name to Sunburst Hospitality Corporation (referred to hereafter as Sunburst). As part of the spin-off, Sunburst and the Company entered into a strategic alliance agreement. Among other things, the strategic alliance agreement, as amended, provided for the determination of liquidated damages related to termination of Choice branded Sunburst properties and certain franchise fee credits. The liquidated damage provisions extend through the life of existing Sunburst franchise agreements. The franchise fee credit provisions expired in October 2003. Other revenues for the year ended December 31, 2003 includes $1.7 million of liquidated damages received from Sunburst for the termination of franchises. As of December 31, 2005, Sunburst operates 26 hotels under franchise with the Company.

In January 2001, the Company received certain consideration including a $35 million seven-year senior subordinated note bearing interest at 11 $^{3}/8$% (the New Note) in conjunction with the restructuring and cancellation of a subordinated term note from Sunburst received pursuant to the spin-off. The New Note accrued interest up until June 2002, at which point interest became payable semi-annually in arrears.

On September 4, 2003, the Company and Sunburst entered into an agreement to amend certain terms of the New Note. At the time of the agreement, the principal amount of the New Note was approximately $41.3 million. Pursuant to the agreement, as an incentive for Sunburst to accelerate repayment of the New Note, the Company agreed to modify the redemption provisions of the New Note. Pursuant to the agreement, at any time prior to January 31, 2004, upon Sunburst s election to redeem the Note, Choice agreed to amend the existing optional redemption provision to allow Sunburst to redeem the New Note at a percentage of the principal amount equal to (i) 105.6875%, plus (ii) 2.84375% multiplied by the number of days prior to January 5, 2005 that redemption is made, divided by 365 days.

On December 19, 2003, Sunburst redeemed the New Note for approximately $47.1 million (including accrued interest of $2.2 million). The Company recognized a gain of $3.4 million in the accompanying consolidated statement of income for the year ended December 31, 2003 related to the note prepayment. The Company also recognized tax benefits of approximately $1.3 million in 2003 through reduction of liabilities for tax contingencies as a result of the gain on the transaction.

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As a result of the December 2003 repayment of the New Note by Sunburst, no interest income was recognized related to the note in 2004 or 2005. The Company recognized interest income related to the New Note of $4.5 million for the year ended December 31, 2003.

Total franchise fees, including royalty, marketing and reservation fees, paid by Sunburst to the Company, net of royalty fee credits, included in the accompanying consolidated financial statements were $5.3 million for each of the years ended December 31, 2005, 2004 and 2003. As of December 31, 2005 and 2004, accounts receivable included $1.0 million and $0.9 million due from Sunburst, respectively.

8. Deferred Revenue

Deferred revenue consist of the following at:

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

9. Accrued Expenses and Other

Accrued expenses and other consisted of the following at:

	December 31,	
	2005	**2004**
	(In thousands)	

Accrued salaries and benefits	**$ 25,044**	$ 20,095
Dividends payable	**8,439**	7,271
Accrued interest	**1,302**	1,261
Other liabilities and contingencies	**16,171**	8,266
Total	**$ 50,956**	$ 36,893

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

10. Long-Term Debt

Debt consisted of the following at:

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Year	(In thousands)
2006	$ 146
2007	146
2008	99,995
2009	173,831
2010	
Total	$ 274,118

In June 2001, the Company entered into a five-year competitive advance and multi-currency credit facility (Old Credit Facility). The Old Credit Facility originally provided for a term loan of $150 million and a revolving credit facility of $110 million. On September 29, 2001, the Company signed an amendment to the Old Credit Facility, for an additional $5 million under the revolving credit facility, bringing the total amount of available commitments to $265 million. The amendment also transferred $35 million from the term loan to the revolving credit facility. As amended, the initial term loan amount was $115 million and the revolving credit facility was $150 million. The term loan was scheduled to partially amortize over the three years ending June 30, 2006. The unamortized balance of the term loan and all outstanding revolving loans were scheduled to mature in June 2006. Borrowings under the Old Credit Facility bore interest, at one of several rates, at the option of the Company, including LIBOR plus 0.60% to 2.0%, based upon the credit rating of the Company and the loan type. The Old Credit Facility required the Company to pay annual fees ranging, based upon the credit rating of the Company, between 1/15 of 1% to 1/2 of 1% of the aggregate available commitment under the revolving credit facility.

In July 2004, the Company entered into a $265 million senior unsecured revolving credit facility (the Revolver) with a syndicate of lenders. The proceeds from the Revolver were used to refinance and terminate the revolving credit facility and term loan outstanding under the Company s Old Credit Facility. In April 2005, the Company increased the available credit under the Revolver from $265 million to $350 million. The Revolver permits the Company to borrow, repay and reborrow revolving loans until the scheduled maturity date in July 2009. Borrowings pursuant to the Revolver bear interest, at one of several rates selected by the Company, based upon the credit rating of the Company and include LIBOR plus 62 1/2 basis points to 125 basis points; prime rate; and prime rate minus 175 basis points. In addition, the Company has the option to request participating banks to bid on loan participation at lower rates than those contractually provided by the Revolver. The Revolver requires the Company to pay a commitment fee ranging, based upon the credit rating of the Company, between 12 1/2 basis points and 25 basis points of the average daily-unused portion of the aggregate available commitment. The Revolver also provides for the issuance of letters of credit on behalf of the Company. The Revolver includes customary financial and other covenants that require the maintenance of certain ratios including maximum leverage and interest coverage. As of December 31, 2005 and 2004, the Company was in compliance with all covenants under the Revolver. The Revolver restricts the Company s ability to make certain investments, incur certain debt, and dispose of assets, among other restrictions.

In 1998, the Company completed a $100 million senior unsecured note offering (the Notes) at a discount of $0.6 million, bearing a coupon rate of 7.13% with an effective rate of 7.22%. The Notes will mature on May 1, 2008, with interest on the Notes to be paid semi-annually. The

Company used the net proceeds from the offering of approximately $99 million to repay amounts outstanding under the Company s previous credit facility. The Notes contain a call provision that would require the Company to pay a premium if the Notes were redeemed prior to their maturity. At December 31, 2005, the call provision would have resulted in a premium of $6.0 million.

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

11. Foreign Operations

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

Choice Hotels Australasia

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

Pursuant to the CHA Transaction, the Company gave the seller the right to put the remaining 45% equity interest in CHA to the Company for approximately $1.1 million. The put right was permitted to be exercised between January 1, 2003 and June 30, 2007. The Company accounted for the put right in accordance with SFAS 133, Accounting for Derivative Instruments and Hedging Activities . SFAS 133 requires the recognition of all derivatives, except certain qualifying hedges, as either assets or liabilities measured at fair value, with changes in value reflected as current period income or loss unless specific hedge accounting criteria are met. The seller exercised the put right in January 2003. The put transaction closed in February 2003, at which time CHA became a wholly owned subsidiary.

The Company accounted for the CHA Transaction in accordance with SFAS No. 141, Business Combinations. The excess of the total purchase price over the net tangible assets acquired of approximately $4.3 million was allocated to identifiable intangible assets as follows:

	Estimated Fair Value	Estimated Useful Lives
	(in thousands)	
Trademarks and non-compete agreements	$ 235	5 years
Franchise rights	4,115	5-15 years
	$ 4,350	

The Company began consolidating the results of CHA on July 1, 2002. Based in Melbourne, Australia, CHA is a franchisor of certain hotel brands in Australia, Papua New Guinea, American Samoa, Fiji and New Zealand.

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Choice Hotels Scandinavia

The Company accounted for its investment, representing 1% of the outstanding common stock of Choice Hotels Scandinavia (CHS) as an available for sale security in accordance with SFAS 115. During 2005, the Company sold its investment in CHS for approximately $1.0 million resulting in a realized gain of $0.2 million. At December 31, 2004 the investment was included in other non-current assets in the accompanying consolidated balance sheets at its fair value of $1.0 million based on quoted market prices. During the years ended December 31, 2004 and 2003, the Company recognized approximately $0.2 million, and $0.1 million respectively, of unrealized gains attributable to this investment as a component of other comprehensive income.

Choice Hotels Canada, Inc.

The Company has a 50% interest in Choice Hotels Canada, Inc. (CHC), a joint venture with a third party. During 2005, 2004 and 2003, the Company recorded $0.8 million, $0.7 million and $0.6 million, respectively, based on CHC s results for the twelve months ended November 30, 2005, 2004 and 2003 of equity method income related to this investment pursuant to APB Opinion No. 18 in the accompanying consolidated statements of income. The Company received dividends from CHC of $0.7 million, $0.8 million and $0.4 million for the years ended December 31, 2005, 2004 and 2003, respectively. During 2005, 2004 and 2003, the Company recognized in the accompanying consolidated statements of income, revenues of $7.7 million, $7.1 million and $6.2 million, respectively, including royalty, marketing, reservation fees and other revenues from CHC.

12. Acquisition of Suburban Franchise Holding Company, Inc.

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

$2.5 million payable if at any time prior to the 3rd anniversary of closing, at least 84 Suburban franchises are open or under construction and at least 79 are open on that date;

An additional $2.5 million payable if at any time prior to the 3rd anniversary of closing, but in no event prior to the 2nd anniversary of closing, at least 100 Suburban franchises are open or under construction and at least 90 are open on that date;

Both contingent payments are subject to at least 51 of the existing Suburban franchises open at the acquisition date, remaining open when the contingent payment is otherwise earned.

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

13. Pension, Profit Sharing, and Incentive Plans

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company sponsors an unfunded non-qualified defined benefit plan (SERP) for certain senior executives. No assets are held with respect to the plan, therefore benefits are funded as paid to participants. The Company accounts for the SERP in accordance with SFAS No. 87, Employers Accounting for Pensions. For the years ended December 31, 2005, 2004 and 2003, the Company recorded $0.9 million, $0.7 million and $0.4 million, respectively, of expense related to the SERP which was included in selling, general and administrative expense in the accompanying consolidated statements of income. Based on the plan retirement age of 65 years old, no benefit payments are anticipated over the next five years and approximately $0.4 million are expected in the five years thereafter. The following table presents the components of net periodic benefit costs for the three years ended December 31, 2005.

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

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

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

Accumulated benefit obligation	**$ 3,425**	$ 2,387

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

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company sponsors two non-qualified retirement savings and investment plans for certain employees and senior executives whose pre-tax deferrals are limited under the Company s 401(k) plan. Employee and Company contributions are maintained in separate irrevocable trusts. Legally, the assets of the trusts remain those of the Company; however, access to the trusts assets is severely restricted. The trusts cannot be revoked by the Company or an acquirer, but the assets are subject to the claims of the Company s general creditors. The participants do not have the right to assign or transfer contractual rights in the trusts. The Company accounts for these plans in accordance with Emerging Issues Task Force (EITF) No. 97-14, Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested. Pursuant to EITF 97-14, as of December 31, 2005 and 2004, the Company had recorded a deferred compensation liability of $25.6 million and $19.0 million, respectively. The change in the deferred compensation obligation related to changes in the fair value of the diversified investments held in trust and to earnings credited to participants is recorded in compensation expense. The diversified investments held in the trusts were $23.3 million and $17.2 million as of December 31, 2005 and 2004, respectively, and are recorded at their fair value, based on quoted market prices. The change in the fair value of the diversified assets held in trust is recorded in accordance with SFAS 115 as trading security income (loss) and is included in other income and expenses, net in the accompanying statements of income.

14. Income Taxes

Income before income taxes was derived from the following:

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

The provisions for income taxes were as follows:

	Years ended December 31,		
	2005	**2004**	**2003**
		(In thousands)	
Current tax expense			

Federal	**$ 54,770**	$ 52,334	$ 44,040
State	**5,476**	4,288	3,979
Foreign	**685**	(315)	758
Deferred tax (benefit) expense			
Federal	**(16,133)**	(15,308)	(7,306)
State	**(1,209)**	(794)	(942)
Foreign	**(412)**	(26)	15
Income taxes	**$ 43,177**	$ 40,179	$ 40,544

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Included in the accompanying consolidated balance sheet as follows:

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

No provision has been made for U.S. federal income taxes on approximately $9 million of accumulated and undistributed earnings of foreign subsidiaries at December 31, 2005 since these earnings are considered to be permanently invested in foreign operations.

On October 22, 2004, the American Jobs Creation Act of 2004 (AJCA) was signed into law. The AJCA included a temporary one-time incentive for United States multinational corporations to repatriate undistributed earnings of foreign subsidiaries by providing an 85 percent dividends received deduction for qualifying dividends from controlled foreign corporations, as defined in the AJCA, at an effective tax cost of 5.25 percent on any such repatriated foreign earnings. The Company elected to apply this provision to qualifying earnings repatriations in 2005. During the fourth quarter of 2005, the Company repatriated earnings totaling approximately $23.5 million, resulting in the recordation of additional income tax totaling approximately $1.2 million.

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A reconciliation of income tax expense at the statutory rate to income tax expense included in the accompanying consolidated statements of income follows:

	Years ended December 31,		
	2005	**2004**	**2003**
	(In thousands, except Federal income tax rate)		
Federal income tax rate	**35%**	35%	35%
Federal taxes at statutory rate	**$ 45,760**	$ 40,083	$ 39,342
State income taxes, net of federal tax benefit	**2,436**	1,933	1,974
Foreign income taxed at different rates	**(1,932)**	(1,718)	(659)
Unrealized tax benefits	**199**	(144)	(617)
Other	**(3,286)**	25	504
Income tax expense	**$ 43,177**	$ 40,179	$ 40,544

We have estimated and accrued for certain tax assessments and the expected resolution of tax contingencies which arise in the course of our business. The ultimate outcome of these tax-related contingencies impact the determination of income tax expense and the timing and amount of related cash flows may not be resolved until several years after the related tax returns have been filed. Predicting the outcome of such tax assessments involves uncertainty; however, we believe that recorded tax liabilities adequately account for our analysis of probable outcomes.

15. Other Non-Current Liabilities

Other non-current liabilities consist of the following at:

	December 31,	
	2005	**2004**
	(In thousands)	
Deferred revenue	**$ 1,662**	$ 1,614
Reservation fees collected in excess of expenditures	**3,607**	
Other liabilities and contingencies	**3,903**	15,818

Total	**$ 9,172**	$ 17,432

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

16. Capital Stock

The Company has stock compensation plans pursuant to which it is authorized to grant restricted stock and options to purchase stock for up to 18.9 million shares of the Company s common stock, of which 1.2 million shares remain available for grant as of December 31, 2005. Restricted stock and stock options may be granted to officers, key employees and non-employee directors.

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted Stock.

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

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

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

Stock Options.

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

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

Weighted average fair value of options granted during the year (grant date price equals market)	**$ 10.11**	$ 7.00	$ 4.33

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

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosures, requires companies to provide additional note disclosures about employee stock-based compensation plans based on a fair value method of accounting.

For purposes of the pro forma disclosure included in the stock-based compensation section of Note 1, compensation cost for the Company s stock option plan was determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123.

The fair value of each option grant has been estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2005, 2004 and 2003:

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

Stock Repurchase Program.

The Company announced a stock repurchase program on June 25, 1998 to increase returns to its shareholders. Treasury stock activity is recorded at cost in the accompanying consolidated financial statements. Through December 31, 2005, the Company had repurchased 33.6 million shares of its common stock (including 33.0 million prior to the 2 for 1 stock split effected in October 2005) at a total cost of $712 million, including 1.1 million shares of common stock (including 0.5 million prior to the 2 for 1 stock split effected in October 2005) at a total cost of $49.2 million during the year ended December 31, 2005.

17. Comprehensive Income

The components of accumulated other comprehensive income are as follows:

December 31,

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The components of other comprehensive income are as follows:

	Amount Before Taxes	Income Tax (Expense)/Benefit	Amount Net of Taxes
2005			
Net unrealized loss	**$ (40)**	**$ 15**	**$ (25)**
Reclassification adjustment for gains included in net income	**(98)**		**(98)**
Foreign currency translation adjustment, net	**(351)**		**(351)**
Amortization of deferred gain on hedge	**(110)**	**43**	**(67)**
Total other comprehensive income	**$ (599)**	**$ 58**	**$ (541)**
2004			
Net unrealized gains	$ 225	$ (84)	$ 141
Foreign currency translation adjustment, net	188		188
Amortization of deferred gain on hedge	(110)	43	(67)
Total other comprehensive income	$ 303	$ (41)	$ 262
2003			
Net unrealized gains	$ 99	$ (37)	$ 62
Foreign currency translation adjustment, net	1,101		1,101
Amortization of deferred gain on hedge	(110)	43	(67)
Total other comprehensive income	$ 1,090	$ 6	$ 1,096

In December 1999, the Company entered into an interest rate swap agreement to fix certain of its variable rate debt in order to reduce the Company s exposure to fluctuations in interest rates. On March 3, 2000, the interest rate swap agreement was settled resulting in a deferred gain. In accordance with SFAS 133, the unamortized gain was reclassified in 2001 to other comprehensive income and is being amortized over the original life of the related debt through 2008 as a reduction of interest expense. In each of 2005, 2004 and 2003, the Company recorded approximately $67,000, net of taxes, of amortization related to this deferred gain.

18. Earnings Per Share

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

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

CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

19. Leases

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

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

20. Reportable Segment Information

The Company has a single reportable segment encompassing its franchising business. Revenues from the franchising business include royalty fees, initial franchise and relicensing fees, marketing and reservation fees, partner services revenue and other revenue. The Company is obligated under its franchise agreements to provide marketing and reservation services appropriate for the successful operation of its systems. These services do not represent separate reportable segments as their operations are directly related to the Company s franchising business. The revenues received from franchisees that are used to pay for part of the Company s central on-going operations are included in franchising revenues and are offset by the related expenses paid for marketing and reservation activities to calculate franchising operating income. Corporate and other revenue consists of hotel operations. Except as described in Note 6, the Company does not allocate interest and dividend income, interest expense or income taxes to its franchising segment.

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

	Year Ended December 31, 2005

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

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Year Ended December 31, 2003			
	Franchising	Corporate & Other	Elimination Adjustments	Consolidated
	(In thousands)			
Revenues	$ 382,301	$ 3,565		$ 385,866
Operating income (loss)	150,490	(36,544)		113,946
Depreciation and amortization	14,671	8,631	(12,077)	11,225
Capital expenditures	7,342	1,138		8,480
Total assets	195,106	72,166		267,272

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

21. Commitments and Contingencies

The Company is a defendant in a number of lawsuits arising in the ordinary course of business. In the opinion of management and general counsel to the Company, the ultimate outcome of such litigation will not have a material adverse effect on the Company s business, financial position, results of operations or cash flows.

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

In the ordinary course of business, the Company enters into numerous agreements that contain standard guarantees and indemnities whereby the Company indemnifies another party for breaches of representations and warranties. Such guarantees or indemnifications are granted under various agreements, including those governing (i) purchases or sales of assets or businesses, (ii) leases of real estate, (iii) licensing of trademarks, (iv) access to credit facilities, (v) issuances of debt or equity securities, and (vi) other operating agreements. The guarantees or indemnifications issued are for the benefit of the (i) buyers in sale agreements and sellers in purchase agreements, (ii) landlords in lease contracts, (iii) franchisees in licensing agreements, (iv) financial institutions in credit facility arrangements, and (v) underwriters in debt or equity security issuances. In addition, these parties are also indemnified against any third party claim resulting from the transaction that is contemplated in the underlying agreement. While some of these guarantees extend only for the duration of the underlying agreement, many survive the expiration of the term of the agreement or extend into perpetuity (unless subject to a legal statute of limitations). There are no specific limitations on the maximum potential amount of future payments that the Company could be required to make under these guarantees, nor is the Company able to develop an estimate of the maximum potential amount of future payments to be made under these guarantees as the triggering events are not subject to predictability. With respect to certain of the aforementioned guarantees, such as indemnifications of landlords against third party claims for the use of real estate property leased by the Company, the Company maintains insurance coverage that mitigates any potential payments to be made.

22. Fair Value of Financial Instruments

The balance sheet carrying amount of cash and cash equivalents and receivables approximates fair value due to the short-term nature of these items. Long-term debt consists of bank loans and senior notes. Interest rates on the Company s bank loans adjust frequently based on current market rates; accordingly, the carrying amount of the Company s bank loans approximates fair value. The $100 million unsecured senior notes have an approximate fair value at December 31, 2005 and 2004 of $104.0 million and $109.0 million, respectively, based on quoted market prices.

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

23. Related Party Transactions

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

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

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

24. Impact of Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), Share-Based Payment (SFAS No. 123R). SFAS No. 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. Effective, January 1, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for all employee awards granted, modified, or settled after January 1, 2003. SFAS No. 123R will require the Company to apply fair value recognition provisions to all unvested equity awards as of the first annual reporting period starting after June 15, 2005, which is the Company s first quarter beginning January 1, 2006.

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

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CHOICE HOTELS INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

25. Selected Quarterly Financial Data (Unaudited)

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

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	2004
	(In thousands, except per share data)				
Revenues	$ 87,167	$ 107,018	$ 127,350	$ 106,673	$ 428,208
Operating income	$ 18,899	$ 32,130	$ 42,488	$ 31,466	$ 124,983
Income before income taxes	$ 16,849	$ 29,498	$ 38,971	$ 29,206	$ 114,524
Net income	$ 10,594	$ 18,503	$ 24,916	$ 20,332	$ 74,345
Per basic share:					
Net income	$ 0.15	$ 0.28	$ 0.38	$ 0.31	$ 1.12
Per diluted share:					
Net income	$ 0.15	$ 0.27	$ 0.36	$ 0.30	$ 1.08

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

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

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

The Company formed a disclosure review committee whose membership includes the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), among others. The disclosure review committee s procedures are considered by the CEO and CFO in performing their evaluations of the Company s disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) and in assessing the accuracy and completeness of the Company s disclosures.

An evaluation was performed under the supervision and with the participation of the Company s CEO and CFO, of the effectiveness of the design and operation of the Company s disclosure controls and procedures. Based on that evaluation, the Company s management, including the CEO and CFO, concluded that the Company s disclosure controls and procedures were effective as of December 31, 2005.

Management s Report on Internal Control Over Financial Reporting

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

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

Management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2005. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework*. Based on management s assessment under those criteria, management concluded that the Company s internal control over financial reporting was effective as of December 31, 2005.

Management s assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Item 9B. Other Information

None.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The required information on directors will be contained in the Company s proxy statement, and reference is expressly made to the proxy statement for the specific information incorporated in this Form 10-K. The required information on executive officers is set forth in Part I of this Form 10-K under an unnumbered item captioned Executive Officers of Choice Hotels International, Inc.

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Code of Ethics

The Company has adopted a Code of Ethics that applies to its Chief Executive Officer, Chief Financial Officer and Controller. A copy of the Code of Ethics is included hereto as Exhibit 14.01.

The Code of Ethics is available free of charge through our internet website located at *www.choicehotels.com*. We will also provide without charge to any person, on the written or oral request of such person, a copy of our Code of Ethics. Requests should be directed to Investor Relations, 10750 Columbia Pike, Silver Spring, MD 20901 (telephone number (301) 592-5026).

Item 11. Executive Compensation.

The required information will be set forth under Executive Compensation and Board Compensation Committee Report on Executive Compensation Compensation of the Chief Executive Officer in the Company s proxy statement, and reference is expressly made to the proxy statement for the specific information incorporated in this Form 10-K.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The required information will be set forth under Security Ownership of Certain Beneficial Owners and Executive Officers and Board of Directors in the Company s proxy statement, and reference is expressly made to the proxy statement for the specific information incorporated in this Form 10-K.

Item 13. Certain Relationships and Related Transactions.

The required information will be set forth under Certain Relationships and Related Transactions and Board of Directors Compensation Committee Interlocks and Insider Participation in the Company s proxy statement, and reference is expressly made to the proxy statement for the specific information incorporated in this Form 10-K.

Item 14. Principal Accounting Fees and Services.

The required information will be set forth under Fiscal 2005 Audit Firm Fee Summary and Audit Committee Matters in the Company s proxy statement, and reference is expressly made to the proxy statement for the specific information incorporated in this Form 10-K.

PART IV

Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K.

(a) List of Documents Filed as Part of this Report

1. Financial Statements

The response to this portion of Item 15 is submitted under Item 8 of this Report on Form 10-K.

2. Financial Statement Schedules

The following are filed as an exhibit to this Annual Report on Form 10-K.

Report of Independent Registered Public Accounting Firm required pursuant to Item 15(a)2 is submitted under Item 8 of this report.

Schedule II-Valuation and Qualifying Accounts

All other schedules are omitted because they are not applicable.

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3. Exhibits

Exhibit Number	Description
3.01(a)	Restated Certificate of Incorporation of Choice Hotels Franchising, Inc. (renamed Choice Hotels International, Inc.)
3.02(a)	Amended and Restated Bylaws of Choice Hotels International, Inc.
4.01(c)	Senior Unsecured Revolving Credit Facility agreement dated July 9, 2004 among Choice Hotels International, Inc., Wachovia Bank, National Association, as agents for the Lenders
4.02(g)	Registration Agreement dated April 28, 1998 between Choice Hotels International, Inc. and Salomon Brothers, Inc., Bear Stearns & Co. Inc. and Lehman Brothers Inc.
4.03(g)	Indenture dated as of May 4, 1998, by and among Choice Hotels International, Inc., Quality Hotels Europe, Inc., QH Europe Partnership and Marine Midland Bank, as Trustee, with respect to the 7.125% Senior Notes due 2008
4.04(g)	Specimen certificate of 7.125% Senior Note due 2008 (Original Note) (Attached as an exhibit to the Indenture set forth as Exhibit 4.03)
4.05(g)	Specimen certificate of 7.125% Senior Note due 2008 (Exchange Note) (Attached as an exhibit to the Indenture set forth as Exhibit 4.03)
4.06*	Agreement to furnish certain debt agreements
4.07(f)	Master Lender Accession agreement dated April 29, 2005 among Choice Hotels International, Inc., Wachovia Bank, National Association, as Administrative Agent for the Lenders
10.01(o)	Second Amended and Restated Employment Agreement between Choice Hotels International, Inc. and Charles A. Ledsinger, Jr. dated December 20, 2005
10.02(p)	Amended and Restated Chairman s Service Agreement dated May 4, 2004 by and between Choice Hotels International, Inc. and Stewart Bainum, Jr.
10.03(d)	Amended and Restated Employment Agreement dated April 13, 1999 by and between Choice Hotels International, Inc. and Thomas Mirgon
10.04(e)	Choice Hotels International, Inc. Non-Employee Director Stock Option and Deferred Compensation Stock Purchase Plan
10.05(e)	Choice Hotels International, Inc. 1997 Non-Employee Director Stock Compensation Plan
10.06(l)	Choice Hotels International, Inc. 1997 Long-Term Incentive Plan
10.07(h)	Second Amended and Restated Employment Agreement dated April 13, 1999 between Choice Hotels International, Inc. and Michael J. DeSantis
10.08(i)	Commercial Lease dated May 29, 1998 among Columbia Pike I, LLC and Colesville Road, LLC (each an assignee of Manor Care, Inc.) and Choice Hotels International, Inc.
10.09(k)	Employment Agreement dated June 3, 1999 between Choice Hotels International, Inc. and Joseph M. Squeri
10.10(m)	Employment Agreement dated May 3, 2000 between Choice Hotels International, Inc. and Daniel Rothfeld
10.11(m)	Employment Agreement dated August 18, 2000 between Choice Hotels International, Inc. and Wayne Wielgus
10.12(n)	Amended and Restated Supplemental Executive Retirement Plan
10.13(b)	Choice Hotels International, Inc. Executive Deferred Compensation Plan
13.01*	Valuation and Qualifying Accounts
14.01(j)	Code of Ethics

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Exhibit Number	Description
21.01*	Subsidiaries of Choice Hotels International, Inc.
23.01*	Consent of PricewaterhouseCoopers LLP
31.1*	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
31.2*	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a)
32*	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350

* Filed herewith

(a) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Registration Statement on Form S-4, filed August 31, 1998 (Reg. No. 333-62543).

(b) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2002, filed March 31, 2003.

(c) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 filed on August 6, 2004.

(d) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 1999, filed on June 4, 1999.

(e) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Registration Statement filed on Form S-8, filed on December 2, 1997 (Reg. No. 333-41357).

(f) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q filed for the quarterly period ended March 31, 2005, filed on May 10, 2005.

(g) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q filed for the quarterly period ended March 31, 1998, filed on May 15, 1998.

(h) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q filed for the quarter ended June 30, 1998, filed on August 11, 1998.

(i) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 1998, filed on March 30, 1999.

(j) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on 10-K for the year ended December 31, 2003, filed March 15, 2004.

(k) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 1999, filed on August 16, 1999.

(l) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Registration Statement on Form S-8, filed September 30, 1997 (Reg. No. 333-36819).

(m) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2000, filed November 14, 2000.

(n) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2000, filed April 2, 2001.

(o) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Current Report on Form 8-K dated December 20, 2005, filed on December 22, 2005.

(p) Incorporated by reference to the identical document filed as an exhibit to Choice Hotels International, Inc. s Annual Report on Form 10-K for the year ended December 31, 2004, filed on March 16, 2005.

(b) Reports on Form 8-K

The Company filed a report on Form 8-K, dated December 20, 2005, reporting that the Company had entered into a Second Amended and Restated Employment Agreement with Charles A. Ledsinger, Jr., the Company s President and Chief Executive Officer.

The Company filed a report on Form 8-K, dated October 27, 2005, reporting that a press release had been issued reporting the Company s earnings for the quarter ended September 30, 2005.

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CHOICE HOTELS INTERNATIONAL, INC.

By: /s/ CHARLES A. LEDSINGER, JR.

Charles A. Ledsinger, Jr.

President and Chief Executive Officer

Dated: March 13, 2006

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Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ STEWART BAINUM, JR. **Stewart Bainum, Jr.**	Chairman, Director	March 14, 2006
/s/ CHARLES A. LEDSINGER, JR. **Charles A. Ledsinger, Jr.**	President, Chief Executive Officer & Director	March 13, 2006
Lawrence R. Levitan	Director	
/s/ RAYMOND E. SCHULTZ **Raymond E. Schultz**	Director	March15 2006
/s/ ERVIN R. SHAMES **Ervin R. Shames**	Director	March 16, 2006
/s/ JOHN T. SCHWIETERS **John T. Schwieters**	Director	March 14, 2006
/s/ FIONA P. DIAS **Fiona P. Dias**	Director	March 12, 2006
/s/ GORDON SMITH **Gordon Smith**	Director	March 15, 2006
/s/ JOSEPH M. SQUERI **Joseph M. Squeri**	Executive Vice President, Operations and Chief Financial Officer	March 13, 2006
/s/ DAVID L. WHITE **David L. White**	Vice President, Finance & Controller	March 14, 2006

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