MARRIOTT INTERNATIONAL INC /MD/
Form 10-Q
October 03, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 5, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File No. 1-13881

MARRIOTT INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware	**52-2055918**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification No.)**
10400 Fernwood Road, Bethesda, Maryland	**20817**
(Address of principal executive offices)	**(Zip Code)**

(301) 380-3000

(Registrant s telephone number, including area code)

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller Reporting Company ¨

(Do not check if smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 349,102,192 shares of Class A Common Stock, par value $0.01 per share, outstanding at September 19, 2008.

Table of Contents

MARRIOTT INTERNATIONAL, INC.

FORM 10-Q TABLE OF CONTENTS

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. *Financial Statements*

MARRIOTT INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

($ in millions, except per share amounts)

(Unaudited)

	Twelve Weeks Ended		Thirty-Six Weeks Ended	
	September 5, 2008	September 7, 2007	September 5, 2008	September 7, 2007
REVENUES				
Base management fees	$ 143	$ 135	$ 452	$ 417
Franchise fees	108	111	314	303
Incentive management fees	52	56	229	243
Owned, leased, corporate housing, and other revenue	260	262	849	824
Timeshare sales and services (including note sale gains of $28 for thirty-six weeks ended September 5, 2008, and $45 for the twelve and thirty-six weeks ended September 7, 2007)	384	389	1,098	1,211
Cost reimbursements	2,016	1,990	6,153	5,903
	2,963	2,943	9,095	8,901
OPERATING COSTS AND EXPENSES				
Owned, leased, and corporate housing-direct	240	235	757	711
Timeshare-direct	337	344	961	987
Reimbursed costs	2,016	1,990	6,153	5,903
General, administrative, and other	167	164	513	518
	2,760	2,733	8,384	8,119
OPERATING INCOME	203	210	711	782
Gains and other income	7	30	19	77
Interest expense	(33)	(42)	(113)	(127)
Interest income	8	8	28	26
Reversal of provision for loan losses			2	
Equity in earnings	2	8	26	9
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES AND MINORITY INTEREST	187	214	673	767
Provision for income taxes	(103)	(93)	(317)	(307)
Minority interest in losses of consolidated subsidiaries, net of tax	10	1	13	1
INCOME FROM CONTINUING OPERATIONS	94	122	369	461
Discontinued operations, net of tax		9	3	59
NET INCOME	$ 94	$ 131	$ 372	$ 520
EARNINGS PER SHARE-Basic				
Earnings from continuing operations	$ 0.27	$ 0.33	$ 1.04	$ 1.21

Earnings from discontinued operations		0.02	0.01	0.15
Earnings per share	$ 0.27	$ 0.35	$ 1.05	$ 1.36
EARNINGS PER SHARE-Diluted				
Earnings from continuing operations	$ 0.26	$ 0.31	$ 1.00	$ 1.14
Earnings from discontinued operations		0.02	0.01	0.15
Earnings per share	$ 0.26	$ 0.33	$ 1.01	$ 1.29
DIVIDENDS DECLARED PER SHARE	$ 0.0875	$ 0.0750	$ 0.2500	$ 0.2125

See Notes to Condensed Consolidated Financial Statements

2

MARRIOTT INTERNATIONAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

($ in millions)

	September 5, 2008 (Unaudited)	December 28, 2007
ASSETS		
Current assets		
Cash and equivalents	$ 117	$ 332
Accounts and notes receivable	1,091	1,148
Inventory	1,892	1,557
Current deferred taxes, net	190	185
Assets held for sale	129	123
Discontinued operations		53
Other	188	174
	3,607	3,572
Property and equipment	1,394	1,329
Intangible assets		
Goodwill	921	921
Contract acquisition costs	721	635
	1,642	1,556
Equity and cost method investments	329	343
Notes receivable		
Loans to equity method investees	5	21
Loans to timeshare owners	503	408
Other notes receivable	179	171
	687	600
Other long-term receivables	175	176
Deferred taxes, net	616	678
Other	654	688
	$ 9,104	$ 8,942
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Current portion of long-term debt	$ 44	$ 175
Accounts payable	657	789
Accrued payroll and benefits	562	642
Liability for guest loyalty program	429	421
Timeshare segment deferred revenue	162	101
Liabilities related to discontinued operations	3	13
Other payables and accruals	809	735
	2,666	2,876
Long-term debt	3,002	2,790
Liability for guest loyalty program	1,061	971
Self-insurance reserves	209	182

Other long-term liabilities		724		661
Minority interest		14		33
Shareholders equity				
Class A Common Stock		5		5
Additional paid-in-capital		3,542		3,531
Retained earnings		3,610		3,332
Treasury stock, at cost		(5,777)		(5,490)
Accumulated other comprehensive income		48		51
		1,428		1,429
	$	9,104	$	8,942

See Notes to Condensed Consolidated Financial Statements

MARRIOTT INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

($ in millions)

(Unaudited)

	Thirty-Six Weeks Ended September 5, 2008	Thirty-Six Weeks Ended September 7, 2007
OPERATING ACTIVITIES		
Net income	$ 372	$ 520
Adjustments to reconcile to cash provided by operating activities:		
Depreciation and amortization	130	134
Minority interest	(20)	(4)
Income taxes	230	(216)
Timeshare activity, net	(273)	(180)
Liability for guest loyalty program	79	76
Working capital changes and other	37	(23)
Net cash provided by operating activities	555	307
INVESTING ACTIVITIES		
Capital expenditures	(220)	(528)
Dispositions	19	439
Loan advances	(20)	(5)
Loan collections and sales	33	86
Equity and cost method investments	(4)	(10)
Contract acquisition costs	(124)	(40)
Other	(51)	76
Net cash (used in) provided by investing activities	(367)	18
FINANCING ACTIVITIES		
Commercial paper, net	226	592
Issuance of long-term debt	17	392
Repayment of long-term debt	(192)	(57)
Issuance of Class A Common Stock	42	168
Dividends paid	(84)	(77)
Purchase of treasury stock	(428)	(1,293)
Other	16	(34)
Net cash used in financing activities	(403)	(309)
(DECREASE) INCREASE IN CASH AND EQUIVALENTS	(215)	16
CASH AND EQUIVALENTS, beginning of period	332	193
CASH AND EQUIVALENTS, end of period	$ 117	$ 209

See Notes to Condensed Consolidated Financial Statements

Table of Contents

MARRIOTT INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The condensed consolidated financial statements present the results of operations, financial position, and cash flows of Marriott International, Inc. (together with its subsidiaries, we, us, or the Company).

The accompanying condensed consolidated financial statements have not been audited. We have condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with U.S. generally accepted accounting principles (GAAP). We believe the disclosures made are adequate to make the information presented not misleading. You should, however, read the condensed consolidated financial statements in conjunction with the consolidated financial statements and notes to those financial statements in our Annual Report on Form 10-K for the fiscal year ended December 28, 2007, (2007 Form 10-K). Certain terms not otherwise defined in this quarterly report have the meanings specified in our 2007 Form 10-K.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements, the reported amounts of revenues and expenses during the reporting periods, and the disclosures of contingent liabilities. Accordingly, ultimate results could differ from those estimates. We have reclassified certain prior year amounts to conform to our 2008 presentation. As a result of the discontinuation of our synthetic fuel business on November 3, 2007, the balances and activities of the synthetic fuel reportable segment have been segregated and reported as discontinued operations for all periods presented.

Our 2008 third quarter ended on September 5, 2008; our 2007 fourth quarter ended on December 28, 2007; and our 2007 third quarter ended on September 7, 2007. In our opinion, the accompanying condensed consolidated financial statements reflect all normal and recurring adjustments necessary to present fairly our financial position as of September 5, 2008, and December 28, 2007, the results of our operations for the twelve and thirty-six weeks ended September 5, 2008, and September 7, 2007, and cash flows for the thirty-six weeks ended September 5, 2008, and September 7, 2007. Interim results may not be indicative of fiscal year performance because of seasonal and short-term variations. We have eliminated all material intercompany transactions and balances between entities consolidated in these financial statements.

2. New Accounting Standards

EITF Issue No. 06-8, Applicability of the Assessment of a Buyer s Continuing Investment under FASB Statement No. 66 for Sales of Condominiums

We adopted the Financial Accounting Standards Board s (FASB) Emerging Issues Task Force (EITF) Issue No. 06-8, Applicability of the Assessment of a Buyer s Continuing Investment under FASB Statement No. 66 for Sales of Condominiums (EITF 06-8) on December 29, 2007, the first day of our 2008 fiscal year. EITF 06-8 states that in assessing the collectibility of the sales price pursuant to paragraph 37(d) of Financial Accounting Standards (FAS) No. 66, Accounting for Sales of Real Estate (FAS No. 66), an entity should evaluate the adequacy of the buyer s initial and continuing investment to conclude that the sales price is collectible. If an entity is unable to meet the criteria of paragraph 37, including an assessment of collectibility using the initial and continuing investment tests described in paragraphs 8 through 12 of FAS No. 66, then the entity should apply the deposit method of accounting as described in paragraphs 65 through 67 of FAS No. 66.

The adoption of EITF 06-8 had no impact on our wholly owned projects. However, in conjunction with the adoption of EITF 06-8 by one joint venture in which we are a partner, we recorded the cumulative effect of applying EITF 06-8 as a reduction of $5 million to our investment in that joint venture, an increase in deferred tax assets of $2 million, and a reduction of $3 million to the opening balance of our retained earnings. In certain circumstances, the application of the continuing investment criterion in EITF 06-8 on the collectibility of the sales price may delay our ability, or the ability of joint ventures in which we are a partner, to recognize revenues and costs using the percentage-of-completion method of accounting.

Financial Accounting Standards No. 157, Fair Value Measurements

We adopted FAS No. 157, Fair Value Measurements (FAS No. 157), on December 29, 2007, the first day of fiscal year 2008. FAS No. 157 defines fair value, establishes a methodology for measuring fair value, and expands the required disclosure for fair value measurements. On February 12, 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which amends FAS No. 157 by delaying its effective date by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. Therefore, beginning on December 29, 2007, this standard applied prospectively to new fair value measurements of financial instruments and recurring fair value measurements of non-financial assets and non-financial liabilities. On January 3, 2009, the beginning of our 2009 fiscal year, the standard will also apply to all other fair value measurements. See Footnote No. 6, Fair Value Measurements, for additional information.

Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115

We adopted FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115 (FAS No. 159), on December 29, 2007, the first day of our 2008 fiscal year. This standard permits entities to choose to measure many financial instruments and certain other items at fair value. While FAS No. 159 became effective for our 2008 fiscal year, we did not elect the fair value measurement option for any of our financial assets or liabilities.

EITF Issue No. 07-6, Accounting for Sales of Real Estate Subject to the Requirements of FASB Statement No. 66, Accounting for Sales of Real Estate, When the Agreement Includes a Buy-Sell Clause

We adopted EITF Issue No. 07-6, Accounting for Sales of Real Estate Subject to the Requirements of FASB Statement No. 66, Accounting for Sales of Real Estate, When the Agreement Includes a Buy-Sell Clause (EITF 07-6), on December 29, 2007, the first day of our 2008 fiscal year. EITF 07-6 clarifies whether a buy-sell clause is a prohibited form of continuing involvement that would preclude partial sales treatment under FAS No. 66. EITF 07-6 is effective for new arrangements entered into and assessments of existing transactions originally accounted for under the deposit, profit sharing, leasing, or financing methods for reasons other than the exercise of a buy-sell clause performed in 2008 and thereafter. The adoption of EITF 07-6 did not have a material impact on our financial statements.

Future Adoption of Accounting Standards

Financial Accounting Standards No. 141 (Revised 2007), Business Combinations

On December 4, 2007, the FASB issued FAS No. 141 (Revised 2007), Business Combinations (FAS No. 141(R)). FAS No. 141(R) will significantly change the accounting for business combinations. Under FAS No. 141(R), an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. Transaction costs will no longer be included in the measurement of the business acquired. Instead, these expenses will be expensed as they are incurred. FAS No. 141(R) also includes a substantial number of new disclosure requirements. FAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, which for us begins with our 2009 fiscal year. FAS No. 141(R) will only have an impact on our financial statements if we are involved in a business combination in fiscal year 2009 or later years.

Table of Contents

Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements-an Amendment of ARB No. 51

On December 4, 2007, the FASB issued FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements-an Amendment of ARB No. 51 (FAS No. 160). FAS No. 160 establishes new accounting and reporting standards for a non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements separate from the parent s equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. FAS No. 160 clarifies that changes in a parent s ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. FAS No. 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. FAS No. 160 must be applied prospectively for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, which for us begins with our 2009 fiscal year except for the presentation and disclosure requirements, which must be applied retrospectively for all periods presented. We are currently evaluating the impact that FAS No. 160 will have on our financial statements.

Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133

In March 2008, the FASB issued FAS No. 161, Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133 (FAS No. 161). FAS No. 161 requires enhanced disclosure related to derivatives and hedging activities and thereby seeks to improve the transparency of financial reporting. Under FAS No. 161, entities are required to provide enhanced disclosures relating to: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedge items are accounted for under FAS No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS No. 133), and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. FAS No. 161 must be applied prospectively to all derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under FAS No. 133 for all financial statements issued for fiscal years and interim periods beginning after November 15, 2008, which for us begins with our 2009 fiscal year. We are currently evaluating the impact that FAS No. 161 will have on our financial statements.

3. Income Taxes

Our federal income tax returns have been examined and we have settled all issues for tax years through 2004 with the exception of one 1994 transaction discussed below. The 2005 and 2006 Internal Revenue Service (IRS) field examinations have been completed, and those years are now being sent to the IRS Appeals Division. The 2007 and 2008 IRS examinations are ongoing as part of the IRS s Compliance Assurance Program. Various state, local and foreign income tax returns are also under examination by taxing authorities.

In the 2008 second quarter, we recorded a $24 million income tax expense related to the treatment of funds received from certain foreign subsidiaries. We are contesting the issue with the IRS for tax years 2005 and 2006. In addition, on May 23, 2008, we reached a settlement with the IRS regarding a 1995 leasing transaction. We recorded a $12 million tax expense in the 2008 second quarter due primarily to prior years tax adjustments, including a settlement with the IRS that resulted in a lower than expected refund of taxes associated with the leasing transaction. The settlement resulted in a $26 million tax refund, which we received during the 2008 second quarter.

Table of Contents

In the 2008 third quarter, we recorded a $29 million income tax expense primarily related to an unfavorable U.S. Court of Federal Claims decision involving a refund claim associated with a 1994 tax planning transaction. The tax had been paid, and we had filed a refund claim to recover the taxes. We expect to appeal the ruling.

For the first three quarters of 2008, we increased unrecognized tax benefits by $77 million, including increases for the foreign subsidiaries issue as well as the 1994 tax planning transaction issue. For the same period, we decreased unrecognized tax benefits by $78 million related primarily to the settlement of the 1995 leasing transaction. The balance of unrecognized tax benefits was $131 million at the end of the 2008 third quarter.

As a large taxpayer, we are under continual audit by the IRS and other taxing authorities. It is possible that the amount of the liability for unrecognized tax benefits could change during the next 52-week period, but we do not anticipate that a significant impact to the unrecognized tax benefit balance will occur.

4. Discontinued Operations-Synthetic Fuel

Our synthetic fuel operations consisted of four coal-based synthetic fuel production facilities (the Facilities). Because tax credits under Section 45K of the Internal Revenue Code are not available for the production and sale of synthetic fuel produced from coal after calendar year-end 2007, and because we estimated that high oil prices during 2007 would result in the phase-out of a significant portion of the tax credits available for synthetic fuel produced and sold in 2007, on November 3, 2007, we shut down the Facilities and permanently ceased production of synthetic fuel. Accordingly, we now report this business as a discontinued operation.

The tax credits available under the Internal Revenue Code for the production and sale of synthetic fuels were established by Congress to encourage the development of alternative domestic energy sources. Congress deemed that the incentives provided by the tax credits would not be necessary if the price of oil increased beyond certain thresholds as prices would then provide a more natural market for these alternative fuels. As a result, the tax credits available under the Internal Revenue Code for the production and sale of synthetic fuel in any given calendar year were phased out if the Reference Price of a barrel of oil for that year fell within a specified range. The Reference Price of a barrel of oil is an estimate of the annual average wellhead price per barrel of domestic crude oil and was determined for each calendar year by the Secretary of the Treasury by April 1 of the following year. The price range within which the credit was phased out was set in 1980 and was adjusted annually for inflation. In 2007, the Reference Price phase-out range was $56.78 to $71.27. Because the Reference Price of a barrel of oil for 2007 was within that range, at $66.52, there was a 67.2 percent reduction of the tax credits available for synthetic fuel produced and sold in 2007. Income from discontinued operations of $3 million for the thirty-six weeks ended September 5, 2008, primarily reflected the recognition in the 2008 second quarter of additional tax credits as a result of the determination by the Secretary of the Treasury in the 2008 second quarter of the Reference Price of a barrel of oil for 2007, partially offset by obligations based on the amount of additional tax credits. The determination resulted in a 67.2 percent reduction of tax credits for the 2007 fiscal year, compared to the reduction of 70.7 percent that had been estimated and recorded in the 2007 fiscal year.

Table of Contents

The following tables provide additional income statement and balance sheet information relating to the discontinued synthetic fuel operations.

Income Statement Summary

($ in millions)	Twelve Weeks Ended September 5, 2008	Twelve Weeks Ended September 7, 2007	Thirty-Six Weeks Ended September 5, 2008	Thirty-Six Weeks Ended September 7, 2007
Revenue	$	$ 97	$ 1	$ 253
Loss from discontinued operations before income taxes	$ (1)	$ (32)	$ (4)	$ (140)
Tax (provision) benefit		12	(3)	51
Tax credits	1	29	10	148
Total tax (provision) benefit	1	41	7	199
Income from discontinued operations	$	$ 9	$ 3	$ 59

Balance Sheet Summary

($ in millions)	At Period End September 5, 2008	At Period End December 28, 2007
Other assets	$	$ 53
Liabilities	(3)	(13)

5. Share-Based Compensation

Under our 2002 Comprehensive Stock and Cash Incentive Plan, we award: (1) stock options to purchase our Class A Common Stock (Stock Option Program); (2) share appreciation rights (SARs) for our Class A Common Stock; (3) restricted stock units of our Class A Common Stock; and (4) deferred stock units. We grant awards at exercise prices or strike prices that are equal to the market price of our Class A Common Stock on the date of grant.

We granted 2.5 million restricted stock units during the first two quarters of 2008 to certain officers and key employees and those units vest generally over four years in equal annual installments commencing one year after the date of grant. The weighted average grant-date fair value of the restricted stock units granted in the first two quarters of 2008 was $35.

We granted an additional 3.0 million restricted stock units during the 2008 third quarter to certain officers and key employees, and those units vest generally over four and a half years with one quarter of the units vesting one and a half years after the date of grant, and the remaining units vest in equal annual installments commencing one year after the first quarter vests. The weighted average grant-date fair value of these restricted stock units was $26.

In the first two quarters of 2008, we granted approximately 108,000 stock options that had a weighted average grant-date fair value of $13 and a weighted average exercise price of $36. The options are exercisable in cumulative installments of one quarter at the end of each of the first four years following the date of grant and expire 10 years after the date of grant.

We granted an additional 110,000 stock options during the 2008 third quarter that become exercisable generally over four and a half years, with one quarter becoming exercisable one and a half years after the date of grant, and the remaining options becoming exercisable in equal annual installments commencing one year after the first quarter become exercisable. The weighted average grant-date fair value of these

9

Table of Contents

options was $10 and they have a weighted average exercise price of $27. These options expire 10 years after the date of grant.

During the first two quarters of 2008, we granted 1.7 million SARs to officers and key employees (Employee SARs) with a weighted average exercise price of $36 and a weighted average grant-date fair value of $13. These SARs expire 10 years after the date of grant and both vest and are exercisable in cumulative installments of one quarter at the end of each of the first four years following the date of grant.

During the first two quarters of 2008, we also granted 3,800 SARs to a director (Non-employee SARs) with a weighted average exercise price of $36 and a weighted average grant-date fair value of $15. These Non-employee SARs expire 10 years after the date of grant and vest upon grant, but are generally not exercisable until one year after grant.

We granted an additional 0.9 million Employee SARs during the 2008 third quarter. These Employee SARs expire 10 years after the date of grant and vest generally over four and a half years with one quarter vesting one and a half years after the date of grant, and the remaining rights vesting in equal annual installments commencing one year after the first quarter vests. These Employee SARs are exercisable upon vesting. The weighted average grant-date fair value of these Employee SARs was $10 and the weighted average exercise price was $27.

We also issued 18,000 deferred stock units with a weighted average grant-date fair value of $36 to Non-employee directors during the first two quarters of 2008. These Non-employee director deferred stock units vest within one year and are distributed upon election.

For SARs and stock options, we use a lattice-based valuation model that incorporates a range of assumptions for inputs. Historical data is used to estimate exercise behaviors for separate groups of retirement eligible and non-retirement eligible employees. The expected terms of stock options and SARs granted are derived from the outputs of the valuation model and represent the periods of time that stock options and SARs granted are expected to be outstanding.

The range of assumptions for the stock options and Employee SARs granted during the first three quarters of 2008 are shown in the following table.

Expected volatility	29%
Dividend yield	0.80%-0.95%
Risk-free rate	3.4%-3.9%
Expected term (in years)	6-9

The risk-free rates are based on the corresponding U.S. Treasury spot rates for the expected duration at the date of grant, converted to a continuously compounded rate. Non-employee SARs were valued using assumptions within the ranges shown above for Employee SARs, except using an expected term of 10 years.

6. Fair Value Measurements

We adopted FAS No. 157 on December 29, 2007, the first day of fiscal year 2008. FAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). The standard outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and the related disclosures. Under GAAP, certain assets and liabilities must be measured at fair value, and FAS No. 157 details the disclosures that are required for items measured at fair value.

Table of Contents

We have various financial instruments we must measure under FAS No. 157 including: certain marketable securities; derivatives; and servicing assets and residual interests related to our asset securitizations. None of our current non-financial assets or non-financial liabilities must be measured at fair value on a recurring basis. We measure our financial assets and liabilities using inputs from the following three levels of the fair value hierarchy. The three levels are as follows:

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access at the measurement date.

Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (i.e., interest rates, yield curves, etc.), and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market corroborated inputs).

Level 3 includes unobservable inputs that reflect our assumptions about the assumptions that market participants would use in pricing the asset or liability. We develop these inputs based on the best information available, including our own data.

In accordance with the fair value hierarchy, the following table shows the fair value as of September 5, 2008, of those financial assets and liabilities that we must measure at fair value and that we classify as Other current assets, Other assets, and Other long-term liabilities :

($ in millions)	**Fair Value Measurements as of September 5, 2008**			
Description	**Balance at September 5, 2008**	**Level 1**	**Level 2**	**Level 3**
Assets:				
Servicing assets and other residual interests	$ 271	$	$	$ 271
Marketable securities	43	19	24	
Liabilities:				
Derivative instruments	(7)	(1)	(3)	(3)

The following tables summarize the changes in fair value of our Level 3 assets and liabilities for both the twelve and thirty-six weeks ended September 5, 2008:

($ in millions)	**Fair Value Measurements of Assets and Liabilities Using Level 3 Inputs**	
	Servicing Assets and Other Residual Interests	**Derivative Instruments**
Beginning balance at June 14, 2008	$ 288	$ 6
Total gains (losses) (realized or unrealized)		
Included in earnings	12	(2)
Included in other comprehensive income		(9)
Transfers in or out of Level 3		
Purchases, sales, issuances, and settlements	(29)	2
Ending balance at September 5, 2008	$ 271	$ (3)
Gains (losses) for the third quarter of 2008 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	$ 12	$ (2)

Table of Contents

($ in millions)	Fair Value Measurements of Assets and Liabilities Using Level 3 Inputs	
	Servicing Assets and Other Residual Interests	**Derivative Instruments**
Beginning balance at December 29, 2007	$ 238	$ (5)
Total gains (losses) (realized or unrealized)		
Included in earnings	14	(10)
Included in other comprehensive income		3
Transfers in or out of Level 3		
Purchases, sales, issuances, and settlements	19	9
Ending balance at September 5, 2008	$ 271	$ (3)
Gains (losses) for the first three quarters of 2008 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	$ 14	$ (10)

At the dates of sale and at the end of each reporting period, we estimate the fair value of our residual interests, including servicing assets, using a discounted cash flow model. The implementation of FAS No. 157 did not result in material changes to the models or processes used to value these assets. These transactions may utilize interest rate swaps to protect the net interest margin associated with the beneficial interest. The discount rates we use in determining the fair values of the residual interests are based on both the general level of interest rates in the market for the weighted average life of each pool and the assumed credit risk of the interests retained. We adjust these discount rates quarterly as interest rates and credit spreads in the market vary.

During 2008 and 2007, we used the following key assumptions to measure the fair value of the residual interests, including servicing assets, at the date of sale: average discount rates of 9.23 percent and 9.22 percent, respectively; average expected annual prepayments, including defaults, of 24.01 percent and 25.18 percent, respectively; expected weighted average life of prepayable notes receivable, excluding prepayments and defaults, of 76 months and 75 months, respectively; and expected weighted average life of prepayable notes receivable, including prepayments and defaults, of 35 months and 34 months, respectively. Our key assumptions are based on experience with notes receivable and servicing assets.

We used the following key assumptions in measuring the fair value of the residual interests, including servicing assets, in our 12 outstanding Timeshare note sales as of September 5, 2008: an average discount rate of 10.13 percent; an average expected annual prepayment rate, including defaults, of 18.44 percent; an expected weighted average life of prepayable notes receivable, excluding prepayments and defaults, of 61 months; and an expected weighted average life of prepayable notes receivable, including prepayments and defaults, of 36 months. We treat the residual interests, including servicing assets, as trading securities under the provisions of FAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and accordingly, we recorded realized and unrealized gains or losses related to these assets in the Timeshare sales and services revenue caption in our Condensed Consolidated Statements of Income.

The most significant estimate involved in the measurement process is the loan repayment rate, followed by the default rate and the discount rate. Estimates of these rates are based on management s expectations of future prepayment rates and default rates, reflecting our historical experience, industry trends, current market interest rates, expected future interest rates, and other considerations. Actual repayment rates, default rates, and discount rates could differ from those projected by management due to changes in a variety of economic factors, including prevailing interest rates and the availability of alternative financing sources to borrowers. If actual prepayments of the loans being serviced were to occur more slowly than had been projected, the carrying value of servicing assets could increase and accretion and servicing income would exceed previously projected amounts. If actual default rates or actual discount rates are lower than expected, the carrying value of retained interests could increase and accretion and servicing income would exceed previously projected amounts. Accordingly, the retained interests, including servicing assets, actually realized, could differ from the amounts initially recorded.

We completed a stress test on the fair value of the residual interests, including servicing assets, as of the end of the 2008 third quarter to measure the change in value associated with independent changes in individual key variables. This methodology applied unfavorable changes that would be statistically significant for the key variables of prepayment rate, discount rate, and weighted average remaining term. Before we applied any of these stress test changes, we determined that the fair value of the residual interests, including servicing assets, was $271 million as of September 5, 2008.

Applying the stress tests, we concluded that each change to a variable shown in the table below would have the following impact on the valuation of our residual interests at the end of the 2008 third quarter.

	Decrease in Quarter-End Valuation (in millions)	Percentage Decrease
100 basis point increase in the prepayment rate	$ 4	1.5%
200 basis point increase in the prepayment rate	8	2.9%
100 basis point increase in the discount rate	6	2.2%
200 basis point increase in the discount rate	12	4.3%
Two month decline in the weighted average remaining term	2	0.9%
Four month decline in the weighted average remaining term	5	1.8%

We value our derivatives using valuations that are calibrated to the initial trade prices. Subsequent valuations are based on observable inputs to the valuation model including interest rates and volatilities. We record realized and unrealized gains and losses on these derivative instruments in gains from the sale of timeshare notes receivable, which are recorded within the Timeshare sales and services revenue caption in our Condensed Consolidated Statements of Income.

7. Earnings Per Share

The table below illustrates the reconciliation of the earnings and number of shares used in the basic and diluted earnings per share calculations.

	Twelve Weeks Ended		Thirty-Six Weeks Ended	
(in millions, except per share amounts)	**September 5, 2008**	**September 7, 2007**	**September 5, 2008**	**September 7, 2007**
Computation of Basic Earnings Per Share				
Income from continuing operations	$ 94	$ 122	$ 369	$ 461
Weighted average shares outstanding	351.2	373.8	353.0	381.6
Basic earnings per share from continuing operations	$ 0.27	$ 0.33	$ 1.04	$ 1.21
Computation of Diluted Earnings Per Share				
Income from continuing operations	$ 94	$ 122	$ 369	$ 461
Weighted average shares outstanding	351.2	373.8	353.0	381.6
Effect of dilutive securities				
Employee stock option and SARs plans	11.3	16.3	13.0	17.5
Deferred stock incentive plans	1.6	1.8	1.6	1.9
Restricted stock units	1.3	2.2	1.8	2.4

Shares for diluted earnings per share	365.4	394.1	369.4	403.4
Diluted earnings per share from continuing operations	$ 0.26	$ 0.31	$ 1.00	$ 1.14

13

Table of Contents

We compute the effect of dilutive securities using the treasury stock method and average market prices during the period. We determine dilution based on earnings from continuing operations.

In accordance with FAS No. 128, Earnings per Share, we have not included the following stock options and SARs in our calculation of diluted earnings per share because the exercise prices were greater than the average market prices for the applicable periods:

(a) for the twelve-week period ended September 5, 2008, 4.9 million options and SARs, with exercise prices ranging from $27.46 to $49.03;

(b) for the twelve-week period ended September 7, 2007, 0.4 million options and SARs, with exercise prices ranging from $45.91 to $49.03;

(c) for the thirty-six week period ended September 5, 2008, 3.9 million options and SARs, with exercise prices ranging from $32.16 to $49.03; and

(d) for the thirty-six week period ended September 7, 2007, 0.4 million options and SARs, with exercise prices of $49.03.

8. Inventory

Inventory, totaling $1,892 million and $1,557 million as of September 5, 2008, and December 28, 2007, respectively, consists primarily of Timeshare segment interval, fractional ownership, and residential products totaling $1,869 million and $1,536 million as of September 5, 2008, and December 28, 2007, respectively. Inventory totaling $23 million and $21 million as of September 5, 2008, and December 28, 2007, respectively, primarily relates to hotel operating supplies for the limited number of properties we own or lease. We value Timeshare segment interval, fractional ownership, and residential products at the lower of cost or net realizable value and generally value operating supplies at the lower of cost (using the first-in, first-out method) or market. Consistent with recognized industry practice, we classify Timeshare segment interval, fractional ownership, and residential products inventory, which has an operating cycle that exceeds 12 months, as a current asset.

We recorded a pretax charge of $22 million in the 2008 third quarter within the Timeshare-direct caption of our Condensed Consolidated Statements of Income related to the impairment of a fractional and whole ownership real estate project held for development by a joint venture that we consolidate. We recorded a pretax benefit of $12 million in the 2008 third quarter within the Minority interest caption of our Condensed Consolidated Statements of Income representing our joint venture partner s pretax share of the $22 million impairment charge. Accordingly, the impact to our Timeshare segment was $10 million. The adjustment was made in accordance with FAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, to adjust the carrying value of the real estate to its estimated fair value at September 5, 2008. The downturn in market conditions including contract cancellations and tightening in the credit markets, especially for jumbo mortgage loans, were the predominant items considered in our analysis. We estimated the fair value of the inventory utilizing a probability weighted cash flow model containing our expectations of future performance discounted at a 10-year risk-free interest rate determined from the yield curve for U.S. Treasury instruments (3.68 percent).

9. Assets Held for Sale

Assets held for sale totaled $129 million at the end of the 2008 third quarter and consisted of property and equipment. The $129 million total reflected the following segment composition: Luxury Lodging-$89 million; North American Full-Service Lodging-$22 million; and North American Limited-Service Lodging-$18 million. There were no liabilities of assets held for sale at the end of the 2008 third quarter.

Assets held for sale totaled $123 million at year-end 2007 and consisted of property and equipment. The $123 million total reflected the following segment composition: Luxury Lodging-$89 million; North

Table of Contents

American Full-Service Lodging-$17 million; and North American Limited-Service Lodging-$17 million. There were no liabilities of assets held for sale at year-end 2007.

10. Property and Equipment

The following table details the composition of our property and equipment balances at September 5, 2008, and December 28, 2007.

($ in millions)	September 5, 2008	December 28, 2007
Land	$ 421	$ 399
Buildings and leasehold improvements	866	833
Furniture and equipment	932	900
Construction in progress	272	216
	2,491	2,348
Accumulated depreciation	(1,097)	(1,019)
	$ 1,394	$ 1,329

11. Acquisitions and Dispositions

2008 Acquisitions

At year-end 2007, we were party to a venture that developed and marketed fractional ownership and residential products. In the first quarter of 2008, we purchased our partner s interest in that joint venture together with additional land. Cash consideration for this transaction totaled $37 million and we acquired assets and liabilities totaling $75 million and $38 million, respectively, on the date of purchase. In the 2008 second quarter, we closed on a transaction for the purchase of real estate for our timeshare operations. The total purchase price was approximately $62 million. Cash consideration totaled approximately $38 million, and non-current liabilities recorded as a result of this transaction were $24 million. In the 2008 third quarter, we closed on a transaction for the purchase of real estate for our timeshare operations for cash consideration of $47 million.

2008 Dispositions

In the 2008 second quarter, we sold our interest in an entity that leases four hotels. In conjunction with that transaction, we received cash proceeds totaling $5 million, and the sales price of the investment approximated its book value. In the 2008 first quarter, we sold two limited-service properties for cash proceeds of $14 million, which were approximately equal to the properties book values. We accounted for each of the sales under the full accrual method in accordance with FAS No. 66 and each property will continue to operate under our brands pursuant to franchise agreements.

12. Notes Receivable

The following table details the composition of our notes receivable balances at September 5, 2008, and December 28, 2007.

($ in millions)	September 5, 2008	December 28, 2007
Loans to timeshare owners	$ 573	$ 476
Lodging senior loans	3	7
Lodging mezzanine and other loans	197	206

		773		689
Less current portion		(86)		(89)
	$	687	$	600

15

Table of Contents

We classify notes receivable due within one year as current assets in the caption Accounts and notes receivable in the accompanying Condensed Consolidated Balance Sheets, including $70 million and $68 million, at September 5, 2008, and December 28, 2007, respectively, related to Loans to timeshare owners.

13. Asset Securitizations

As noted in Footnote No. 11, Asset Securitization, in our 2007 Form 10-K, we periodically sell, without recourse, through special purpose entities, notes receivable originated by our Timeshare segment in connection with the sale of timeshare interval and fractional products. We continue to service the notes and transfer all proceeds collected to special purpose entities. We retain servicing assets and other interests in the notes and account for these assets and interests as residual interests. The interests are limited to the present value of cash available after paying financing expenses and program fees and absorbing credit losses.

In June 2008, prior to the end of our second quarter, we sold to a newly formed trust $300 million of notes receivable originated by our Timeshare segment in connection with the sale of timeshare interval and fractional ownership products. On the same day, the trust issued $246 million of the trust s notes. In connection with the sale of notes receivable, we received net proceeds of $237 million. We retained residual interests with a fair value on the day of sale of $93 million. We recorded note sale gains totaling $28 million through the 2008 third quarter. See Footnote No. 6, Fair Value Measurements, earlier in this report for additional information regarding our servicing assets and other residual interests. Also, see Asset Securitizations later in this report in Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations for information regarding volatility in the credit markets.

14. Long-term Debt

Our long-term debt at September 5, 2008, and December 28, 2007, consisted of the following:

($ in millions)	**September 5, 2008**	**December 28, 2007**
Senior Notes:		
Series C, interest rate of 7.875%, face amount of $76, maturing September 15, 2009	$ 76	$ 76
Series E, matured January 15, 2008		91
Series F, interest rate of 4.625%, face amount of $350, maturing June 15, 2012	349	349
Series G, interest rate of 5.810%, face amount of $427, maturing November 10, 2015	404	402
Series H, interest rate of 6.200%, face amount of $350, maturing June 15, 2016	349	349
Series I, interest rate of 6.375%, face amount of $350, maturing June 15, 2017	346	346
Series J, interest rate of 5.625%, face amount of $400, maturing February 15, 2013	397	397
Commercial paper, average interest rate of 3.0% at September 5, 2008	811	585
Mortgage debt, average interest rate of 7.9% at September 5, 2008, maturing through May 1, 2025	161	196
Other	153	174
	3,046	2,965
Less current portion	(44)	(175)
	$ 3,002	$ 2,790

At the end of our 2008 third quarter, all debt, other than mortgage debt, was unsecured.

Table of Contents

While we are predominantly a manager and franchisor of hotel properties, we depend on capital to buy, develop, and maintain hotels and also to develop timeshare properties. Events over the past several months, including recent failures and near failures of a number of large financial service companies, have made the capital markets increasingly volatile.

In response to historic events on Wall Street and the severe dislocation of the capital markets, in September 2008 (our 2008 fourth quarter) we borrowed under our $2.5 billion multicurrency revolving bank credit facility (the Credit Facility) to supplement dramatically reduced liquidity from the commercial paper market. We made these borrowings to fund anticipated short-term commercial paper maturities and, to a lesser extent, other general corporate needs, including working capital and capital expenditures. As of October 2, 2008, borrowings totaling $908 million were outstanding under the Credit Facility, and currently bear interest at the London Interbank Offered Rate (LIBOR) plus a spread of 35 basis points (0.35 percent), which is based on our public debt rating. We expect to replace these Credit Facility borrowings with commercial paper as stability returns to that market and we can again issue commercial paper on favorable terms.

Lehman Commercial Paper Inc. (LCPI), a subsidiary of Lehman Brothers Holdings Inc., has $96 million (3.8 percent) of the $2.5 billion in commitments under the Credit Facility. Although LCPI, to date, has not filed for bankruptcy (to our knowledge), LCPI has not funded its share of our fourth quarter 2008 draws under the Credit Facility, and we have no reason to expect that LCPI will do so in the future. Accordingly, unless this situation changes, the total effective size of the Credit Facility is approximately $2.4 billion.

15. Comprehensive Income and Capital Structure

For the twelve weeks ended September 5, 2008, and September 7, 2007, respectively, net income totaled $94 million and $131 million, while comprehensive income totaled $71 million and $118 million. The principal difference between net income and comprehensive income for the twelve weeks ended September 5, 2008, primarily relates to foreign currency translation adjustments and, to a lesser extent, mark-to-market adjustments associated with both available-for-sale securities and cash flow hedges. The principal difference between net income and comprehensive income for the twelve weeks ended September 7, 2007, primarily relates to mark-to-market adjustments associated with available-for-sale securities.

For the thirty-six weeks ended September 5, 2008, and September 7, 2007, respectively, net income totaled $372 million and $520 million, while comprehensive income totaled $369 million and $508 million. The principal difference between net income and comprehensive income for the thirty-six weeks ended September 5, 2008, primarily relates to mark-to-market adjustments associated with available-for-sale securities, partially offset by both mark-to-market adjustments associated with cash flow hedges and foreign currency translation adjustments. The principal difference between net income and comprehensive income for the thirty-six weeks ended September 7, 2007, primarily relates to mark-to-market adjustments associated with available-for-sale securities, partially offset by foreign currency translation adjustments.

We included the net change in unrealized holding losses on available-for-sale securities in accumulated other comprehensive income of $5 million and $4 million for the twelve-week periods ended September 5, 2008, and September 7, 2007, respectively, and $12 million and $15 million, respectively, for the thirty-six weeks then ended. The amount of gains reclassified out of accumulated other comprehensive income as a result of the sale of securities totaled zero for each of the twelve-week periods ended September 5, 2008, and September 7, 2007, and zero and $10 million, respectively, for the thirty-six weeks then ended.

For the thirty-six weeks ended September 5, 2008, approximately 3.9 million shares of our Class A Common Stock were issued upon conversion, exercise, or satisfaction of required conditions. In addition, during the first three quarters of 2008 we repurchased approximately 11.9 million shares of our Class A Common Stock at an average price of $31.18 per share.

Table of Contents

16. Contingencies

Guarantees

We issue guarantees to certain lenders and hotel owners primarily to obtain long-term management contracts. The guarantees generally have a stated maximum amount of funding and a term of three to 10 years. The terms of guarantees to lenders generally require us to fund if cash flows from hotel operations are inadequate to cover annual debt service or to repay the loan at the end of the term. The terms of the guarantees to hotel owners generally require us to fund if the hotels do not attain specified levels of operating profit. Guarantee fundings to lenders and hotel owners are generally recoverable as loans repayable to us out of future hotel cash flows and/or proceeds from the sale of hotels. We also enter into project completion guarantees with certain lenders in conjunction with hotels and Timeshare segment properties that we or our joint venture partners are building.

The maximum potential amount of future fundings for guarantees where we are the primary obligor and the carrying amount of the liability for expected future fundings at September 5, 2008, are as follows:

($ in millions)

Guarantee Type	Maximum Potential Amount of Future Fundings	Liability for Expected Future Fundings at September 5, 2008
Debt service	$ 48	$ 1
Operating profit	180	27
Other	93	7
Total guarantees where we are the primary obligor	$ 321	$ 35

The liability for expected future fundings at September 5, 2008, is included in our Condensed Consolidated Balance Sheets as follows: $1 million in the Other payables and accruals line item and $34 million in the Other long-term liabilities line item.

Our guarantees of $321 million listed in the preceding table include $36 million of operating profit guarantees that will not be in effect until the underlying properties open and we begin to operate the properties, along with $13 million of debt service guarantees that will not be in effect until the underlying debt has been funded.

The guarantees of $321 million in the preceding table do not include $216 million of guarantees that expire in the years 2011 through 2013, related to Senior Living Services lease obligations and lifecare bonds for which we are secondarily liable. Sunrise Senior Living, Inc. (Sunrise) is the primary obligor of the leases and a portion of the lifecare bonds, and CNL Retirement Properties, Inc. (CNL), which subsequently merged with Health Care Property Investors, Inc., is the primary obligor of the remainder of the lifecare bonds. Prior to our sale of the Senior Living Services business in 2003, these preexisting guarantees were guarantees by us of obligations of consolidated Senior Living Services subsidiaries. Sunrise and CNL have indemnified us for any guarantee fundings we may be called on to make in connection with these lease obligations and lifecare bonds. We do not expect to fund under the guarantees.

The table also does not include lease obligations for which we became secondarily liable when we acquired the Renaissance Hotel Group N.V. in 1997, consisting of annual rent payments of approximately $6 million and total remaining rent payments through the initial term of approximately $72 million. Most of these obligations expire at the end of 2023. CTF Holdings Ltd. (CTF) had originally made available 35 million in cash collateral in the event that we are required to fund under such guarantees (approximately 7 million [$10 million] remained at the end of the 2008 third quarter). As CTF obtains releases from the landlords and these hotels exit the system, our contingent liability exposure of approximately $72 million will decline. Since the time we assumed these guarantees, we have not funded any amounts and we do not expect to fund any amounts under these guarantees in the future.

In addition to the guarantees noted in the preceding table, we have provided a project completion guarantee to a lender for a project with an estimated aggregate total cost of $586 million. Payments for cost overruns for this project will be satisfied by the joint venture through contributions from the partners, and we are liable on a several basis with our partners in an amount equal to our pro rata ownership in the joint venture, which is 34 percent. We do not expect to fund under the guarantee. At the end of the 2008 third quarter, the carrying value of the liabilities associated with this project completion guarantee was $6 million.

In addition to the guarantees described in the preceding paragraphs, in conjunction with financing obtained for specific projects or properties owned by joint ventures in which we are a party, we may provide industry standard indemnifications to the lender for loss, liability, or damage occurring as a result of the actions of the other joint venture owner or our own actions.

Commitments and Letters of Credit

In addition to the guarantees noted previously, as of September 5, 2008, we had extended approximately $3 million of loan commitments to owners of lodging properties, under which we expect to fund approximately $2 million, which expire as follows: $1 million within one year and $1 million in two to three years. We do not expect to fund the remaining $1 million of commitments, which expire after five years.

At September 5, 2008, we also had commitments to invest up to $53 million of equity for minority interests in partnerships that plan to purchase North American full-service and limited-service properties or purchase or develop hotel-anchored mixed-use real estate projects, which expire as follows: $14 million within one year; $29 million within three years; and $10 million in over three years. Of the $53 million in commitments, we expect to fund $14 million within one year; $10 million in one to two years; and $29 million within three years. In addition, as of September 5, 2008, we had commitments, with no expiration date, to fund up to $12 million in joint ventures for development of new properties, which we expect to fund within three years. Also, as of September 5, 2008, we had a commitment, with no expiration date, to invest up to $29 million (20 million) in a joint venture in which we are a partner. We do not expect to fund under this commitment.

At September 5, 2008, we had $128 million of letters of credit outstanding, the majority of which related to our self-insurance programs. Surety bonds issued as of September 5, 2008, totaled $571 million, the majority of which were requested by federal, state or local governments related to our lodging operations, including our Timeshare segment and self-insurance programs.

17. Business Segments

We are a diversified hospitality company with operations in five business segments:

North American Full-Service Lodging, which includes the Marriott Hotels & Resorts, Marriott Conference Centers, JW Marriott Hotels & Resorts, Renaissance Hotels & Resorts, and Renaissance ClubSport properties located in the continental United States and Canada;

North American Limited-Service Lodging, which includes the Courtyard, Fairfield Inn, SpringHill Suites, Residence Inn, TownePlace Suites, and Marriott ExecuStay properties located in the continental United States and Canada;

International Lodging, which includes the Marriott Hotels & Resorts, JW Marriott Hotels & Resorts, Renaissance Hotels & Resorts, Courtyard, Fairfield Inn, Residence Inn, and Marriott Executive Apartments properties located outside the continental United States and Canada;

Luxury Lodging, which includes The Ritz-Carlton and Bulgari Hotels & Resorts properties worldwide; and

Table of Contents

Timeshare, which includes the development, marketing, operation, and sale of Marriott Vacation Club, The Ritz-Carlton Club and Residences, Grand Residences by Marriott, and Horizons by Marriott Vacation Club timeshare, fractional ownership, and residential properties worldwide.

In addition to the brands noted above, in 2007, we announced our new brand of family-friendly resorts and spas, Nickelodeon Resorts by Marriott and a new brand of lifestyle boutique hotels, Edition. As of September 5, 2008, no properties were yet open under either brand.

We evaluate the performance of our segments based primarily on the results of the segment without allocating corporate expenses, interest expense, income taxes, or indirect general, administrative, and other expenses. With the exception of the Timeshare segment, we do not allocate interest income to our segments. Because note sales are an integral part of the Timeshare segment, we include note sale gains in our Timeshare segment results. We also include interest income associated with Timeshare segment notes in our Timeshare segment results because financing sales are an integral part of that segment s business. Additionally, we allocate other gains or losses, equity in earnings or losses from our joint ventures, divisional general, administrative, and other expenses, and minority interests in income of losses of consolidated subsidiaries to each of our segments. Other unallocated corporate represents that portion of our revenues, general, administrative, and other expenses, equity in earnings or losses, and other gains or losses that are not allocable to our segments.

We aggregate the brands presented within our North American Full-Service, North American Limited-Service, International, Luxury, and Timeshare segments considering their similar economic characteristics, types of customers, distribution channels, the regulatory business environment of the brands and operations within each segment and our organizational and management reporting structure.

Revenues

	Twelve Weeks Ended		Thirty-Six Weeks Ended	
($ in millions)	**September 5, 2008**	**September 7, 2007**	**September 5, 2008**	**September 7, 2007**
North American Full-Service Segment	$ 1,239	$ 1,241	$ 3,917	$ 3,767
North American Limited-Service Segment	544	540	1,570	1,541
International Segment	342	343	1,093	1,056
Luxury Segment	357	339	1,147	1,048
Timeshare Segment	463	463	1,326	1,438
Total segment revenues	2,945	2,926	9,053	8,850
Other unallocated corporate	18	17	42	51
	$ 2,963	$ 2,943	$ 9,095	$ 8,901

Income from Continuing Operations

	Twelve Weeks Ended		Thirty-Six Weeks Ended	
($ in millions)	**September 5, 2008**	**September 7, 2007**	**September 5, 2008**	**September 7, 2007**
North American Full-Service Segment	$ 66	$ 78	$ 290	$ 324
North American Limited-Service Segment	103	119	301	337
International Segment	50	57	179	166
Luxury Segment	17	15	66	44
Timeshare Segment	49	39	123	190
Total segment financial results	285	308	959	1,061
Other unallocated corporate	(58)	(59)	(183)	(192)
Interest expense, interest income, and provision for loan losses	(25)	(34)	(83)	(101)
Income taxes	(108)	(93)	(324)	(307)

$ 94	$ 122	$ 369	$ 461

20

Table of Contents

Minority Interest

We allocate net minority interest in losses of consolidated subsidiaries to our segments. Accordingly, as of September 5, 2008, and September 7, 2007, we allocated net minority interest in losses of consolidated subsidiaries as reflected in our Condensed Consolidated Statements of Income as shown in the following table:

	Twelve Weeks Ended		Thirty-Six Weeks Ended	
($ in millions)	September 5, 2008	September 7, 2007	September 5, 2008	September 7, 2007
International Segment	$	$	$ (1)	$
Timeshare Segment	15	1	21	1
Total segment minority interest	15	1	20	1
Provision for income taxes	(5)		(7)	
	$ 10	$ 1	$ 13	$ 1

Equity in Earnings (Losses) of Equity Method Investees

	Twelve Weeks Ended		Thirty-Six Weeks Ended	
($ in millions)	September 5, 2008	September 7, 2007	September 5, 2008	September 7, 2007
North American Full-Service Segment	$ 1	$	$ 2	$ 1
North American Limited-Service Segment		1	1	2
International Segment	(1)	1		3
Luxury Segment	(1)		(1)	(2)
Timeshare Segment	2	5	9	4
Total segment equity in earnings	1	7	11	8
Other unallocated corporate	1	1	15	1
	$ 2	$ 8	$ 26	$ 9

Assets

	At Period End	
($ in millions)	September 5, 2008	December 28, 2007
North American Full-Service Segment	$ 1,406	$ 1,322
North American Limited-Service Segment	474	486
International Segment	814	855
Luxury Segment	817	748
Timeshare Segment	3,570	3,142
Total segment assets	7,081	6,553
Other unallocated corporate	2,023	2,336
Discontinued operations		53
	$ 9,104	$ 8,942

18. Variable Interest Entities

At the end of the 2008 first quarter, we consolidated a holding company that held the 100 percent interest in four entities that were variable interest entities under FIN 46, Consolidation of Variable Interest Entities-revised (FIN 46(R)), and the combined capital in the four variable interest entities was $1 million, which was used primarily to fund hotel working capital. Our equity at risk totaled $4 million

Table of Contents

and we held 55 percent of the common equity shares of the holding company. We sold our interest in the holding company during the 2008 second quarter.

We are party to a venture that develops and markets fractional ownership and residential interests, and we consolidate this venture as we are the primary beneficiary. At the end of the 2008 third quarter, a loan we made to the venture was outstanding, with a balance due to us of $65 million. At the end of the 2008 third quarter, the carrying amount of consolidated assets that are collateral for the variable interest entity s obligations totaled $82 million and comprised $77 million of real estate held for development, property, equipment, and other long-term assets and $5 million of cash. The creditors of the variable interest entity do not have general recourse to our credit.

In conjunction with the transaction with CTF described more fully in Footnote No. 11, Acquisitions and Dispositions, under the caption 2005 Acquisitions, in our 2007 Form 10-K, we manage certain hotels on behalf of four tenant entities 100 percent owned by CTF, which lease the hotels from third-party owners. At the end of the 2008 third quarter, the number of hotels totaled 14. The entities have minimal equity and minimal assets comprised of hotel working capital. CTF has placed money in a trust account to cover cash flow shortfalls and to meet rent payments. The terms of the trust require that the cash flows for the four tenant entities be pooled for purposes of making rent payments and determining cash flow shortfalls. At the end of the 2008 third quarter, the trust account held approximately $29 million. The entities are variable interest entities under FIN 46(R). We do not consolidate the entities, because we do not bear the majority of the expected losses. We are secondarily liable (after exhaustion of funds from the trust account) for rent payments for eight of the 14 hotels in the event that there are cash flow shortfalls. Future minimum lease payments through the end of the lease term for these eight hotels totaled approximately $106 million. In addition, we are also secondarily liable for rent payments of up to an aggregate cap of $44 million for the six other hotels in the event that there are cash flow shortfalls.

19. Leases

In the 2008 second quarter we, as a lessee, entered into a lease agreement for one property with aggregate minimum lease payments of $63 million through the initial lease term, which ends in 2019. Future minimum lease payments for each of the next five years and thereafter are as follows: $3 million in 2008; $6 million in each of 2009, 2010, 2011, and 2012; and $36 million thereafter.

Table of Contents

Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Forward-Looking Statements

We make forward-looking statements in Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report based on the beliefs and assumptions of our management and on information currently available to us. Forward-looking statements include information about our possible or assumed future results of operations which follow under the headings Business and Overview, Liquidity and Capital Resources, and other statements throughout this report preceded by, followed by or that include the words believes, expects, anticipates, intends, plans, estimates or similar expressions.

Forward-looking statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed in these forward-looking statements, including the risks and uncertainties described below and other factors we describe from time to time in our periodic filings with the U.S. Securities and Exchange Commission (the SEC). We therefore caution you not to rely unduly on any forward-looking statements. The forward-looking statements in this report speak only as of the date of this report, and we undertake no obligation to update or revise any forward-looking statement, whether as a result of new information, future developments or otherwise.

In addition, see the Item 1A. Risk Factors caption in the Part II-OTHER INFORMATION section of this report.

BUSINESS AND OVERVIEW

U.S. lodging demand declined in the first three quarters of 2008 as a result of slowing economic growth, particularly impacting transient travel. Outside the United States, international lodging demand was generally stronger in most markets, but has softened progressively throughout 2008 as well. Leisure transient demand in the United States weakened in the first quarter of 2008 and was joined by weakening business transient demand beginning in the second quarter of 2008. Last minute new group meeting demand and attendance at group meetings have also softened. While some business customers increased room nights, including professional services firms, defense contractors, and insurance companies, others declined, including companies associated with the financial services, automotive, and telecommunications industries. In general, for the properties in our system, luxury, international, and full-service properties experienced stronger demand worldwide than our limited-service properties.

In this slower demand environment, we are working aggressively to enhance property-level house profit margins by modifying menus and restaurant hours, reviewing room amenities, and not filling some vacant positions. While varying by property, most properties in our system have instituted contingency plans with very tight cost controls. We have also reduced above-property costs by scaling back systems, processing, and support areas that are allocated to the hotels to be roughly flat relative to revenue. On the revenue side, we benefit from ongoing group business from contracts signed over the past several years as well as recent price increases for ancillary operations. Furthermore, we continue to develop new sales promotions with a focus on leisure and group business opportunities to increase property-level revenue, rather than simply discounting room rates. We also continue to enhance our Marriott Rewards loyalty program offerings and specifically market to this large and growing customer base. In response to increased hesitancy to finalize bookings, particularly on the group side, we have also implemented sales associate and customer incentives to close on business.

For our North American comparable properties, Revenue per Available Room (RevPAR) increased modestly in the first three quarters of 2008, compared to the year-ago period, with greater strength in Manhattan, New York, Orlando, Florida, and Los Angeles, California and weaker RevPAR in suburban markets near, among other areas, Orange County, California, Chicago, Illinois, and Detroit, Michigan. International guest demand for many U.S. properties remains strong. Internationally, RevPAR increases in the first three quarters of 2008 versus the prior year period were stronger, particularly in the Middle East, Central and Southeast Asia, South America, and Central Europe. References to RevPAR throughout this report are in constant dollars unless otherwise noted.

We currently have over 130,000 rooms in our development pipeline. During the first three quarters of 2008, we opened 21,958 rooms (gross), which included 416 residential units. We expect to open approximately 30,000 rooms (gross) not including residential units for the 2008 full year. For the first three quarters of 2008, approximately 18 percent of the rooms added to our system were conversions from competitor brands and 24 percent of the new rooms were located outside the United States.

Events over the past several months, including recent failures and near failures of a number of large financial service companies have made the capital markets increasingly volatile. Accordingly, given the difficult lending environment, the company, owners or franchisees may decide to reevaluate continuing some number of projects included in the development pipeline. While the company has invested in few of its pipeline projects, possible delays, cancellations, or financial restructurings of projects under development could have a negative impact on our financial results.

At the end of the third quarter of 2008, 49 percent of the hotel rooms in our system were operated under management agreements, 49 percent were operated under franchise agreements, and 2 percent were owned or leased by us. Our emphasis on property management and franchising tends to provide more stable earnings in periods of economic softness while continued unit expansion, reflecting properties added to our system, generates ongoing growth.

U.S. demand for timeshare intervals also softened in the first three quarters of 2008 while demand in Latin America and Asia for timeshare products was stronger. Demand for Ritz-Carlton fractional and residential units was particularly weak and, as noted in greater detail in the BUSINESS SEGMENTS: Timeshare caption later in this report, we recorded a $22 million pretax impairment charge ($10 million net of minority interest benefit) in the 2008 third quarter to adjust the carrying value of fractional and whole ownership real estate held for development to its estimated fair value. We have increased our timeshare marketing efforts. Since the sale of timeshare and fractional intervals and condominiums follows the percentage-of-completion accounting method, soft demand is frequently reflected in results in later accounting periods.

Our brands remain strong as a result of superior customer service with an emphasis on guest and associate satisfaction, the worldwide presence and quality of our brands, our Marriott Rewards loyalty program, an information-rich and easy-to-use Web site, a multi-channel central reservations system, and desirable property amenities. We, along with owners and franchisees, continue to invest in our brands by means of new, refreshed, and reinvented properties, new room and public space designs, and enhanced amenities and technology offerings. We continue to enhance the appeal of our proprietary Web site, www.Marriott.com, through functionality and service improvements, and we continue to capture an increasing proportion of property-level reservations via this cost efficient channel. We have added other languages to Marriott.com and we have enabled guests to use handheld devices to confirm reservations and get directions.

CONSOLIDATED RESULTS

The following discussion presents an analysis of results of our operations for the twelve weeks and thirty-six weeks ended September 5, 2008, compared to the twelve weeks and thirty-six weeks ended September 7, 2007. We opened 213 properties (32,745 rooms) while 50 properties (9,163 rooms) exited the system since the third quarter of 2007.

Revenues

Twelve Weeks. Revenues increased by $20 million (1 percent) to $2,963 million in the third quarter of 2008 from $2,943 million in the third quarter of 2007, primarily related to reimbursed costs as a small increase in base management fee growth was offset by small decreases in franchise and incentive management fees. Base management fees increased by $8 million primarily as a result of unit growth and, to a lesser extent, modest RevPAR improvement. RevPAR increases over the year-ago quarter were driven primarily by rate increases. Incentive management fees decreased by $4 million, reflecting a $14 million decrease in incentive management fees earned in North America, partially offset by a $10 million increase in incentive management fees earned from international properties. The decrease in incentive management fees reflected lower profitability of hotels driven by lower lodging demand and higher property-level wages and benefits costs and utilities costs, particularly in North America. Partially offsetting the decreases, incentive management fees from international properties increased reflecting stronger demand and unit growth. See the BUSINESS SEGMENTS discussion later in this report for additional information. Franchise fees decreased by $3 million as compared to the 2007 third quarter and reflected lower relicensing fees, partially offset by the impact of unit growth. Compared to the year-ago quarter, cost reimbursements revenue increased by $26 million, while Timeshare sales and services revenue decreased by $5 million and owned, leased, corporate housing, and other revenue decreased by $2 million.

The $2 million (1 percent) decrease in owned, leased, corporate housing, and other revenue largely reflected the impact of lower revenue associated with owned and leased properties reflecting weaker demand, and to a lesser extent lower revenue associated with properties under renovation in the third quarter of 2008. In addition, there were no termination fees received in the 2008 third quarter, compared to $3 million of termination fees received in the 2007 third quarter. Partially offsetting these decreases was higher affinity card endorsement revenue in the 2008 third quarter compared to the 2007 third quarter.

The $26 million (1 percent) increase in cost reimbursements revenue to $2,016 million in the third quarter of 2008 from $1,990 million in the year-ago quarter primarily resulted from wage increases, sales growth, and the growth in the number of properties we manage. We added two managed properties (3,059 rooms) and 149 franchised properties (18,066 rooms) to our system since the end of the 2007 third quarter, net of properties exiting the system. Cost reimbursements revenue represents reimbursements of costs incurred on behalf of managed and franchised properties and relates, predominantly, to payroll costs at managed properties where we are the employer. This revenue and related expense has no impact on either our operating income or net income because we record cost reimbursements based upon the costs incurred, with no added markup.

Timeshare sales and services revenue in the third quarter of 2008 decreased by $5 million (1 percent) compared to the year-ago quarter. The decrease primarily reflected revenue recognition of contract sales for several projects in the 2007 third quarter that reached reportability thresholds, lower revenue from several projects with limited available inventory in 2008, and slow demand for fractional and residential products. Partially offsetting these decreases was higher revenue associated with the Asia Pacific points program, revenue associated with projects that became reportable subsequent to the 2007 third quarter, and increased services and financing revenue.

Thirty-six Weeks. Revenues increased by $194 million (2 percent) to $9,095 million in the first three quarters of 2008 from $8,901 million in the first three quarters of 2007, as a result of growth across the system and increased room rates. Base management and franchise fees increased by $46 million as a result of stronger RevPAR and unit growth. RevPAR increases over the year-ago period were driven primarily by rate increases. Incentive management fees decreased by $14 million primarily reflecting the recognition in the 2007 period of: 1) incentive fees totaling $15 million that were calculated based on prior periods results, but not earned and due until 2007; and 2) $4 million of incentive management fees from business interruption proceeds associated with Hurricane Katrina. The decrease in incentive management fees also reflected lower property-level profitability due to lower demand and higher property-level wages and benefits costs and utilities costs, particularly in North America. Partially offsetting the decreases, incentive management fees from international properties increased reflecting stronger demand and unit growth. See the BUSINESS SEGMENTS discussion later in this report for additional information.

Cost reimbursements revenue increased by $250 million and owned, leased, corporate housing, and other revenue increased by $25 million, while Timeshare sales and services revenue decreased by $113 million.

Table of Contents

The $250 million (4 percent) increase in cost reimbursements revenue to $6,153 million in the first three quarters of 2008 from $5,903 million in the year-ago period. The increase in reimbursed costs was primarily attributable to wage increases, sales growth, and the growth in the number of properties we manage.

The $25 million (3 percent) increase in owned, leased, corporate housing, and other revenue largely reflected the impact of newly opened properties in the first three quarters of 2008, and, to a lesser extent, RevPAR growth and higher branding fees associated with the sale of branded residential real estate. Partially offsetting these increases were lower revenue for leased properties and the impact of properties undergoing renovation in 2008.

Timeshare sales and services revenue in the first three quarters of 2008 decreased by $113 million (9 percent) compared to the year-ago period. The decrease primarily reflected revenue recognition of contract sales for several projects in the 2007 period that reached reportability thresholds and lower revenue from several projects with limited available inventory in 2008, as well as a decrease of $17 million in note sale gains in the first three quarters of 2008 compared to the year-ago period. Partially offsetting these decreases in revenue in the first three quarters of 2008 compared to the year-ago period was higher revenue associated with the Asia Pacific points program, revenue associated with projects that became reportable subsequent to the 2007 third quarter, and increased services revenue.

Operating Income

Twelve Weeks. Operating income decreased by $7 million (3 percent) to $203 million in the third quarter of 2008 from $210 million in the third quarter of 2007. The decrease in operating income reflected $7 million of lower owned, leased, corporate housing, and other revenue net of direct expenses, $3 million of higher general, administrative, and other expenses, $4 million of lower incentive management fees, and $3 million of lower franchise fees, partially offset by an increase in base management fees of $8 million and $2 million of higher Timeshare sales and services revenue net of direct expenses.

Timeshare sales and services revenue net of direct expenses totaled $47 million. The increase of $2 million (4 percent) from the year-ago quarter was largely due to $5 million of higher services revenue net of services expenses and $2 million of higher financing revenue net of financing expenses, mostly offset by $6 million of lower reacquired and resales revenue net of reacquired and resales expenses. Development revenue, net of product costs and marketing and selling costs, remained relatively unchanged and reflected lower revenue from several projects with limited available inventory in the 2008 period, a $22 million pretax impairment charge ($10 million net of minority interest benefit), slow demand for fractional and residential products, start-up costs and low reportability in the 2008 period associated with newer projects that have not yet reached revenue recognition thresholds, as well as revenue recognition for several projects that reached reportability thresholds in the 2007 third quarter. Lower reacquired and resales revenue net of reacquired and resales expenses was driven by higher marketing and selling costs coupled with increased product cost relative to the 2007 quarter. See BUSINESS SEGMENTS: Timeshare, later in this report for additional information regarding our Timeshare segment.

General, administrative, and other expenses increased by $3 million (2 percent) to $167 million in the third quarter of 2008 from $164 million in the third quarter of 2007. The increase reflected, among other things, our unit growth and development, systems improvements, and initiatives to enhance our brands globally. Of the $3 million increase in total general, administrative, and other expenses, an increase of $4 million was attributable to our Lodging segments and a decrease of $1 million, was unallocated. Additionally, the 2008 third quarter included a $7 million favorable impact associated with deferred compensation expenses reflecting mark-to-market valuations, while the year-ago quarter reflected no impact associated with mark-to-market valuations.

Table of Contents

The $7 million (26 percent) decrease in owned, leased, corporate housing, and other revenue net of direct expenses reflected $3 million of lower revenue in 2008 associated with a service contract that terminated at the end of the 2007 fiscal year and the impact of several properties undergoing renovations in 2008. In addition, there were no termination fees received in the third quarter of 2008, compared to $3 million in the 2007 quarter. Partially offsetting these decreases, the 2008 third quarter reflected $4 million of higher affinity card endorsement revenue. The reasons for the base management fees increase and the franchise fee and incentive management fee decreases, compared to the year-ago quarter, are noted in the preceding Revenues discussion.

Thirty-six Weeks. Operating income decreased by $71 million (9 percent) to $711 million in the first three quarters of 2008 from $782 million in the first three quarters of 2007. The decrease in operating income reflected $87 million of lower Timeshare sales and services revenue net of direct expenses, $21 million of lower owned, leased, corporate housing, and other revenue net of direct expenses, and $14 million of lower incentive management fees, partially offset by an increase in combined base management and franchise fees of $46 million and $5 million of lower general, administrative, and other expenses.

Timeshare sales and services revenue net of direct expenses totaled $137 million. The decline of $87 million (39 percent) from the year-ago period primarily reflected $70 million of lower development revenue, net of product costs and marketing and selling costs and $16 million of lower financing revenue net of financing expenses. Lower development revenue, net of product costs and marketing and selling costs, primarily reflected lower revenue from several projects with limited available inventory in 2008, a $22 million pretax impairment charge ($10 million net of minority interest benefit), slow demand for fractional and residential products, start-up costs, and low reportability in 2008 associated with newer projects that have not yet reached revenue recognition thresholds, as well as revenue recognition for several projects that reached reportability thresholds in the first three quarters of 2007. The decrease in financing revenue net of financing costs primarily reflected lower note sale gains in 2008, compared to the year-ago period. See BUSINESS SEGMENTS: Timeshare, later in this report for additional information regarding our Timeshare segment.

General, administrative, and other expenses decreased by $5 million (1 percent) to $513 million in the first three quarters of 2008 from $518 million in the first three quarters of 2007. The 2007 period included a charge of $35 million, resulting from excise taxes associated with the settlement of issues raised during the examination by the Internal Revenue Service (IRS) and Department of Labor of our employee stock ownership plan (ESOP) feature of our Employees Profit Sharing, Retirement and Savings Plan and Trust (the Plan). Additionally impacting general, administrative, and other expenses was a $40 million increase in 2008 of expenses associated with, among other things, our unit growth and development, systems improvements, and initiatives to enhance our brands globally, and a $9 million reversal of reserves in the 2007 period. Additionally, the first three quarters of 2008 included an $11 million favorable impact associated with deferred compensation expenses, compared to an $8 million unfavorable impact in the year-ago period, both of which reflected mark-to-market valuations. Of the $5 million decrease in total general, administrative, and other expenses, an increase of $23 million was attributable to our Lodging segments and a decrease of $28 million, primarily reflecting the 2007 ESOP settlement charge, was unallocated.

The $21 million (19 percent) decrease in owned, leased, corporate housing, and other revenue net of direct expenses primarily reflected $6 million of lower profits associated with two properties undergoing renovation in the first three quarters of 2008, $4 million of lower income, primarily reflecting lower land rent, and $11 million of lower revenue associated with a services contract that terminated at the end of the 2007 fiscal year. Partially offsetting the decreases were $5 million of higher branding fees in the first three quarters of 2008 associated with the sale of branded residential real estate. The reasons for the combined base management and franchise fees increase of $46 million (6 percent) over the year-ago period, are noted in the preceding Revenues discussion.

Table of Contents

Gains and Other Income

The table below shows our gains and other income for the twelve weeks and thirty-six weeks ended September 5, 2008, and September 7, 2007:

($ in millions)	Twelve Weeks Ended September 5, 2008	Twelve Weeks Ended September 7, 2007	Thirty-Six Weeks Ended September 5, 2008	Thirty-Six Weeks Ended September 7, 2007
Gains on sales of real estate and other	$ 2	$ 22	$ 7	$ 29
Gain on forgiveness of debt		3		12
Other note sale/repayment gains				1
Gain on sale of joint venture and other investments	2	2	3	23
Income from cost method joint ventures	3	3	9	12
	$ 7	$ 30	$ 19	$ 77

Twelve Weeks. The $20 million decrease in gains on sales of real estate and other in the third quarter of 2008 primarily reflected a $15 million gain associated with the sale of real estate in our International segment as well as other smaller gains on sale of real estate in the 2007 third quarter that did not occur in the 2008 third quarter. The $3 million gain on forgiveness of debt in the 2007 third quarter was associated with government incentives. The loans were forgiven in recognition of our contribution to job growth and economic development.

Thirty-six Weeks. The $22 million decrease in gains on sales of real estate and other in the first three quarters of 2008 primarily reflected a $15 million gain associated with the sale of real estate in our International segment as well as other smaller gains on sale of real estate in the first three quarters of 2007 that did not occur in the first three quarters of 2008. The $12 million gain on forgiveness of debt for the first three quarters of 2007 was associated with government incentives noted in the Twelve Weeks discussion. Gain on sale of joint venture and other investments of $23 million in the first three quarters of 2007 reflected an $11 million gain associated with the sale of stock we held and net gains totaling $12 million on the sale of joint venture investments.

Interest Expense

Twelve Weeks. Interest expense decreased by $9 million (21 percent) to $33 million for the third quarter of 2008 compared to $42 million in the third quarter of 2007. The decrease in interest expense compared to the 2007 quarter reflected a $4 million favorable variance to last year for higher capitalized interest associated with construction projects and a $4 million decline in interest costs associated with various programs (including our Marriott Rewards, gift certificates, and self-insurance programs). The decline in interest on these programs that we operate on behalf of owners was attributable to lower interest rates. Commercial paper interest rates were lower in the 2008 third quarter than the year-ago quarter yielding a $4 million reduction in interest expense. Additionally, our Series E Senior Notes matured in early 2008 yielding a $2 million favorable variance to the 2007 quarter. These favorable variances were partially offset by the impact of the Series J Senior Notes issuance, which occurred in the fourth quarter of 2007 that increased our interest expense in the 2008 third quarter by $5 million.

Thirty-six Weeks. Interest expense decreased by $14 million (11 percent) to $113 million for the first three quarters of 2008 compared to $127 million in the first three quarters of 2007. The decrease in interest expense compared to the prior year reflected a charge of $13 million for interest on the excise taxes associated with the ESOP settlement and related interest rates in the second quarter of 2007. Commercial paper interest rates were lower in the 2008 period than in the 2007 period, and as a result, year-over-year interest expense was lower by $5 million. There was also an $8 million favorable variance to last year for higher capitalized interest associated with construction projects and a $10 million decrease in interest costs associated with various programs that we operate on behalf of owners (including our Marriott Rewards, gift certificates, and self-insurance programs) as a result of lower interest rates. Additionally, our Series E

Table of Contents

Senior Notes matured in early 2008 yielding a $4 million favorable variance to the year-ago period. These favorable variances to the year-ago period were partially offset by the impact of the Series I and Series J Senior Notes issuances, which occurred in the second half of 2007 that increased our interest expense in the 2008 period by $26 million.

Interest Income, Provision for Loan Losses, and Income Tax

Twelve Weeks. Interest income was unchanged at $8 million in the third quarter of 2008 compared to the year-ago quarter.

Our tax provision increased by $10 million (11 percent) to a tax provision of $103 million in the third quarter of 2008 from a tax provision of $93 million in the third quarter of 2007 and reflected the impact of a higher tax rate in the third quarter of 2008 and a $7 million unfavorable impact in the 2008 third quarter associated with deferred compensation compared to the year-ago quarter, partially offset by the impact associated with lower pretax income in 2008. The higher tax rate in the 2008 third quarter reflected a $29 million income tax expense primarily related to an unfavorable U.S. Court of Federal Claims decision involving a 1994 tax planning transaction. The tax had been paid, and we had filed a refund claim to recover the taxes. We expect to appeal the ruling.

Thirty-six Weeks. Interest income, before the provision for loan losses, increased by $2 million (8 percent) to $28 million in the first three quarters of 2008 from $26 million in the year-ago period. The $2 million reversal of a loan loss provision in the first three quarters of 2008 reflected the reversal of loan loss provisions totaling $5 million as two previously impaired loans were repaid to us, partially offset by a $3 million loan loss provision associated with one property. There was no loan loss provision in the first three quarters of 2007.

Our tax provision increased by $10 million (3 percent) to a tax provision of $317 million in the first three quarters of 2008 from a tax provision of $307 million in the first three quarters of 2007 and reflected both a $19 million unfavorable impact associated with deferred compensation in the 2008 period compared to the 2007 period and a higher tax rate in the first three quarters of 2008, partially offset by the impact associated with lower pretax income in 2008 and $6 million of taxes in 2007 associated with additional interest on the ESOP settlement. The higher tax rate in 2008 reflected: 1) $29 million of income tax expense primarily related to an unfavorable U.S. Court of Federal Claims decision involving a refund claim associated with a 1994 tax planning transaction; 2) $12 million of income tax expense in the 2008 second quarter due primarily to prior years tax adjustments, including a settlement with the IRS that resulted in a lower than expected refund of taxes associated with a 1995 leasing transaction; and 3) $24 million of income tax expense in the 2008 second quarter related to the tax treatment of funds received from certain foreign subsidiaries that is in ongoing discussions with the IRS.

Equity in Earnings

Twelve Weeks. Equity in earnings decreased by $6 million (75 percent) to earnings of $2 million in the third quarter of 2008 from earnings of $8 million in the third quarter of 2007 and primarily reflected a $3 million decrease associated with prior year activity from a Timeshare segment joint venture which is now consolidated.

Thirty-six Weeks. Equity in earnings increased by $17 million to earnings of $26 million in the first three quarters of 2008 from earnings of $9 million in the first three quarters of 2007 and primarily reflected $14 million of increased earnings from a joint venture which sold portfolio assets in the 2008 period and had significant associated gains, $9 million of increased earnings from another joint venture primarily reflecting insurance proceeds received by that joint venture in the 2008 period, and a $5 million increase primarily reflecting favorable reportability for our fractional and residential product in one joint venture, partially offset by an unfavorable $11 million impact associated with tax law changes in a country in which two international joint ventures operate.

Table of Contents

Minority Interest

Twelve Weeks. Minority interest increased by $9 million in the third quarter of 2008 to a $10 million benefit from a benefit of $1 million in the third quarter of 2007. The minority interest benefit of $10 million is net of tax and reflected our partners share of losses totaling $15 million associated with joint ventures we consolidate net of our partners share of tax benefits of $5 million associated with the losses. See our BUSINESS SEGMENTS: Timeshare, later in this report for additional information.

Thirty-six Weeks. Minority interest increased by $12 million in the first three quarters of 2008 to a $13 million benefit from a benefit of $1 million in the first three quarters of 2007. The minority interest benefit of $13 million is net of tax and reflected our partners share of losses totaling $20 million associated with joint ventures we consolidate net of our partners share of tax benefits of $7 million associated with the losses.

Income from Continuing Operations

Twelve Weeks. Compared to the year-ago quarter, income from continuing operations decreased by $28 million (23 percent) to $94 million in the third quarter of 2008, and diluted earnings per share from continuing operations decreased by $0.05 (16 percent) to $0.26. As discussed in more detail in the preceding sections beginning with Operating Income, the decrease versus the prior year was due to lower gains and other income ($23 million), higher taxes ($10 million), lower owned, leased, corporate housing, and other revenue net of direct expenses ($7 million), lower equity method joint venture results ($6 million), and higher general, administrative, and other expenses ($3 million). Partially offsetting these unfavorable variances were lower interest expense ($9 million), a higher minority interest benefit ($9 million), higher Timeshare sales and services revenue net of direct expenses ($2 million), and higher fee income ($1 million).

Thirty-six Weeks. Compared to the year-ago period, income from continuing operations decreased by $92 million (20 percent) to $369 million in the first three quarters of 2008, and diluted earnings per share from continuing operations decreased by $0.14 (12 percent) to $1.00. As discussed in more detail in the preceding sections beginning with Operating Income, the decrease versus the prior year was due to lower Timeshare sales and services revenue net of direct expenses ($87 million), lower gains and other income ($58 million), lower owned, leased, corporate housing, and other revenue net of direct expenses ($21 million), and higher income taxes ($10 million). Partially offsetting these unfavorable variances were higher fee income ($32 million), higher equity investment results ($17 million), lower interest expense ($14 million), a higher minority interest benefit ($12 million), lower general, administrative, and other expenses ($5 million), higher interest income ($2 million), and the reversal of loan loss provisions ($2 million).

BUSINESS SEGMENTS

We are a diversified hospitality company with operations in five business segments:

North American Full-Service Lodging, which includes the Marriott Hotels & Resorts, Marriott Conference Centers, JW Marriott Hotels & Resorts, Renaissance Hotels & Resorts, and Renaissance ClubSport properties located in the continental United States and Canada;

North American Limited-Service Lodging, which includes the Courtyard, Fairfield Inn, SpringHill Suites, Residence Inn, TownePlace Suites, and Marriott ExecuStay properties located in the continental United States and Canada;

International Lodging, which includes the Marriott Hotels & Resorts, JW Marriott Hotels & Resorts, Renaissance Hotels & Resorts, Courtyard, Fairfield Inn, Residence Inn, and Marriott Executive Apartments properties located outside the continental United States and Canada;

Luxury Lodging, which includes The Ritz-Carlton and Bulgari Hotels & Resorts properties worldwide; and

Timeshare, which includes the development, marketing, operation, and sale of Marriott Vacation Club, The Ritz-Carlton Club and Residences, Grand Residences by Marriott, and Horizons by Marriott Vacation Club timeshare, fractional ownership, and residential properties worldwide.

In addition to the brands noted above, in 2007, we announced our new brand of family-friendly resorts and spas, Nickelodeon Resorts by Marriott and a new brand of lifestyle boutique hotels, Edition. As of September 5, 2008, no properties were yet open under either brand.

We evaluate the performance of our segments based primarily on the results of the segment without allocating corporate expenses, interest expense, income taxes, or indirect general, administrative, and other expenses. With the exception of the Timeshare segment, we do not allocate interest income to our segments. Because note sales are an integral part of the Timeshare segment, we include note sale gains in our Timeshare segment results. We also include interest income associated with our Timeshare segment notes in our Timeshare segment results because financing sales are an integral part of that segment s business. Additionally, we allocate other gains and losses, equity in earnings or losses from our joint ventures, divisional general, administrative, and other expenses, and minority interests in income or losses of consolidated subsidiaries to each of our segments. Other unallocated corporate represents that portion of our revenues, general, administrative, and other expenses, equity in earnings or losses, and other gains or losses that are not allocable to our segments.

We aggregate the brands presented within our North American Full-Service, North American Limited-Service, International, Luxury, and Timeshare segments considering their similar economic characteristics, types of customers, distribution channels, the regulatory business environment of the brands and operations within each segment and our organizational and management reporting structure.

Revenues

	Twelve Weeks Ended		**Thirty-Six Weeks Ended**	
($ in millions)	**September 5, 2008**	**September 7, 2007**	**September 5, 2008**	**September 7, 2007**
North American Full-Service Segment	$ 1,239	$ 1,241	$ 3,917	$ 3,767
North American Limited-Service Segment	544	540	1,570	1,541
International Segment	342	343	1,093	1,056
Luxury Segment	357	339	1,147	1,048
Timeshare Segment	463	463	1,326	1,438
Total segment revenues	2,945	2,926	9,053	8,850
Other unallocated corporate	18	17	42	51
	$ 2,963	$ 2,943	$ 9,095	$ 8,901

Income from Continuing Operations

	Twelve Weeks Ended		**Thirty-Six Weeks Ended**	
($ in millions)	**September 5, 2008**	**September 7, 2007**	**September 5, 2008**	**September 7, 2007**
North American Full-Service Segment	$ 66	$ 78	$ 290	$ 324
North American Limited-Service Segment	103	119	301	337
International Segment	50	57	179	166
Luxury Segment	17	15	66	44
Timeshare Segment	49	39	123	190
Total segment financial results	285	308	959	1,061
Other unallocated corporate	(58)	(59)	(183)	(192)
Interest expense, interest income, and provision for loan losses	(25)	(34)	(83)	(101)
Income taxes	(108)	(93)	(324)	(307)
	$ 94	$ 122	$ 369	$ 461

31

Table of Contents

Minority Interest

We allocate net minority interest in losses of consolidated subsidiaries to our segments. Accordingly, as of September 5, 2008, and September 7, 2007, we allocated net minority interest in losses of consolidated subsidiaries as reflected in our Condensed Consolidated Statements of Income as shown in the following table:

	Twelve Weeks Ended		Thirty-Six Weeks Ended	
($ in millions)	September 5, 2008	September 7, 2007	September 5, 2008	September 7, 2007
International Segment	$	$	$ (1)	$
Timeshare Segment	15	1	21	1
Total segment minority interest	15	1	20	1
Provision for income taxes	(5)		(7)	
	$ 10	$ 1	$ 13	$ 1

Equity in Earnings (Losses) of Equity Method Investees

	Twelve Weeks Ended		Thirty-Six Weeks Ended	
($ in millions)	September 5, 2008	September 7, 2007	September 5, 2008	September 7, 2007
North American Full-Service Segment	$ 1	$	$ 2	$ 1
North American Limited-Service Segment		1	1	2
International Segment	(1)	1		3
Luxury Segment	(1)		(1)	(2)
Timeshare Segment	2	5	9	4
Total segment equity in earnings	1	7	11	8
Other unallocated corporate	1	1	15	1
	$ 2	$ 8	$ 26	$ 9

Assets

	At Period End	
($ in millions)	September 5, 2008	December 28, 2007
North American Full-Service Segment	$ 1,406	$ 1,322
North American Limited-Service Segment	474	486
International Segment	814	855
Luxury Segment	817	748
Timeshare Segment	3,570	3,142
Total segment assets	7,081	6,553
Other unallocated corporate	2,023	2,336
Discontinued operations		53

	$ 9,104	$ 8,942

Our business includes our North American Full-Service, North American Limited-Service, International, Luxury, and Timeshare segments. We consider total segment revenues and total segment financial results to be meaningful indicators of our performance because they measure our growth in profitability and enable investors to compare the revenues and results of our operations to those of other lodging companies.

Table of Contents

We consider RevPAR to be a meaningful indicator of our performance because it measures the period-over-period change in room revenues for comparable properties. We calculate RevPAR by dividing room sales for comparable properties by room nights available to guests for the period. RevPAR may not be comparable to similarly titled measures, such as revenues.

Company-operated house profit margin is the ratio of property-level gross operating profit (also known as house profit) to total property-level revenue. We consider house profit margin to be a meaningful indicator of our performance because this ratio measures our overall ability as the operator to produce property-level profits by generating sales and controlling the operating expenses over which we have the most direct control. Gross operating profit includes room, food and beverage, and other revenue and the related expenses including payroll and benefits expenses, as well as repairs and maintenance, utility, general and administrative, and sales and marketing expenses. Gross operating profit does not include the impact of management fees, furniture, fixtures and equipment replacement reserves, insurance, taxes, or other fixed expenses.

We added 208 properties (32,113 rooms) and 50 properties (9,163 rooms) exited the system since the end of the 2007 third quarter, not including residential products. We also added five residential properties (632 units) since the end of the 2007 third quarter.

Twelve Weeks. Total segment financial results decreased by $23 million (7 percent) to $285 million for the third quarter of 2008 from $308 million in the year-ago quarter, and total segment revenues increased by $19 million to $2,945 million for the third quarter of 2008, a 1 percent increase from revenues of $2,926 million in the third quarter of 2007, with luxury and full-service properties experiencing stronger demand than limited-service properties. The increase in revenues included a $26 million increase in cost reimbursements revenue, which does not impact operating income or net income. The results, compared to the year-ago quarter, reflected an $8 million (6 percent) increase in base management fees to $143 million in the 2008 third quarter from $135 million in the 2007 third quarter, a $14 million increase in minority interest benefit, and an increase of $2 million in Timeshare sales and services revenue net of direct expenses. Partially offsetting these favorable variances was a decrease of $21 million in gains and other income, a $6 million decrease in earnings associated with equity investments, a decrease of $4 million in incentive management fees, a $3 million decrease in franchise fees, a $4 million increase in general, administrative, and other expenses, and a decrease of $9 million in owned, leased, corporate housing, and other revenue net of direct expenses.

Higher RevPAR for comparable rooms, resulting from both domestic and international rate increases and new unit growth, drove the increase in base management fees. Compared to the third quarter of 2007, incentive management fees decreased by $4 million (7 percent) in the 2008 third quarter. In the third quarter of 2008, 55 percent of our managed properties paid incentive management fees to us versus 59 percent in the year-ago quarter.

Systemwide RevPAR, which includes data from our franchised properties, in addition to our owned, leased, and managed properties, for comparable North American properties decreased by 0.7 percent and RevPAR for our comparable North American company-operated properties decreased by 1.0 percent.

Systemwide RevPAR for comparable international properties increased by 6.2 percent and RevPAR for comparable international company-operated properties increased by 5.7 percent. Worldwide RevPAR for comparable systemwide properties increased by 0.7 percent (2.2 percent using actual dollars) while worldwide RevPAR for comparable company-operated properties increased by 1.1 percent (3.4 percent using actual dollars).

Compared to the year-ago quarter, worldwide comparable company-operated house profit margins for the third quarter of 2008 decreased by 50 basis points, reflecting RevPAR declines and higher operating costs in North America, partially offset by the impact of stronger international RevPAR and cost control plans at most properties in our system. North American company-operated house profit margins declined by 130 basis points reflecting modest RevPAR improvement and significant cost controls at most properties, more than offset by the impact of decreased demand and higher operating costs including those associated with wages and benefits and utilities. For the third quarter of 2008, house profit per available room (HP-PAR) at our North American managed properties decreased by 4.3 percent. HP-PAR at our North American limited-service managed properties decreased by 6.4 percent and worldwide HP-PAR for all our brands decreased by 0.4 percent on a constant U.S. dollar basis.

Thirty-six Weeks. Total segment financial results decreased by $102 million (10 percent) to $959 million in the first three quarters of 2008 from $1,061 million in the year-ago period, and total segment revenues increased by $203 million to $9,053 million for the first three quarters of 2008, a 2 percent increase from revenues of $8,850 million for the first three quarters of 2007, with international, luxury, and full-service properties experiencing stronger demand than limited-service properties. The increase in revenues included a $250 million increase in cost reimbursements revenue, which does not impact operating income or net income. The results, compared to the year-ago period, reflected a $46 million (6 percent) increase in combined base management and franchise fees to $766 million for the 2008 period from $720 million in the first three quarters of 2007, a $19 million increase in minority interest benefit, and a $3 million increase in earnings associated with equity investments. Partially offsetting these favorable variances was a decrease of $87 million in Timeshare sales and services revenue net of direct expenses, a decrease of $34 million in gains and other income, $23 million of increased general, administrative, and other expenses, $14 million of lower incentive management fees, and a decrease of $12 million in owned, leased, corporate housing, and other revenue net of direct expenses.

Higher RevPAR for comparable rooms, resulting from both domestic and international rate increases and new unit growth, drove the increase in base management and franchise fees. Compared to the first three quarters of 2007, incentive management fees decreased by $14 million (6 percent) in the first three quarters of 2008 and reflected the recognition in the 2007 period of $15 million of incentive management fees that were calculated based on prior periods results, but not earned and due until 2007. In the first three quarters of 2008, 62 percent of our managed properties paid incentive management fees to us versus 66 percent in the year-ago period.

Systemwide RevPAR for comparable North American properties increased by 0.8 percent and RevPAR for our comparable North American company-operated properties increased by 0.9 percent.

Systemwide RevPAR for comparable international properties increased by 7.7 percent, and RevPAR for comparable international company-operated properties increased by 7.6 percent. Worldwide RevPAR for comparable systemwide properties increased by 2.1 percent (3.5 percent using actual dollars) while worldwide RevPAR for comparable company-operated properties increased by 2.8 percent (4.9 percent using actual dollars).

Compared to the year-ago period, worldwide comparable company-operated house profit margins for the first three quarters of 2008 were flat, reflecting strong RevPAR associated with international properties and cost control plans at most properties in our system, offset by almost flat RevPAR associated with properties in North America and higher expenses in North America primarily due to increased utilities and payroll costs. North American company-operated house profit margins declined by 80 basis points reflecting modest RevPAR improvement and significant cost controls at most properties, more than offset by the impact of decreased demand and higher operating costs, including those associated with wages and benefits and utilities. For the first three quarters of 2008, HP-PAR at our North American managed properties decreased by 0.8 percent. HP-PAR at our North American limited-service managed properties decreased by 3.4 percent, and worldwide HP-PAR for all our brands increased by 2.9 percent on a constant U.S. dollar basis.

Table of Contents

Summary of Properties by Brand

We opened 42 lodging properties (6,528 rooms) during the third quarter of 2008, while six properties (838 rooms) exited the system, increasing our total properties to 3,105 (550,453 rooms) inclusive of 25 home and condominium products (2,332 units) for which we manage the related owners associations. Unless otherwise indicated, our references to Marriott Hotels & Resorts throughout this report include Marriott Conference Centers and JW Marriott Hotels & Resorts. References to Renaissance Hotels & Resorts include Renaissance ClubSport, and references to Fairfield Inn include Fairfield Inn & Suites.

The table below shows properties we operated or franchised, by brand, as of September 5, 2008 (excluding 2,314 corporate housing rental units associated with our ExecuStay brand):

	Company-Operated		Franchised	
Brand	**Properties**	**Rooms**	**Properties**	**Rooms**
U.S. Locations				
Marriott Hotels & Resorts	146	74,086	171	51,845
Marriott Conference Centers	12	3,279		
JW Marriott Hotels & Resorts	11	6,736	5	1,552
Renaissance Hotels & Resorts	37	16,694	36	10,503
Renaissance ClubSport	1	174	1	175
The Ritz-Carlton	37	11,603		
The Ritz-Carlton-Residential (1)	19	1,938		
Courtyard	276	42,955	439	56,721
Fairfield Inn	2	855	545	47,687
SpringHill Suites	26	3,940	172	19,117
Residence Inn	132	18,154	409	46,398
TownePlace Suites	34	3,661	120	11,742
Marriott Vacation Club (2)	39	9,257		
The Ritz-Carlton Club-Fractional (2)	6	311		
The Ritz-Carlton Club-Residential (1), (2)	2	138		
Grand Residences by Marriott-Fractional (2)	1	199		
Grand Residences by Marriott-Residential (1), (2)	1	65		
Horizons by Marriott Vacation Club (2)	2	444		
Non-U.S. Locations				
Marriott Hotels & Resorts	123	35,612	34	9,951
JW Marriott Hotels & Resorts	21	8,181	1	61
Renaissance Hotels & Resorts	51	17,369	14	4,315
The Ritz-Carlton	33	10,171		
The Ritz-Carlton-Residential (1)	2	184		
The Ritz-Carlton Serviced Apartments	2	387		
Bulgari Hotels & Resorts	2	117		
Marriott Executive Apartments	18	2,930	1	99
Courtyard	36	7,659	42	7,049
Fairfield Inn			9	1,109
SpringHill Suites			1	124
Residence Inn	1	190	17	2,475
Marriott Vacation Club (2)	10	2,071		
The Ritz-Carlton Club-Fractional (2)	3	114		
The Ritz-Carlton Club-Residential (1), (2)	1	7		
Grand Residences by Marriott-Fractional (2)	1	49		
Total	1,088	279,530	2,017	270,923

(1) Represents projects where we manage the related owners association. Residential products are included once they possess a certificate of occupancy.

(2) Indicates a Timeshare product. Includes products in active sales as well as those that are sold out.

Table of Contents

Total Lodging Products by Segment

At September 5, 2008, we operated or franchised the following properties by segment (excluding 2,314 corporate housing rental units associated with our ExecuStay brand):

	Total Lodging Products					
	Properties			Rooms		
	U.S.	Non-U.S.	Total	U.S.	Non-U.S.	Total
North American Full-Service Lodging Segment [1]						
Marriott Hotels & Resorts	313	12	325	123,164	4,556	127,720
Marriott Conference Centers	12		12	3,279		3,279
JW Marriott Hotels & Resorts	15		15	7,901		7,901
Renaissance Hotels & Resorts	73	3	76	27,197	1,034	28,231
Renaissance ClubSport	2		2	349		349
	415	15	430	161,890	5,590	167,480
North American Limited-Service Lodging Segment [1]						
Courtyard	715	16	731	99,676	2,847	102,523
Fairfield Inn	547	8	555	48,542	903	49,445
SpringHill Suites	198	1	199	23,057	124	23,181
Residence Inn	541	17	558	64,552	2,590	67,142
TownePlace Suites	154		154	15,403		15,403
	2,155	42	2,197	251,230	6,464	257,694
International Lodging Segment [1]						
Marriott Hotels & Resorts	4	145	149	2,767	41,007	43,774
JW Marriott Hotels & Resorts	1	22	23	387	8,242	8,629
Renaissance Hotels & Resorts		62	62		20,650	20,650
Courtyard		62	62		11,861	11,861
Fairfield Inn		1	1		206	206
Residence Inn		1	1		75	75
Marriott Executive Apartments		19	19		3,029	3,029
	5	312	317	3,154	85,070	88,224
Luxury Lodging Segment						
The Ritz-Carlton	37	33	70	11,603	10,171	21,774
Bulgari Hotels & Resorts		2	2		117	117
The Ritz-Carlton-Residential [2]	19	2	21	1,938	184	2,122
The Ritz-Carlton Serviced Apartments		2	2		387	387
	56	39	95	13,541	10,859	24,400
Timeshare Lodging Segment [3]						
Marriott Vacation Club	39	10	49	9,257	2,071	11,328
The Ritz-Carlton Club-Fractional	6	3	9	311	114	425
The Ritz-Carlton Club-Residential [2]	2	1	3	138	7	145
Grand Residences by Marriott-Fractional	1	1	2	199	49	248
Grand Residences by Marriot-Residential [1], [2]	1		1	65		65
Horizons by Marriott Vacation Club	2		2	444		444
	51	15	66	10,414	2,241	12,655

Total	2,682	423	3,105	440,229	110,224	550,453

(1) North American includes properties located in the continental United States and Canada. International includes properties located outside the continental United States and Canada.

(2) Represents projects where we manage the related owners association. Residential products are included once they possess a certificate of occupancy.

(3) Includes resorts that are in active sales as well as those that are sold out. Products in active sales may not be ready for occupancy.

Table of Contents

The following table provides additional detail, by brand, as of September 5, 2008, for our Timeshare properties:

	Total Properties [1]	Properties in Active Sales [2]
100 Percent Company-Developed		
Marriott Vacation Club	49	26
The Ritz-Carlton Club and Residences	9	7
Grand Residences by Marriott and Residences	3	3
Horizons by Marriott Vacation Club	2	2
Joint Ventures		
The Ritz-Carlton Club and Residences	3	3
Total	66	41

(1) Includes products that are in active sales as well as those that are sold out. Residential products are included once they possess a certificate of occupancy.

(2) Products in active sales may not be ready for occupancy.

Statistics

The following tables show occupancy, average daily rate, and RevPAR for comparable properties, for each of the brands in our North American Full-Service and North American Limited-Service segments, for our International segment by region, and the principal brand in our Luxury segment, The Ritz-Carlton. We have not presented statistics for company-operated Fairfield Inn properties in these tables because we operate only a limited number of properties, as the brand is predominantly franchised, and such information would not be meaningful (identified as nm in the tables that follow). Systemwide statistics include data from our franchised properties, in addition to our owned, leased, and managed properties.

The occupancy, average daily rate, and RevPAR statistics used throughout this report for the twelve weeks ended September 5, 2008, include the period from June 14, 2008, through September 5, 2008, and the statistics for the twelve weeks ended September 7, 2007, include the period from June 16, 2007, through September 7, 2007, (except in each case, for The Ritz-Carlton brand properties and properties located outside of the continental United States and Canada, which for them includes the period from June 1 through the end of August). The occupancy, average daily rate, and RevPAR statistics used throughout this report for the thirty-six weeks ended September 5, 2008, include the period from December 29, 2007, through September 5, 2008, and the statistics for the thirty-six weeks ended September 7, 2007, include the period from December 30, 2006, through September 7, 2007 (except in each case for The Ritz-Carlton brand properties and properties located outside of the continental United States and Canada, which for them includes the period from January 1 through the end of August).

Table of Contents

	Comparable Company-Operated North American Properties (1) Twelve Weeks Ended September 5, 2008	Change vs. 2007	Comparable Systemwide North American Properties (1) Twelve Weeks Ended September 5, 2008	Change vs. 2007
Marriott Hotels & Resorts (2)				
Occupancy	75.1%	-1.5% pts.	72.3%	-1.8% pts.
Average Daily Rate	$ 167.39	2.5%	$ 156.37	2.1%
RevPAR	$ 125.67	0.5%	$ 113.12	-0.3%
Renaissance Hotels & Resorts				
Occupancy	72.3%	-0.9% pts.	72.5%	-0.5% pts.
Average Daily Rate	$ 154.39	1.4%	$ 146.33	1.5%
RevPAR	$ 111.61	0.1%	$ 106.03	0.9%
Composite North American Full-Service (3)				
Occupancy	74.6%	-1.4% pts.	72.4%	-1.6% pts.
Average Daily Rate	$ 165.17	2.3%	$ 154.76	2.0%
RevPAR	$ 123.19	0.4%	$ 111.99	-0.2%
The Ritz-Carlton North America				
Occupancy	70.7%	-2.8% pts.	70.7%	-2.8% pts.
Average Daily Rate	$ 295.75	2.2%	$ 295.75	2.2%
RevPAR	$ 209.12	-1.7%	$ 209.12	-1.7%
Composite North American Full-Service and Luxury (4)				
Occupancy	74.2%	-1.5% pts.	72.3%	-1.6% pts.
Average Daily Rate	$ 177.40	2.1%	$ 162.72	1.9%
RevPAR	$ 131.63	0.1%	$ 117.59	-0.3%
Residence Inn				
Occupancy	80.5%	-1.5% pts.	81.6%	-1.0% pts.
Average Daily Rate	$ 124.76	0.4%	$ 126.52	2.2%
RevPAR	$ 100.41	-1.4%	$ 103.19	0.9%
Courtyard				
Occupancy	71.3%	-2.4% pts.	73.3%	-2.1% pts.
Average Daily Rate	$ 124.21	0.1%	$ 124.57	1.2%
RevPAR	$ 88.52	-3.1%	$ 91.28	-1.5%
Fairfield Inn				
Occupancy	nm	nm	73.3%	-3.2% pts.
Average Daily Rate	nm	nm	$ 93.82	2.1%
RevPAR	nm	nm	$ 68.74	-2.2%
TownePlace Suites				
Occupancy	73.5%	-4.9% pts.	74.9%	-3.2% pts.
Average Daily Rate	$ 87.32	0.2%	$ 89.96	2.1%
RevPAR	$ 64.14	-6.0%	$ 67.33	-2.1%
SpringHill Suites				
Occupancy	73.6%	-3.6% pts.	73.2%	-3.0% pts.
Average Daily Rate	$ 106.54	-0.6%	$ 108.36	0.6%
RevPAR	$ 78.41	-5.2%	$ 79.37	-3.3%
Composite North American Limited-Service (5)				
Occupancy	74.0%	-2.3% pts.	75.5%	-2.1% pts.
Average Daily Rate	$ 121.04	0.3%	$ 116.21	1.8%
RevPAR	$ 89.60	-2.8%	$ 87.77	-1.0%
Composite North American (6)				
Occupancy	74.1%	-1.9% pts.	74.3%	-1.9% pts.
Average Daily Rate	$ 152.58	1.6%	$ 133.93	1.9%
RevPAR	$ 113.10	-1.0%	$ 99.45	-0.7%

(1) Statistics are for the twelve weeks ended September 5, 2008, and September 7, 2007, except for Ritz-Carlton for which the statistics are for the three months ended August 31, 2008, and August 31, 2007.

(2) Marriott Hotels & Resorts includes JW Marriott Hotels & Resorts.

(3) Composite North American Full-Service statistics include Marriott Hotels & Resorts and Renaissance Hotels & Resorts properties located in the continental United States and Canada.

(4) Composite North American Full-Service and Luxury includes Marriott Hotels & Resorts, Renaissance Hotels & Resorts, and Ritz-Carlton.

(5) Composite North American Limited-Service statistics include Residence Inn, Courtyard, Fairfield Inn, TownePlace Suites, and SpringHill Suites properties located in the continental United States and Canada.

(6) Composite North American statistics include Marriott Hotels & Resorts, Renaissance Hotels & Resorts, Residence Inn, Courtyard, Fairfield Inn, TownePlace Suites, SpringHill Suites, and The Ritz-Carlton properties located in the continental United States and Canada.

Table of Contents

	Comparable Company-Operated Properties [1] Three Months Ended August 31, 2008	Change vs. 2007	Comparable Systemwide Properties [1] Three Months Ended August 31, 2008	Change vs. 2007
Caribbean and Latin America [2]				
Occupancy	74.6%	-2.0% pts.	71.1%	-2.3% pts.
Average Daily Rate	$ 183.61	12.9%	$ 165.72	11.6%
RevPAR	$ 137.04	10.0%	$ 117.87	8.1%
Continental Europe [2]				
Occupancy	73.8%	-3.4% pts.	73.2%	-2.3% pts.
Average Daily Rate	$ 211.57	9.7%	$ 218.88	11.5%
RevPAR	$ 156.17	4.9%	$ 160.18	8.0%
United Kingdom [2]				
Occupancy	79.0%	-1.8% pts.	78.3%	-2.4% pts.
Average Daily Rate	$ 182.42	2.0%	$ 181.32	2.4%
RevPAR	$ 144.05	-0.4%	$ 142.03	-0.6%
Middle East and Africa [2]				
Occupancy	73.4%	2.7% pts.	73.4%	2.7% pts.
Average Daily Rate	$ 143.48	13.6%	$ 143.48	13.6%
RevPAR	$ 105.38	17.9%	$ 105.38	17.9%
Asia Pacific [2], [3]				
Occupancy	71.3%	-4.1% pts.	71.9%	-3.2% pts.
Average Daily Rate	$ 154.45	9.9%	$ 155.55	7.4%
RevPAR	$ 110.07	4.0%	$ 111.81	2.8%
Regional Composite [4], [5]				
Occupancy	74.1%	-2.6% pts.	73.3%	-2.2% pts.
Average Daily Rate	$ 180.96	8.7%	$ 181.93	8.9%
RevPAR	$ 134.06	5.0%	$ 133.36	5.7%
International Luxury [6]				
Occupancy	71.2%	-% pts.	71.2%	-% pts.
Average Daily Rate	$ 294.99	8.8%	$ 294.99	8.8%
RevPAR	$ 210.17	8.8%	$ 210.17	8.8%
Total International [7]				
Occupancy	73.8%	-2.3% pts.	73.1%	-2.0% pts.
Average Daily Rate	$ 193.48	8.9%	$ 192.08	9.1%
RevPAR	$ 142.71	5.7%	$ 140.43	6.2%

(1) We report financial results for all properties on a period-end basis, but report statistics for properties located outside the continental United States and Canada on a month-end basis. The statistics are for June 1 through the end of August. For the properties located in countries that use currencies other than the U.S. dollar, the comparison to 2007 was on a constant U.S. dollar basis.

(2) Regional information includes Marriott Hotels & Resorts, Renaissance Hotels & Resorts, and Courtyard properties located outside of the continental United States and Canada.

(3) Excludes Hawaii.

(4) Includes Hawaii.

(5) Regional Composite statistics include all properties located outside of the continental United States and Canada for Marriott Hotels & Resorts, Renaissance Hotels & Resorts, and Courtyard.

(6) Includes The Ritz-Carlton properties located outside of North America and Bulgari Hotels & Resorts.

(7) Total International includes Regional Composite statistics and statistics for The Ritz-Carlton International and Bulgari Hotels & Resorts.

Table of Contents

	Comparable Company-Operated Properties [1] Three Months Ended August 31, 2008	Change vs. 2007	Comparable Systemwide Properties [1] Three Months Ended August 31, 2008	Change vs. 2007
Composite Luxury [2]				
Occupancy	70.9%	-1.5% pts.	70.9%	-1.5% pts.
Average Daily Rate	$ 295.41	5.0%	$ 295.41	5.0%
RevPAR	$ 209.59	2.7%	$ 209.59	2.7%
Total Worldwide [3]				
Occupancy	74.0%	-2.0% pts.	74.1%	-2.0% pts.
Average Daily Rate	$ 164.04	3.9%	$ 143.43	3.4%
RevPAR	$ 121.42	1.1%	$ 106.23	0.7%

(1) We report financial results for all properties on a period-end basis, but report statistics for properties located outside the continental United States and Canada on a month-end basis. The statistics are for June 1 through the end of August. For the properties located in countries that use currencies other than the U.S. dollar, the comparison to 2007 was on a constant dollar basis.

(2) Composite Luxury includes worldwide properties for The Ritz-Carlton and Bulgari Hotels & Resorts.

(3) Total Worldwide statistics include all properties worldwide for Marriott Hotels & Resorts, Renaissance Hotels & Resorts, Residence Inn, Courtyard, Fairfield Inn, TownePlace Suites, SpringHill Suites, and The Ritz-Carlton. Statistics for properties located in the continental United States and Canada (except for The Ritz-Carlton) represent the twelve weeks ended September 5, 2008, and September 7, 2007. Statistics for all The Ritz-Carlton brand properties and properties located outside of the continental United States and Canada represent the three months ended August 31, 2008, and August 31, 2007.

Table of Contents

	Comparable Company-Operated North American Properties (1) Thirty-Six Weeks Ended September 5, 2008	Change vs. 2007	Comparable Systemwide North American Properties (1) Thirty-Six Weeks Ended September 5, 2008	Change vs. 2007
Marriott Hotels & Resorts (2)				
Occupancy	72.8%	-1.1% pts.	70.3%	-1.4% pts.
Average Daily Rate	$ 177.81	3.3%	$ 164.12	3.1%
RevPAR	$ 129.50	1.8%	$ 115.31	1.1%
Renaissance Hotels & Resorts				
Occupancy	71.9%	-0.2% pts.	71.4%	-0.4% pts.
Average Daily Rate	$ 167.55	1.9%	$ 156.26	1.9%
RevPAR	$ 120.55	1.6%	$ 111.54	1.4%
Composite North American Full-Service (3)				
Occupancy	72.7%	-0.9% pts.	70.4%	-1.2% pts.
Average Daily Rate	$ 176.02	3.0%	$ 162.85	2.9%
RevPAR	$ 127.92	1.7%	$ 114.71	1.1%
The Ritz-Carlton North America				
Occupancy	72.8%	-0.5% pts.	72.8%	-0.5% pts.
Average Daily Rate	$ 339.50	1.6%	$ 339.50	1.6%
RevPAR	$ 247.26	0.9%	$ 247.26	0.9%
Composite North American Full-Service and Luxury (4)				
Occupancy	72.7%	-0.9% pts.	70.6%	-1.2% pts.
Average Daily Rate	$ 190.42	2.9%	$ 172.23	2.9%
RevPAR	$ 138.41	1.6%	$ 121.52	1.1%
Residence Inn				
Occupancy	77.3%	-1.0% pts.	77.8%	-0.8% pts.
Average Daily Rate	$ 127.37	1.5%	$ 126.98	2.8%
RevPAR	$ 98.47	0.2%	$ 98.79	1.8%
Courtyard				
Occupancy	69.5%	-1.4% pts.	70.8%	-1.4% pts.
Average Daily Rate	$ 129.27	1.1%	$ 127.43	2.2%
RevPAR	$ 89.91	-0.9%	$ 90.18	0.3%
Fairfield Inn				
Occupancy	nm	nm	68.9%	-2.7% pts.
Average Daily Rate	nm	nm	$ 93.07	3.7%
RevPAR	nm	nm	$ 64.12	-0.3%
TownePlace Suites				
Occupancy	70.0%	-4.6% pts.	71.8%	-2.3% pts.
Average Daily Rate	$ 88.11	1.6%	$ 89.91	2.0%
RevPAR	$ 61.71	-4.6%	$ 64.53	-1.2%
SpringHill Suites				
Occupancy	72.3%	-0.7% pts.	71.5%	-2.0% pts.
Average Daily Rate	$ 110.19	1.2%	$ 110.17	2.0%
RevPAR	$ 79.72	0.2%	$ 78.73	-0.8%
Composite North American Limited-Service (5)				
Occupancy	71.9%	-1.4% pts.	72.4%	-1.6% pts.
Average Daily Rate	$ 125.09	1.3%	$ 117.56	2.7%
RevPAR	$ 89.92	-0.6%	$ 85.06	0.5%
Composite North American (6)				
Occupancy	72.3%	-1.1% pts.	71.7%	-1.4% pts.

Average Daily Rate	$ 161.60	2.4%	$ 138.51	2.8%
RevPAR	$ 116.89	0.9%	$ 99.26	0.8%

(1) Statistics are for the thirty-six weeks ended September 5, 2008, and September 7, 2007, except for Ritz-Carlton for which the statistics are for the eight months ended August 31, 2008, and August 31, 2007.

(2) Marriott Hotels & Resorts includes JW Marriott Hotels & Resorts.

(3) Composite North American Full-Service statistics include Marriott Hotels & Resorts and Renaissance Hotels & Resorts properties located in the continental United States and Canada.

(4) Composite North American Full-Service and Luxury includes Marriott Hotels & Resorts, Renaissance Hotels & Resorts, and Ritz-Carlton.

(5) Composite North American Limited-Service statistics include Residence Inn, Courtyard, Fairfield Inn, TownePlace Suites, and SpringHill Suites properties located in the continental United States and Canada.

(6) Composite North American statistics include Marriott Hotels & Resorts, Renaissance Hotels & Resorts, Residence Inn, Courtyard, Fairfield Inn, TownePlace Suites, SpringHill Suites, and The Ritz-Carlton properties located in the continental United States and Canada.

Table of Contents

	Comparable Company-Operated Properties (1)		Comparable Systemwide Properties (1)	
	Eight Months Ended August 31, 2008	Change vs. 2007	Eight Months Ended August 31, 2008	Change vs. 2007
Caribbean and Latin America (2)				
Occupancy	76.6%	0.3% pts.	72.0%	-0.9% pts.
Average Daily Rate	$ 198.18	9.8%	$ 180.54	8.6%
RevPAR	$ 151.89	10.2%	$ 129.99	7.3%
Continental Europe (2)				
Occupancy	71.1%	-2.0% pts.	69.8%	-0.4% pts.
Average Daily Rate	$ 209.69	8.8%	$ 214.00	9.9%
RevPAR	$ 149.15	5.9%	$ 149.41	9.2%
United Kingdom (2)				
Occupancy	75.1%	-1.5% pts.	74.5%	-1.7% pts.
Average Daily Rate	$ 184.39	3.3%	$ 183.01	3.4%
RevPAR	$ 138.56	1.2%	$ 136.40	1.1%
Middle East and Africa (2)				
Occupancy	77.5%	4.0% pts.	77.5%	4.0% pts.
Average Daily Rate	$ 163.19	12.5%	$ 163.19	12.5%
RevPAR	$ 126.48	18.7%	$ 126.48	18.7%
Asia Pacific (2), (3)				
Occupancy	72.9%	-1.3% pts.	72.8%	-1.5% pts.
Average Daily Rate	$ 159.33	7.8%	$ 159.81	6.4%
RevPAR	$ 116.15	6.0%	$ 116.34	4.3%
Regional Composite (4), (5)				
Occupancy	73.8%	-0.8% pts.	72.4%	-0.6% pts.
Average Daily Rate	$ 185.19	7.8%	$ 184.69	7.9%
RevPAR	$ 136.65	6.7%	$ 133.77	7.0%
International Luxury (6)				
Occupancy	73.0%	1.9% pts.	73.0%	1.9% pts.
Average Daily Rate	$ 320.15	8.5%	$ 320.15	8.5%
RevPAR	$ 233.84	11.5%	$ 233.84	11.5%
Total International (7)				
Occupancy	73.7%	-0.5% pts.	72.5%	-0.4% pts.
Average Daily Rate	$ 200.38	8.3%	$ 197.23	8.3%
RevPAR	$ 147.69	7.6%	$ 142.97	7.7%

(1) We report financial results for all properties on a period-end basis, but report statistics for properties located outside the continental United States and Canada on a month-end basis. The statistics are for January 1 through the end of August. For the properties located in countries that use currencies other than the U.S. dollar, the comparison to 2007 was on a constant U.S. dollar basis.

(2) Regional information includes Marriott Hotels & Resorts, Renaissance Hotels & Resorts, and Courtyard properties located outside of the continental United States and Canada.

(3) Excludes Hawaii.

(4) Includes Hawaii.

(5) Regional Composite statistics include all properties located outside of the continental United States and Canada for Marriott Hotels & Resorts, Renaissance Hotels & Resorts, and Courtyard.

(6) Includes The Ritz-Carlton properties located outside of North America and Bulgari Hotels & Resorts.

(7) Total International includes Regional Composite statistics and statistics for The Ritz-Carlton International and Bulgari Hotels & Resorts.

Table of Contents

	Comparable Company-Operated Properties [1] Eight Months Ended August 31, 2008	Change vs. 2007	Comparable Systemwide Properties [1] Eight Months Ended August 31, 2008	Change vs. 2007
Composite Luxury [2]				
Occupancy	72.9%	0.6% pts.	72.9%	0.6% pts.
Average Daily Rate	$ 330.84	4.4%	$ 330.84	4.4%
RevPAR	$ 241.26	5.2%	$ 241.26	5.2%
Total Worldwide [3]				
Occupancy	72.7%	-0.9% pts.	71.8%	-1.3% pts.
Average Daily Rate	$ 171.75	4.2%	$ 147.39	4.0%
RevPAR	$ 124.84	2.8%	$ 105.80	2.1%

(1) We report financial results for all properties on a period-end basis, but report statistics for properties located outside the continental United States and Canada on a month-end basis. The statistics are for January 1 through the end of August. For the properties located in countries that use currencies other than the U.S. dollar, the comparison to 2007 was on a constant dollar basis.

(2) Composite Luxury includes worldwide properties for The Ritz-Carlton and Bulgari Hotels & Resorts.

(3) Total Worldwide statistics include all properties worldwide for Marriott Hotels & Resorts, Renaissance Hotels & Resorts, Residence Inn, Courtyard, Fairfield Inn, TownePlace Suites, SpringHill Suites, and The Ritz-Carlton. Statistics for properties located in the continental United States and Canada (except for The Ritz-Carlton) represent the thirty-six weeks ended September 5, 2008, and September 7, 2007. Statistics for all The Ritz-Carlton brand properties and properties located outside of the continental United States and Canada represent the eight months ended August 31, 2008, and August 31, 2007.

Table of Contents

North American Full-Service Lodging includes *Marriott Hotels & Resorts*, *Marriott Conference Centers*, *JW Marriott Hotels & Resorts*, *Renaissance Hotels & Resorts*, and *Renaissance ClubSport*.

	Twelve Weeks Ended			Thirty-Six Weeks Ended		
($ in millions)	September 5, 2008	September 7, 2007	Change 2008/2007	September 5, 2008	September 7, 2007	Change 2008/2007
Segment revenues	$ 1,239	$ 1,241	%	$ 3,917	$ 3,767	4%
Segment results	$ 66	$ 78	-15%	$ 290	$ 324	-10%

Since the third quarter of 2007, across our North American Full-Service Lodging segment we added 14 properties (4,749 rooms) and three properties (613 rooms) left the system.

Twelve Weeks. Compared to the year-ago quarter, RevPAR for comparable company-operated North American full-service properties increased by 0.4 percent to $123.19, occupancy decreased by 1.4 percentage points to 74.6 percent, and average daily rates increased by 2.3 percent to $165.17.

The $12 million decrease in segment results, compared to the year-ago quarter, primarily reflected a $5 million decrease in owned, leased, and other revenue net of direct expenses and a $7 million decrease in incentive management fees.

The $7 million decrease in incentive management fees was largely due to lower property-level margins. Owned, leased, and other revenue net of direct expenses decreased by $5 million and primarily reflected lower contract termination fees received and the impact of one property undergoing renovation.

Cost reimbursements revenue and expenses associated with our North American Full-Service segment properties totaled $1,114 million compared to $1,117 million in the year-ago quarter.

Thirty-six Weeks. Compared to the year-ago period, RevPAR for comparable company-operated North American full-service properties increased by 1.7 percent to $127.92, occupancy decreased by 0.9 percentage points to 72.7 percent, and average daily rates increased by 3.0 percent to $176.02.

The $34 million decrease in segment results, compared to the first three quarters of 2007, primarily reflected a $23 million decrease in owned, leased, and other revenue net of direct expenses, a $6 million decrease in gains and other income, and a $12 million decrease in incentive management fees, partially offset by a $6 million increase in base management and franchise fees.

The $6 million increase in base management and franchise fees was largely due to unit growth. The $12 million decrease in incentive management fees was in part due to the recognition, in the first three quarters of 2007, of business interruption insurance proceeds totaling $3 million associated with Hurricane Katrina and also reflected lower property-level margins.

Owned, leased, and other revenue net of direct expenses decreased by $23 million and primarily reflected an unfavorable $6 million impact associated with two properties undergoing renovations in 2008, $3 million of losses associated with a new property, which opened in 2008, $4 million of lower contract termination fees received, $2 million of lower land rent income, and an unfavorable $3 million impact associated with one property sold.

Gains and other income was $6 million lower in the first three quarters of 2008, compared to the first three quarters of 2007, and primarily reflected a loss associated with one property that was sold in the 2008 period.

Cost reimbursements revenue and expenses associated with our North American Full-Service segment properties totaled $3,448 million compared to $3,299 million in the year-ago period.

Table of Contents

North American Limited-Service Lodging includes *Courtyard*, *Fairfield Inn*, *SpringHill Suites*, *Residence Inn*, *TownePlace Suites*, and *Marriott ExecuStay*.

	Twelve Weeks Ended			Thirty-Six Weeks Ended		
($ in millions)	September 5, 2008	September 7, 2007	Change 2008/2007	September 5, 2008	September 7, 2007	Change 2008/2007
Segment revenues	$ 544	$ 540	1%	$ 1,570	$ 1,541	2%
Segment results	$ 103	$ 119	-13%	$ 301	$ 337	-11%

Since the third quarter of 2007, across our North American Limited-Service Lodging segment we added 162 properties (18,696 rooms) and 21 properties (2,430 rooms) left the system. The properties that left the system were mainly older properties associated with our Fairfield Inn brand.

Twelve Weeks. Compared to the year-ago quarter, RevPAR for comparable company-operated North American limited-service properties decreased by 2.8 percent to $89.60, occupancy decreased by 2.3 percentage points to 74.0 percent, and average daily rates increased by 0.3 percent to $121.04.

The $16 million decrease in segment results, compared to the third quarter of 2007, primarily reflected $6 million of lower incentive management fees, $6 million of decreased owned, leased, corporate housing, and other revenue net of direct expenses, $3 million of lower franchise fees, and $2 million of lower gains and other income.

The $6 million decrease in incentive management fees was largely due to lower property-level revenue and property-level margins. The $3 million decrease in franchise fees reflected lower relicensing fees, partially offset by the impact associated with unit growth.

The $6 million decrease in owned, leased, corporate housing, and other revenue net of direct expenses reflected that there were no franchise agreement termination fees in the 2008 quarter, compared to the receipt of $2 million of similar fees in the 2007 quarter, and $2 million of reduced results for leased properties reflecting lower revenue and margins.

Cost reimbursements revenue and expenses associated with our North American Limited-Service segment properties totaled $372 million compared to $357 million in the year-ago quarter.

Thirty-six Weeks. Compared to the year-ago period, RevPAR for comparable company-operated North American limited-service properties decreased by 0.6 percent to $89.92, occupancy decreased by 1.4 percentage points to 71.9 percent, and average daily rates increased by 1.3 percent to $125.09.

The $36 million decrease in segment results, compared to the first three quarters of 2007, reflected $29 million of lower incentive management fees, $12 million of lower owned, leased, corporate housing, and other revenue net of direct expenses, and $4 million of lower gains and other income, partially offset by an $11 million increase in base management and franchise fees.

The $11 million increase in base management and franchise fees was largely due to unit growth. The $29 million decrease in incentive management fees was largely due to lower revenue and property-level margins and the recognition, in the first three quarters of 2007, of $15 million of incentive management fees that were calculated based on prior periods results, but not earned and due until 2007.

The $12 million decrease in owned, leased, corporate housing, and other revenue net of direct expenses primarily reflected $3 million of franchise agreement termination fees received in the first three quarters of 2007, which were associated with eight Fairfield Inn properties that left our system, and lower revenue and margins at leased properties.

Table of Contents

Cost reimbursements revenue and expenses associated with our North American Limited-Service segment properties totaled $1,078 million compared to $1,023 million in the year-ago period.

International Lodging includes *International Marriott Hotels & Resorts*, *International JW Marriott Hotels & Resorts*, *International Renaissance Hotels & Resorts*, *International Courtyard*, *International Fairfield Inn*, *International Residence Inn*, and *Marriott Executive Apartments*.

	Twelve Weeks Ended			Thirty-Six Weeks Ended		
($ in millions)	**September 5, 2008**	**September 7, 2007**	**Change 2008/2007**	**September 5, 2008**	**September 7, 2007**	**Change 2008/2007**
Segment revenues	$ 342	$ 343	-%	$ 1,093	$ 1,056	4%
Segment results	$ 50	$ 57	-12%	$ 179	$ 166	8%

Since the third quarter of 2007, across our International Lodging segment we added 19 properties (6,087 rooms) and 24 properties (5,512 rooms) left the system. The properties that left the system largely left due to quality issues.

Twelve Weeks. Compared to the year-ago quarter, RevPAR for comparable company-operated international properties increased by 5.0 percent to $134.06, occupancy decreased by 2.6 percentage points to 74.1 percent, and average daily rates increased by 8.7 percent to $180.96. Results for our international operations were strong across many regions. The Middle East, Central Europe, the Caribbean, and South America all had particularly strong RevPAR increases, compared to the year-ago quarter.

The $7 million decrease in segment results in the third quarter of 2008, compared to the year-ago quarter, primarily reflected a $17 million decrease in gains and other income, a $2 million decrease in joint venture equity earnings, and a $2 million increase in general, administrative, and other expenses, partially offset by a $9 million increase in incentive management fees and a $5 million increase in base management and franchise fees. The increase in fees was largely due to higher RevPAR, driven by rate increases and, to a lesser extent, the increase in fees related to unit growth. The decrease in gains and other income primarily reflected gains associated with the sale of real estate in 2007.

Cost reimbursements revenue and expenses associated with our International segment properties totaled $169 million compared to $173 million in the year-ago quarter.

Thirty-six Weeks. Compared to the year-ago period, RevPAR for comparable company-operated international properties increased by 6.7 percent to $136.65, occupancy decreased by 0.8 percentage points to 73.8 percent, and average daily rates increased by 7.8 percent to $185.19. Results for our international operations were strong across many regions. The Middle East, Central and Southeast Asia, South America, and Central Europe all had particularly strong RevPAR increases, compared to the year-ago period.

The $13 million increase in segment results in the first three quarters of 2008, compared to the year-ago period, primarily reflected a $25 million increase in incentive management fees, a $17 million increase in combined base management and franchise fees, a $3 million increase in owned, leased, and other revenue net of direct expenses, partially offset by a $21 million decrease in gains and other income, a $7 million increase in general, administrative, and other expenses, and a decrease of $3 million in joint venture equity earnings.

The increase in fees was largely due to higher RevPAR, driven by rate increases and, to a lesser extent, the increase in fees reflected unit growth and productivity improvements, which increased property-level margins and incentive management fees. The $3 million increase in owned, leased, and other revenue net of direct expenses primarily reflected increased termination fees received in the first three quarters of 2008.

Table of Contents

Joint venture equity results were lower than the year-ago period by $3 million primarily reflecting an unfavorable $11 million impact associated with tax law changes in a country in which two joint ventures operate, mostly offset by a $9 million impact associated with insurance proceeds received by one of those same joint ventures.

The $21 million decrease in gains and other income in the first three quarters of 2008, compared to the first three quarters of 2007, reflected the recognition of gains totaling $6 million in 2008, as compared to gains in 2007 of $27 million. The 2007 gains primarily reflected a $10 million gain associated with the sale of a joint venture and a gain totaling $15 million associated with the sale of real estate. The $7 million increase in general, administrative, and other expenses reflected costs associated with unit growth and development.

Cost reimbursements revenue and expenses associated with our International segment properties totaled $501 million compared to $502 million in the year-ago period.

Luxury Lodging includes *The Ritz-Carlton* and *Bulgari Hotels & Resorts*.

	Twelve Weeks Ended			Thirty-Six Weeks Ended		
($ in millions)	**September 5, 2008**	**September 7, 2007**	**Change 2008/2007**	**September 5, 2008**	**September 7, 2007**	**Change 2008/2007**
Segment revenues	$ 357	$ 339	5%	$ 1,147	$ 1,048	9%
Segment results	$ 17	$ 15	13%	$ 66	$ 44	50%

Since the third quarter of 2007, across our Luxury Lodging segment we added eight properties (1,937 rooms) and two properties (608 rooms) left the system. In addition, we added five residential products (627 units) since the 2007 third quarter.

Twelve Weeks. Compared to the year-ago quarter, RevPAR for comparable company-operated luxury properties increased by 2.7 percent to $209.59, occupancy decreased by 1.5 percentage points to 70.9 percent, and average daily rates increased by 5.0 percent to $295.41.

The $2 million increase in segment results, compared to the third quarter of 2007, primarily reflected increased base management fees over the year-ago quarter associated with new properties added to the system and RevPAR growth driven by rate increases, partially offset by the receipt in the 2007 quarter of $2 million of business interruption insurance proceeds associated with Hurricane Katrina.

Cost reimbursements revenue and expenses associated with our Luxury segment properties totaled $294 million compared to $279 million in the year-ago quarter.

Thirty-six Weeks. Compared to the year-ago period, RevPAR for comparable company-operated luxury properties increased by 5.2 percent to $241.26, occupancy increased by 0.6 percentage points to 72.9 percent, and average daily rates increased by 4.4 percent to $330.84.

The $22 million increase in segment results, compared to the first three quarters of 2007, reflected a $9 million increase in base management and incentive management fees and $20 million of higher owned, leased, and other revenue net of direct expenses, partially offset by $5 million of increased general, administrative, and other expenses and $3 million of lower gains and other income. The increase in fees over the year-ago period reflected RevPAR growth driven by rate increases and new properties added to the system as well as the receipt in the 2007 period of $2 million of business interruption insurance proceeds associated with Hurricane Katrina.

The $20 million increase in owned, leased, and other revenue net of direct expenses reflected $7 million of improved results in 2008 associated with one property which was being renovated in 2007, $6 million of increased branding fees, and charges totaling $3 million in 2007 associated with a new property. The

Table of Contents

$5 million increase in general, administrative, and other expenses primarily reflected costs associated with unit growth and development.

Cost reimbursements revenue and expenses associated with our Luxury segment properties totaled $933 million compared to $882 million in the year-ago period.

Timeshare includes *Marriott Vacation Club*, *The Ritz-Carlton Club and Residences*, *Grand Residences by Marriott*, and *Horizons by Marriott Vacation Club*.

	Twelve Weeks Ended			Thirty-Six Weeks Ended		
($ in millions)	September 5, 2008	September 7, 2007	Change 2008/2007	September 5, 2008	September 7, 2007	Change 2008/2007
Segment Revenues						
Segment revenues	$ 463	$ 463	-%	$ 1,326	$ 1,438	-8%
Segment Results						
Base fee revenue	$ 12	$ 10		$ 35	$ 30	
Timeshare sales and services, net	47	45		137	224	
Joint venture equity earnings	2	5		9	4	
Minority interest	15	1		21	1	
General, administrative, and other expense	(27)	(22)		(79)	(69)	
Segment results	$ 49	$ 39	26%	$ 123	$ 190	-35%
Sales and Services Revenue						
Development	$ 265	$ 279		$ 722	$ 846	
Services	81	77		244	225	
Financing	31	28		107	120	
Other revenue	7	5		25	20	
Sales and services revenue	$ 384	$ 389	-1%	$ 1,098	$ 1,211	-9%
Contract Sales						
Timeshare	$ 283	$ 313		$ 859	$ 877	
Fractional	18	12		34	27	
Residential	(6)	6		33	6	
Total company	295	331		926	910	
Timeshare		7			23	
Fractional	6	7		17	46	
Residential	5	5		30	56	
Total joint venture	11	19		47	125	
Total Timeshare segment contract sales	$ 306	$ 350	-13%	$ 973	$ 1,035	-6%

Twelve Weeks. Timeshare segment contract sales, including sales made by our timeshare joint venture projects, represent sales of timeshare interval, fractional ownership, and residential products before the adjustment for percentage-of-completion accounting. Timeshare segment contract sales decreased by $44 million (13 percent) compared to the 2007 third quarter to $306 million from $350 million. The decrease in Timeshare segment contract sales in the third quarter of 2008, compared to the year-ago quarter, reflected decreased timeshare contract sales as well as decreased residential contract sales, reflecting the soft real estate market. Somewhat offsetting the declines were higher timeshare sales associated with the Asia Pacific points program and stronger fractional sales at the new Lake Tahoe resort.

Timeshare segment revenues remained unchanged at $463 million relative to the 2007 quarter and reflected a $5 million decrease in Timeshare sales and services revenue, offset by a $3 million increase in cost reimbursements revenue and $2 million of increased base management fees. Timeshare sales and services revenue, compared to the year-ago quarter primarily reflected lower revenue from several projects with limited available inventory in 2008, and soft demand for fractional and residential projects. Offsetting the decrease was higher revenue associated with the Asia Pacific points program, revenue associated with projects that became reportable subsequent to the 2007 third quarter, and increased services and financing revenue. Timeshare segment revenues for the third quarters of 2008 and 2007 included $13 million and $11 million, respectively, of interest income associated with Timeshare segment notes receivable, which was recorded in our Condensed Consolidated Statements of Income in the Timeshare sales and services revenue line.

Segment results of $49 million in the third quarter of 2008 increased by $10 million from $39 million in the 2007 third quarter, and primarily reflected $2 million of increased base management fees, $2 million of higher Timeshare sales and services revenue net of direct expenses, a higher minority interest benefit of $14 million, partially offset by $5 million of higher general, administrative, and other expenses and $3 million of lower joint venture equity results.

The $2 million increase in Timeshare sales and services revenue net of direct expenses, primarily reflected $5 million of higher services revenue net of services expenses and $2 million of higher financing revenue net of financing expenses, mostly offset by $6 million of lower reacquired and resales revenue net of reacquired and resales expenses. Development revenue net of product costs and marketing and selling costs remained relatively unchanged and reflected lower revenue from several projects with limited available inventory in 2008 and lower demand for fractional and residential projects, partially offset by higher reportability in 2008 for newer projects that reached revenue recognition thresholds and favorable product costs compared to the year-ago quarter. In addition, development revenue net of product costs and marketing and selling costs reflected a $22 million pretax impairment charge. We recorded a pretax charge of $22 million ($10 million net of minority interest benefit) in the 2008 third quarter within the Timeshare-direct caption of our Condensed Consolidated Statements of Income related to the impairment of a fractional and whole ownership real estate project held for development by a joint venture that we consolidate. The adjustment was made in accordance with FAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, to adjust the carrying value of the real estate to its estimated fair value at September 5, 2008. The downturn in market conditions including contract cancellations, and tightening in the credit markets, especially for jumbo mortgage loans, were the predominant items considered in our analysis. We estimated the fair value of the inventory utilizing a probability weighted cash flow model containing our expectations of future performance discounted at a 10 year risk-free interest rate determined from the yield curve for U.S. Treasury instruments (3.68 percent). The $15 million benefit associated with minority interest reflected our joint venture partner s portion of the losses of subsidiaries that we consolidate. Most of this was due to a pretax benefit of $12 million in the 2008 third quarter representing our joint venture partner s pretax share of the $22 million impairment charge. Accordingly, the impact of the impairment charge to our Timeshare segment was $10 million.

The increase in financing revenue, net of financing costs, primarily reflected higher accretion and interest income, and higher services revenue net of services expense primarily reflected lower expenses. The lower reacquired and resales revenue net of reacquired and resales expenses was driven by higher marketing and selling costs coupled with increased product cost relative to the 2007 quarter. Compared to the year-ago quarter, the $3 million decrease in joint venture equity results primarily reflected favorable prior year activity at one project for which the joint venture is now consolidated.

Cost reimbursements revenue and expenses associated with Timeshare segment properties totaled $67 million compared to $64 million in the year-ago quarter.

Thirty-six Weeks. Timeshare segment contract sales decreased by $62 million (6 percent) compared to the first three quarters of 2007 to $973 million from $1,035 million. The decrease in Timeshare segment contract sales in the first three quarters of 2008, compared to the year-ago period, reflected a small decrease in residential sales, more than offset by a $22 million decrease for fractional sales and a $41 million decrease in timeshare sales. Sales of fractional units were slow reflecting the soft real estate market. The decrease in timeshare contract sales reflected lower sales in 2008 associated with projects approaching sellout and lower demand, partially offset by higher sales associated with the Asia Pacific points program.

The $112 million decrease in Timeshare segment revenues to $1,326 million from $1,438 million reflected a $113 million decrease in Timeshare sales and services revenue, a $4 million decrease in cost reimbursements revenue, partially offset by $5 million of increased base management fees. The decrease in Timeshare sales and services revenue, compared to the year-ago period, primarily reflected lower revenue from projects with limited available inventory in 2008, a decrease of $17 million in note sale gains in the first three quarters of 2008 compared to the year-ago period, as well as revenue recognition for several projects in the first three quarters of 2007 that reached reportability thresholds. Partially offsetting the decrease was higher revenue associated with the Asia Pacific points program, revenue that became reportable subsequent to the 2007 period, and increased services revenue. Timeshare segment revenues for the first three quarters of 2008 and the first three quarters of 2007 included $42 million and $34 million, respectively, of interest income and note sale gains of $28 million and $45 million for the first three quarters of 2008 and 2007, respectively.

Segment results of $123 million in the first three quarters of 2008 decreased by $67 million from $190 million in the first three quarters of 2007, and reflected $87 million of lower Timeshare sales and services revenue net of direct expenses and $10 million of higher general, administrative, and other expenses, partially offset by $5 million of increased joint venture equity results, a $20 million higher minority interest benefit, and $5 million of increased base management fees.

The $87 million decrease in Timeshare sales and services revenue net of direct expenses primarily reflected $70 million of lower development revenue net of product costs and marketing and selling costs and $16 million of lower financing revenue net of financing expenses. Lower development revenue net of product costs and marketing and selling costs primarily reflected start-up costs in 2008 for newer projects, lower demand for fractional and residential projects, the impact of other projects nearing sell-out in 2008, and revenue recognition for several projects in the 2007 period that reached reportability thresholds. Additionally, the decrease reflected a $22 million pretax impairment charge ($10 million net of minority interest benefit) in 2008 as noted in the Twelve Weeks discussion. The $21 million benefit associated with minority interest reflected our joint venture partner s portion of the losses of subsidiaries that we consolidate and includes the impact of the pretax benefit of $12 million in the 2008 third quarter associated with the impairment charge as noted in the Twelve Weeks discussion. Partially offsetting these unfavorable variances were higher reportability in 2008 for newer projects that reached reportability thresholds and favorable product costs compared to the year-ago period.

The decrease in financing revenue, net of financing costs, primarily reflected lower note sale gains in the first three quarters of 2008 compared to the 2007 period. The $5 million increase in joint venture equity results primarily reflected favorable reportability in the first three quarters of 2008 for our fractional and residential product in one joint venture. The $10 million increase in general, administrative, and other expenses reflected costs associated with development.

Cost reimbursements revenue and expenses associated with Timeshare segment properties totaled $193 million compared to $197 million in the year-ago period.

Table of Contents

DISCONTINUED OPERATIONS

Synthetic Fuel

The tax credits provided under Internal Revenue Code Section 45K were only available for the production and sale of synthetic fuels produced from coal through December 31, 2007. Given high oil prices in 2007 and the anticipated phase out of a significant portion of tax credits available for synthetic fuel produced and sold in 2007, we permanently ceased operations at our synthetic fuel facilities on November 3, 2007, and now report this business as a discontinued operation. See Footnote No. 4, Discontinued Operations-Synthetic Fuel, in this report for additional information regarding the Synthetic Fuel segment.

Twelve Weeks. For the third quarter of 2007, the synthetic fuel operation generated revenue of $97 million. There was no income from the Synthetic Fuel segment in the third quarter of 2008 compared to $9 million in the third quarter of 2007.

Thirty-six Weeks. For the first three quarters of 2007, the synthetic fuel operation generated revenue of $253 million. Income from the Synthetic Fuel segment totaled $3 million, net of tax, in the first three quarters of 2008 and $59 million in the first three quarters of 2007. Income from the Synthetic Fuel segment of $3 million for the 2008 third quarter year-to-date period primarily reflected the recognition in the 2008 second quarter of additional tax credits as a result of the determination by the Secretary of the Treasury in the 2008 second quarter of the Reference Price of a barrel of oil for 2007, partially offset by obligations based on the amount of additional tax credits.

SHARE-BASED COMPENSATION

Under our 2002 Comprehensive Stock and Cash Incentive Plan, we award: (1) stock options to purchase our Class A Common Stock (Stock Option Program); (2) share appreciation rights (SARs) for our Class A Common Stock; (3) restricted stock units of our Class A Common Stock; and (4) deferred stock units. We grant awards at exercise prices or strike prices that are equal to the market price of our Class A Common Stock on the date of grant.

We granted 5.5 million restricted stock units and approximately 2.6 million SARs during the first three quarters of 2008 to certain officers and key employees. During that time period, we also granted approximately 218,000 stock options and issued 18,000 deferred stock units. See Footnote No. 5, Share-Based Compensation, earlier in this report for additional information on vesting periods and weighted average grant-date fair values.

NEW ACCOUNTING STANDARDS

EITF Issue No. 06-8, Applicability of the Assessment of a Buyer s Continuing Investment under FASB Statement No. 66 for Sales of Condominiums

We adopted the Financial Accounting Standards Board s (FASB) Emerging Issues Task Force (EITF) Issue No. 06-8, Applicability of the Assessment of a Buyer s Continuing Investment under FASB Statement No. 66 for Sales of Condominiums (EITF 06-8) on December 29, 2007, the first day of our 2008 fiscal year. EITF 06-8 states that in assessing the collectibility of the sales price pursuant to paragraph 37(d) of Financial Accounting Standards (FAS) No. 66, Accounting for Sales of Real Estate (FAS No. 66), an entity should evaluate the adequacy of the buyer s initial and continuing investment to conclude that the sales price is collectible. If an entity is unable to meet the criteria of paragraph 37, including an assessment of collectibility using the initial and continuing investment tests described in paragraphs 8 through 12 of FAS No. 66, then the entity should apply the deposit method of accounting as described in paragraphs 65 through 67 of FAS No. 66.

The adoption of EITF 06-8 had no impact on our wholly owned projects. However, in conjunction with the adoption of EITF 06-8 by one joint venture in which we are a partner, we recorded the cumulative effect of applying EITF 06-8 as a reduction of $5 million to our investment in that joint venture, an increase in deferred tax assets of $2 million, and a reduction of $3 million to the opening balance of our retained earnings. In certain circumstances, the application of the continuing investment criterion in EITF 06-8 on the collectibility of the sales price may delay our ability, or the ability of joint ventures in which we are a partner, to recognize revenues and costs using the percentage-of-completion method of accounting.

Financial Accounting Standards No. 157, Fair Value Measurements

We adopted FAS No. 157, Fair Value Measurements (FAS No. 157), on December 29, 2007, the first day of fiscal year 2008. FAS No. 157 defines fair value, establishes a methodology for measuring fair value, and expands the required disclosure for fair value measurements. On February 12, 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which amends FAS

No. 157 by delaying its effective date by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. Therefore, beginning on December 29, 2007, this standard applied prospectively to new fair value measurements of financial instruments and recurring fair value measurements of non-financial assets and non-financial liabilities. On January 3, 2009, the beginning of our 2009 fiscal year, the standard will also apply to all other fair value measurements. See Footnote No. 6, Fair Value Measurements, for additional information.

Table of Contents

Our servicing assets and residual interests, which are measured using Level 3 inputs in the FAS No. 157 hierarchy, accounted for 86 percent of the total fair value of our financial assets at September 5, 2008, that are required to be measured at fair value using the guidance found in FAS No. 157. We treat the residual interests, including servicing assets, as trading securities under the provisions of FAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and accordingly, we recorded realized and unrealized gains or losses related to these assets in the Timeshare sales and services revenue caption in our Condensed Consolidated Statements of Income.

At the dates of sale and at the end of each reporting period, we estimate the fair value of our residual interests, including servicing assets, using a discounted cash flow model. The implementation of FAS No. 157 did not result in material changes to the models or processes used to value these assets. These transactions may utilize interest rate swaps to protect the net interest margin associated with the beneficial interest. The discount rates we use in determining the fair values of the residual interests are based on both the general level of interest rates in the market for the weighted average life of each pool and the assumed credit risk of the interests retained. We adjust these discount rates quarterly as interest rates and credit spreads in the market vary.

During 2008, we used the following key assumptions to measure the fair value of the residual interests, including servicing assets, at the date of sale: average discount rates of 9.23 percent; average expected annual prepayments, including defaults, of 24.01 percent; expected weighted average life of prepayable notes receivable, excluding prepayments and defaults, of 76 months; and expected weighted average life of prepayable notes receivable, including prepayments and defaults, of 35 months. Our key assumptions are based on experience with notes receivable and servicing assets.

The most significant estimate involved in the measurement process is the loan repayment rate, followed by the default rate and the discount rate. Estimates of these rates are based on management s expectations of future prepayment rates and default rates, reflecting our historical experience, industry trends, current market interest rates, expected future interest rates, and other considerations. Actual repayment rates, default rates, and discount rates could differ from those projected by management due to changes in a variety of economic factors, including prevailing interest rates and the availability of alternative financing sources to borrowers. If actual prepayments of the loans being serviced were to occur more slowly than had been projected, the carrying value of servicing assets could increase and accretion and servicing income would exceed previously projected amounts. If actual default rates or actual discount rates are lower than expected, the carrying value of retained interests could increase and accretion and servicing income would exceed previously projected amounts. Accordingly, the retained interests, including servicing assets, actually realized, could differ from the amounts initially recorded.

We completed a stress test on the fair value of the residual interests, including servicing assets, as of the end of the 2008 third quarter to measure the change in value associated with independent changes in individual key variables. This methodology applied unfavorable changes that would be statistically significant for the key variables of prepayment rate, discount rate, and weighted average remaining term. Before we applied any of these stress test changes, we determined that the fair value of the residual interests, including servicing assets, was $271 million as of September 5, 2008.

Table of Contents

Applying the stress tests, we concluded that each change to a variable shown in the table below would have the following impact on the valuation of our residual interests at the end of the 2008 third quarter.

	Decrease in Quarter-End Valuation (in millions)	Percentage Decrease
100 basis point increase in the prepayment rate	$ 4	1.5%
200 basis point increase in the prepayment rate	8	2.9%
100 basis point increase in the discount rate	6	2.2%
200 basis point increase in the discount rate	12	4.3%
Two month decline in the weighted average remaining term	2	0.9%
Four month decline in the weighted average remaining term	5	1.8%

We value our derivatives using valuations that are calibrated to the initial trade prices. Subsequent valuations are based on observable inputs to the valuation model including interest rates and volatilities. We record realized and unrealized gains and losses on these derivative instruments in gains from the sale of timeshare notes receivable, which are recorded within the Timeshare sales and services revenue caption in our Condensed Consolidated Statements of Income.

Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115

We adopted FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115 (FAS No. 159), on December 29, 2007, the first day of our 2008 fiscal year. This standard permits entities to choose to measure many financial instruments and certain other items at fair value. While FAS No. 159 became effective for our 2008 fiscal year, we did not elect the fair value measurement option for any of our financial assets or liabilities.

EITF Issue No. 07-6, Accounting for Sales of Real Estate Subject to the Requirements of FASB Statement No. 66, Accounting for Sales of Real Estate, When the Agreement Includes a Buy-Sell Clause

We adopted EITF Issue No. 07-6, Accounting for Sales of Real Estate Subject to the Requirements of FASB Statement No. 66, Accounting for Sales of Real Estate, When the Agreement Includes a Buy-Sell Clause (EITF 07-6), on December 29, 2007, the first day of our 2008 fiscal year. EITF 07-6 clarifies whether a buy-sell clause is a prohibited form of continuing involvement that would preclude partial sales treatment under FAS No. 66. EITF 07-6 is effective for new arrangements entered into and assessments of existing transactions originally accounted for under the deposit, profit sharing, leasing, or financing methods for reasons other than the exercise of a buy-sell clause performed in fiscal years 2008 and thereafter. The adoption of EITF 07-6 did not have a material impact on our financial statements.

Future Adoption of Accounting Standards

Financial Accounting Standards No. 141 (Revised 2007), Business Combinations

On December 4, 2007, the FASB issued FAS No. 141 (Revised 2007), Business Combinations (FAS No. 141(R)). FAS No. 141(R) will significantly change the accounting for business combinations. Under FAS No. 141(R), an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. Transaction costs will no longer be included in the measurement of the business acquired. Instead, these expenses will be expensed as they are incurred. FAS No. 141(R) also includes a substantial number of new disclosure requirements. FAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, which for us begins with our 2009 fiscal year. FAS No. 141(R) will only have an impact on our financial statements if we are involved in a business combination in fiscal year 2009 or later years.

Table of Contents

Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements-an Amendment of ARB No. 51

On December 4, 2007, the FASB issued FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements-an Amendment of ARB No. 51 (FAS No. 160). FAS No. 160 establishes new accounting and reporting standards for a non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements separate from the parent s equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. FAS No. 160 clarifies that changes in a parent s ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. FAS No. 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. FAS No. 160 must be applied prospectively for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008, which for us begins with our 2009 fiscal year, except for the presentation and disclosure requirements, which must be applied retrospectively for all periods presented. We are currently evaluating the impact that FAS No. 160 will have on our financial statements.

Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133

In March 2008, the FASB issued FAS No. 161, Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133 (FAS No. 161). FAS No. 161 requires enhanced disclosure related to derivatives and hedging activities and thereby seeks to improve the transparency of financial reporting. Under FAS No. 161, entities are required to provide enhanced disclosures relating to: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedge items are accounted for under FAS No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS No. 133), and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. FAS No. 161 must be applied prospectively to all derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under FAS No. 133 for all financial statements issued for fiscal years and interim periods beginning after November 15, 2008, which for us begins with our 2009 fiscal year. We are currently evaluating the impact that FAS No. 161 will have on our financial statements.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

Cash Requirements and Our Credit Facilities

At September 5, 2008, our available borrowing capacity amounted to $1.678 billion and reflected capacity of $2.5 billion under our multicurrency revolving credit facility (the Credit Facility), plus our cash balance of $117 million, less letters of credit outstanding totaling $128 million and less $811 million of outstanding commercial paper supported by the facility.

While we are predominantly a manager and franchisor of hotel properties, we depend on capital to buy, develop, and maintain hotels and to develop timeshare properties. Events over the past several months, including recent failures and near failures of a number of large financial service companies, have made the capital markets increasingly volatile.

In response to the historic events on Wall Street and the severe dislocation of the capital markets, in September 2008 (our 2008 fourth quarter) we borrowed under the Credit Facility to supplement dramatically reduced liquidity from the commercial paper market. We made these borrowings to fund anticipated short-term commercial paper maturities and, to a lesser extent, other general corporate needs, including working capital and capital expenditures. As of October 2, 2008, borrowings totaling $908 million were outstanding under the Credit Facility, and currently bear interest at the London Interbank Offered Rate (LIBOR) plus a spread of 35 basis points (0.35 percent), which is based on our public debt rating. We expect to replace these Credit Facility borrowings with commercial paper as stability returns to that market and we can again issue commercial paper on favorable terms.

Lehman Commercial Paper Inc. (LCPI), a subsidiary of Lehman Brothers Holdings Inc., which has $96 million (3.8 percent) of the $2.5 billion in commitments under the Credit Facility. Although LCPI, to date, has not filed for bankruptcy (to our knowledge), LCPI has not funded its share of our fourth quarter 2008 draws under the Credit Facility, and we have no reason to expect that LCPI will do so in the future. Accordingly, unless this situation changes, the total effective size of the Credit Facility is approximately $2.4 billion. The loss of $96 million in effective capacity is not material to us, and the Credit Facility, together with cash we expect to generate from operations, remains adequate to meet our short-term and long-term liquidity requirements, finance our long-term growth plans, meet debt service, and fulfill other cash requirements.

We periodically evaluate opportunities to issue and sell additional debt or equity securities, obtain credit facilities from lenders, or repurchase, refinance, or otherwise restructure our long-term debt for strategic reasons, or to further strengthen our financial position.

Cash and equivalents totaled $117 million at September 5, 2008, a decrease of $215 million from year-end 2007, reflecting activity for the thirty-six weeks ended September 5, 2008, as follows: purchases of treasury stock ($428 million); capital expenditures ($220 million); loan advances and other investing activities, net of loan collections and sales ($166 million); and dividend payments ($84 million). Partially offsetting these outflows were cash inflows associated with the following: operating cash inflows ($555 million); commercial paper and other debt issuances, net of debt repayments ($51 million); common stock issuances ($42 million); dispositions ($19 million); and other cash inflows ($16 million).

Table of Contents

While our Timeshare segment generates strong operating cash flow, year-to-year cash flow varies based on the timing of both cash outlays for the acquisition and development of new resorts and cash received from purchaser financing. We include timeshare reportable sales we finance in cash from operations when we collect cash payments or the notes are sold for cash. The following table shows the net operating activity from our Timeshare segment (which does not include the portion of income from continuing operations from our Timeshare segment):

	Thirty-Six Weeks Ended	
($ in millions)	**September 5, 2008**	**September 7, 2007**
Timeshare segment development (in excess of) less than cost of sales	$ (212)	$ 6
New Timeshare segment mortgages, net of collections	(401)	(348)
Note repurchases	(37)	(21)
Financially reportable sales less than (in excess of) closed sales	68	(112)
Note sale gains	(28)	(45)
Note sale proceeds	237	270
Collection on retained interests in notes sold and servicing fees	74	81
Other cash inflows (outflows)	26	(11)
Net cash outflows from Timeshare segment activity	$ (273)	$ (180)

We estimate that, for the 20-year period from 2008 through 2027, the cost of completing improvements and currently planned amenities for our owned timeshare properties will be approximately $3.4 billion.

Asset Securitizations

In June 2008, prior to the end of our second quarter, we sold to a newly formed trust $300 million of notes receivable originated by our Timeshare segment in connection with the sale of timeshare interval and fractional products. On the same day, the trust issued $246 million of the trust s notes. In connection with the sale of notes receivable, we received net proceeds of $237 million. We retained residual interests with a fair value on the day of sale of $93 million. We recorded note sale gains totaling $28 million through the 2008 third quarter. We used the following key assumptions to measure the fair value of the residual interests, including servicing assets, at the date of sale: average discount rate of 9.23 percent; average expected annual prepayments, including defaults, of 24.01 percent; expected weighted average life of prepayable notes receivable, excluding prepayments and defaults, of 76 months; and expected weighted average life of prepayable notes receivable, including prepayments and defaults, of 35 months. Our key assumptions are based on our experience with Timeshare segment notes receivable that we originate.

Less favorable conditions in the asset securitization markets have reduced our gain from Timeshare segment note sales during the past year, as the trusts that purchased our mortgage notes have had to issue debt at higher relative interest rates and, in the second quarter 2008 transaction, we retained a larger residual interest in the trust. For example, in the 2008 second quarter note sale, the trust that purchased our mortgage notes issued AAA rated asset backed notes at a spread of 325 basis points over the 3.935 percent interest swap rate on LIBOR, compared to AAA note spreads of 100 basis points over the 4.782 percent interest swap rate on LIBOR for the 2007 fourth quarter note sale and 30 basis points over the 5.192 percent interest swap rate on LIBOR for the 2007 second quarter note sale. In addition, while the trusts in the fourth and second quarter 2007 securitizations each also issued 15.5 percent of the total principal amount of their asset backed notes at less than AAA ratings, we believed that the market for lower rated notes during the second quarter of 2008 was insufficient to permit issuance of AA, A, and BBB+ rated notes at attractive spreads. Accordingly, we decided to retain a larger residual interest in the trust for the second quarter 2008 transaction rather than having the trust offer lower rated notes.

While the Company s timeshare loan portfolio remains strong, current conditions in the capital markets significantly lower the likelihood that the Company can complete a timeshare note sale in the 2008 fourth quarter.

Table of Contents

Contractual Obligations

There have been no significant changes to our Contractual Obligations table in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations of our 2007 Form 10-K, other than those resulting from: 1) changes in the amount of outstanding debt; and 2) a new lease agreement we entered into as a lessee.

As of the end of the 2008 third quarter, debt had increased by $81 million to $3,046 million compared to $2,965 million at year-end 2007, reflecting increased commercial paper borrowings of $226 million, partially offset by the repayment upon maturity of $91 million of Series E Senior Notes in the 2008 first quarter and decreased mortgage and other debt of $54 million. Among other things, the increase in commercial paper debt was used for share repurchases and capital expenditures. At the end of the 2008 third quarter, future debt payments plus interest totaled $3,862 million and are due as follows: $55 million in 2008; $426 million in 2009 and 2010; $598 million in 2011 and 2012; and $2,783 million thereafter.

As further described in Footnote No. 19, Leases, future minimum lease payments associated with a lease entered into in 2008, for each of the next five years and thereafter are as follows: $3 million in 2008; $6 million in each of 2009, 2010, 2011, and 2012; and $36 million thereafter.

Share Repurchases

We purchased 11.9 million shares of our Class A Common Stock during the thirty-six weeks ended September 5, 2008, at an average price of $31.18 per share. See Part II, Item 2 of this Form 10-Q for additional information on our share repurchases, including the August 2007 authorized increase in the number of shares that may be repurchased. The Company does not anticipate meaningful share repurchase activity in the 2008 fourth quarter or in fiscal year 2009.

Dividends

In May 2008, our Board of Directors increased the quarterly cash dividend by 17 percent to $0.0875 per share.

Acquisitions and Dispositions

2008 Acquisitions

At year-end 2007, we were party to a venture that developed and marketed fractional ownership and residential products. In the first quarter of 2008, we purchased our partner s interest in that joint venture and concurrent with this transaction, we purchased additional land from our partner as well. Cash consideration for this transaction totaled $37 million and we acquired assets and liabilities totaling $75 million and $38 million, respectively, on the date of purchase. In the 2008 second quarter, we closed on a transaction for the purchase of real estate for our timeshare operations. The total purchase price was approximately $62 million. Cash consideration totaled approximately $38 million, and non-current liabilities recorded as a result of this transaction were $24 million. In the 2008 third quarter, we closed on a transaction for the purchase of real estate for our timeshare operations for cash consideration of $47 million.

2008 Dispositions

In the first half of 2008, we sold two limited-service properties for cash proceeds of $14 million, which were approximately equal to the properties book values. We accounted for each of the sales under the full accrual method in accordance with FAS No. 66 and each property will continue to operate under our brands pursuant to franchise agreements. In the 2008 second quarter, we sold our interest in an entity that leases four hotels. In conjunction with that transaction, we received cash proceeds totaling $5 million, and the sales price of the investment approximated its book value.

Table of Contents

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect reported amounts and related disclosures. We have discussed those estimates that we believe are critical and require the use of complex judgment in their application in our 2007 Form 10-K. Since the date of our 2007 Form 10-K, there have been no material changes to our critical accounting policies or the methodologies or assumptions we apply under them.

Item 3. ***Quantitative and Qualitative Disclosures About Market Risk***

Our exposure to market risk has not materially changed since December 28, 2007.

Item 4. ***Controls and Procedures***

Disclosure Controls and Procedures

As of the end of the period covered by this quarterly report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the Exchange Act)), and management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management s control objectives. You should note that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and we cannot assure you that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. Based upon the foregoing evaluation, our Chief Executive Officer and the Chief Financial Officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the SEC, and to provide reasonable assurance that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting

There were no changes in internal control over financial reporting that occurred during the third quarter of 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

Item 1. ***Legal Proceedings***

From time to time, we are subject to certain legal proceedings and claims in the ordinary course of business, including adjustments proposed during governmental examinations of the various tax returns we file. We currently are not aware of any legal proceedings or claims that we believe will have, individually or in aggregate, a material adverse effect on our business, financial condition, or operating results.

Item 1A. ***Risk Factors***

We are subject to various risks that could have a negative effect on the Company and its financial condition. You should understand that these risks could cause results to differ materially from those expressed in forward-looking statements contained in this report and in other Company communications. Because there is no way to determine in advance whether, or to what extent, any present uncertainty will ultimately impact our business, you should give equal weight to each of the following:

Lodging Industry Risks

The lodging industry is highly competitive, which may impact our ability to compete successfully with other hotel and timeshare properties for customers. We generally operate in markets that contain numerous competitors. Each of our hotel and timeshare brands competes with major hotel chains in national and international venues and with independent companies in regional markets. Our ability to remain competitive and to attract and retain business and leisure travelers depends on our success in distinguishing the quality, value, and efficiency of our lodging products and services from those offered by others. If we are unable to compete successfully in these areas, this could limit our operating margins, diminish our market share, and reduce our earnings.

We are subject to the range of operating risks common to the hotel, timeshare, and corporate apartment industries. The profitability of the hotels, vacation timeshare resorts, and corporate apartments that we operate or franchise may be adversely affected by a number of factors, including:

(1) the availability of and demand for hotel rooms, timeshare interval, fractional ownership, and residential products, and apartments;

(2) international, national, and regional economic and geopolitical conditions;

(3) the impact of war, actual or threatened terrorist activity and heightened travel security measures instituted in response to war, terrorist activity or threats;

(4) the desirability of particular locations and changes in travel patterns;

(5) travelers fears of exposure to contagious diseases, such as Avian Flu and Severe Acute Respiratory Syndrome (SARS);

(6) the occurrence of natural disasters, such as earthquakes, tsunamis, and hurricanes;

(7) taxes and government regulations that influence or determine wages, prices, interest rates, construction procedures, and costs;

(8) the availability and cost of capital to allow us and potential hotel owners and joint venture partners to fund investments;

(9) regional and national development of competing properties;

(10) increases in wages and other labor costs, energy, healthcare, insurance, transportation and fuel, and other expenses central to the conduct of our business or the cost of travel for our customers, including recent increases in energy costs and any resulting increase in travel costs or decrease in airline capacity; and

(11) organized labor activities, which could cause the diversion of business from hotels involved in labor negotiations, loss of group business, and/or increased labor costs.

Any one or more of these factors could limit or reduce the demand or the prices we are able to obtain for hotel rooms, timeshare units, residential units, and corporate apartments or could increase our costs and therefore reduce the profit of our lodging businesses. Reduced demand for hotels could also give rise to losses under loans, guarantees, and minority equity investments that we have made in connection with hotels that we manage. Even where such factors do not reduce demand, our profit margins may suffer if we are unable to fully recover increased operating costs from our customers.

The current slowdown in the lodging industry and the economy generally will continue to impact our financial results and growth. The present economic slowdown and the uncertainty over its breadth, depth and duration has had a negative impact on the lodging industry. Many economists have reported that the U.S. economy is slowing and may be in, or nearing, a recession. Substantial increases in transportation fuel costs, increases in air and ground travel costs and decreases in airline capacity stemming from higher fuel costs, have reduced demand for our hotel rooms and interval and fractional timeshare products. Accordingly, our financial results have been impacted by the economic slowdown and both our future financial results and growth could be further harmed if the economic slowdown continues for a significant period or becomes worse, or if transportation fuel costs remain at current high levels for an extended period or increase further.

Operational Risks

Our new branded hotel products may not be successful. We recently announced two new branded hotel products, Nickelodeon Resorts by Marriott® and Edition, and may launch additional branded hotel products in the future. We cannot assure that these brands will be accepted by hotel owners, potential franchisees, or the traveling public, that we will recover the costs we incurred in developing the brands, or that the brands will be successful. In addition, each of these new brands involves cooperation and/or consultation with a third party, including some shared control over product design and development, sales and marketing, and brand standards. Disagreements with these third parties regarding areas of consultation or shared control could slow the development of these new brands and/or impair our ability to take actions we believe to be advisable for the success and profitability of such brands.

Our lodging operations are subject to international, national, and regional conditions. Because we conduct our business on a national and international platform, our activities are susceptible to changes in the performance of regional and global economies. In recent years, our business was hurt by decreases in travel resulting from recent economic conditions, the military action in Iraq, and the heightened travel security measures that have resulted from the threat of further terrorism. Our future economic performance is similarly subject to the economic environment in the United States and other regions, which has become increasingly uncertain with recent failures and near failures of a number of large financial service companies such as Lehman Brothers, Fannie Mae, Freddie Mac, and American International Group (AIG), the resulting unknown pace of business travel, and the occurrence of any future incidents in the countries where we operate.

Risks relating to natural disasters, contagious disease, terrorist activity, and war could reduce the demand for lodging, which may adversely affect our revenues. So called Acts of God, such as hurricanes, earthquakes, and other natural disasters and the spread of contagious diseases, such as Avian Flu and SARS, in locations where we own, manage or franchise significant properties, and areas of the world from which we draw a large number of customers can cause a decline in the level of business and leisure travel and reduce the demand for lodging. Actual or threatened war, terrorist activity, political unrest, civil strife, and other geopolitical uncertainty can have a similar effect. Any one or more of these events may reduce the overall demand for hotel rooms, timeshare units, and corporate apartments or limit the prices that we are able to obtain for them, both of which could adversely affect our profits.

We may have disputes with the owners of the hotels that we manage or franchise. Consistent with our focus on management and franchising, we own very few of our lodging properties. The nature of our responsibilities under our management agreements to manage each hotel and enforce the standards required

Table of Contents

for our brands under both management and franchise agreements may be subject to interpretation and may give rise to disagreements in some instances. We seek to resolve any disagreements in order to develop and maintain positive relations with current and potential hotel owners and joint venture partners but have not always been able to do so. Failure to resolve such disagreements has in the past resulted in litigation, and could do so in the future.

Damage to, or other potential losses involving, properties that we own, manage or franchise may not be covered by insurance. We have comprehensive property and liability insurance policies with coverage features and insured limits that we believe are customary. Market forces beyond our control may nonetheless limit the scope of insurance coverage that we can obtain and our ability to obtain coverage at reasonable rates. Certain types of losses, generally of a catastrophic nature, such as earthquakes, hurricanes and floods, or terrorist acts, may be uninsurable or too expensive to justify obtaining insurance. As a result, we may not be successful in obtaining insurance without increases in cost or decreases in coverage levels. In addition, in the event of a substantial loss, the insurance coverage we carry may not be sufficient to pay the full market value or replacement cost of our lost investment or that of hotel owners or in some cases could result in certain losses being totally uninsured. As a result, we could lose some or all of the capital we have invested in a property, as well as the anticipated future revenue from the property, and we could remain obligated for guarantees, debt, or other financial obligations related to the property.

Development and Financing Risks

Our growth strategy depends upon third-party owners/operators, and future arrangements with these third parties may be less favorable. Our present growth strategy for development of additional lodging facilities entails entering into and maintaining various arrangements with property owners. The terms of our management agreements, franchise agreements, and leases for each of our lodging facilities are influenced by contract terms offered by our competitors, among other things. We cannot assure you that any of our current arrangements will continue or that we will be able to enter into future collaborations, renew agreements, or enter into new agreements in the future on terms that are as favorable to us as those that exist today.

Our ability to grow our management and franchise systems is subject to the range of risks associated with real estate investments. Our ability to sustain continued growth through management or franchise agreements for new hotels and the conversion of existing facilities to managed or franchised Marriott brands is affected, and may potentially be limited, by a variety of factors influencing real estate development generally. These include site availability, financing, planning, zoning and other local approvals, and other limitations that may be imposed by market and submarket factors, such as projected room occupancy, changes in growth in demand compared to projected supply, territorial restrictions in our management and franchise agreements, costs of construction, and anticipated room rate structure.

While we are predominantly a manager and franchisor of hotel properties, we depend on capital to buy, develop and maintain hotels and to develop timeshare properties, and we or our hotel owners may be unable to access capital when necessary. In order to fund new hotel investments, as well as refurbish and improve existing hotels, both the Company and current and potential hotel owners must periodically spend money. The availability of funds for new investments and maintenance of existing hotels depends in large measure on capital markets and liquidity factors over which we can exert little control. Events over the past several months, including recent failures and near failures of a number of large financial service companies, have made the capital markets increasingly volatile. As a result, many current and prospective hotel owners are finding hotel financing to be increasingly expensive and difficult to obtain. In addition, the recent bankruptcy of Lehman Brothers may prevent some projects that are in construction or development, including a few in which the Company has minority equity investments, from drawing on existing Lehman Brothers financing commitments, and replacement financing may not be available or may only be available on less favorable terms. Delays, increased costs and other impediments to restructuring such projects may affect our ability to realize fees, recover loans and guarantee advances, or realize equity investments from such projects. Our ability to recover loan and guarantee advances from hotel operations or from owners through the proceeds of hotel sales, refinancing of debt or otherwise may also affect our ability to recycle and raise new capital. In addition, downgrades of our public debt ratings by Standard & Poor s, Moody s Investor Service or similar companies could increase our cost of capital.

Continued or increased volatility in the credit markets will likely adversely impact our ability to sell the loans that our Timeshare business generates. Our Timeshare business provides financing to purchasers of our timeshare and fractional properties, and we periodically sell interests in those loans in the securities markets. Recent increased volatility in the credit markets will likely impact the timing and volume of the timeshare loans that we sell. Market conditions over the past year have resulted in terms that are less favorable to us than they have been historically, and further volatility and deterioration during the last few weeks will likely prevent a planned fourth quarter 2008 sale, may delay planned 2009 sales until the markets stabilize, or prevent us from selling our timeshare notes entirely. Although we expect to realize the economic value of our timeshare note portfolio even if future note sales are temporarily or indefinitely delayed, such delays could reduce or postpone future gains and could result in either increased borrowings to provide capital to replace anticipated proceeds from such sales or reduced spending in order to maintain our leverage and return targets.

Our development activities expose us to project cost, completion, and resale risks. We develop new hotel, timeshare interval, fractional ownership, and residential properties, both directly and through partnerships, joint ventures, and other business structures with third parties. Our involvement in the development of properties presents a number of risks, including that: (1) construction delays, cost overruns, lender financial defaults, or so called Acts of God such as earthquakes, hurricanes, floods or fires may increase overall project costs or result in project cancellations; (2) we may be unable to recover development costs we incur for projects that are not pursued to completion; (3) conditions within capital markets may limit our ability, or that of third parties with whom we do business, to raise capital for completion of projects that have commenced or development of future properties; and (4) properties that we develop could become less attractive due to changes in mortgage rates, market absorption or oversupply, with the result that we may not be able to sell such properties for a profit or at the prices or selling pace we anticipate.

Development activities that involve our co-investment with third parties may result in disputes that could increase project costs, impair project operations, or increase project completion risks. Partnerships, joint ventures, and other business structures involving our co-investment with third parties generally include some form of shared control over the operations of the business and create additional risks, including the possibility that other investors in such ventures could become bankrupt or otherwise lack the financial resources to meet their obligations, or could have or develop business interests, policies or objectives that are inconsistent with ours. Although we actively seek to minimize such risks before investing in partnerships, joint ventures or similar structures, actions by another investor may present additional risks of project delay, increased project costs, or operational difficulties following project completion.

Risks associated with development and sale of residential properties that are associated with our lodging and timeshare properties or brands may reduce our profits. In certain hotel and timeshare projects we participate, through minority interests and/or licensing fees, in the development and sale of residential properties associated with our brands, including luxury residences, and condominiums under our Ritz-Carlton and Marriott brands. Such projects pose additional risks beyond those generally associated with our lodging and timeshare businesses, which may reduce our profits or compromise our brand equity, including the following:

- Decreases in residential real estate and vacation home prices or demand generally, which have historically been cyclical, could reduce our profits or even result in losses on residential sales, result in significant carrying costs if the pace of sales is slower than we anticipate, or make it more difficult to convince future hotel development partners of the value added by our brands;

Increases in interest rates, reductions in mortgage availability, or increases in the costs of residential ownership could prevent potential customers from buying residential products or reduce the prices they are willing to pay; and

Residential construction may be subject to warranty and liability claims, and the costs of resolving such claims may be significant.

Technology, Information Protection, and Privacy Risks

A failure to keep pace with developments in technology could impair our operations or competitive position. The lodging and timeshare industries continue to demand the use of sophisticated technology and systems, including those used for our reservation, revenue management and property management systems, our Marriott Rewards program, and technologies we make available to our guests. These technologies and systems must be refined, updated, and/or replaced with more advanced systems on a regular basis. If we are unable to do so as quickly as our competitors or within budgeted costs and time frames, our business could suffer. We also may not achieve the benefits that we anticipate from any new technology or system, and a failure to do so could result in higher than anticipated costs or could impair our operating results.

An increase in the use of third-party Internet services to book online hotel reservations could adversely impact our revenues. Some of our hotel rooms are booked through Internet travel intermediaries such as Expedia.com®, Travelocity.com®, and Orbitz.com®, as well as lesser known online travel service providers. These intermediaries initially focused on leisure travel, but now also provide offerings for corporate travel and group meetings. Although Marriott s Look No Further® Best Rate Guarantee has greatly reduced the ability of intermediaries to undercut the published rates at our hotels, intermediaries continue to use a variety of aggressive online marketing methods to attract customers, including the purchase of trademarked online keywords such as Marriott from Internet search engines such as Google® and Yahoo® to steer customers toward their websites (a practice currently being challenged by various trademark owners in federal court). Our business and profitability could be harmed if online intermediaries succeed in significantly shifting loyalties from our lodging brands to their travel services, diverting bookings away from Marriott.com, or through their fees increasing the overall cost of internet bookings for our hotels.

Failure to maintain the integrity of internal or customer data could result in faulty business decisions, damage of reputation and/or subject us to costs, fines or lawsuits. Our businesses require collection and retention of large volumes of internal and customer data, including credit card numbers and other personally identifiable information of our customers as they are entered into, processed by, summarized by, and reported by our various information systems and those of our service providers. We also maintain personally identifiable information about our employees. The integrity and protection of that customer, employee, and company data is critical to us. If that data is inaccurate or incomplete we could make faulty decisions. Our customers and employees also have a high expectation that we will adequately protect their personal information, and the regulatory environment surrounding information security and privacy is increasingly demanding, both in the United States and other jurisdictions in which we operate. A significant theft, loss or fraudulent use of customer, employee or company data could adversely impact our reputation and could result in remedial and other expenses, fines and litigation.

Changes in privacy law could adversely affect our ability to market our products effectively. Our Timeshare segment and, to a lesser extent, our other lodging segments, rely on a variety of direct marketing techniques, including telemarketing, email marketing, and postal mailings. Any further restrictions in laws such as the Telemarketing Sales Rule, CANSPAM Act, and various U.S. state laws, or new federal laws, regarding marketing and solicitation or international data protection laws that govern these activities could adversely affect the continuing effectiveness of telemarketing, email, and postal mailing techniques and could force further changes in our marketing strategy. If this occurs, we may not be able to develop adequate alternative marketing strategies, which could impact the amount and timing of our sales of timeshare units and other products. We also obtain access to potential customers from travel service providers or other companies with whom we have substantial relationships and market to some individuals on these lists directly or by including our marketing message in the other company s marketing materials.

Table of Contents

If access to these lists was prohibited or otherwise restricted, our ability to develop new customers, and introduce them to our products could be impaired.

Other Risks

If we cannot attract and retain talented associates our business could suffer. We compete with other companies both within and outside of our industry for talented personnel. If we are not able to recruit, train, develop and retain sufficient numbers of talented associates, we could experience increased associate turnover, decreased guest satisfaction, low morale, inefficiency or internal control failures. Insufficient numbers of talented associates could also limit our ability to grow and expand our businesses.

Delaware law and our governing corporate documents contain, and our board of directors could implement, anti-takeover provisions that could deter takeover attempts. Under the Delaware business combination statute, a stockholder holding 15 percent or more of our outstanding voting stock could not acquire us without board of director s consent for at least three years after the date the stockholder first held 15 percent or more of the voting stock. Our governing corporate documents also, among other things, require supermajority votes in connection with mergers and similar transactions. In addition, our Board of Directors could, without stockholder approval, implement other anti-takeover defenses, such as a stockholder rights plan to replace the stockholder s rights plan that expired in March 2008.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***

(a) Unregistered Sale of Securities

None.

(b) Use of Proceeds

None.

(c) Issuer Purchases of Equity Securities

(in millions, except per share amounts) Period	Total Number of Shares Purchased	Average Price per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs [1]	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs [1]
June 14, 2008-July 11, 2008		$		24.6
July 12, 2008-August 8, 2008	1.2	26.10	1.2	23.4
August 9, 2008-September 5, 2008	2.1	27.34	2.1	21.3

(1) On August 2, 2007, we announced that our Board of Directors increased, by 40 million shares, the authorization to repurchase our Class A Common Stock for a total outstanding authorization of approximately 51 million shares on that date. We repurchase shares in the open market and in privately negotiated transactions.

Item 3. ***Defaults Upon Senior Securities***

None.

Item 4. ***Submission of Matters to a Vote of Security Holders***

None.

Item 5. ***Other Information***

None.

Table of Contents

Item 6. ***Exhibits***

Exhibit No.	Description	Incorporation by Reference (where a report is indicated below, that document has been previously filed with the SEC and the applicable exhibit is incorporated by reference thereto)
3.(i)	Restated Certificate of Incorporation of the Company.	Exhibit No. 3.(i) to our Form 8-K filed August 22, 2006 (File No. 001-13881).
3.(ii)	Amended and Restated Bylaws.	Exhibit No. 3.(ii) to our Form 8-K filed August 22, 2006 (File No. 001-13881).
12	Statement of Computation of Ratio of Earnings to Fixed Charges.	*Filed with this report.*
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a).	*Filed with this report.*
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a).	*Filed with this report.*
32	Section 1350 Certifications.	*Furnished with this report.*

Table of Contents

SIGNATURES

Pursuant to the requirements 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.

MARRIOTT INTERNATIONAL, INC.

3rd day of October, 2008

/s/ Arne M. Sorenson
Arne M. Sorenson

Executive Vice President and Chief Financial Officer

/s/ Carl T. Berquist
Carl T. Berquist

Executive Vice President, Financial

Information and Enterprise Risk Management and

Principal Accounting Officer

66

:nowrap;">

—

15,044

15,044

Total liabilities measured at fair value

$

—

$

—

$

27,148

$

27,148

	December 31, 2017 (In thousands) Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Description				
Assets measured at fair value				

Cash and cash equivalents	$91,217	$ —	$ —	$91,217
Restricted cash	6,389	—	—	6,389
Total Assets measured at fair value	$97,606	$ —	$ —	$97,606
Liabilities measured at fair value				
Contingent consideration	$—	$ —	$ 12,418	$12,418
Warrant liabilities	—	—	14,090	14,090
Total liabilities measured at fair value	$—	$ —	$ 26,508	$26,508

The Company's financial liabilities consisted of contingent consideration potentially payable to Sofar related to the Senhance Acquisition in September 2015 (Note 3). This liability is reported as Level 3 as estimated fair value of the contingent consideration related to the acquisition requires significant management judgment or estimation and is calculated using the income approach, using various revenue and cost assumptions and applying a probability to each outcome. The change in fair value of the contingent consideration of $0.1 million for the nine months ended September 30, 2018 was primarily due to a change in the estimated discount rate, the effect of the passage of time on the fair value measurement and the impact of foreign currency exchange rates. The change in fair value of the contingent consideration of $1.2 million for the nine months ended September 30, 2017 was primarily due to the change in discount rate, effect of the passage of time on the fair value measurement and the impact of foreign currency exchange rates. Adjustments associated with the change in fair value of contingent consideration are included in the Company's consolidated statements of operations and comprehensive loss.

On April 28, 2017, the Company sold 24.9 million units (the "Units"), each consisting of one share of the Company's Common Stock, a Series A warrant to purchase one share of Common Stock with an exercise price of $1.00 per share (the "Series A Warrants"), and a Series B warrant to purchase 0.75 shares of Common Stock with an exercise price of $1.00 per share (the "Series B Warrants," together with the Series A Warrants, the "Warrants"), at an offering price of $1.00 per Unit. Each Series A Warrant was exercisable at any time beginning on the date of issuance, and from time to time thereafter, through and including the first anniversary of the issuance date, unless terminated earlier as provided in the Series A Warrant. Receipt of 510(k) clearance for the Senhance System on October 13, 2017, triggered the acceleration of the expiration date of the Series A Warrants to October 31, 2017. Each Series B Warrant may be exercised at any time beginning on the date of issuance and from time to time thereafter through and including the fifth anniversary of the issuance date.

The fair value of the Series A Warrants of $2.5 million at the date of issuance was estimated using the Black-Scholes Merton model which used the following inputs: term of 1 year, risk free rate of 1.07%, no dividends, volatility of 73.14%, and share price of $0.65 per share based on the trading price of the Company's Common Stock. All Series A Warrants were exercised as of December 31, 2017.

The change in fair value of warrants for the nine months ended September 30, 2018 and 2017 of $24.4 million and $25.2 million, respectively was included in the Company's consolidated statement of operations and comprehensive loss. The following table presents the inputs and valuation methodologies used for the Company's fair value of the Series B warrants:

Series B	September 30, 2018	December 31, 2017	April 28, 2017 (date of issuance)
Fair value	$15.0 million	$14.1 million	$6.2 million
Valuation methodology	Monte Carlo	Monte Carlo	Black-Scholes Merton
Term	3.58 years	4.33 years	5 years
Risk free rate	2.90%	2.13%	1.81%
Dividends	—	—	—
Volatility	89.47%	80.60%	73.14%
Share price	$ 5.80	$ 1.93	$ 0.65
Probability of additional financing	100% in 2019	25% in 2018 and 75% in 2019	Not Applicable

The following table presents quantitative information about the inputs and valuation methodologies used for the Company's fair value measurements classified in Level 3, with the exception of the warrant liability, which is explained above as of September 30, 2018 and December 31, 2017:

	Valuation Methodology	Significant Unobservable Input	Weighted Average (range, if applicable)
Contingent consideration	Probability weighted income approach	Milestone dates	2018 to 2021

Discount rate	9% to 12%
Probability of occurrence	100%

The following table summarizes the change in fair value, as determined by Level 3 inputs, for all assets and liabilities using unobservable Level 3 inputs for the nine months ended September 30, 2018:

	Fair Value Measurement at Reporting Date (Level 3) (In thousands) (unaudited)	
	Common stock warrants	Contingent consideration
Balance at December 31, 2017	$14,090	$ 12,418
Exercise of warrants	(23,484)	—
Change in fair value	24,438	81
Payment for contingent consideration	—	(395)
Balance at September 30, 2018	$15,044	$ 12,104
Current portion	—	555
Long-term portion	15,044	11,549
Balance at September 30, 2018	$15,044	$ 12,104

17

6. Accounts Receivable, Net
The following table presents the components of accounts receivable:

	September 30, 2018	December 31, 2017
	(In thousands)	
	(unaudited)	
Gross accounts receivable	$5,742	$ 1,609
Allowance for uncollectible accounts	(73)	(73)
Total accounts receivable, net	$5,669	$ 1,536

7. Inventories
The components of inventories are as follows:

	September 30, 2018	December 31, 2017
	(In thousands)	
	(unaudited)	
Finished goods	$4,212	$ 4,432
Raw materials	6,030	6,385
Total inventories	$10,242	$ 10,817

8. Other Current Assets
The following table presents the components of other current assets:

	September 30, 2018	December 31, 2017
	(In thousands)	
	(unaudited)	
Advances to vendors	$6,406	$ 6,403
Prepaid expenses	2,540	1,519
Other receivables	93	1,422
Total	$9,039	$ 9,344

9. Property and Equipment

Property and equipment consisted of the following:

	September 30, 2018	December 31, 2017
	(In thousands)	
	(unaudited)	
Machinery, manufacturing and demonstration equipment	$12,095	$ 10,866
Computer equipment	2,260	2,187
Furniture	628	598
Leasehold improvements	2,273	2,237
Total property and equipment	17,256	15,888
Accumulated depreciation and amortization	(10,597)	(9,218)
Property and equipment, net	$6,659	$ 6,670

Depreciation expense was $1,876,000 and $1,816,000, for the nine months ended September 30, 2018 and 2017, respectively.

10. Goodwill, In-Process Research and Development and Intellectual Property
Goodwill

Goodwill of $93.8 million was recorded in connection with the Merger, as described in Note 1, and goodwill of $38.3 million was recorded in connection with the Senhance Acquisition, as described in Note 3. The carrying value of goodwill and the change in the balance for the nine months ended September 30, 2018 is as follows:

	Goodwill (In thousands) (unaudited)
Balance at December 31, 2017	$ 71,368
Foreign currency translation impact	(699)
Balance at September 30, 2018	$ 70,669

Accumulated impairment of goodwill as of September 30, 2018 and December 31, 2017 was $61.8 million. No impairment was recorded as of September 30, 2018 and December 31, 2017.

During the second quarter of 2017, the Company's stock price experienced a significant decline. The Company performed a Step 1 goodwill impairment test as of the second quarter of 2017 and determined that no charge to goodwill for impairment was required during such second quarter. As of December 31, 2017, the Company elected to bypass the qualitative assessment and calculated the fair value of the Company's reporting unit, which exceeded the carrying amount. Accordingly, no charge for goodwill impairment was required as of December 31, 2017. No impairment indicators were noted during the nine months ended September 30, 2018.

In-Process Research and Development

As described in Note 3, on September 21, 2015, the Company acquired all of the assets related to the Senhance System and recorded $17.1 million of IPR&D. The estimated fair value of the IPR&D was determined using a probability-weighted income approach, which discounts expected future cash flows to present value. The projected cash flows were based on certain key assumptions, including estimates of future revenue and expenses, taking into account the stage of development of the technology at the acquisition date and the time and resources needed to complete development. The Company used a discount rate of 45% and cash flows that have been probability adjusted to reflect the risks of product commercialization, which the Company believes are appropriate and representative of market participant assumptions.

On October 13, 2017, upon receipt of regulatory clearance to commercialize the products associated with the IPR&D assets in the United States, the assets were deemed definite-lived, transferred to developed technology and are amortized based on their estimated useful lives.

Intellectual Property

As described in Note 3, on September 21, 2015, the Company acquired all of the developed technology related to the Senhance System and recorded $48.5 million of intellectual property. The estimated fair value of the intellectual property was determined using a probability-weighted income approach, which discounts expected future cash flows to present value. The projected cash flows were based on certain key assumptions, including estimates of future revenue and expenses, taking into account the stage of development of the technology at the acquisition date and the time and resources needed to complete development. The Company used a discount rate of 45% and cash flows that have been probability adjusted to reflect the risks of product commercialization, which the Company believes are appropriate and representative of market participant assumptions.

In November 2016, the Company agreed to enter into a technology and patents purchase agreement with Sofar to acquire from Sofar certain technology and intellectual property rights related to the Senhance Acquisition, and formerly licensed by the Company. The technology and patents were acquired in 2017 at an acquisition price of $400,000.

The components of gross intellectual property, accumulated amortization, and net intellectual property as of September 30, 2018 and December 31, 2017 are as follows:

	September 30, 2018 (In thousands) (unaudited)				December 31, 2017 (In thousands)			
	Gross Carrying Amount	Accumulated Amortization	Foreign currency translation impact	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Foreign currency translation impact	Net Carrying Amount
Developed technology	66,413	(27,936)	4,074	42,551	66,413	(19,724)	5,529	52,218
Technology and patents purchased	400	(62)	36	374	400	(30)	50	420
Total intellectual property	$66,813	$(27,998)	$ 4,110	$42,925	$66,813	$ (19,754)	$ 5,579	$52,638

The weighted average remaining useful life of the developed technology and technology and patents purchased was 4 years and 8.6 years, respectively as of September 30, 2018 and 4.8 years and 9.3 years, respectively as of December 31, 2017.

11. Income Taxes

Income taxes have been accounted for using the asset and liability method in accordance with ASC 740 “Income Taxes”. The Company computes its interim provision for income taxes by applying the estimated annual effective tax rate method. The Company estimates an annual effective tax rate of 5.0% for the year ending December 31, 2018. This rate does not include the impact of any discrete items. The Company incurred losses for the nine month period ended September 30, 2018 and is forecasting additional losses through the year, resulting in an estimated net loss for both financial statement and tax purposes for the year ending December 31, 2018. Due to the Company’s history of losses, there is not sufficient evidence to record a net deferred tax asset associated with the U.S., Luxembourg, Swiss, and Asian operations. Accordingly, a full valuation allowance has been recorded related to the net deferred tax asset in those jurisdictions. There is no net deferred tax asset recorded in relation to TransEnterix Italia and accordingly no valuation allowance has been recorded in that jurisdiction The deferred tax benefit during the nine months ended September 30, 2018 and 2017, was approximately $2.6 million and $2.3 million, respectively.

The Company’s effective tax rate for each of the nine-month periods ended September 30, 2018 and 2017 was 4.4% and 3.3%, respectively. At September 30, 2018, the Company had no unrecognized tax benefits that would affect the Company’s effective tax rate.

At September 30, 2018, the Company’s accounting for the 2017 Tax Cuts and Jobs Act is still in process; however, it expects to complete the accounting by December 2018. Updates to the Company’s calculations may result in changes to the provisional adjustments recorded at year-end.

12. Accrued Expenses

The following table presents the components of accrued expenses:

	September 30, 2018	December 31, 2017
	(In thousands)	
	(unaudited)	
Compensation and benefits	$4,975	$ 4,533
Other	814	504
Deferred rent	437	595
Legal and professional fees	400	386
Consulting and other vendors	299	1,414
Taxes and other assessments	190	3,192
Interest	159	309
Royalties	158	41
Total	$7,432	$ 10,974

13. Notes Payable

On May 23, 2018, the Company and its domestic subsidiaries, as co-borrowers, entered into a Loan and Security Agreement (the "Hercules Loan Agreement") with several banks and other financial institutions or entities from time to time party to the Loan Agreement (collectively, the "Lender") and Hercules Capital, Inc., as administrative agent and collateral agent (the "Agent"). Under the Hercules Loan Agreement, the Lender has agreed to make certain term loans to the Company in the aggregate principal amount of up to $40,000,000, with funding of the first $20,000,000 tranche occurring on May 23, 2018 (the "Initial Funding Date"). The Company will be eligible to draw on the second tranche of $10,000,000 upon achievement of certain Senhance System revenue-related milestones for its 2018 fiscal year, and a third tranche of $10,000,000 upon achievement of designated trailing six month GAAP net revenue from Senhance System sales. The Company is entitled to make interest-only payments until December 1, 2020, and at the end the interest-only period, the Company will be required to repay the term loans over an eighteen-month period based on an eighteen-month amortization schedule, with a final maturity date of June 1, 2022. The term loans will be required to be repaid if the term loans are accelerated following an event of default.

The term loans bear interest at a rate equal to the greater of (i) 9.55% per annum (the "Fixed Rate") and (ii) the Fixed Rate plus the prime rate (as reported in The Wall Street Journal) minus 5.00%. Following the draw of the third tranche, the Fixed Rate will be reduced to 9.20% effective on the first interest payment date to occur during the first fiscal quarter following the draw of the third tranche. On the Initial Funding Date, the Company was obligated to pay a facility fee of $400,000, recorded as a debt discount. In addition, the Company is permitted to prepay the term loans in full at any time, with a prepayment fee of 3.0% of the outstanding principal amount of the loan in the first year after the Initial Funding Date, 2.0% if the prepayment occurs in the second year after the Initial Funding Date and 1.0% thereafter. Upon prepayment of the term loans in full or repayment of the terms loans at the maturity date or upon acceleration, the Company is required to pay a final fee of 6.95% of the aggregate principal amount of term loans funded. The final payment fee is accreted to interest expense over the life of the term loan and included within notes payable on the consolidated balance sheet.

The Company's obligations under the Hercules Loan Agreement are to be guaranteed by all current and future material foreign subsidiaries of the Company and are secured by a security interest in all of the assets of the Company and their current and future domestic subsidiaries and all of the assets of their current and future material foreign subsidiaries, including a security interest in the intellectual property. The Hercules Loan Agreement contains customary representations and covenants that, subject to exceptions, restrict the Company's and its subsidiaries' ability to do the following, among other things: declare dividends or redeem or repurchase equity interests; incur additional indebtedness and liens; make loans and investments; engage in mergers, acquisitions, and asset sales; transact with affiliates; undergo a change in control; add or change business locations; and engage in businesses that are not related to its existing business. Under the terms of the Hercules Loan Agreement, the Company is required to maintain cash and/or investment property in accounts which perfect the Agent's first priority security interest in such accounts in an amount equal to the lesser of (i) (x) 120% of the then-outstanding principal balance of the term loans, including accrued interest and any other fees payable under the agreement to the extent accrued and payable plus (y) an amount equal to the then-outstanding accounts payable of the Company on a consolidated basis that are more than 90 days past due and (ii) 80% of the aggregate cash of the Company and its consolidated subsidiaries. The Agent is granted the option to invest up to $2,000,000 in any future equity offering broadly marketed by the Company to investors on the same terms as the offering to other investors.

In connection with its entrance into the Hercules Loan Agreement, the Company repaid its existing loan and security agreement (the "Innovatus Loan Agreement") with Innovatus Life Sciences Lending Fund I, LP ("Innovatus"). The

Company recognized a loss of $1.4 million on the extinguishment of notes payable which is included in interest expense on the consolidated statements of operations and comprehensive loss for the nine months ended September 30, 2018. The Company paid $680,000 in final payment obligations and $287,000 in prepayment fees under the Innovatus Loan Agreement upon repayment.

Under the Innovatus Loan Agreement, entered into on May 10, 2017, Innovatus agreed to make certain term loans in the aggregate principal amount of up to $17,000,000. Funding of the first $14,000,000 tranche occurred on May 10, 2017.

The Innovatus Loan Agreement allowed for interest-only payments for up to twenty-four months at a fixed rate equal to 11% per annum, of which 2.5% could be paid in-kind and added to the outstanding principal amount of the term loans until the earlier of (i) the first anniversary following the funding date and (ii) the Company's failure to achieve an Interest-Only Milestone. At the end of the interest-only period, the Company would be required to repay the term loans over a two-year period, based on a twenty-four (24) month amortization schedule, with a final maturity date of May 10, 2021.

In connection with the funding, the Company paid a facility fee of $170,000 on the date of funding of the first tranche and incurred additional debt issuance costs of approximately $1.2 million, recorded as debt discount. In addition, the Company issued warrants to the Lender to purchase shares of the Company's common stock that will expire five (5) years from such issue date. The warrants issued in connection with funding of the first tranche entitle the Lender to purchase up to 1,244,746 shares of the Company's common stock at an exercise price of $1.00 per share. The Company estimated the fair value of the warrants to be $300,000. The value of the warrants was classified as equity and recorded as a discount to the loan. The debt discount was amortized as interest expense using the effective interest method over the life of the loan. As of September 30, 2018 and December 31, 2017, the unamortized debt discount was $0 and $1.0 million, respectively.

In connection with its entrance into the Innovatus Loan Agreement, the Company repaid its then-existing credit facility with Silicon Valley Bank and Oxford Finance LLC, which loan and security agreement, as subsequently amended and restated is referred to as the “SVB Loan Agreement.” The Company recognized a loss of $308,000 on the extinguishment of notes payable which is included in interest expense on the consolidated statements of operations and comprehensive loss for the year ended December 31, 2017. The Company paid $1.3 million in final payment obligations and $255,000 in facility fees under the SVB Loan Agreement upon repayment.

In connection with the issuance of the notes payable and amendments under the SVB Loan Agreement, the Company incurred approximately $371,000 in debt issuance costs paid to Silicon Valley Bank and Oxford Finance and third parties and $280,000 in debt issuance costs related to issuance of warrants to such prior lenders. The unamortized balance of $107,000 as of December 31, 2016, was amortized using the effective interest method, until the debt was extinguished in May 2017. At the time of extinguishment in May 2017, $63,000 of unamortized debt issuance costs were included in the loss on extinguishment of notes payable.

14.Warrants

The following table summarizes the change in warrants for the nine months ended September 30, 2018:

	Number of Warrants	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2017	13,162,668	$ 1.08	4.5	$ 0.39
Exercised	(8,562,631)	1.09	—	—
Cancelled	(95,600)	1.65	—	—
Outstanding at September 30, 2018	4,504,437	1.03	4.0	$ 0.26

In connection with the borrowings under the SVB Loan Agreement, the Company issued warrants to Silicon Valley Bank and Oxford Finance to purchase shares of the Company’s Common Stock amounting to an aggregate of 430,815 warrants under the SVB Loan Agreement. The warrants expire seven years from their respective issue date. In February 2018, the Company terminated its relationship with a vendor who had been issued warrants to acquire 950,000 shares of Common Stock (the “Service Warrants”) with staggered vesting requirements. As part of the termination agreement, the Company accelerated the full vesting of the Service Warrants.

15. Purchase Agreement, Controlled Equity Offering and Public Offering of Common Stock

On April 28, 2017, the Company sold 24.9 million units, each consisting of one share of the Company’s Common Stock, a Series A warrant to purchase one share of Common Stock, and a Series B warrant to purchase 0.75 shares of

Common Stock, at a public offering price of $1.00 per unit for aggregate gross proceeds of $24.9 million in an underwritten firm commitment public offering. Net proceeds after issuance costs were $23.2 million, assuming no exercise of the warrants. The closing of the public offering occurred on May 3, 2017.

On December 16, 2016, the Company entered into a purchase agreement (the “LPC Purchase Agreement”) with Lincoln Park Capital Fund, LLC, (“Lincoln Park”), pursuant to which the Company had the right to sell to Lincoln Park up to an aggregate of $25.0 million in shares of the Company’s Common Stock, subject to certain limitations and conditions set forth in the LPC Purchase Agreement. The Company issued to Lincoln Park 345,421 shares of Common Stock as commitment shares in consideration for the LPC Purchase Agreement through April 27, 2017. Sales under the LPC Purchase Agreement for the year ended December 31, 2016 were 300,000 shares, with gross proceeds of $412,500 and net proceeds of $392,500. Sales under the LPC Purchase Agreement for the year ended December 31, 2017 were 3,972,741 shares, with gross and net proceeds of $5,304,000. Effective April 27, 2017, the Company terminated the LPC Purchase Agreement. The LPC Purchase Agreement provided the Company with an election to terminate the Purchase Agreement for any reason or for no reason by delivering a notice to Lincoln Park, and the Company did not incur any early termination penalties in connection with the termination of the LPC Purchase Agreement.

On August 31, 2017, the Company entered into an At-the-Market Equity Offering Sales Agreement (the “2017 Sales Agreement”) with Stifel, Nicolaus & Company, Incorporated (“Stifel”), as sales agent, pursuant to which the Company can sell through Stifel, from time to time, up to $50.0 million in shares of Common Stock in an at-the-market offering. The Company pays Stifel a commission of approximately 3% of the aggregate gross proceeds received from all sales of common stock under the 2017 Sales Agreement. Unless otherwise terminated earlier, the 2017 Sales Agreement continues until all shares available under the Sales Agreement have been sold.

The following table summarizes the total sales under the 2017 Sales Agreement for the periods indicated (in thousands, except per share amounts):

	2017 Sales Agreement Year Ended December 31, 2017
Total shares of common stock sold	15,998.5
Average price per share	$ 3.13
Gross proceeds	$ 50,000
Commissions earned by Stifel	$ 1,500
Other issuance costs	$ 97

16. Basic and Diluted Net Loss per Share

Basic net loss per common share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net loss per common share is computed giving effect to all dilutive potential common shares that were outstanding during the period. Diluted potential common shares consist of incremental shares issuable upon exercise of stock options, warrants and restricted stock units. In computing diluted net loss per share for the nine months ended September 30, 2018 and 2017, no adjustment has been made to the weighted average outstanding common shares as the assumed exercise of outstanding options, warrants and restricted stock units would be anti-dilutive.

17. Related Person Transactions

On September 18, 2015, TransEnterix Italia entered into a services agreement for receipt of administrative services from Sofar and payment of rent to Sofar, a stockholder that owned approximately 9% and 12% of the Company’s Common Stock at September 30, 2018 and 2017, respectively. Expenses for administrative services were approximately $0 and $52,000 for the nine months ended September 30, 2018 and 2017, respectively. The services agreement terminated in 2017.

As discussed in Note 3, in September 2015, the Company completed the Senhance Acquisition using a combination of cash, stock and potential post-acquisition milestone payments. On December 30, 2016, the Company entered into an Amendment to the Senhance Acquisition purchase agreement with Sofar to restructure the terms of the Second Tranche of the Cash Consideration. Under the Amendment, the Second Tranche was restructured to reduce the contingent cash consideration by €5.0 million in exchange for the issuance of 3,722,685 shares of the Company's Common Stock with an aggregate fair market value of €5.0 million. On January 4, 2017, the Company issued to Sofar 3,722,685 shares of the Common Stock with a fair value of €5.0 million. The price per share was $1.404 and was calculated based on the average of the closing prices of the Company's Common Stock on ten consecutive trading days ending one day before the execution of the Amendment.

In March 2018, TransEnterix Europe entered into a Service Supply Agreement with 1Med S.A. for certain regulatory consulting services. Andrea Biffi, a current member of the Company's Board of Directors, owns a non-controlling interest in 1Med S.A. Expenses under the Service Supply Agreement were approximately $62,000 for the nine months ended September 30, 2018.

18. Commitments and Contingencies

Contingent Consideration

As discussed in Note 3, in September 2015, the Company completed the Senhance Acquisition using a combination of cash, stock and potential post-acquisition milestone payments. These milestone payments may be payable in the future, depending on the achievement of certain regulatory and commercial milestones. On December 30, 2016, the Company entered into an Amendment to restructure the terms of the Second Tranche of the Cash Consideration. Under the Amendment, the Second Tranche was restructured to reduce the contingent cash consideration by €5.0 million in exchange for the issuance of 3,722,685 shares of the Company's Common Stock with an aggregate fair market value of €5.0 million. As of December 31, 2017, the fair value of the contingent consideration was $12.4 million. On September 30, 2018, the fair value of the contingent consideration was $12.1 million.

Legal Proceedings

No liability or related charge was recorded to earnings in the Company’s consolidated financial statements for legal contingencies for the nine months ended September 30, 2018 or the year ended December 31, 2017, as all pending litigation, including two putative derivative claims, was dismissed in 2017 with prejudice in the Company's favor.

19. Subsequent Events

On September 23, 2018, the Company entered into an Asset Purchase Agreement (the “MST Purchase Agreement”) with MST Medical Surgery Technologies Ltd., an Israeli private company (the “Seller”), and two of the Company’s wholly owned subsidiaries, as purchasers of the assets of the Seller, including the intellectual property assets (collectively, the “Buyers”). The closing of the transactions contemplated by the MST Purchase Agreement occurred on October 31, 2018, pursuant to which the Company acquired the Seller’s assets consisting of intellectual property and tangible assets related to surgical analytics with its core image analytics technology designed to empower and automate the surgical environment, with a focus on medical robotics and computer-assisted surgery. The core technology acquired under the MST Purchase Agreement is a software-based image analytics information platform powered by advanced visualization, scene recognition, artificial intelligence, machine learning and data analytics.

Under the terms of the MST Purchase Agreement, at the closing the Buyers purchased substantially all of the assets of the Seller. The acquisition price consisted of two tranches. At or prior to the closing of the transaction the Buyers paid $5.8 million in cash and the Company issued 3.15 million shares of the Company’s common stock. A second tranche of $6.6 million in additional consideration will be payable in cash, stock or cash and stock, at the discretion of the Company, within one year after the closing date.

The MST Purchase Agreement contains customary representations and warranties of the parties and the parties have customary indemnification obligations, which are subject to certain limitations described further in the MST Purchase Agreement.

On October 23, 2018, Hercules funded the Second Tranche of $10,000,000 under the Hercules Loan Agreement. The Second Tranche funding remains subject to all terms and conditions under the Hercules Loan Agreement.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes to our consolidated financial statements included in this report. The following discussion contains forward-looking statements. See cautionary note regarding "Forward-Looking Statements" at the beginning of this report.

Overview

TransEnterix is a medical device company that is digitizing the interface between the surgeon and the patient to improve minimally invasive surgery by addressing the clinical and economic challenges associated with current laparoscopic and robotic options in today's value-based healthcare environment. The Company is focused on the commercialization of the Senhance™ System, which digitizes laparoscopic minimally invasive surgery. The Senhance System allows for robotic precision, haptic feedback, surgeon camera control via eye sensing and improved ergonomics while offering responsible economics.

The Senhance System has been granted a CE Mark in Europe for laparoscopic abdominal and pelvic surgery, as well as limited thoracic operations excluding cardiac and vascular surgery. In April 2017, the Company submitted a 510(k) application to the FDA for the Senhance System. On October 13, 2017, the Company received 510(k) clearance from the FDA for use in laparoscopic colorectal and gynecologic surgery. These indications cover 23 procedures, including benign and oncologic procedures. In May 2018, the Company received 510(k) clearance from the FDA expanding the indications for use in laparoscopic inguinal hernia and laparoscopic cholecystectomy (gallbladder removal) surgery. The Senhance System is available for sale in the U.S., the EU and select other countries.

The Senhance System is a multi-port robotic surgery system which allows multiple robotic arms to control instruments and a camera. The system features advanced technology to enable surgeons with haptic feedback and the ability to move the camera via eye movement. The system replicates laparoscopic motion that is familiar to experienced surgeons, and integrates three-dimensional high definition vision technology. The Senhance System also offers responsible economics to hospitals by offering robotic technology with reusable instruments thereby reducing additional costs per surgery when compared to other robotic solutions.

The Company has also developed the SurgiBot System, a single-port, robotically enhanced laparoscopic surgical platform. On December 18, 2017, the Company announced that it had entered into an agreement with GBIL to advance the SurgiBot System towards global commercialization. The agreement transfers ownership of the SurgiBot System assets, while the Company retains the option to distribute or co-distribute the SurgiBot System outside of China. GBIL intends to have the SurgiBot System manufactured in China and obtain Chinese regulatory clearance from the CFDA while entering into a nationwide distribution agreement with CSIMC for the Chinese market. The agreement provides the Company with proceeds of at least $29 million, of which $7.5 million was received in December 2017 and an additional $7.5 million including a $3.0 million equity investment at $2.33 per share of common stock, was received at the second closing in March 2018. The remaining $14.0 million, representing minimum royalties, will be paid beginning at the earlier of receipt of Chinese regulatory approval or five years after the second closing.

We believe that future outcomes of minimally invasive surgery will be enhanced through our combination of more advanced tools and robotic functionality, which are designed to: (i) empower surgeons with improved precision, dexterity and visualization; (ii) improve patient satisfaction and enable a desirable post-operative recovery; and (iii) provide a cost-effective robotic system, compared to existing alternatives today, for a wide range of clinical applications. Our strategy is to focus on the commercialization and further development of the Senhance System.

From our inception, we devoted a substantial percentage of our resources to research and development and start-up activities, consisting primarily of product design and development, clinical studies, manufacturing, recruiting qualified personnel and raising capital.

Since inception, we have been unprofitable. As of September 30, 2018, we had an accumulated deficit of $503.0 million.

We expect to continue to invest in research and development and sales and marketing and increase selling, general and administrative expenses as we grow. As a result, we will need to generate significant revenue in order to achieve profitability.

Debt Refinancing

On May 23, 2018, the Company and its domestic subsidiaries, as co-borrowers, entered into a Loan and Security Agreement (the "Hercules Loan Agreement") with several banks and other financial institutions or entities from time to time party to the Hercules Loan Agreement (collectively, the "Lender") and Hercules Capital, Inc., as administrative agent and collateral agent (the "Agent"). Under the Hercules Loan Agreement, the Lender has agreed to make certain term loans to the Company in the aggregate principal amount of up to $40,000,000, with funding of the first $20,000,000 tranche occurring on May 23, 2018 (the "Initial Funding Date"). The Company will be eligible to draw on the second tranche of $10,000,000 upon achievement of certain Senhance System revenue-related milestones for its 2018 fiscal year, and a third tranche of $10,000,000 upon achievement of designated trailing six month GAAP net revenue from Senhance System sales. The Company is entitled to make interest-only payments until December 1, 2020, and at the end the interest-only period, the Company will be required to repay the term loans over an eighteen-month period based on an eighteen-month amortization schedule, with a final maturity date of June 1, 2022. The term loans will be required to be repaid if the term loans are accelerated following an event of default. The Company is in compliance with its debt covenants under the Hercules Loan Agreement as of September 30, 2018.

The term loans bear interest at a rate equal to the greater of (i) 9.55% per annum (the "Fixed Rate") and (ii) the Fixed Rate plus the prime rate (as reported in The Wall Street Journal) minus 5.00%. Following the draw of the third tranche, the Fixed Rate will be reduced to 9.20% effective on the first interest payment date to occur during the first fiscal quarter following the draw of the third tranche. On the Initial Funding Date, the Company was obligated to pay a facility fee $400,000. In addition, the Company is permitted to prepay the term loans in full at any time, with a prepayment fee of 3.0% of the outstanding principal amount of loan in the first year after the Initial Funding Date, 2.0% if the prepayment occurs in the second year after the Initial Funding Date and 1.0% thereafter. Upon prepayment of the term loans in full or repayment of the terms loans at the maturity date or upon acceleration, the Company is required to pay a final fee of 6.95% of the aggregate principal amount of term loans funded.

The Company's obligations under the Hercules Loan Agreement are to be guaranteed by all current and future material foreign subsidiaries of the Company and are secured by a security interest in all of the assets of the Company and their current and future domestic subsidiaries and all of the assets of their current and future material foreign subsidiaries, including a security interest in the intellectual property. The Hercules Loan Agreement contains customary representations and covenants that, subject to exceptions, restrict the Company's and its subsidiaries' ability to do the following, among things: declare dividends or redeem or repurchase equity interests; incur additional indebtedness and liens; make loans and investments; engage in mergers, acquisitions, and asset sales; transact with affiliates; undergo a change in control; add or change business locations; and engage in businesses that are not related to its existing business. Under the terms of the Hercules Loan Agreement, the Company is required to maintain cash and/or investment property in accounts which perfect the Agent's first priority security interest in such accounts in an amount equal to the lesser of (i) (x) 120% of the then-outstanding principal balance of the term loans, including accrued interest and any other fees payable under the agreement to the extent accrued and payable plus (y) an amount equal to the then-outstanding accounts payable of the Company on a consolidated basis that are more than 90 days past due and (ii) 80% of the aggregate cash of the Company and its consolidated subsidiaries. The Agent is granted the option to invest up to $2,000,000 in any future equity offering broadly marketed by the Company to investors on the same terms as the offering to other investors.

In connection with its entrance into the Hercules Loan Agreement, the Company repaid its existing credit facility with Innovatus Life Sciences Lending Fund I, LP ("Innovatus") entered into on May 10, 2017, which loan and security agreement is referred to as the Innovatus Loan Agreement (the "Innovatus Loan Agreement").

Under the Innovatus Loan Agreement, the Lender has agreed to make certain term loans in the aggregate principal amount of up to $17,000,000. Funding of the first $14,000,000 tranche occurred on May 10, 2017.

The Innovatus Loan Agreement allowed for interest-only payments for up to twenty-four months at a fixed rate equal to 11% per annum, of which 2.5% could be paid in-kind and added to the outstanding principal amount of the term loans until the earlier of (i) the first anniversary following the funding date and (ii) the Company’s failure to achieve an Interest-Only Milestone. At the end of the interest-only period, the Company would have been required to repay the term loans over a two-year period, based on a twenty-four (24) month amortization schedule, with a final maturity date of May 10, 2021.

In connection with the funding, the Company paid a facility fee of $170,000 on the date of funding of the first tranche. In addition, the Company issued warrants to the Lender to purchase shares of the Company’s common stock. Additional warrants will be issued on the funding date of each subsequent tranche and will expire five (5) years from such issue date. The warrants issued in connection with funding of the first tranche entitle the Lender to purchase up to 1,244,746 shares of the Company’s common stock at an exercise price of $1.00 per share.

In connection with its entrance into the Innovatus Loan Agreement, the Company repaid its then-existing credit facility with Silicon Valley Bank and Oxford Finance LLC under the SVB Loan Agreement.

Public Offering of Units

On April 28, 2017, we entered into an underwriting agreement with Stifel, Nicolaus & Company, Incorporated, or the Underwriter, relating to an underwritten public offering of an aggregate of 24,900,000 Units, each consisting of one share of the Company’s Common Stock, a Series A Warrant to purchase one share of Common Stock and a Series B Warrant to purchase 0.75 shares of Common Stock at an offering price to the public of $1.00 per Unit. Certain of the Company’s officers, directors and existing stockholders purchased approximately $2.5 million of Units in the public offering. The closing of the public offering occurred on May 3, 2017.

Each Series A Warrant had an initial exercise price of $1.00 per share and was able to be exercised at any time beginning on the date of issuance, and from time to time thereafter, through and including the first anniversary of the issuance date, unless terminated earlier as provided in the Series A Warrant. Receipt of 510(k) clearance for the Senhance System on October 13, 2017, triggered the acceleration of the expiration date of the Series A Warrants to October 31, 2017. As of December 31, 2017, all of the Series A Warrants had been exercised.

Each Series B Warrant has an initial exercise price of $1.00 per share and may be exercised at any time beginning on the date of issuance and from time to time thereafter through and including the fifth anniversary of the issuance date, or by May 3, 2022. As of September 30, 2018, Series B Warrants representing approximately 15.8 million shares had been exercised.

The exercise prices and the number of shares issuable upon exercise of the outstanding Series B Warrants are subject to adjustment upon the occurrence of certain events, including, but not limited to, stock splits or dividends, business combinations, sale of assets, similar recapitalization transactions, or other similar transactions. The Series B Warrants are subject to adjustment in the event that the Company issues or is deemed to issue shares of common stock for less than the then applicable exercise price of the Series B Warrants. The exercisability of the Series B Warrants may be limited if, upon exercise, the holder or any of its affiliates would beneficially own more than 4.99% of our common stock. If, at any time Series B Warrants are outstanding, any fundamental transaction occurs, as described in the Series B Warrants and generally including any consolidation or merger into another corporation, the consummation of a transaction whereby another entity acquires more than 50% of the Company’s outstanding voting stock, or the sale of all or substantially all of its assets, the successor entity must assume in writing all of the obligations to the Series B Warrant holders. Additionally, in the event of a fundamental transaction, each Series B Warrant holder will have the right to require the Company, or its successor, to repurchase the Series B Warrants for an amount of cash equal to the Black-Scholes value of the remaining unexercised portion of such Series B Warrants.

The underwriting agreement contains customary representations, warranties and agreements by the Company, customary conditions to closing, indemnification obligations of the Company and the Underwriters, including for liabilities under the Securities Act of 1933, as amended, other obligations of the parties and termination provisions. The representations, warranties and covenants contained in the underwriting agreement were made only for purposes of such agreement and as of specific dates, were solely for the benefit of the parties to such agreement, and may be subject to limitations agreed upon by the contracting parties.

The net proceeds to the Company from the offering were approximately $23.2 million, prior to any exercise of the Series A Warrants or Series B Warrants, after deducting underwriting discounts and commissions and estimated offering expenses paid by the Company. The net proceeds to the Company from the exercise of all of the Series A Warrants and the Series B Warrants exercised prior to September 30, 2018 were approximately $37.4 million.

The Units were issued pursuant to a prospectus supplement dated April 28, 2017 and an accompanying base prospectus dated June 22, 2016 that form a part of the registration statement on Form S-3 that the Company filed with the SEC on November 7, 2014 and was declared effective on December 19, 2014 (File No. 333-199998), and post-effectively amended pursuant to Post-Effective Amendment No. 1 on Form S-3, as filed with the SEC on March 8, 2016 and declared effective on June 22, 2016 and a related registration statement filed pursuant to Rule 462(b) promulgated under the Securities Act of 1933.

On December 15, 2017, we filed a registration statement on Form S-3 (File No. 333-222103) to register shares of common stock underlying outstanding Series B Warrants previously issued as part of the Company's May 3, 2017 public offering. The new registration statement replaced the registration statement on Form S-3 that expired on December 19, 2017 with respect to these securities. On January 26, 2018, we filed an Amendment No. 1 to such registration statement on Form S-3 to update the information, in the registration statement. The registration statement covers up to 9,579,884 shares of common stock underlying the outstanding Series B Warrants. This registration statement on Form S-3 was declared effective on January 29, 2018.

Lincoln Park Purchase Agreement

On December 16, 2016, we entered into a purchase agreement, or the LPC Purchase Agreement, with Lincoln Park Capital Fund, LLC, an Illinois limited liability company, or Lincoln Park, pursuant to which we had the right to sell to Lincoln Park up to an aggregate of $25,000,000 in shares of our common stock, subject to certain limitations and conditions set forth in the LPC Purchase Agreement. Effective April 27, 2017, we terminated the LPC Purchase Agreement. The LPC Purchase Agreement provided us with an election to terminate the Purchase Agreement for any reason or for no reason by delivering a notice to Lincoln Park, and we did not incur any early termination penalties in connection with the termination of the LPC Purchase Agreement. Prior to termination, we sold shares of our common stock to Lincoln Park under the LPC Purchase Agreement for gross proceeds of approximately $5.7 million.

At-the-Market Offerings

On February 9, 2016, we entered into a Controlled Equity Offering SM Sales Agreement, or the 2016 Sales Agreement, with Cantor Fitzgerald & Co., or Cantor, under which we could offer and sell, through Cantor, up to approximately $43.6 million in shares of common stock in an at-the market offering, or the 2016 ATM Offering. The 2016 Sales Agreement was terminated, effective September 10, 2017. We paid Cantor a commission of approximately 3% of the aggregate gross proceeds received from all sales of common stock under the 2016 Sales Agreement.

On August 31, 2017, we entered into an At-the-Market Equity Offering Sales Agreement, or the 2017 Sales Agreement, with Stifel, Nicolaus & Company, Incorporated, or Stifel, under which we could offer and sell, through Stifel, up to approximately $50.0 million in shares of common stock in an at-the-market offering, or the 2017 ATM Offering. All sales of shares were made pursuant to an effective shelf registration statement on Form S-3 filed with the SEC. We paid Stifel a commission of approximately 3% of the aggregate gross proceeds received from all sales of common stock under the 2017 Sales Agreement. As of October 31, 2017, the 2017 ATM Offering was completed.

The following table summarizes the total sales under the 2016 Sales Agreement and 2017 Sales Agreement for the periods indicated (in thousands, except per share amounts):

	2017 Sales Agreement Year Ended December 31, 2017	2016 Sales Agreement Year Ended December 31, 2016
Total shares of common stock sold	15,998.5	8,763.4
Average price per share	$ 3.13	$ 4.70
Gross proceeds	$ 50,000	$ 41,156
Commissions earned by Stifel or Cantor	$ 1,500	$ 1,235
Other issuance costs	$ 97	$ 185

Senhance Acquisition and Related Transactions

Membership Interest Purchase Agreement and Amendment

On September 21, 2015, the Company announced that it had entered into a Membership Interest Purchase Agreement, dated September 18, 2015 with Sofar S.p.A., as the Seller, Vulcanos S.r.l., as the acquired company, and TransEnterix International, Inc., a wholly owned subsidiary of the Company as the Buyer. The closing of the transactions contemplated by the Purchase Agreement occurred on September 21, 2015. The Buyer acquired all of the membership interests of the acquired company from the Seller, and changed the name of the acquired company to TransEnterix Italia S.r.l. On the closing date, pursuant to the Purchase Agreement, the Company completed the strategic acquisition from Sofar S.p.A. of all of the assets, employees and contracts related to the advanced robotic system for minimally invasive laparoscopic surgery now known as the Senhance System, or the Senhance Acquisition.

Under the terms of the Purchase Agreement, the consideration consisted of the issuance of 15,543,413 shares of the Company's common stock, or the Securities Consideration, and approximately $25,000,000 U.S. Dollars and €27,500,000 Euro in cash consideration, or the Cash Consideration. The Securities Consideration was issued in full at closing of the acquisition; the Cash Consideration was or will be paid in four tranches, with US $25,000,000 paid at closing and the remaining Cash Consideration of €27,500,000 to be paid in three additional tranches based on achievement of negotiated milestones. On December 30, 2016, the Company and Sofar entered into an Amendment to the Purchase Agreement to restructure the terms of the second tranche of the Cash Consideration. Under the Amendment, the second tranche was restructured to reduce the contingent cash consideration by €5.0 million in exchange for the issuance of 3,722,685 shares of the Company's common stock with an aggregate fair market value of €5.0 million, which were issued on January 4, 2017. The price per share was $1.404 and was calculated based on the average of the closing prices of the Company's common stock on ten consecutive trading days ending one day before the execution of the Amendment.

The issuance of the initial Securities Consideration was effected as a private placement of securities under Section 4(a)(2) of the Securities Act, and Regulation D promulgated thereunder. The issuance of the additional shares in January 2017 was made under an existing shelf registration statement on Form S-3.

As of September 30, 2018, the Company has paid all Cash Consideration due under the second tranche.

The Purchase Agreement contains customary representations and warranties of the parties and the parties have customary indemnification obligations, which are subject to certain limitations described further in the Purchase Agreement.

Registration Rights

In connection with the Senhance Acquisition, we also entered into a Registration Rights Agreement, dated as of September 21, 2015, with the Seller, pursuant to which we agreed to register the Securities Consideration shares for resale following the end of the lock-up periods described below. The resale Registration Statement has been filed and is effective.

Results of Operations

Revenue

Our revenue consisted of product revenue resulting from the sale of Senhance Systems in Europe, Asia and U.S., and related instruments, accessories and services for systems sold in the current and prior periods.

We expect to experience some unevenness in the number and trend, and average selling price, of units sold on a quarterly basis given the early stage of commercialization of our products.

Product and service revenue for the three months ended September 30, 2018 increased to $5.4 million compared to $0.2 million for the three months ended September 30, 2017. The $5.2 million increase was the result of the revenue recognized on the sale of four Senhance Systems.

Product and service revenue for the nine months ended September 30, 2018 increased to $16.6 million compared to $3.7 for the nine months ended September 30, 2017. The $12.9 million increase was primarily the result of the revenue recognized on the sale of ten Senhance Systems.

Cost of Revenue

Cost of revenue consists primarily of costs related to contract manufacturing, materials, and manufacturing overhead. We expense all inventory provisions as cost of revenue. The manufacturing overhead costs include the cost of quality assurance, material procurement, inventory control, facilities, equipment depreciation and operations supervision and management. We expect overhead costs as a percentage of revenues to become less significant as our production volume increases. We expect cost of revenue to increase in absolute dollars to the extent our revenues grow and as we continue to invest in our operational infrastructure to support anticipated growth.

Cost of revenue for the three months ended September 30, 2018 increased to $4.2 million as compared to $0.9 million for the three months ended September 30, 2017. This increase over the prior year period was the result of increased sales and costs for manufacturing overhead and field service.

Cost of revenue for the nine months ended September 30, 2018 increased to $10.5 million as compared to $3.2 million for the nine months ended September 30, 2017. This increase over the prior year period was the result of increased sales and costs for manufacturing overhead and field service.

Research and Development

Research and development, or R&D expenses primarily consist of engineering, product development and regulatory expenses incurred in the design, development, testing and enhancement of our products and legal services associated with our efforts to obtain and maintain broad protection for the intellectual property related to our products. In future periods, we expect R&D expenses to increase moderately as we continue to invest in new products and solutions to be offered with the Senhance System. R&D expenses are expensed as incurred.

R&D expenses for the three months ended September 30, 2018 decreased 2% to $4.8 million as compared to $4.9 million for the three months ended September 30, 2017. The $0.1 million decrease resulted primarily from decreased miscellaneous costs of $0.5 million offset by increased personnel related costs of $0.4 million.

R&D expenses for the nine months ended September 30, 2018 decreased 8% to $15.4 million as compared to $16.8 million for the nine months ended September 30, 2017. The $1.4 million decrease resulted primarily from decreased preclinical lab expense of $0.5 million, decreased miscellaneous costs of $0.4 million, decreased depreciation and equipment maintenance of $0.3 million, decreased contract engineering services, consulting and other outside services of $0.2 million, and decreased supplies expense of $0.1 million, offset by increased personnel costs of $0.1 million. The decreases primarily relate to costs incurred in the prior-year period relating to the FDA 510(k) submission of the Senhance System.

Sales and Marketing

Sales and marketing expenses include costs for sales and marketing personnel, travel, demonstration product, market development, physician training, tradeshows, marketing clinical studies and consulting expenses. We expect sales and marketing expenses to increase significantly in support of our Senhance System commercialization.

Sales and marketing expenses for the three months ended September 30, 2018 increased 29% to $5.8 million compared to $4.5 million for the three months ended September 30, 2017. The $1.3 million increase was primarily related to increased personnel related costs of $0.5 million, increased consulting and outside service costs of $0.3 million, increased other costs of $0.3 million and increased demonstration and supplies expense of $0.2 million as we increased our U.S. sales and marketing team following receipt of 510(k) clearance for the Senhance System.

Sales and marketing expenses for the nine months ended September 30, 2018 increased 48% to $17.8 million compared to $12.0 million for the nine months ended September 30, 2017. The $5.8 million increase was primarily related to increased personnel related costs of $3.8 million, increased consulting and outside service costs of $1.1 million, increased other costs of $0.5 million and increased depreciation expense of $0.4 million as we increased our U.S. sales and marketing team following receipt of 510(k) clearance for the Senhance System.

General and Administrative

General and administrative expenses consist of personnel costs related to the executive, finance and human resource functions, as well as professional service fees, legal fees, accounting fees, insurance costs, and general corporate expenses. In future periods, we expect general and administrative expenses to increase to support our sales, marketing, and research and development efforts.

General and administrative expenses for the three months ended September 30, 2018 increased 28% to $3.7 million compared to $2.9 million for the three months ended September 30, 2017. The $0.8 million increase was primarily due to increased personnel costs of $0.4 million and increased outsourced services expense of $0.4 million. The increase primarily relates to increased support of sales, marketing, and research and development efforts as we shift to commercialization.

General and administrative expenses for the nine months ended September 30, 2018 increased 15% to $10.0 million compared to $8.7 million for the nine months ended September 30, 2017. The $1.3 million increase was primarily due to increased personnel costs of $0.9 million and increased outsourced services expense of $0.4 million. The increase primarily relates to increased support of sales, marketing, and research and development efforts as we shift to commercialization.

Gain from Sale of SurgiBot Assets, Net

The gain from the sale of SurgiBot assets, net to GBIL was $11.9 million for the nine months ended September 30, 2018.

Amortization of Intangible Assets

Amortization of intangible assets for the three months ended September 30, 2018 increased to $2.7 million compared to $1.8 million for the three months ended September 30, 2017. The $0.9 million increase was primarily the result of the amortization of in-process research and development transferred to intellectual property in October 2017.

Amortization of intangible assets for the nine months ended September 30, 2018 increased to $8.2 million compared to $5.1 million for the nine months ended September 30, 2017. The $3.1 million increase was primarily the result of the amortization of in-process research and development transferred to intellectual property in October 2017.

Change in Fair Value of Contingent Consideration

The change in fair value of contingent consideration in connection with the Senhance Acquisition was $(1.4) million for the three months ended September 30, 2018 compared to $0.8 million for the three months ended September 30, 2017. The $2.2 million decrease was primarily related to the effect of a change in the estimated discount rate, the change in the passage of time on the fair value measurement, and the impact of foreign currency exchange rates.

The change in fair value of contingent consideration in connection with the Senhance Acquisition was $0.1 million for the nine months ended September 30, 2018 compared to $1.2 million for the nine months ended September 30, 2017. The $1.1 million decrease was primarily related to the effect of a change in the estimated discount rate, the change in the passage of time on the fair value measurement, and the impact of foreign currency exchange rates.

Acquisition Related Costs

Acquisition related costs of $0.3 million for the three and nine months ended September 30, 2018, were incurred in connection with the MST Purchase Agreement.

Reversal of Transfer Fee Accrual

In connection with the Senhance acquisition, the Company recorded an accrual of $3.0 million in the 2015 third quarter for the potential assessment of additional transfer fees. In September 2018, the Company determined that the accrual was no longer required and reversed the accrual.

Change in Fair Value of Warrant Liabilities

The change in fair value of Series A Warrants and Series B Warrants issued in April 2017 was $8.8 million for the three months ended September 30, 2018 compared to $22.9 million for the three months ended September 30, 2017. The $14.1 million decrease for the three months ended September 30, 2018 includes remeasurement associated with the warrants exercised during the quarter ended September 30, 2018 and the outstanding warrants at September 30, 2018. The remeasurement related to the warrants exercised was primarily the result of the difference in the stock price at the date of exercise and June 30, 2018. The expense related to the warrants outstanding at September 30, 2018 was primarily the result of the difference between the stock price at September 30, 2018 and at June 30, 2018.

The change in fair value of Series A Warrants and Series B Warrants issued in April 2017 was $24.4 million for the nine months ended September 30, 2018 compared to $25.2 million for the nine months ended September 30, 2017. The $0.8 million decrease for the nine months ended September 30, 2018 includes remeasurement associated with the warrants exercised during the nine months ended September 30, 2018 and the outstanding warrants at September 30, 2018. The remeasurement related to the warrants exercised was primarily the result of the difference in the stock price at the date of exercise and December 31, 2017. The expense related to the warrants outstanding at September 30, 2018 was primarily the result of the difference between the stock price at September 30, 2018 and at December 31, 2017.

Interest Income

Interest income for the three months ended September 30, 2018 increased to $0.4 million compared to $0.1 million for the three months ended September 30, 2017. The $0.3 million increase was primarily related to the increase in funds available for investment, and the related interest rates on short term investments.

Interest income for the nine months ended September 30, 2018 increased to $1.0 million compared to $0.1 million for the nine months ended September 30, 2017. The $0.9 million increase was primarily related to the increase in funds available for investment, and the related interest rates on short term investments.

Interest Expense

Interest expense for the three months ended September 30, 2018 increased to $0.7 million compared to $0.6 million for the three months ended September 30, 2017. The $0.1 million increase was primarily related to the increased notes payable.

Interest expense for the nine months ended September 30, 2018 increased to $3.4 million compared to $1.6 million for the nine months ended September 30, 2017. The $1.8 million increase was primarily related to the $1.4 million loss on extinguishment of debt and the increase in notes payable.

Income Tax Benefit

Income tax benefit consists primarily of taxes related to the amortization of purchase accounting intangibles in connection with the Italian taxing jurisdiction for TransEnterix Italia as a result of the acquisition of the Senhance System. We recognized $0.8 million and $0.7 million of income tax benefit for the three months ended September 30, 2018 and 2017, respectively. We recognized $2.6 million and $2.3 million of income tax benefit for the nine months ended September 30, 2018 and 2017, respectively.

Liquidity and Capital Resources

Sources of Liquidity

Since our inception we have incurred significant losses and, as of September 30, 2018, we had an accumulated deficit of $503.0 million. We have not yet achieved profitability and we cannot assure investors that we will achieve profitability with our existing capital resources. As of September 30, 2018, the Company's cash and restricted cash balance and short-term investments were approximately $82.1 million. We believe that our existing cash and cash equivalents and short-term investments, together with cash received from sales of our products, will be sufficient to fund operations through at least the next 12 months. We expect to continue to fund sales and marketing, research and development and general and administrative expenses at similar to current or higher levels and, as a result, we will need to generate significant revenues to achieve profitability. Our principal sources of cash to date have been proceeds from public offerings of common stock, private placements of common and preferred stock, incurrence of debt and the sale of equity securities held as investments.

We currently have one effective shelf registration statement on file with the SEC, which registers up to $150.0 million of debt securities, common stock, preferred stock, or warrants, or any combination thereof for future financing transactions. The shelf registration statement was declared effective by the SEC on May 19, 2017. We have raised $50.0 million in gross proceeds and approximately $48.5 million in net proceeds under such shelf registration statement through the sale of all the shares available under the 2017 ATM Offering. As of September 30, 2018, we had $100.0 million available for future financings under such shelf registration statement.

Consolidated Cash Flow Data

	Nine Months Ended September 30,	
(in millions)	2018	2017
Net cash (used in) provided by		
Operating activities	$(35.6)	$(37.5)
Investing activities	(35.6)	(1.9)
Financing activities	16.1	36.0
Effect of exchange rate changes on cash and cash equivalents	(0.1)	(0.3)
Net decrease in cash, cash equivalents and restricted cash	$(55.2)	$(3.7)

Operating Activities

For the nine months ended September 30, 2018, cash used in operating activities of $35.6 million consisted of a net loss of $55.3 million and cash used for working capital of $6.1 million, offset by non-cash items of $25.8 million. The non-cash items primarily consisted of $24.4 million change in fair value of warrant liabilities, $8.8 million of amortization, $6.7 million of stock-based compensation expense, $1.9 million of depreciation, $1.4 million loss on debt extinguishment, and $0.1 million change in fair value of contingent consideration, offset by $11.9 million gain from sale of SurgiBot assets, $3.0 million recovery of transfer fee and $2.6 million deferred income tax benefit. The decrease in cash from changes in working capital included $1.3 million increase in inventories, $4.3 million increase in accounts receivable and $0.9 million decrease in accounts payable, offset by $0.4 million increase in deferred revenue.

Investing Activities

For the nine months ended September 30, 2018, net cash used in investing activities was $35.6 million. This amount primarily consists of $39.6 million purchase of short-term investments and $0.5 million purchases of property and equipment, offset by $4.5 million proceeds related to the sale of the SurgiBot assets.

Financing Activities

For the nine months ended September 30, 2018, net cash provided by financing activities was $16.1 million. This amount was primarily related to $18.8 million in proceeds from the issuance of debt, which was partially offset by $15.3 million in payment of debt, $11.4 million in proceeds from the exercise of stock options and warrants and $3.0 million received for shares issued related to the sale of the SurgiBot assets, offset by $1.6 million related to the taxes withheld on RSU awards and $0.4 million payment of contingent consideration.

Operating Capital and Capital Expenditure Requirements

We believe that our existing cash and cash equivalents and short-term investments, together with cash received from sales of our products, will be sufficient to meet our anticipated cash needs through at least the next 12 months. We intend to spend substantial amounts on commercial activities, on research and development activities, including product development, regulatory and compliance, clinical studies in support of our future product offerings, the enhancement and protection of our intellectual property, on notes payable payments as they come due, and on contingent consideration payments in connection with the acquisition of the Senhance System. We will need to obtain additional financing to pursue our business strategy, to respond to new competitive pressures or to take advantage of opportunities that may arise. To meet our capital needs, we are considering multiple alternatives, including, but not limited to, additional equity financings, debt financings, strategic collaborations and other funding transactions. There can be no assurance that we will be able to complete any such transaction on acceptable terms or otherwise. If we are unable to obtain the necessary capital, we will need to pursue a plan to license or sell our assets, seek to be acquired by another entity, cease operations and/or seek bankruptcy protection.

Cash and cash equivalents held by our foreign subsidiaries totaled $3.3 million at September 30, 2018, including restricted cash. We do not intend or currently foresee a need to repatriate cash and cash equivalents held by our foreign subsidiaries. If these funds are needed in the U.S., we believe that the potential U.S. tax impact to repatriate these funds would be immaterial.

Hercules Loan Agreement

On May 23, 2018, the Company and its domestic subsidiaries, as co-borrowers, entered into a Loan and Security Agreement with several banks and other financial institutions or entities from time to time party to the Loan Agreement and Hercules Capital, Inc., as administrative agent and collateral agent. Please see the description of the Hercules Loan Agreement above in this "Management's Discussion and Analysis of Financial Condition and Results of Operations Debt Refinancing."

Innovatus Loan Agreement

On May 10, 2017, the Company and its domestic subsidiaries, as co-borrowers, entered into the Innovatus Loan Agreement with Innovatus Life Sciences Lending Fund I, LP, as Lender and Collateral Agent. Please see the description of the Innovatus Loan Agreement above in this "Management's Discussion and Analysis of Financial Condition and Results of Operations Debt Refinancing."

In connection with the entry into the Hercules Loan Agreement, the proceeds of which were used to repay the Innovatus Loan, we were obligated to pay final payment and prepayment fees under the Innovatus Loan Agreement. The final payment fee obligation was $1.0 million and was paid during the nine months ended September 30, 2018.

Off-Balance Sheet Arrangements

As of September 30, 2018, the Company did not have any off-balance sheet arrangements.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations set forth above under the headings "Results of Operations" and "Liquidity and Capital Resources" have been prepared in accordance with U.S. GAAP and should be read in conjunction with our financial statements and notes thereto appearing in this Form 10-Q and in the Fiscal 2017 Form 10-K. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our critical accounting policies and estimates, including identifiable intangible assets and goodwill, contingent consideration, warrant liabilities, stock-based compensation, inventory, and revenue recognition. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. A more detailed discussion on the application of these and other accounting policies can be found in Note 2 in the Notes to the Financial Statements in this Form 10-Q. Actual results may differ from these estimates under different assumptions and conditions.

While all accounting policies impact the financial statements, certain policies may be viewed as critical. Critical accounting policies are those that are both most important to the portrayal of financial condition and results of operations and that require management's most subjective or complex judgments and estimates. Our management believes the policies that fall within this category are the policies on accounting for identifiable intangible assets and goodwill, contingent consideration, warrants liabilities, stock-based compensation, inventory and revenue recognition.

Identifiable Intangible Assets and Goodwill

Identifiable intangible assets consist of purchased patent rights recorded at cost and developed technology acquired as part of a business acquisition recorded at estimated fair value. Intangible assets are amortized over 5 to 10 years. We periodically evaluate identifiable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Indefinite-lived intangible assets, such as goodwill, are not amortized. We test the carrying amounts of goodwill for recoverability on an annual basis or when events or changes in circumstances indicate evidence of potential impairment exists by performing either a qualitative evaluation or a quantitative test. The qualitative evaluation is an assessment of factors, including industry, market and general economic conditions, market value, and future projections to determine whether it is more likely than not that the fair value of a reporting unit is less than it's carrying amount, including goodwill.

As of December 31, 2017, we elected to bypass the qualitative assessment and calculated the fair value of our reporting unit, which exceeded the carrying amount. Accordingly, no charge for goodwill impairment was required as of December 31, 2017.

A significant amount of judgment is involved in determining if an indicator of goodwill impairment has occurred. Such indicators may include, among others: a significant decline in expected future cash flows; a sustained, significant decline in the Company's stock price and market capitalization; a significant adverse change in legal factors or in the business climate; adverse assessment or action by a regulator; and unanticipated competition. Key assumptions used in the annual goodwill impairment test are highly judgmental and include: selection of comparable companies and amount of control premium. Any change in these indicators or key assumptions could have a significant negative impact on the Company's financial condition, impact the goodwill impairment analysis or cause the Company to perform a goodwill impairment analysis more frequently than once per year.

Contingent Consideration

Contingent consideration is recorded as a liability and measured at fair value using a discounted cash flow model utilizing significant unobservable inputs including the probability of achieving each of the potential milestones and an estimated discount rate associated with the risks of the expected cash flows attributable to the various milestones. Significant increases or decreases in any of the probabilities of success or changes in expected timelines for achievement of any of these milestones would result in a significantly higher or lower fair value of these milestones, respectively, and commensurate changes to the associated liability. The fair value of the contingent consideration at each reporting date will be updated by reflecting the changes in fair value in our statements of operations and comprehensive loss.

Warrant Liabilities

For the Series B Warrants, the warrants are recorded as liabilities and are revalued at each reporting period. The change in fair value is recognized in the consolidated statements of operations and comprehensive loss. The selection of the appropriate valuation model and the inputs and assumptions that are required to determine the valuation requires significant judgment and requires management to make estimates and assumptions that affect the reported amount of the related liability and reported amounts of the change in fair value. Actual results could differ from those estimates, and changes in these estimates are recorded when known. As the warrant liability is required to be measured at fair value at each reporting date, it is reasonably possible that these estimates and assumptions could change in the near term.

Stock-Based Compensation

We recognize as expense, the grant-date fair value of stock options and other stock based compensation issued to employees and non-employee directors over the requisite service periods, which are typically the vesting periods. We use the Black-Scholes-Merton model to estimate the fair value of our stock-based payments. The volatility assumption used in the Black-Scholes-Merton model is based on the calculated historical volatility based on an analysis of reported data for a peer group of companies as well as the Company's historical volatility. The expected term of options granted by us has been determined based upon the simplified method, because we do not have sufficient historical information regarding our options to derive the expected term. Under this approach, the expected term is the mid-point between the weighted average of vesting period and the contractual term. The risk-free interest rate is based on U.S. Treasury rates whose term is consistent with the expected life of the stock options. We have not paid and do not anticipate paying cash dividends on our shares of common stock; therefore, the expected dividend yield is assumed to be zero. We estimate forfeitures based on our historical experience and adjust the estimated forfeiture rate based upon actual experience.

Inventory

Inventory, which includes material, labor and overhead costs, is stated at the lower of cost, determined on a first-in, first-out basis, or net realizable value. We record reserves, when necessary, to reduce the carrying value of inventory to its net realizable value. At the point of loss recognition, a new, lower-cost basis for that inventory is established, and any subsequent improvements in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

Revenue Recognition

Our revenue consists of product revenue resulting from the sale of systems, system components, instruments and accessories, and service revenue. We account for a contract with a customer when there is a legally enforceable contract between the Company and the customer, the rights of the parties are identified, the contract has commercial substance, and collectability of the contract consideration is probable. Our revenues are measured based on consideration specified in the contract with each customer, net of any sales incentives and taxes collected from customers that are remitted to government authorities.

Our system sale arrangements generally contain multiple products and services. For these bundled sale arrangements, we account for individual products and services as separate performance obligations if they are distinct, which is if a product or service is separately identifiable from other items in the bundled package, and if a customer can benefit from it on its own or with other resources that are readily available to the customer. Our system sale arrangements include a combination of the following performance obligations: system(s), system components, instruments, accessories, and system service. Our system sale arrangements generally include a five-year period of service. The first year of service is generally free and included in the system sale arrangement and the remaining four years are generally included at a stated service price. We consider the service terms in the arrangements that are legally enforceable to be performance obligations. Other than service, we generally satisfy all of the performance obligations up-front. System components, system accessories, instruments, accessories, and service are also sold on a standalone basis.

We recognize revenues as the performance obligations are satisfied by transferring control of the product or service to a customer. We generally recognize revenue for the performance obligations at the following points in time:

- System sales. For systems and system components sold directly to end customers, revenue is recognized when we transfer control to the customer, which is generally at the point when acceptance occurs that indicates customer acknowledgment of delivery or installation, depending on the terms of the arrangement. For systems sold through distributors, with the distributors responsible for installation, revenue is recognized generally at the time of shipment. Our system arrangements generally do not provide a right of return. The systems are generally covered by a one-year warranty. Warranty costs were not material for the periods presented.

35

- Instruments and accessories. Revenue from sales of instruments and accessories is recognized when control is transferred to the customers, which generally occur at the time of shipment, but also occur at the time of delivery depending on the customer arrangement. Accessory products include sterile drapes used to help ensure a sterile field during surgery, vision products such as replacement endoscopes, camera heads, light guides, and other items that facilitate use of the Senhance Surgical System.
- Service. Service revenue is recognized ratably over the term of the service period as the customers benefit from the service throughout the service period. Revenue related to services performed on a time-and-materials basis is recognized when performed.

For multiple-element arrangements, revenue is allocated to each performance obligation based on its relative standalone selling price. Standalone selling prices are based on observable prices at which we separately sell the products or services. Due to limited sales to date, standalone selling prices are not yet directly observable. We estimate the standalone selling price using the market assessment approach considering market conditions and entity-specific factors including, but not limited to, features and functionality of the products and services, geographies, type of customer, and market conditions. We regularly review standalone selling prices and update these estimates if necessary. Transaction price allocated to remaining performance obligations relates to amounts allocated to products and services for which the revenue has not yet been recognized. A significant portion of this amount relates to service obligations performed under our system sales contracts that will be invoiced and recognized as revenue in future periods.

We invoice our customers based on the billing schedules in our sales arrangements. Contract assets for the periods presented primarily represent the difference between the revenue that was recognized based on the relative selling price of the related performance obligations and the contractual billing terms in the arrangements. Deferred revenue for the periods presented was primarily related to service obligations, for which the service fees are billed up-front, generally annually. The associated deferred revenue is generally recognized ratably over the service period.

In connection with assets recognized from the costs to obtain a contract with a customer, we have determined that sales incentive programs for our sales team do not meet the requirements to be capitalized as we do not expect to generate future economic benefits from the related revenue from the initial sales transaction.

Recent Accounting Pronouncements

See "Note 2. Summary of Significant Accounting Policies" of the Notes to Consolidated Financial Statements in the Company's Fiscal 2017 Form 10-K, as well as the notes to the consolidated financial statements above in this Form 10-Q, for a full description of recent accounting pronouncements including the respective expected dates of adoption and effects on Consolidated Balance Sheets and Consolidated Statements of Operations and Comprehensive Loss.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

General

We have limited exposure to market risks from instruments that may impact the Balance Sheets, Statements of Operations and Comprehensive Loss, and Statements of Cash Flows. Such exposure is due primarily to changing interest rates and foreign currency exchange rates.

Interest Rates

The primary objective for our investment activities is to preserve principal while maximizing yields without significantly increasing risk. This is accomplished by investing excess cash in money market funds and Treasury securities. As of September 30, 2018, approximately 100% of the investment portfolio was in cash equivalents with very short term maturities and therefore not subject to any significant interest rate fluctuations.

Foreign Currency Exchange Rate Risk

We conduct operations in several different countries, including the U.S. and throughout Europe and Asia, and portions of our revenues, expenses, assets and liabilities are denominated in U.S. dollars, Euros or other currencies. Since our consolidated financial statements are presented in U.S. dollars, we must translate revenues, income and expenses, as well as assets and liabilities, into U.S. dollars at exchange rates in effect during or at the end of each reporting period. We have not historically hedged our exposure to foreign currency fluctuations. Accordingly, increases or decreases in the value of the U.S. dollar against the Euro and other currencies could materially affect our net operating revenues, operating income and the value of balance sheet items denominated in foreign currencies.

During the nine months ended September 30, 2018, 83% of our revenue and approximately 39% of our operating expenses, excluding the offsetting impact of the gain from sale of SurgiBot assets, were denominated in currencies other than the U.S. dollar, most notably the Euro. Based on actual results over the past year, a hypothetical 10% increase or decrease in the U.S. dollar against the Euro would have increased or decreased revenue by approximately \$1.4 million and operating expenses by approximately \$2.1 million.

ITEM 4. CONTROLS AND PROCEDURES
Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2018. We maintain disclosure controls and procedures that are designed to provide reasonable assurance that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow for timely decisions regarding required disclosure. Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2018, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Controls Over Financial Reporting

There were no changes in the Company’s internal control over financial reporting during the last quarter that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1 Legal Proceedings
None.

Item 1A Risk Factors.
Reference is made to the Risk Factors included in our Fiscal 2017 Form 10-K.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds.
The following table summarizes the Company’s purchases of its common stock for the quarter ended September 30, 2018:

	Issuer Purchases of Equity Securities			
Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs
July 1 - 31, 2018	360,371	$ 3.84	—	—
August 1 - 31, 2018	—	—	—	—
September 1 - 30, 2018	—	—	—	—
Total	360,371	$ 3.84	—	—

(1) These amounts consist of 360,371 shares we acquired from employees associated with the withholding of shares to pay certain withholding taxes upon the vesting of stock-based compensation in accordance with the terms of our equity compensation plan that were previously approved by our stockholders and disclosed in our proxy statements. We purchased these shares at their fair market value, as determined by reference to the closing price of our common stock on the day prior to the vesting date.

Item 3 Defaults Upon Senior Securities.
None.

Item 4 Mine Safety Disclosures.
Not applicable.

Item 5 Other Information
None.

ITEM 6. EXHIBITS

Exhibit No.	Description
2.1	Asset Purchase Agreement, dated September 23, 2018, by and among MST Medical Surgery Technologies Ltd., TransEnterix, Inc., TransEnterix Europe, S.A.R.L., a Luxemburg limited liability company acting through its Swiss branch being established under the name "TransEnterix Europe Sarl, Bertrange, Swiss Branch Lugano," and TransEnterix Israel Ltd. (incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on September 25, 2018).
10.1	Lock-Up Agreement, dated October 31, 2018, by and between TransEnterix, Inc. and MST Medical Surgery Technologies Ltd. (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on November 1, 2018).
10.2	Registration Rights Agreement, dated October 31, 2018, by and between TransEnterix, Inc. and MST Medical Surgery Technologies Ltd. (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed with the SEC on November 1, 2018).
31.1 *	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).
31.2 *	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).
32.1 *	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2 *	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS *	XBRL Instance Document.
101.SCH *	XBRL Taxonomy Extension Schema Document.
101.CAL *	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF *	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB *	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE *	XBRL Taxonomy Extension Presentation Linkbase Document.

* Filed herewith

39

SIGNATURES

Pursuant to the requirements 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.

	TransEnterix, Inc.
Date: November 8, 2018	By: /s/ Todd M. Pope Todd M. Pope President and Chief Executive Officer
Date: November 8, 2018	By: /s/ Joseph P. Slattery Joseph P. Slattery Executive Vice President and Chief Financial Officer

40