

ITT EDUCATIONAL SERVICES INC
Form 10-Q
October 22, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

☒

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

For the quarterly period ended September 30, 2004

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 number **1-13144**

ITT EDUCATIONAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

36-2061311

(I.R.S. Employer Identification No.)

13000 North Meridian Street

Carmel, Indiana

(Address of principal executive offices)

46032-1404

(Zip Code)

Registrant's telephone number, including area code: **(317) 706-9200**

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

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to such filing requirements for the past 90 days.

Yes o No ý

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ý No o

45,937,076

Number of shares of Common Stock, \$.01 par value, outstanding at September 30, 2004

ITT EDUCATIONAL SERVICES, INC.

Carmel, Indiana

Quarterly Report to Securities and Exchange Commission

September 30, 2004

PART I

FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS.

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Consolidated Statements of Income (unaudited) for the three and nine months ended September 30, 2004 and 2003

Consolidated Balance Sheets as of September 30, 2004 and 2003 (unaudited) and December 31, 2003

Consolidated Statements of Cash Flows (unaudited) for the three and nine months ended September 30, 2004 and 2003

Consolidated Statements of Shareholders' Equity for the three months ended March 31, 2004, June 30, 2004 and September 30, 2004 (unaudited) and the year ended December 31, 2003

Notes to Consolidated Financial Statements

ITT EDUCATIONAL SERVICES, INC.
CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

(unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|------------|------------------------------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| Revenues | \$ 157,945 | \$ 134,382 | \$ 450,606 | \$ 378,213 |
| Costs and Expenses | | | | |
| Cost of educational services | 75,033 | 69,681 | 229,536 | 210,463 |
| Student services and administrative expenses | 43,771 | 39,495 | 130,265 | 113,417 |
| Special legal and other investigation costs | 9,837 | | 25,143 | |
| Total costs and expenses | 128,641 | 109,176 | 384,944 | 323,880 |
| Operating income | 29,304 | 25,206 | 65,662 | 54,333 |
| Interest income, net | 959 | 551 | 2,316 | 1,549 |
| Income before income taxes | 30,263 | 25,757 | 67,978 | 55,882 |
| Income taxes | 11,803 | 9,916 | 26,512 | 21,514 |
| Net income | \$ 18,460 | \$ 15,841 | \$ 41,466 | \$ 34,368 |
| Earnings per common share (basic): | \$ 0.40 | \$ 0.35 | \$ 0.91 | \$ 0.76 |
| Earnings per common share (diluted): | \$ 0.39 | \$ 0.34 | \$ 0.89 | \$ 0.75 |

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

| | September 30, 2004 (unaudited) | December 31, 2003 | September 30, 2003 (unaudited) |
|---|-----------------------------------|-------------------|-----------------------------------|
| Assets | | | |
| Current assets | | | |
| Cash and cash equivalents | \$ 166,702 | \$ 168,273 | \$ 159,749 |
| Restricted cash | | 8,496 | |
| Short-term investments | 145,719 | 63,938 | 37,912 |
| Accounts receivable, net | 14,041 | 9,398 | 9,943 |
| Deferred and prepaid income tax | 4,842 | 2,906 | 2,950 |
| Prepays and other current assets | 5,572 | 3,635 | 4,409 |
| Total current assets | 336,876 | 256,646 | 214,963 |
| Property and equipment, net | 92,515 | 81,503 | 78,910 |
| Direct marketing costs | 13,813 | 10,844 | 10,470 |
| Investments | 3,275 | 13,467 | 6,455 |
| Other assets | 989 | 810 | 811 |
| Total assets | \$ 447,468 | \$ 363,270 | \$ 311,609 |
| Liabilities and Shareholders' Equity | | | |
| Current liabilities | | | |
| Accounts payable | \$ 48,148 | \$ 36,543 | \$ 41,297 |
| Accrued compensation and benefits | 17,499 | 16,986 | 13,925 |
| Other accrued liabilities | 29,866 | 18,444 | 16,146 |
| Deferred revenue | 136,094 | 130,364 | 110,087 |
| Total current liabilities | 231,607 | 202,337 | 181,455 |
| Deferred income tax | 4,814 | 4,691 | 2,714 |
| Minimum pension liability | 7,012 | 7,012 | 8,041 |
| Other liabilities | 3,020 | 3,106 | 2,582 |
| Total liabilities | 246,453 | 217,146 | 194,792 |
| Shareholders' equity | | | |
| Preferred stock, \$.01 par value, 5,000,000 shares authorized, none issued or outstanding | | | |
| Common stock, \$.01 par value, 150,000,000 shares authorized, 54,068,904 issued and outstanding | 540 | 540 | 540 |
| Capital surplus | 58,866 | 52,688 | 49,838 |
| Retained earnings | 260,241 | 221,400 | 199,956 |
| Accumulated other comprehensive (loss) | (4,263) | (4,263) | (4,888) |
| Treasury stock, 8,131,828, 8,638,535 and 8,798,609 shares, at cost | (114,369) | (124,241) | (128,629) |
| Total shareholders' equity | 201,015 | 146,124 | 116,817 |
| Total liabilities and shareholders' equity | \$ 447,468 | \$ 363,270 | \$ 311,609 |

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| Cash flows provided by (used for) operating activities: | | | | |
| Net income | \$ 18,460 | \$ 15,841 | \$ 41,466 | \$ 34,368 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 3,920 | 4,787 | 13,708 | 15,800 |
| Provision for doubtful accounts | 2,803 | 1,482 | 7,704 | 5,024 |
| Deferred taxes | (52) | (1,006) | (1,812) | (4,452) |
| Increase/decrease in operating assets and liabilities: | | | | |
| Short-term investments | (6,895) | (7,687) | 4,448 | 5,796 |
| Accounts receivable | (5,524) | (3,103) | (12,347) | (5,994) |
| Direct marketing costs | (887) | 148 | (2,969) | 139 |
| Accounts payable and accrued liabilities | 732 | 1,094 | 23,453 | 32,518 |
| Prepays and other assets | 1,308 | 1,188 | (2,116) | 1,625 |
| Deferred revenue | 13,573 | 15,060 | 5,730 | 7,090 |
| Net cash provided by (used for) operating activities | 27,438 | 27,804 | 77,265 | 91,914 |
| Cash flows provided by (used for) investing activities: | | | | |
| Facility and land purchases | (1,837) | (3,766) | (8,635) | (21,069) |
| Capital expenditures, net | (6,134) | (5,046) | (16,085) | (11,057) |
| Proceeds from maturities of held-to-maturity investments | 87,420 | | 146,622 | |
| Purchase of held-to-maturity investments | (127,888) | (24,492) | (222,659) | (24,492) |
| Net cash provided by (used for) investing activities | (48,439) | (33,304) | (100,757) | (56,618) |
| Cash flows provided by (used for) financing activities: | | | | |
| Purchase of treasury stock | | | | (28,726) |
| Exercise of stock options | 4,376 | 9,037 | 13,425 | 22,142 |
| Net cash provided by (used for) financing activities | 4,376 | 9,037 | 13,425 | (6,584) |
| Net increase (decrease) in cash, cash equivalents and restricted cash | (16,625) | 3,537 | (10,067) | 28,712 |
| Cash, cash equivalents and restricted cash at beginning of period | 183,327 | 156,212 | 176,769 | 131,037 |
| Cash, cash equivalents and restricted cash at end of period | \$ 166,702 | \$ 159,749 | \$ 166,702 | \$ 159,749 |

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands)

| | Common Stock | | Capital Surplus | Retained Earnings | Comprehensive Income | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | | Total |
|--|--------------|--------|-----------------|-------------------|----------------------|---|----------------|--------------|------------|
| | Shares | Amount | | | | | Shares | Amount | |
| Balance as of December 31, 2002 | 54,069 | \$ 540 | \$ 40,393 | \$ 184,409 | | \$ (4,888) | (8,986) | \$ (131,430) | \$ 89,024 |
| Exercise of stock options | | | | (21,867) | | | 1,425 | 35,906 | 14,039 |
| Tax benefit from exercise of stock options | | | 12,295 | | | | | | 12,295 |
| Purchase of treasury stock | | | | | | | (1,078) | (28,726) | (28,726) |
| Issue treasury stock for board of directors plan | | | | | | | 1 | 9 | 9 |
| Comprehensive income: | | | | | | | | | |
| Net income for 2003 | | | | 58,858 | \$ 58,858 | | | | 58,858 |
| Other comprehensive income, net of tax: | | | | | | | | | |
| Minimum pension liability adjustment | | | | | 625 | 625 | | | 625 |
| Other comprehensive income | | | | | 625 | | | | |
| Comprehensive income | | | | | \$ 59,483 | | | | |
| Balance as of December 31, 2003 | 54,069 | 540 | 52,688 | 221,400 | | (4,263) | (8,638) | (124,241) | 146,124 |
| For the three months ended March 31, 2004 (unaudited): | | | | | | | | | |
| Exercise of stock options | | | 150 | (2,029) | | | 285 | 6,114 | 4,235 |
| Tax benefit from exercise of stock options | | | 4,259 | | | | | | 4,259 |
| Net income | | | | 9,026 | | | | | 9,026 |
| Balance as of March 31, 2004 | 54,069 | 540 | 57,097 | 228,397 | | (4,263) | (8,353) | (118,127) | 163,644 |
| For the three months ended June 30, 2004 (unaudited): | | | | | | | | | |
| Exercise of stock options | | | 28 | (74) | | | 21 | 394 | 348 |
| Tax benefit from exercise of stock options | | | 207 | | | | | | 207 |
| Net income | | | | 13,980 | | | | | 13,980 |
| Balance as of June 30, 2004 | 54,069 | 540 | 57,332 | 242,303 | | (4,263) | (8,332) | (117,733) | 178,179 |
| For the three months ended September 30, 2004 (unaudited): | | | | | | | | | |
| Exercise of stock options | | | 257 | (522) | | | 200 | 3,364 | 3,099 |
| Tax benefit from exercise of stock options | | | 1,277 | | | | | | 1,277 |
| Net income | | | | 18,460 | | | | | 18,460 |
| Balance as of September 30, 2004 | 54,069 | \$ 540 | \$ 58,866 | \$ 260,241 | | \$ (4,263) | (8,132) | \$ (114,369) | \$ 201,015 |

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

ITT EDUCATIONAL SERVICES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

(Dollar amounts in thousands, unless otherwise stated)

1. **Basis of Presentation**

We prepared the accompanying unaudited consolidated financial statements in accordance with generally accepted accounting principles for interim periods. In the opinion of our management, the financial statements contain all adjustments necessary to present fairly our financial condition and results of operations. Certain information and footnote disclosures, including significant accounting policies, normally included in a complete presentation of financial statements prepared in accordance with generally accepted accounting principles, have been omitted. The interim financial statements should be read in conjunction with the audited financial statements and notes thereto contained in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission (SEC) for the year ended December 31, 2003.

2. **Summary of Certain Accounting Principles and Policies**

Stock Options. We adopted and our stockholders approved the ITT Educational Services, Inc. 1994 Stock Option Plan and the 1997 ITT Educational Services, Inc. Incentive Stock Plan, and we also established the 1999 Outside Directors Stock Option Plan (collectively, the Plans). We have adopted the disclosure only provisions of Statements of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. Accordingly, no compensation cost has been recognized in the financial statements for the Plans. We have elected, as permitted by the standard, to continue following the intrinsic value based method of accounting for stock options consistent with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. Under the intrinsic method, compensation cost for stock options is measured as the excess, if any, of the quoted market price of our common stock at the measurement date over the exercise price.

If compensation costs for the Plans had been determined based on the fair value of the stock options at grant date consistent with SFAS No. 123, our compensation costs would have increased and our net income and earnings per share could have been reduced to the proforma amounts indicated below:

| | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|------------------------|--|-------------------------------------|-----------|------------------------------------|-----------|
| | | 2004 | 2003 | 2004 | 2003 |
| Net income as reported | | \$ 18,460 | \$ 15,841 | \$ 41,466 | \$ 34,368 |
| Deduct: | Total stock-based employee compensation expense determined under the fair value based method for stock options, net of tax | (2,233) | (1,389) | (6,294) | (3,880) |
| Proforma net income | | \$ 16,227 | \$ 14,452 | \$ 35,172 | \$ 30,488 |
| Earnings per share: | | | | | |

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| | | | | | | | | |
|---------------------|----|------|----|------|----|------|----|------|
| Basic as reported | \$ | 0.40 | \$ | 0.35 | \$ | 0.91 | \$ | 0.76 |
| Basic proforma | \$ | 0.35 | \$ | 0.32 | \$ | 0.77 | \$ | 0.68 |
| Diluted as reported | \$ | 0.39 | \$ | 0.34 | \$ | 0.89 | \$ | 0.75 |
| Diluted proforma | \$ | 0.35 | \$ | 0.31 | \$ | 0.75 | \$ | 0.66 |

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------|-------------------------------------|------|------------------------------------|------|
| | 2004 | 2003 | 2004 | 2003 |
| Risk free interest rates | 3.8% | 3.1% | 3.3% | 2.7% |
| Expected lives (in years) | 5 | 5 | 5 | 5 |
| Volatility | 59% | 57% | 58% | 57% |
| Dividend yield | None | None | None | None |

Contingent Liabilities. We are subject to litigation in the ordinary course of our business. When we are aware of a claim or potential claim, we assess the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, we record a liability for the loss. The liability recorded includes probable and estimatable legal costs associated with the claim or potential claim. If the loss is not probable or the amount of the loss cannot be reasonably estimated, we disclose the claim if the likelihood of a potential loss is reasonably possible and the amount involved is material.

3. New Accounting Pronouncements

In December 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 132 revised (SFAS No. 132R), Employers' Disclosures about Pensions and Other Postretirement Benefits. The provisions of SFAS No. 132R do not change the measurement and recognition provisions of SFAS No. 87, Employers' Accounting for Pensions, SFAS No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, and SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. SFAS No. 132R adds interim period and annual financial statement disclosures. See Note 8, which presents the additional interim disclosures required by SFAS No. 132R.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements to certain entities in which the equity investors do not have either a controlling financial interest or sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for variable interest entities in which companies hold a variable interest. We do not hold variable interests in variable interest entities and, therefore, FIN 46 does not have an impact on our financial condition or results of operations.

In January and May 2004, the FASB issued two staff positions with respect to the application of SFAS No. 106 on the accounting and disclosure requirements related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Drug Act). The Drug Act affects postretirement health care benefits that companies may provide to their employees. We do not provide any postretirement health care benefits to our employees, and, therefore, those staff positions do not have an impact on our financial condition or results of operation.

In June 2004, the FASB's Emerging Issues Task Force (EITF) issued EITF 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. EITF 03-1 provides further guidance on the meaning of other-than-temporary impairment and its application to debt and equity securities in accordance with Accounting Principle Board (APB) No. 18, The Equity Method of Accounting for Investments in Common Stock, and SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. EITF 03-1 is effective

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for all reporting periods beginning after June 15, 2004. Until further guidance is provided by the FASB, we are unable to determine the effect, if any, that EITF 03-1 will have on our financial condition or results of operations. See Note 5 for additional disclosures regarding our investments.

4. **Special Legal and Other Investigation Costs**

Consistent with our accounting policy for contingent liabilities (pursuant to which we accrue probable legal costs associated with a claim or a potential claim), we recorded a charge of \$9,700 in the three months ended March 31, 2004 and \$3,000 in the three months ended June 30, 2004 for estimated legal costs associated with the investigation of us being conducted by the U.S. Department of Justice (DOJ), the inquiry initiated by the SEC into the allegations being investigated by the DOJ, and the securities class action and shareholder derivative lawsuits filed against us, certain of our current and former executive officers and each of our Directors (collectively, the Actions), as described below in Note 10. We regularly evaluate the reasonableness of our estimate of the probable legal costs associated with the Actions and make any adjustments considered necessary. As a result of our most recent review of this estimate, we recorded an incremental charge of \$8,005 for legal costs associated with the Actions during

the three months ended September 30, 2004. During the nine months ended September 30, 2004, we were billed \$14,595 of those legal costs. We believe that it is probable that we will incur at least \$20,705 in legal costs related to these matters. Due to the uncertainty regarding the outcomes of these matters, however, we cannot estimate the maximum amount of costs that we could potentially incur with respect to these matters. In accordance with the financial accounting standards for loss contingencies, we have accrued what we believe to be a reasonable estimate of costs that is probable we will incur. If our estimate proves to be inadequate, however, it is possible that we could subsequently be required to record a charge to earnings which could have a material adverse effect on our results of operations.

We incurred non-legal costs related to the Actions in the amount of \$1,832 during the three months ended September 30, 2004 and \$4,438 during the nine months ended September 30, 2004. Those costs were expensed as incurred and primarily included fees charged by our independent registered public accounting firm for the performance of extended audit procedures as a result of the Actions, costs to create an electronic database of all documents seized in connection with the DOJ investigation and other non-legal costs related to the Actions.

5. Investments

Investments with original maturity dates of less than 90 days are included in cash and cash equivalents and are recorded at cost, which approximates market value. Investments classified as trading securities that have maturity dates in excess of 90 days at the time of purchase are recorded at their market value and are included in short-term investments. Investments classified as held-to-maturity include investments that are recorded at their amortized cost. Short-term investments have maturity dates within one year following the balance sheet date. Non-current investments have maturity dates between one and three years following the balance sheet date.

The cost of securities sold is based on the first-in, first-out method. All of our investments are in marketable debt securities.

| | As of September 30, 2004 | | | As of Dec. 31, 2003 | | | As of September 30, 2003 | | |
|---------------------------|--------------------------|------------------|------------|---------------------|------------------|------------|--------------------------|------------------|------------|
| | Trading securities | Held-to-maturity | Total | Trading securities | Held-to-maturity | Total | Trading securities | Held-to-maturity | Total |
| Cash and cash equivalents | \$ 166,702 | \$ | \$ 166,702 | \$ 168,273 | \$ | \$ 168,273 | \$ 159,749 | \$ | \$ 159,749 |
| Short-term investments | 8,899 | 136,820 | 145,719 | 13,347 | 50,591 | 63,938 | 19,910 | 18,002 | 37,912 |
| Non-current investments | | 3,275 | 3,275 | | 13,467 | 13,467 | | 6,455 | 6,455 |
| | \$ 175,601 | \$ 140,095 | \$ 315,696 | \$ 181,620 | \$ 64,058 | \$ 245,678 | \$ 179,659 | \$ 24,457 | \$ 204,116 |

As of September 30, 2004, there were no gross unrealized losses on our trading securities.

6. Property and Equipment

During the three months ended September 30, 2004, we purchased two parcels of land for \$1,837 on which we intend to build facilities. During the nine months ended September 30, 2004, we purchased four parcels of land for \$4,850 on which we are building or intend to build facilities, and we purchased one of our facilities for \$3,785 that we previously leased under an operating lease agreement.

7. **Earnings Per Share**

Earnings per common share for all periods have been calculated in conformity with SFAS No. 128, Earnings Per Share. This data is based on historical net income and the average number of shares of our common stock outstanding during each period.

| | Average Shares Outstanding (in thousands) | | | |
|---------|--|--------|------------------------------------|--------|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| Basic | 45,871 | 45,119 | 45,735 | 44,988 |
| Diluted | 46,743 | 46,415 | 46,759 | 46,126 |

The difference in the number of shares used to calculate basic and diluted earnings per share represents the average number of shares assumed issued under our stock option plans less shares assumed to be purchased with proceeds from the exercise of those stock options. Outstanding stock options that have exercise prices greater than the average market price of our common shares (706,000 shares at September 30, 2004 and 1,000 shares at September 30, 2003) have been excluded from the calculation of our earnings per common share, because the effect would be antidilutive.

8. Employee Pension Benefits

The net periodic benefit costs for the ESI Pension Plan (Pension Plan) and the ESI Excess Pension Plan (Excess Plan) are as follows:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|------------------------------------|---|----------|--|----------|
| | 2004 | 2003 | 2004 | 2003 |
| Service cost | \$ 1,765 | \$ 1,470 | \$ 5,295 | \$ 4,410 |
| Interest cost | 570 | 444 | 1,710 | 1,334 |
| Expected return on assets | (550) | (393) | (1,650) | (1,177) |
| Recognized net actuarial loss | 250 | 249 | 750 | 745 |
| Amortization of prior service cost | (25) | (22) | (75) | (66) |
| Net periodic pension cost | \$ 2,010 | \$ 1,748 | \$ 6,030 | \$ 5,246 |

In January 2004, we contributed \$6,700 to the Pension Plan. In July 2004, we contributed \$2,000 to the Pension Plan, which fulfilled all of our remaining contribution requirements in 2004. The Excess Plan is a non-qualified, unfunded retirement plan and, therefore, we do not currently plan to make any contributions to it in 2004.

9. Letter of Credit

During the nine months ended September 30, 2004, we provided a \$7,000 irrevocable standby letter of credit to one of our insurers to secure the surety bonds issued by that insurer which are required as part of our normal course of operations by various education authorities that regulate us. The letter of credit is collateralized by our investments. As of September 30, 2004, the total face value of those surety bonds was \$11,319.

10. Contingencies

We are subject to litigation in the ordinary course of our business. When we are aware of a claim or potential claim, we assess the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, we record a liability for the loss. The liability recorded includes probable and estimatable legal costs associated with the claim or potential claim. If the loss is not probable or the amount of the loss cannot be reasonably estimated, we disclose the claim if the likelihood of a potential loss is reasonably possible and the amount involved is material.

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Among the legal actions currently pending is *United States ex rel. Dan Graves and Susan Newman v. ITT Educational Services, Inc., et al.* This action is a qui tam action that was filed on November 5, 1999 in the United States District Court for the Southern District of Texas by two former employees (relators) on behalf of themselves and the federal government (the Qui Tam Action). The Qui Tam Action alleges, among other things, violations of the False Claims Act, 31 U.S.C. § 3730, by us, one of our employees and our registered public accounting firm in connection with how we compensated our sales representatives. The relators seek various forms of recovery on behalf of themselves and the federal government, including: (a) treble the amount of unspecified damages sustained by the federal government; (b) a civil penalty of up to \$10 for each violation of the False Claims Act; (c) double back pay for Susan Newman; and (d) attorney s fees, costs and interest.

A qui tam action is a civil lawsuit brought by one or more individuals (a qui tam relator) on behalf of the federal or state government for an alleged submission to the government of a false claim for payment. A qui tam action is always filed under seal and remains under seal until the government decides whether to intervene in the litigation. Whenever a relator files a qui tam action, the government typically initiates an investigation in order to determine whether to intervene in the litigation. If the government intervenes, it has primary control over the litigation. If the government declines to intervene, the relator may pursue the litigation on behalf of the federal or state government and, if successful, receives a portion of the government s recovery.

On May 25, 2001, the DOJ declined to intervene in the Qui Tam Action. On March 31, 2002, the court dismissed all of the claims against all of the defendants for failure to allege facts sufficient to support the claims and gave the relators 20 days to file an amended complaint. The relators filed an amended complaint on April 22, 2002 against all of the defendants. On March 31, 2003, the court issued a final judgment in the Qui Tam Action dismissing with prejudice all of the relators' claims against us and all of the other defendants for failure to state a claim. On April 28, 2003, the relators filed a notice of appeal to the United States Court of Appeals for the Fifth Judicial Circuit. The oral argument before the appellate court on the relators' appeal occurred on October 4, 2004. On October 20, 2004, the appellate court affirmed the district court's judgment that dismissed with prejudice all of the relators' claims against us and the other defendants in the Qui Tam Action.

On February 25, 2004, federal agents executed search warrants at our corporate headquarters and at ten of our 77 ITT Technical Institutes nationwide. On that same date, our Directors and executive officers and some of our other employees each received a federal grand jury subpoena that was issued, along with the search warrants, by the U.S. District Court, Southern District of Texas, located in Houston, Texas. The search warrants and subpoenas seek broad categories of documents, including documents containing information relating to our figures and rates for placement, retention, graduation and attendance, recruitment and admissions materials, student grades, graduate salaries, transferability of credits to other institutions, and personnel records. Although no formal charges have been filed, we believe that the DOJ is investigating claims alleging, among other matters, falsification of records relating to student attendance, grades and academic progress and graduate job placement statistics, and fraudulent misrepresentations regarding the transferability of credits. We, our Directors and our executive officers are continuing to work with the DOJ to resolve its investigation. The costs that we have incurred in connection with the DOJ investigation have had a material adverse effect on our financial condition and results of operations, and there can be no assurance that the ultimate outcome of the DOJ investigation will not have a further material adverse effect on our financial condition and results of operations.

On March 4, 2004, we were notified by the Fort Worth, Texas regional office of the SEC that it has initiated an inquiry into the allegations being investigated by the DOJ as described in the preceding paragraph. We are cooperating with the SEC in its inquiry. There can be no assurance, however, that the ultimate outcome of the SEC inquiry will not have a material adverse effect on our financial condition or results of operations.

In October 2002, the Office of the Attorney General for the State of California (CAG) informed us that it had initiated an investigation of our ITT Technical Institutes in California. We believe that the CAG's investigation is in response to one or more qui tam actions filed against us under the state and/or federal False Claims Acts. The CAG has not asserted any claims against us, and we have not been informed of the specific matters that the CAG is investigating. Based on the information that the CAG has requested, however, we believe that the CAG is investigating, among other matters, whether one or more of our California ITT Technical Institutes:

falsified records relating to student attendance, grades and academic progress;

falsified student grade point average calculations used to qualify students for financial aid under the State's Cal Grant Program; and

retaliated against employees who may have complained about those alleged acts.

We are cooperating with the CAG in its investigation, and we have been conducting our own investigation of the same matters. While we cannot assure you of the ultimate outcome of the CAG investigation, based on the results of our investigation to date, we do not believe that the CAG investigation and any qui tam actions that may be associated with the investigation will have a material adverse effect on our financial condition, results of operations or cash flows.

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On August 19, 2004, a consolidated complaint in a securities class action lawsuit was filed against us and 10 of our current and former Directors and executive officers in the United States District Court for the Southern District of Indiana under the following caption: *City of Austin Police Retirement System, Individually And On Behalf Of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* This action is a result of the Court's June 18, 2004 order to consolidate 13 separate securities class action lawsuits filed from February 26, 2004 through April 23, 2004. The consolidated complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "1934 Act"), and Rule 10b-5 promulgated thereunder, by engaging in an unlawful course of conduct, pursuant to which the defendants knowingly or recklessly engaged in acts, transactions, practices and courses of business to conceal adverse material information about our financial condition, and that this conduct operated as a fraud and deceit upon the plaintiffs. The complaint also alleges that the defendants made various deceptive and untrue statements of material facts and omitted to state material facts necessary in order to

make the statements made, in light of the circumstances under which they were made, not misleading to the plaintiffs, causing the plaintiffs to purchase our securities at artificially inflated prices. The putative class period in this action is from October 17, 2002 through March 8, 2004. The plaintiffs seek, among other things, an award of unspecified compensatory damages, interest, costs, expenses and attorney's fees. All of the defendants intend to defend themselves vigorously against the allegations made in the complaint. There can be no assurance, however, that the ultimate outcome of this or other actions (including other actions under federal or state securities laws) will not have a material adverse effect on our financial condition or results of operations.

On or about April 29, 2004, a consolidated complaint in a shareholder derivative lawsuit was filed against five of our current and former executive officers, 10 of our current and former Directors and PricewaterhouseCoopers LLP ("PWC"), our independent registered public accounting firm, in the Superior Court of Hamilton County, Indiana under the following caption: *In Re ITT Educational Services, Inc. Derivative Litigation*. This action is a result of the Court's March 30, 2004 order to consolidate two separate shareholder derivative lawsuits filed on or about February 27, 2004. The consolidated complaint alleges, among other things, that:

certain individual defendants breached a fiduciary duty by selling our common stock and misappropriating our information;

all defendants breached their fiduciary duties to us, abused their ability to control and influence us, grossly mismanaged us, caused us to waste corporate assets and were unjustly enriched; and

PWC breached a duty of care and professional competence to us and breached its contracts with us.

The consolidated complaint seeks unspecified damages, extraordinary equitable and/or injunctive relief, disgorgement of profits, benefits and other compensation, costs and attorneys' fees. All of the individual defendants intend to defend themselves vigorously against the allegations in the complaint.

On September 7, 2004, a shareholder derivative lawsuit was filed against five of our current and former executive officers, 10 of our current and former Directors and PWC, in the United States District Court for the Southern District of Indiana under the following caption: *Alaska Electrical Pension Fund Derivatively on Behalf of ITT Educational Services, Inc. v. Rene R. Champagne, et al.* The complaint alleges, among other things, that the defendants caused us to violate state and federal education finance laws and regulations by falsifying our student records and federal securities laws by falsifying our accounting, auditing and financial reporting between October 2002 and April 2004. As a result, the complaint alleges, among other things, that the individual defendants:

breached and/or aided and abetted in the breach of:

a duty to disseminate accurate information about us;

fiduciary duties of care, candor and loyalty to us and disclosure to our shareholders;

a duty to test, oversee and monitor our system of internal controls, governance procedures and disclosure procedures; and

a duty to ensure that our internal controls, governance procedures and disclosure procedures were functioning

in an effective manner and in compliance with Pub. L. 107-204, 116 Stat. 745 (2002);

abused their ability to control and influence us;

grossly mismanaged us;

committed constructive fraud;

will be and have been unjustly enriched at our expense; and

violated Section 10(b) of the 1934 Act and Rule 10-5 promulgated thereunder by:

disseminating or approving false statements that they knew or recklessly disregarded were misleading;

failing to disclose material facts necessary in order to make those statements not misleading; and

misappropriating our proprietary information.

In addition, the complaint alleges, among other things, that PWC:

violated Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder by:

disseminating or approving false statements that it knew or recklessly disregarded were misleading; and

failing to disclose material facts necessary in order to make those statements not misleading;

was negligent and committed accounting malpractice by failing to conduct its audits of our 2002 and 2003 fiscal year financial statements in accordance with generally accepted accounting principles, generally accepted auditing standards and SEC rules;

aided and abetted the individual defendants :

breach of fiduciary duties to us;

abuse of their control of us; and

gross mismanagement of us; and

violated their duty of candor to our shareholders.

The complaint seeks unspecified damages, extraordinary equitable and/or injunctive relief, punitive damages, costs and expenses, attorneys' fees, pre-judgment interest, an order directing the defendants to account for all damages caused by them and all profits, special benefits and unjust enrichment they obtained, and an order directing us to reform and improve our corporate governance and internal control procedures. All of the individual defendants intend to defend themselves vigorously against the allegations in the complaint.

Although the derivative actions are brought nominally on behalf of us, we expect to incur defense costs and other expenses in connection with the derivative lawsuits, and there can be no assurance that the ultimate outcome of these or other actions will not have a material adverse effect on our financial condition or results of operations.

On July 7, 2004, we received a derivative demand letter pursuant to Del. Ct. Ch. R. 23.1 on behalf of a purported shareholder demanding that our Board of Directors commence a civil action against each of our current directors, one former director and four of our current and former executive officers to recover for our benefit the amount of damages sustained by us as a result of the misconduct alleged in the letter. The misconduct alleged in the letter is similar to the type of misconduct alleged against the individual defendants in the consolidated shareholder derivative lawsuit described above. The demand letter indicates that the purported shareholder named therein will commence a shareholder's derivative action on our behalf, if our Board does not commence an action as demanded therein within a reasonable period of time. We have informed the purported shareholder that, because of other events, we have been conducting an extensive investigation of the same matters referred to in the demand letter and will consider what, if any, claims should be brought against any of the individuals identified in the letter after our investigation is completed.

The current and former executive officers named in one or more of the securities class action and shareholder derivative lawsuits and derivative demand letter described above include: Gene A. Baugh, Rene R. Champagne, Clark D. Elwood, Eugene W. Feichtner, Martin A. Grossman, Thomas W. Lauer, Kevin M. Modany and Omer E. Waddles.

Certain of our current and former officers and Directors are or may become a party in certain of the actions described above. Our By-laws and Restated Certificate of Incorporation obligate us to indemnify our officers and Directors to the fullest extent permitted by Delaware law, provided that their conduct complied with certain requirements. We are obligated to advance defense costs to our officers and Directors, subject to the individual's obligation to repay such amount if it is ultimately determined that the individual was not entitled to indemnification. In addition, our indemnity obligation can, under certain circumstances, include indemnifiable judgments, penalties, fines and amounts paid in settlement in connection with those actions.

As previously disclosed, on March 4, 2004, our Board of Directors appointed a Special Committee of independent Directors. The Special Committee has completed its investigation relating to the conduct and integrity of our senior management. In late June 2004, the Special Committee reported to our Board of Directors that it had found no evidence that our senior management had engaged in any violations of our policies and procedures or any wrongful or criminal conduct related to the matters that are the subject of the DOJ and CAG investigations and

the securities class action lawsuit described above. The Special Committee also reported that when allegations of possible violations have been brought to the attention of our senior management, we have investigated those allegations and our senior management has taken appropriate action when responding to those allegations and any violations found.

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

This management's discussion and analysis of financial condition and results of operations should be read in conjunction with the same titled section contained in our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2003 for discussion of, among other matters, the following items:

Cash receipts from financial aid programs

Nature of capital additions

Seasonality of revenues

Components of income statement captions

Federal regulations regarding:

Timing of receipt of funds from the federal student financial aid programs under Title IV of the Higher Education Act of 1965, as amended (the Title IV Programs)

Percentage of applicable revenues that may be derived from the Title IV Programs

Return of Title IV Program funds for withdrawn students

Default rates

Private loan programs

Repurchased shares of our common stock

Minimum pension liability

Our hybrid education delivery model, pursuant to which certain program courses are taught in residence on campus and others are taught online over the Internet (the Hybrid Delivery Model)

Among the factors that could cause our actual results to differ materially include the Actions, as described in Note 10 of the Notes to Consolidated Financial Statements set forth elsewhere in this report. The effects of the DOJ investigation of us could result in monetary fines or penalties or other sanctions imposed on us, including our loss of eligibility to participate in student financial aid programs, that could materially adversely affect our financial condition and operations. The results of the SEC inquiry into the allegations being investigated by the DOJ could result in the restatement of our financial statements, monetary fines or penalties or other sanctions that could materially adversely affect our financial condition and operations. The results of the securities class action and shareholder derivative lawsuits filed against us, if adversely determined, could have a material adverse effect on our financial condition and results of operations.

Critical Accounting Policies and Estimates

This management's discussion and analysis of financial condition and results of operations is based on our consolidated financial statements, which have been prepared in conformity with generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses and contingent assets and liabilities. Actual results may differ from those estimates and judgments under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant estimates and judgments used in the preparation of our consolidated financial statements. These policies should be read in conjunction with Note 1 of the Notes to Consolidated Financial Statements contained in our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2003.

Property and Equipment. We include all property and equipment in the financial statements at cost and make provisions for depreciation of property and equipment using the straight-line method. Estimated useful lives generally range from three to ten years for our furniture and equipment, three to 14 years for leasehold improvements, 20 to 40 years for the buildings and three to eight years for capitalized software. Changes in circumstances, such as changes in our curricula and technological advances, may result in the actual useful lives of our property, equipment and capitalized software differing from our estimates. We regularly review and evaluate the estimated useful lives of our property and equipment and capitalized software. Although we believe our assumptions and estimates are reasonable, deviations from our assumptions and estimates could produce a materially different result.

Recognition of Revenues. Tuition revenues are recorded on a straight-line basis over the length of the applicable course. If a student withdraws from an institute, the standards of most state education authorities that regulate our institutes, the accrediting commission that accredits our institutes and our own internal policy limit a student's obligation for tuition and fees to the institute depending on when the student withdraws during an academic quarter (Refund Policies). The terms of the Refund Policies vary by state, and the limitations imposed by the Refund Policies are generally based on the portion of the academic quarter that has elapsed at the time the student withdraws. The greater the portion of the academic quarter that has elapsed at the time the student withdraws, the greater the student's obligation is to the institute for the tuition and fees related to that academic quarter. We record revenues net of any refunds paid as a result of any applicable Refund Policy. On an individual student basis, tuition earned in excess of cash received is recorded as accounts receivable, and cash received in excess of tuition earned is recorded as deferred revenue.

The cost of the textbooks is amortized on a straight-line basis over the applicable course length and the deferral of textbook costs is recorded in prepaids and other current assets. Academic fees (which are charged only one time to students on their first day

of class attendance) and admission processing fees (which were charged only one time to students upon being evaluated for admission to their programs of study) are recognized as revenue on a straight-line basis over the average course length of 24 months. If a student withdraws from an institute, all unrecognized revenue relating to his or her fees, net of any refunds paid as a result of any applicable Refund Policy, is recognized upon the student's departure.

More than 95% of our revenues represent tuition charges and less than 5% of our revenues represent bookstore sales and student fees. The amount of tuition earned depends on the cost per credit hour of the courses in the program, the number of courses in the program, how long a student remains enrolled in the program, how many program courses a student takes during each period of enrollment in the program, and the total number of students enrolled in each program. Each of these factors is known at the time our tuition revenues are calculated and is not subject to estimation.

Direct Marketing Costs. Direct costs incurred relating to the enrollment of new students are capitalized using the successful efforts method. Direct marketing costs subject to capitalization include salaries and employee benefits of recruiting representatives and other direct costs less admission processing fees. Successful efforts is the ratio of students enrolled to prospective students interviewed. The higher the rate of interviewed students who enroll, the greater the percentage of our direct marketing costs that are capitalized. We amortize our direct marketing costs on a cost-pool-by-cost-pool basis over the period that we expect to receive revenue streams associated with those assets. The direct costs subject to capitalization are readily quantifiable and are not subject to estimation. The amortization method is based on historical trends of student enrollment and retention activity and is not subject to significant assumptions. We regularly evaluate the future recoverability of these deferred costs.

Contingent Liabilities. We are subject to litigation in the ordinary course of our business. When we are aware of a claim or potential claim, we assess the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, we record a liability for the loss. If it is probable that we will incur legal costs associated with a claim or potential claim, we (a) accrue the amount of legal costs that can be reasonably estimated, (b) regularly evaluate the reasonableness of our estimate and (c) make adjustments thereto that we determine to be appropriate. If the loss is not probable or the amount of the loss cannot be reasonably estimated, we disclose the claim if the likelihood of a potential loss is reasonably possible and the amount involved is material. See Note 4 of the Notes to Consolidated Financial Statements set forth elsewhere in this report regarding the estimated legal costs associated with the Actions.

New Accounting Pronouncements

In December 2003, the FASB issued SFAS No. 132 revised (SFAS No. 132R), Employers' Disclosures about Pensions and Other Postretirement Benefits. The provisions of SFAS No. 132R do not change the measurement and recognition provisions of SFAS No. 87, Employers' Accounting for Pensions, SFAS No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, and SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. SFAS No. 132R adds interim period and annual financial statement disclosures. See Note 8 of the Notes to Consolidated Financial Statements set forth elsewhere in this report, which presents the additional interim disclosures required by SFAS No. 132R.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements to certain entities in which the equity investors do not have either a controlling financial interest or sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for variable interest entities in which companies hold a variable interest. We do not hold

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variable interests in variable interest entities and, therefore, FIN 46 does not have an impact on our financial condition or results of operations.

In January and May 2004, the FASB issued two staff positions with respect to the application of SFAS No. 106 on the accounting and disclosure requirements related to the Drug Act. The Drug Act affects postretirement health care benefits that companies may provide to their employees. We do not provide any postretirement health care benefits to our employees and, therefore, those staff positions do not have an impact on our financial condition or results of operation.

In June 2004, the EITF issued EITF 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. EITF 03-1 provides further guidance on the meaning of other-than-temporary impairment and its application to debt and equity securities in accordance with APB No. 18, The Equity Method of Accounting for Investments in Common Stock, and SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. EITF 03-1 is effective for all reporting periods beginning after June 15, 2004. Until further guidance is provided by the FASB, we are unable to determine the

effect, if any, that EITF 03-1 will have on our financial condition or results of operations. See Note 5 of the Notes to Consolidated Financial Statements set forth elsewhere in this report, which presents additional disclosures regarding our investments.

Results of Operations

The following table sets forth the percentage relationship of certain statement of income data to revenues for the periods indicated.

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|--|---|--------|--|--------|
| | 2004 | 2003 | 2004 | 2003 |
| Revenues | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of educational services | 47.5 | 51.9 | 50.9 | 55.6 |
| Student services and administrative expenses | 27.7 | 29.3 | 28.9 | 30.0 |
| Special legal and other investigation costs | 6.2 | | 5.6 | |
| Operating income | 18.6 | 18.8 | 14.6 | 14.4 |
| Interest income, net | 0.6 | 0.4 | 0.5 | 0.4 |
| Income before income taxes | 19.2% | 19.2% | 15.1% | 14.8% |

The following table sets forth our total student enrollment:

| Total Student Enrollment as of: | 2004 | | 2003 | |
|------------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
| | Total Student Enrollment | Increase Over Prior Year | Total Student Enrollment | Increase Over Prior Year |
| March 31 | 38,192 | 18.2% | 32,313 | 4.3% |
| June 30 | 38,810 | 16.0% | 33,443 | 6.0% |
| September 30 | 42,222 | 13.6% | 37,159 | 9.9% |
| December 31 | Not applicable | Not applicable | 37,076 | 13.6% |

The following table sets forth our total new student enrollment:

| New Student Enrollment | | 2004 | | 2003 | |
|--------------------------------|------------------------------|--------------------------------|------------------------------|--------------------------------|--|
| For the Three Months Ended: | New Student Enrollment | Increase Over Prior Year | New Student Enrollment | Increase Over Prior Year | |
| March 31 | 9,255 | 28.0% | 7,233 | 6.1% | |
| June 30 | 10,261 | 18.3% | 8,677 | 14.6% | |
| September 30 | 14,534 | 14.5% | 12,693 | 19.1% | |
| December 31 | Not applicable | Not applicable | 7,277 | 27.4% | |
| Total for the year | Not applicable | Not applicable | 35,880 | 16.6% | |

| For the Nine Months Ended: | | | | | |
|-------------------------------|--------|-------|--------|-------|--|
| September 30 | 34,050 | 19.0% | 28,603 | 14.2% | |

We generally organize the academic schedule for programs of study offered at our institutes on the basis of four 12-week academic quarters in a calendar year that typically begin in March, June, September and December. To measure the persistence of our students, the number of continuing students in any academic quarter is divided by the total student enrollment as of the end of the immediate preceding academic quarter. A continuing student is any student who, in any academic quarter, is enrolled in a program of study at an ITT Technical Institute and was enrolled in the same program at any ITT Technical Institute at the end of the immediate preceding academic quarter. Total student enrollment includes all new and continuing students enrolled at our ITT Technical Institutes at the end of an academic quarter.

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The following table sets forth the rates of our students' persistence for each quarter in 2004, 2003, and 2002:

| | March 31 | For the Three Months Ended, | | Dec. 31 |
|------|----------|-----------------------------|----------|----------------|
| | | June 30 | Sept. 30 | |
| 2004 | 78% | 75% | 71% | Not applicable |
| 2003 | 77% | 77% | 73% | 80% |
| 2002 | 79% | 77% | 73% | 80% |

Three Months Ended September 30, 2004 Compared with Three Months Ended September 30, 2003

Revenues increased \$23.5 million, or 17.5%, to \$157.9 million in the three months ended September 30, 2004 from \$134.4 million in the three months ended September 30, 2003, primarily due to:

- a 6.0% increase in tuition rates in March 2004;
- a 16.0% increase in the total student enrollment at June 30, 2004 compared to June 30, 2003; and
- a 14.5% increase in new student enrollment at our institutes in the three months ended September 30, 2004 compared to the same period in 2003.

The increase in revenues was partially offset by a decrease in our students' persistence from 73% in the three months ended September 30, 2003 to 71% in the same period in 2004.

Student enrollment increases were primarily a result of:

- opening new institutes;
- an increased number of institutes offering bachelor degree programs;
- an increased number of new programs of study offered by our institutes;
- an increased number of responses to our marketing and advertising;
- operational changes that increased the percentage of new student enrollments arising from those responses;
- the availability of private student loans to supplement federal student financial aid;
- national demographic trends that are favorable to the postsecondary education industry; and

the use of the Hybrid Delivery Model at more institutes.

The decrease in our students' persistence was primarily a result of:

an increase in the number of students in their first and second academic quarters of enrollment (who persist at lower rates than students enrolled in later academic quarters) in 2004 compared to 2003; and

an increase in the number of online courses that students were registered to take (in which students typically persist at a lower rate than residence courses) in 2004 compared to 2003.

Cost of educational services increased \$5.3 million, or 7.7%, to \$75.0 million in the three months ended September 30, 2004 from \$69.7 million in the three months ended September 30, 2003. The principal causes of this increase included:

the costs required to service the increased enrollment;

normal inflationary cost increases for wages, rent and other costs of services;

increased costs due to opening new institutes (one opened in June 2003 and one opened in December 2003); and

increased costs associated with using the Hybrid Delivery Model at more institutes.

Cost of educational services as a percentage of revenues decreased to 47.5% in the three months ended September 30, 2004 from 51.9% in the three months ended September 30, 2003. The primary causes of this decrease included:

continued facility and faculty utilization efficiencies;

certain fixed costs at our institutes did not increase proportionately with increases in our revenues resulting from increased student enrollment and tuition rate increases;

new and renegotiated vendor contracts; and

a net reduction of occupancy costs resulting from our purchase of one facility in the three months ended December 31, 2003 and one facility in the three months ended June 30, 2004 that we had previously leased.

Student services and administrative expenses increased \$4.3 million, or 10.8%, to \$43.8 million in the three months ended September 30, 2004 from \$39.5 million in the three months ended September 30, 2003. The principal causes of this increase included:

an increase in the amount of compensation costs as a result of inflation and hiring more financial aid administrators to service a greater number of new and continuing students; and

an increase in media advertising costs (17.3%) to promote new program offerings.

Student services and administrative expenses decreased to 27.7% of revenues in the three months ended September 30, 2004 compared to 29.3% of revenues in the three months ended September 30, 2003, primarily due to:

an increase in the amount of marketing costs deferred as a result of changes to the admission processing fee; and

certain fixed costs at our corporate headquarters that did not increase proportionately with increases in our revenues resulting from increased student enrollment and tuition rate increases.

We recorded an incremental charge of \$8.0 million for legal costs associated with the Actions during the three months ended September 30, 2004. In addition, we incurred \$1.8 million of other non-legal investigation costs associated with the Actions during the three months ended September 30, 2004. See Note 4 of the Notes to Consolidated Financial Statements set forth elsewhere in this report.

Operating income increased \$4.1 million, or 16.3%, to \$29.3 million in the three months ended September 30, 2004 from \$25.2 million in the three months ended September 30, 2003. The operating margin decreased to 18.6% of revenues in the three months ended September 30, 2004 from 18.8% in the three months ended September 30, 2003, primarily as a result of the \$8.0 million of legal costs and \$1.8 million of other non-legal investigation costs associated with the Actions. Those costs more than offset the increase in operating margin generated as a result of:

continued facility and faculty utilization efficiencies;

certain fixed costs at our institutes that did not increase proportionately with increases in our revenues resulting from increased student enrollment and tuition rate increases;

new and renegotiated vendor contracts; and

a net reduction of occupancy costs resulting from our purchase of six facilities in 2003 and one facility in 2004.

Income Taxes. Our combined effective federal and state income tax rate in 2004 was 39.0% compared to 38.5% in 2003, primarily due to changes in state tax laws.

Nine Months Ended September 30, 2004 Compared with Nine Months Ended September 30, 2003

Revenues increased \$72.4 million, or 19.1%, to \$450.6 million in the nine months ended September 30, 2004 from \$378.2 million in the nine months ended September 30, 2003, primarily due to:

- a 6.0% increase in tuition rates in March 2004;
- a 13.6% increase in the total student enrollment at December 31, 2003 compared to December 31, 2002; and
- a 19.0% increase in new student enrollment at our institutes in the nine months ended September 30, 2004 compared to the same period in 2003, which was primarily a result of:
 - opening new institutes;
 - an increased number of institutes offering bachelor degree programs;
 - an increased number of new programs of study offered by our institutes;
 - an increased number of responses to our marketing and advertising;
 - operational changes that increased the percentage of new student enrollments arising from those responses;
 - the availability of private student loans to supplement federal student financial aid; and
 - the use of the Hybrid Delivery Model at more institutes.

Cost of educational services increased \$19.0 million, or 9.1%, to \$229.5 million in the nine months ended September 30, 2004 from \$210.5 million in the nine months ended September 30, 2003. The principal causes of this increase included:

the costs required to service the increased enrollment;

normal inflationary cost increases for wages, rent and other costs of services;

increased costs due to opening new institutes (one opened in March 2003, one opened in June 2003 and one opened in December 2003); and

increased costs associated with using the Hybrid Delivery Model at more institutes.

Cost of educational services as a percentage of revenues decreased to 50.9% in the nine months ended September 30, 2004 from 55.6% in the nine months ended September 30, 2003. The primary causes of this decrease included:

continued facility and faculty utilization efficiencies;

certain fixed costs at our institutes did not increase proportionately with increases in our revenues resulting from increased student enrollment and tuition rate increases;

new and renegotiated vendor contracts; and

a net reduction of occupancy costs resulting from our purchase of six facilities in 2003 and one facility in 2004 that we had previously leased.

Student services and administrative expenses increased \$16.9 million, or 14.9%, to \$130.3 million in the nine months ended September 30, 2004 from \$113.4 million in the nine months ended September 30, 2003. The principal causes of this increase included:

an increase in the amount of compensation costs as a result of inflation and hiring more financial aid administrators to service a greater number of new and continuing students; and

an increase in media advertising costs (20.3%).

Student services and administrative expenses decreased to 28.9% of revenues in the nine months ended September 30, 2004 compared to 30.0% of revenues in the nine months ended September 30, 2003, primarily due to:

an increase in the amount of marketing costs deferred as a result of changes to the admission processing fee; and

certain fixed costs at our corporate headquarters that did not increase proportionately with increases in our revenues resulting from increased student enrollment and tuition rate increases.

Special legal costs of \$20.7 million were accrued in the nine months ended September 30, 2004 for our estimated legal costs associated with the Actions. In addition, other non-legal investigation costs associated with the Actions of \$4.4 million were incurred during the nine months ended September 30, 2004. See Note 4 of the Notes to Consolidated Financial Statements set forth elsewhere in this report.

Operating income increased \$11.4 million, or 20.9%, to \$65.7 million in the nine months ended September 30, 2004 from \$54.3 million in the nine months ended September 30, 2003. The operating margin increased to 14.6% of revenues in the nine months ended September 30, 2004 from 14.4% in the nine months ended September 30, 2003, primarily as a result of:

continued facility and faculty utilization efficiencies;

certain fixed costs at our institutes that did not increase proportionately with increases in our revenues resulting from increased student enrollment and tuition rate increases;

new and renegotiated vendor contracts; and

a net reduction of occupancy costs resulting from our purchase of six facilities in 2003 and one facility in 2004.

The operating margin increase was partially offset by the \$20.7 million special legal costs accrual and the \$4.4 million of other investigation costs.

Income Taxes. Our combined effective federal and state income tax rate in 2004 was 39.0% compared to 38.5% in 2003, primarily due to changes in state tax laws.

Financial Condition, Liquidity and Capital Resources

Due to the seasonal pattern of enrollments and our receipt of tuition payments, comparisons of financial position and cash generated from operations should be made both to the end of the previous year and to the corresponding period during the previous year.

Our Board of Directors has authorized us to repurchase outstanding shares of our common stock in the open market or through privately negotiated transactions in accordance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended.

The following table sets forth the repurchase of outstanding shares of our common stock during the three and nine months ended September 30, 2004 and 2003:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|------|------------------------------------|-----------|
| | 2004 | 2003 | 2004 | 2003 |
| Number of shares repurchased | | | | 1,078,000 |
| Total cost of shares repurchased (in millions) | | | \$ | 28.7 |
| Average cost per share | | | \$ | 26.65 |

All of the repurchased shares of our common stock became treasury shares upon repurchase and most of the repurchased shares continue to be held as treasury shares. As of September 30, 2004, our existing repurchase authorization permits us to repurchase an additional 4.2 million shares of our common stock. We may elect to repurchase additional shares of our common stock from time to time in the future, depending on market conditions and other considerations. The purpose of the stock repurchase program is to help us achieve our long-term goal of enhancing shareholder value.

Net cash provided by operating activities was \$27.4 million in the three months ended September 30, 2004 compared to \$27.8 million in the three months ended September 30, 2003. Net cash provided by operating activities decreased \$14.6 million to \$77.3 million in the nine months ended September 30, 2004 compared to \$91.9 million in the nine months ended September 30, 2003, primarily as a result of:

a large amount realized in the prior periods following the initial implementation of new cash management strategies; and

delays in completing student financial aid applications which resulted in a reduction in cash from deferred revenue and an increase in accounts receivable.

As of September 30, 2004, we had \$140.1 million of investments that we plan to hold until maturity. The maturity dates extend beyond one year for \$3.3 million of those investments.

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Deferred revenue, which represents the cash received from students in excess of tuition earned, increased \$26.0 million to \$136.1 million at September 30, 2004 from \$110.1 million at September 30, 2003. This increase was primarily due to increased tuition revenue resulting from a greater number of students and higher tuition rates, and our students' increased usage of supplemental private loans.

We purchased one facility for \$3.8 million and two parcels of land for \$3.0 million (on which we intend to build facilities) during the three months ended June 30, 2004. We purchased two parcels of land for \$1.8 million (on which we intend to build facilities) during the three months ended September 30, 2004. We have agreed to purchase, for \$2.2 million, two parcels of land in the three months ending December 31, 2004 on which we intend to build facilities. We have agreed to purchase a facility for \$4.6 million in late 2004 or early 2005. We may purchase additional facilities during the remainder of 2004. Capital expenditures were \$6.1 million in the three months ended September 30, 2004 compared to \$5.0 million in the three months ended September 30, 2003. Capital expenditures were \$16.1 million in the nine months ended September 30, 2004 compared to \$11.1 million in the nine months ended September 30, 2003.

We do not believe that any reduction in cash and cash equivalents or investments that may result from their use to effect any future stock repurchases or facility purchases will have a material adverse effect on our expansion plans, planned capital expenditures, ability to meet any applicable regulatory financial responsibility standards, or ability to conduct normal operations.

Contractual Obligations

The following table sets forth the specified contractual obligations as of September 30, 2004.

| Contractual Obligations | Total | Payment due by period | | | |
|-----------------------------|----------|-----------------------|-------------------------------|--------------|----------------------|
| | | Less than 1 Year | 1-3 Years (In millions) | 3-5 Years | More than 5 Years |
| Operating Lease Obligations | \$ 133.6 | \$ 26.1 | \$ 44.8 | \$ 34.9 | \$ 27.8 |
| Purchase Obligations | 6.7 | 5.7 (1) | 1.0 | | |
| Total | \$ 140.3 | \$ 31.8 | \$ 45.8 | \$ 34.9 | \$ 27.8 |

(1) Includes supplies and a \$4.6 million real estate contract to purchase a facility containing one of our institutes that we expect to complete in late 2004 or early 2005.

Off-Balance Sheet Arrangements

As of September 30, 2004, we leased our non-owned facilities under operating lease agreements. A majority of the operating leases contain renewal options that can be exercised after the initial lease term. Renewal options are generally for periods of one to five years. All operating leases will expire over the next 13 years and management expects that those leases will be renewed or replaced by other leases in the normal course of business, or that we will purchase the facilities represented by those leases or other facilities where we can operate our institutes. There are no material restrictions imposed by the lease agreements, and we have not entered into any significant guarantees related to the leases. We are required to make additional payments under the operating lease terms for taxes, insurance and other operating expenses incurred during the operating lease period.

As part of our normal course of operations, one of our insurers issues surety bonds for us that are required by various education authorities that regulate us. We are obligated to reimburse our insurer for any of those surety bonds that are paid by the insurer. As of September 30, 2004, the total face amount of those surety bonds was \$11.3 million. We also have provided a \$7.0 million irrevocable standby letter of credit to our insurer to secure our obligations under those surety bonds. The letter of credit is collateralized by our investments.

Except for the operating lease agreements, the surety bonds and the standby letter of credit disclosed above, we do not have any off-balance sheet arrangements.

Forward-Looking Statements

All statements, trend analyses and other information contained in this report that are not historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act. Forward-looking statements are made based upon our management's current expectations and beliefs concerning future developments and their potential effects on us. There can be no assurance that future developments

affecting us will be those anticipated by our management.

These forward-looking statements involve a number of risks and uncertainties. Among the factors that could cause actual results to differ materially are the following:

business conditions and growth in the postsecondary education industry and in the general economy;

changes in federal and state governmental regulations with respect to education and accreditation standards, or the interpretation or enforcement thereof, including, but not limited to, the level of government funding for, and our eligibility to participate in, student financial aid programs utilized by our students;

the results of the Qui Tam Action which, if adversely determined, could result in a demand for repayment of federal student financial aid funds, trebled under the False Claims Act, and penalties;

effects of any change in our ownership resulting in a change in control, including, but not limited to, the consequences of such changes on the accreditation and federal and state regulation of the institutes;

our ability to implement our growth strategies;

receptivity of students and employers to our existing program offerings and new curricula;

loss of lender access to our students for student loans;

the effects of the DOJ investigation of us which could result in monetary fines or penalties or other sanctions imposed on us (including our loss of eligibility to participate in student financial aid programs) that could materially adversely affect our financial condition and operations;

the results of the SEC inquiry into the allegations being investigated by the DOJ which could result in the restatement of our financial statements, monetary fines or penalties or other sanctions that could materially adversely affect our financial condition and operations; and

the results of the securities class action and shareholder derivative lawsuits filed against us which, if adversely determined, could have a material adverse affect on our financial condition and results of operations.

Readers are also directed to other risks and uncertainties discussed in other documents we file with the SEC. We undertake no obligation to update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Our investments with original maturity dates of less than 90 days are included in cash and cash equivalents and are recorded at cost, which approximates market value. Our investments classified as trading securities that have maturity dates in excess of 90 days at the time of purchase are recorded at their market value and are included in short-term investments. Our investments classified as held-to-maturity include investments that are recorded at their amortized cost. Short-term investments have maturity dates within one year following the balance sheet date. Our non-current investments have maturity dates between one and three years following the balance sheet date.

We estimate that the market risk associated with our investments in marketable debt securities can best be measured by a potential decrease in the fair value of these securities resulting from a hypothetical 10% increase in interest rates. If such a hypothetical increase in rates were to occur, the reduction in the market value of our portfolio of securities would not be material.

Item 4. CONTROLS AND PROCEDURES.

We are responsible for establishing and maintaining a set of disclosure controls and procedures (DCP) that are designed to ensure that information required to be disclosed by us in the reports filed by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. In addition, we are responsible for establishing and maintaining adequate internal

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control over our financial reporting (IC) that is designed to provide reasonable assurances that our records are maintained in reasonable detail to accurately and fairly reflect transactions, our transactions are properly authorized, our assets are safeguarded against unauthorized or improper acquisition, use or disposition, and our transactions are properly recorded and reported to permit the preparation of our financial statements in conformity with generally accepted accounting principles. As of the end of our third fiscal quarter of 2004, we conducted an evaluation, under the framework of the Committee of Sponsoring Organizations of the Treadway Commission and the supervision (and with the participation) of our management, including our Chairman and Chief Executive Officer and Senior Vice President and Chief Financial Officer, of the effectiveness of the design and operation of our DCP pursuant to Rule 13a-15 of the Exchange Act. Based on that evaluation, our Chairman and Chief Executive Officer and Senior Vice President and Chief Financial Officer concluded that our DCP are effective.

There were no changes in our IC during our third fiscal quarter of 2004 that materially affected or are reasonably likely to materially affect our IC.

PART II

OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS.

The information set forth in Note 10 of the Notes to Consolidated Financial Statements set forth elsewhere in this report is incorporated herein by reference.

We cannot assure you of the ultimate outcome of any litigation involving us. Any litigation alleging violations of education or consumer protection laws and/or regulations, misrepresentation, fraud or deceptive practices may also subject our affected institutes to additional regulatory scrutiny.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

The following table sets forth information regarding purchases made by us of shares of our common stock on a monthly basis during the third quarter of 2004:

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid 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) |
|--|--|------------------------------------|---|---|
| July 1, 2004 through July 31, 2004 | | \$ | | 4,216,300 |
| August 1, 2004 through August 31, 2004 | | | | 4,216,300 |
| September 1, 2004 through September 30, 2004 | | | | 4,216,300 |
| Total | | \$ | | |

(1) On October 17, 2002, we announced that our Board of Directors on October 15, 2002 authorized us to repurchase 5.0 million shares of our common stock (the 2002 Repurchase Program). As of September 30, 2004, 4,216,300 shares remained to be repurchased under the 2002 Repurchase Program. The terms of the 2002 Repurchase Program provide that we may repurchase shares of our common stock, from time to time depending on market conditions and other considerations, in the open market or through privately negotiated transactions in accordance with Rule 10b-18 of the Exchange Act. Unless earlier terminated by our Board of Directors, the 2002 Repurchase Program will expire when we repurchase all shares authorized for repurchase thereunder.

Item 5. OTHER INFORMATION.

In late June 2004, our independent registered public accounting firm completed its compliance attestation examination of the Title IV Programs in which we participated during 2003. In connection with that effort, our independent registered public accounting firm re-issued its opinion with respect to our financial statements for the period ended December 31, 2003.

Item 6. EXHIBITS.

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A list of exhibits required to be filed as part of this report is set forth in the Index to Exhibits, which immediately precedes the exhibits, and is incorporated herein by reference.

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.

ITT Educational Services, Inc.

Date: October 22, 2004

By:

/s/ Kevin M. Modany

Kevin M. Modany

Senior Vice President and Chief Financial Officer

(Duly Authorized Officer and Principal Financial Officer)

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INDEX TO EXHIBITS

| Exhibit No. | Description |
|------------------------|---|
| 10.44 | 1999 Outside Directors Stock Option Plan Form of Non-Qualified Stock Option Agreement |
| 10.45 | 1997 ITT Educational Services, Inc. Incentive Stock Plan Form of Nonqualified Stock Option Award Agreement |
| 10.46 | Seventh Amendment of ESI Pension Plan |
| 11 | Statement re Computation of Per Share Earnings |
| 31.1 | Chief Executive Officer's Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 |
| 31.2 | Chief Financial Officer's Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 |
| 32.1 | Chief Executive Officer's Certification Pursuant to 18 U.S.C. Section 1350 |
| 32.2 | Chief Financial Officer's Certification Pursuant to 18 U.S.C. Section 1350 |

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