

ITT EDUCATIONAL SERVICES INC

Form 10-Q/A

February 10, 2006

Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q/A**

(Amendment No. 2)

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(Mark One)

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

For the quarterly period ended March 31, 2005

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

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**ITT EDUCATIONAL SERVICES, INC.**

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(Exact name of registrant as specified in its charter)

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**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**

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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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

**46,165,579**

Number of shares of Common Stock, \$.01 par value, outstanding at March 31, 2005

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**Table of Contents**

**ITT EDUCATIONAL SERVICES, INC.**

Carmel, Indiana

Quarterly Report to Securities and Exchange Commission

March 31, 2005

**EXPLANATORY NOTE**

This Amendment No. 2 on Form 10-Q/A ( Form 10-Q/A ) to our Quarterly Report on Form 10-Q for the three months ended March 31, 2005, initially filed with the U.S. Securities and Exchange Commission ( SEC ) on April 26, 2005 and amended on April 27, 2005 ( Original Filing ), reflects a restatement ( Restatement ) of our Consolidated Financial Statements as discussed in Note 11 of the Notes to Consolidated Financial Statements. The determination to restate those financial statements was made as a result of our management 's identification of errors related to how we reported restricted cash and where we reported the tax benefit from stock option exercises on our Consolidated Statements of Cash Flows. Those errors were identified as a result of additional controls and enhanced procedures that we adopted during the preparation of our Consolidated Financial Statements in connection with the financial reporting close process of our 2005 fiscal year that ended on December 31, 2005. Further information on the effect of the Restatement on our Consolidated Statements of Cash Flows can be found in Note 11 of the Notes to Consolidated Financial Statements.

This Form 10-Q/A only amends and restates Items 1, 2 and 4 of Part I of the Original Filing. References to this Form 10-Q have been revised to refer to this Form 10-Q/A, and references to our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2004 have been revised to refer to the Form 10-K/A filed for that year. Although this Form 10-Q/A contains all of the items required to be included in a Quarterly Report on Form 10-Q, no other information in the Original Filing is amended hereby. The foregoing items have not been updated to reflect other events occurring after the Original Filing or to modify or update those disclosures affected by subsequent events. In addition, pursuant to the rules of the SEC, Item 6 of Part II of the Original Filing has been amended to contain the currently dated certifications from our Chief Executive Officer and Chief Financial Officer, as required by Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, and Section 906 of the Sarbanes-Oxley Act of 2002. Updated certifications of our Chief Executive Officer and Chief Financial Officer are attached to this Form 10-Q/A as Exhibits 31.1, 31.2, 32.1 and 32.2.

Except for the foregoing amended information, this Form 10-Q/A continues to speak as of the date of the Original Filing, and we have not updated the disclosure contained herein to reflect events that occurred at a later date. Other events occurring after the filing of the Original Filing or other disclosures necessary to reflect subsequent events have been addressed in our reports filed with the SEC subsequent to the filing of the Original Filing, including the Quarterly Reports on Form 10-Q for the periods ended June 30 and September 30, 2005, amendments of which are being filed concurrently with the filing of this Form 10-Q/A.

With this filing, we have amended the Original Filing. As such, our Consolidated Financial Statements as of and for the three months ended March 31, 2005 and 2004 and the related financial information contained in the Original Filing should no longer be relied upon. In addition, the financial information contained in our Quarterly Reports on Form 10-Q for the three months ended June 30 and September 30, 2005, previously filed by us, should no longer be relied upon.

**Table of Contents**

PART I

FINANCIAL INFORMATION

**Item 1. FINANCIAL STATEMENTS.**

**INDEX**

	<b>Page</b>
<u>Consolidated Balance Sheets as of March 31, 2005 and 2004 (unaudited) and December 31, 2004</u>	3
<u>Consolidated Statements of Income (unaudited) for the three months ended March 31, 2005 and 2004</u>	4
<u>Consolidated Statements of Cash Flows (unaudited) for the three months ended March 31, 2005 and 2004 (Restated)</u>	5
<u>Consolidated Statements of Shareholders' Equity for the three months ended March 31, 2005 (unaudited) and the year ended December 31, 2004</u>	6
<u>Notes to Consolidated Financial Statements (Restated)</u>	7

**Table of Contents****ITT EDUCATIONAL SERVICES, INC.****CONSOLIDATED BALANCE SHEETS****(In thousands, except per share data)**

	<b>March 31,</b>	<b>December 31,</b>	<b>March 31,</b>
	<b>2005</b>	<b>2004</b>	<b>2004</b>
	<b>(unaudited)</b>		<b>(unaudited)</b>
<b>Assets</b>			
Current assets			
Cash and cash equivalents	\$ 25,575	\$ 9,389	\$ 23,056
Restricted cash		8,194	
Short-term investments	320,563	332,570	222,227
Accounts receivable, net	12,785	10,430	8,519
Deferred and prepaid income tax	8,128	6,587	6,846
Prepays and other current assets	14,898	5,611	6,972
	<u>381,949</u>	<u>372,781</u>	<u>267,620</u>
Total current assets	381,949	372,781	267,620
Property and equipment, net	107,180	98,746	79,660
Direct marketing costs	15,609	14,713	11,979
Investments	5,182	6,363	20,674
Other assets	981	786	961
	<u>510,901</u>	<u>493,389</u>	<u>380,894</u>
Total assets	\$ 510,901	\$ 493,389	\$ 380,894
<b>Liabilities and Shareholders Equity</b>			
Current liabilities			
Accounts payable	\$ 36,748	\$ 33,769	\$ 36,627
Accrued compensation and benefits	10,837	16,122	12,335
Other accrued liabilities	30,573	26,418	25,878
Deferred revenue	150,663	156,792	127,685
	<u>228,821</u>	<u>233,101</u>	<u>202,525</u>
Total current liabilities	228,821	233,101	202,525
Deferred income tax	10,778	12,842	4,709
Minimum pension liability	9,101	9,101	7,012
Other liabilities	7,069	3,271	3,004
	<u>255,769</u>	<u>258,315</u>	<u>217,250</u>
Total liabilities	255,769	258,315	217,250
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	61,872	59,657	57,097
Retained earnings	308,172	293,910	228,397
Accumulated other comprehensive (loss)	(5,532)	(5,532)	(4,263)
Treasury stock, 7,903,325, 8,074,919 and 8,353,475 shares, at cost	(109,920)	(113,501)	(118,127)
	<u>255,132</u>	<u>235,074</u>	<u>163,644</u>
Total shareholders equity	255,132	235,074	163,644

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Total liabilities and shareholders' equity	\$ 510,901	\$ 493,389	\$ 380,894
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The accompanying notes are an integral part of these financial statements.

- 3 -

**Table of Contents**

**ITT EDUCATIONAL SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**

(In thousands, except per share data)

(unaudited)

	Three Months Ended March 31,	
	2005	2004
<b>Revenue</b>	\$ 160,153	\$ 141,730
<b>Costs and Expenses</b>		
Cost of educational services	80,121	76,493
Student services and administrative expenses	49,194	41,449
Special legal and other investigation costs	7,712	9,700
<b>Total costs and expenses</b>	<b>137,027</b>	<b>127,642</b>
Operating income	23,126	14,088
Interest income, net	1,714	709
Income before income taxes	24,840	14,797
Income taxes	9,812	5,771
Net income	<b>\$ 15,028</b>	<b>\$ 9,026</b>
Earnings per common share (basic):	<b>\$ 0.33</b>	<b>\$ 0.20</b>
Earnings per common share (diluted):	<b>\$ 0.32</b>	<b>\$ 0.19</b>

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

**Table of Contents****ITT EDUCATIONAL SERVICES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(Restated, See Note 11)</b>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 15,028	\$ 9,026
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	4,296	4,867
Provision for doubtful accounts	2,871	2,501
Deferred income taxes	(3,604)	(3,922)
Tax benefit from stock option exercises	2,005	4,259
Changes in operating assets and liabilities:		
Restricted cash	8,194	8,496
Short-term investments		(2,074)
Accounts receivable	(5,226)	(1,622)
Prepays and other assets	(9,482)	(3,488)
Direct marketing costs, net	(896)	(1,135)
Accounts payable and accrued liabilities	5,666	2,765
Deferred revenue	(6,129)	(2,679)
<b>Net cash flows from operating activities</b>	<b>12,723</b>	<b>16,994</b>
<b>Cash flows from investing activities:</b>		
Facility expenditures and land purchases	(9,584)	
Capital expenditures, net	(3,146)	(3,024)
Proceeds from sales and maturities of investments	193,747	240,986
Purchase of investments	(180,559)	(279,177)
<b>Net cash flows from investing activities</b>	<b>458</b>	<b>(41,215)</b>
<b>Cash flows from financing activities:</b>		
Purchase of treasury stock		
Exercise of stock options	3,005	4,235
<b>Net cash flows from financing activities</b>	<b>3,005</b>	<b>4,235</b>
<b>Net change in cash and cash equivalents</b>	<b>16,186</b>	<b>(19,986)</b>
Cash and cash equivalents at beginning of period	9,389	43,042
<b>Cash and cash equivalents at end of period</b>	<b>\$ 25,575</b>	<b>\$ 23,056</b>



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

**Table of Contents****ITT EDUCATIONAL SERVICES, INC.****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

(In thousands)

	<u>Common Stock</u>				<u>Compre- hensive Income</u>	<u>Accumulated</u>	<u>Treasury Stock</u>		<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Capital Surplus</u>	<u>Retained Earnings</u>		<u>Other Compre- hensive Income (Loss)</u>	<u>Shares</u>	<u>Amount</u>	
Balance as of December 31, 2003	54,069	\$ 540	\$ 52,688	\$ 221,400		\$ (4,263)	(8,638)	\$ (124,241)	\$ 146,124
Exercise of stock options			614	(2,753)			563	10,740	8,601
Tax benefit from stock option exercises			6,355						6,355
Comprehensive income:									
Net income for 2004				75,263	\$ 75,263				75,263
Other comprehensive income, net of tax:									
Minimum pension liability adjustment					(1,269)	(1,269)			(1,269)
Other comprehensive income					(1,269)				(1,269)
Comprehensive income					\$ 73,994				
Balance as of December 31, 2004	54,069	540	59,657	293,910		(5,532)	(8,075)	(113,501)	235,074
For the three months ended March 31, 2005 (unaudited):									
Exercise of stock options			196	(766)			171	3,575	3,005
Tax benefit from stock option exercises			2,005						2,005
Issue treasury stock for Directors Deferred Compensation Plan			14				1	6	20
Net income				15,028					15,028
Balance as of March 31, 2005	54,069	\$ 540	\$ 61,872	\$ 308,172		\$ (5,532)	(7,903)	\$ (109,920)	\$ 255,132

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

**Table of Contents**

**ITT EDUCATIONAL SERVICES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2005**

**(Dollar amounts in thousands, except per share data and unless otherwise stated)**

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements include the accounts of ITT Educational Services, Inc. and its wholly-owned subsidiaries. We prepared the accompanying unaudited consolidated financial statements in accordance with U.S. generally accepted accounting principles for interim periods and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures, including significant accounting policies, normally included in a complete presentation of financial statements prepared in accordance with and pursuant to those principles, rules and regulations have been omitted. In the opinion of our management, the financial statements contain all adjustments necessary to fairly state our financial condition and results of operations. 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/A as filed with the SEC for the year ended December 31, 2004.

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

*Revision in the Classification of Certain Cash Equivalents and Investments.* Certain cash equivalents and investments reclassifications have been made to the 2004 financial statements to conform to the 2005 presentation. Previously, some of our investments in auction rate debt securities and variable rate demand notes were recorded in cash and cash equivalents instead of short-term investments, based on their interest reset dates rather than their remaining contractual maturity dates. In addition, we had classified some of our investments in auction rate debt securities, variable rate demand notes and auction rate preferred equity securities as held-to-maturity securities instead of available-for-sale securities.

As a result, our Consolidated Balance Sheets were affected as follows:

cash and cash equivalents decreased and short-term investments increased by \$163,372 as of March 31, 2004; and

investments as of March 31, 2004 did not change.

We also made corresponding adjustments to our Consolidated Statements of Cash Flows for the three months ended March 31, 2004, as follows:

net cash provided by proceeds from sales and maturities of investments increased \$217,830 for the three months ended March 31, 2004;

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net cash used for purchase of investments increased \$255,971 for the three months ended March 31, 2004; and

net increase (decrease) in cash, cash equivalents and restricted cash decreased \$38,141 for the three months ended March 31, 2004.

The reclassifications had no impact on our total current assets, cash flows provided by (used for) operating activities, or total consolidated results reported in any period presented.

*Stock Options.* We adopted and our stockholders approved the ITT Educational Services, Inc. 1994 Stock Option Plan ( 1994 Stock Plan ) and the 1997 ITT Educational Services, Inc. Incentive Stock Plan ( 1997 Stock Plan ). We also established the 1999 Outside Directors Stock Option Plan ( 1999 Directors Stock Plan ), which provides for awards of non-qualified stock options to non-employee Directors. The 1994 Stock Plan, the 1997 Stock Plan and the 1999 Directors Stock Plan are referred to herein collectively as 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 ( APB ) 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 for the three months ended March 31, 2005 and 2004 would have been reduced to the proforma amounts indicated below:

**Table of Contents**

	Three Months	
	Ended March 31,	
	2005	2004
Net income as reported	\$ 15,028	\$ 9,026
Deduct: Total stock-based employee compensation expense determined under the fair value based method for stock options, net of tax	(1,942)	(1,922)
<b>Proforma net income</b>	<b>\$ 13,086</b>	<b>\$ 7,104</b>
<b>Earnings per share:</b>		
Basic as reported	\$ 0.33	\$ 0.20
Basic proforma	\$ 0.28	\$ 0.16
Impact of stock options	\$ (0.05)	\$ (0.04)
Diluted as reported	\$ 0.32	\$ 0.19
Diluted proforma	\$ 0.28	\$ 0.15
Impact of stock options	\$ (0.04)	\$ (0.04)

The fair value of each option grant: (a) in 2005 was estimated on the date of grant using the AON Actuarial Binomial Model for stock option pricing with the following assumptions for the three months ended March 31, 2005; and (b) in 2004 was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions for the three months ended March 31, 2004.

	Three Months Ended	
	March 31,	
	2005	2004
Risk free interest rates	3.8%	3.2%
Expected lives (in years)	4.89	5.0
Volatility	46%	57%
Dividend yield	None	None

*Leases.* We lease our non-owned facilities under operating lease agreements. Certain of our lease agreements contain: renewal options, which can be exercised after the initial lease term; rent holidays; tenant improvement allowances; and/or rent escalation clauses. We record rent expense associated with each lease agreement evenly over the term of the lease in accordance with SFAS No. 13, Accounting for Leases. The difference between rent expense recorded and amounts paid is recorded as accrued rent on our Consolidated Balance Sheets. We amortize leasehold improvements using the straight-line method over the shorter of the life of the improvement or the remaining term of the lease.

**3. New Accounting Pronouncements**

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 APB Opinion 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. In September 2004, the FASB issued FASB Staff Position

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EITF 03-1-1, which delays the effective date until additional guidance is issued for the application of the recognition and measurement provisions of EITF 03-1 to investments in securities that are impaired. The disclosure requirements of EITF 03-1, however, are effective for annual periods ending 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.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment* that revises SFAS No. 123, *Accounting for Stock-Based Compensation* and supercedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Under this revised standard, all share-based payments to employees, including grants of employee stock options, must be reflected in the financial statements using the fair value method with the related expenses recognized over the service period. SFAS No. 123R will

## **Table of Contents**

be effective for fiscal years beginning after June 15, 2005 and allows for several alternative transition methods. We expect to adopt SFAS No. 123R in our 2006 fiscal year on a modified-prospective basis without restating prior periods, which will require that we recognize compensation expense for all stock option and other equity-based awards that vest or become exercisable after the effective date. We are currently evaluating the impact that SFAS No. 123R will have on our financial condition or results of operations.

### **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 \$7,712 in the three months ended March 31, 2005 and \$9,700 in the three months ended March 31, 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, shareholder derivative and books and records inspection 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 were billed \$2,214 of those legal costs in the three months ended March 31, 2005 and \$15,950 of those legal costs in the year ended December 31, 2004. We regularly evaluate the reasonableness of our estimate of the probable legal costs associated with the Actions and make any adjustments considered necessary. We believe that it is probable that we will incur at least \$28,417 in legal costs related to these matters (\$20,705 recorded in the year ended December 31, 2004 and \$7,712 recorded in the three months ended March 31, 2005). 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 are 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 did not incur any non-legal costs related to the Actions during the three months ended March 31, 2005 or 2004. We incurred \$4,438 of non-legal costs related to the Actions during the year ended December 31, 2004.

### **5. Investments**

We have investments in marketable debt and auction rate preferred equity securities, which are classified as available-for-sale or held-to-maturity, depending on our investment intentions with regard to those securities. Marketable debt securities classified as available-for-sale securities that have remaining contractual maturity dates in excess of 90 days at the time of purchase are recorded at their market value. Marketable debt securities classified as held-to-maturity securities are recorded at their amortized cost, because we have the intent and ability to hold those investments until they mature. Auction rate preferred equity securities classified as available-for-sale securities are recorded at their market value. Investments that we intend to hold for more than one year are recorded as non-current investments.

Our investments included auction rate debt securities, variable rate demand notes and auction rate preferred equity securities that were classified as available-for-sale securities and recorded in short-term investments and investments on our Consolidated Balance Sheets as of March 31, 2005, December 31, 2004 and March 31, 2004. Despite the long-term nature of the contractual maturities of our auction rate debt securities and variable rate demand notes, we have the ability to quickly liquidate those investments. We also had no material gross unrealized holding or realized gains (losses) from our investments in auction rate debt securities and variable rate demand notes for the three months ending March 31, 2005 and 2004. All income generated from those investments was recorded as interest income.

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

	As of March 31, 2005			As of Dec. 31, 2004			As of March 31, 2004			
	Available- For-Sale	Held-to- Maturity	Total	Available- For-Sale	Held-to- Maturity	Total	Trading Securities	Available- For-Sale	Held-to- Maturity	Total
Short-term investments	\$ 300,726	\$ 19,837	\$ 320,563	\$ 309,567	\$ 23,003	\$ 332,570	\$ 15,165	\$ 193,713	\$ 13,349	\$ 207,062
Non-current investments	1,002	4,180	5,182	1,000	5,363	6,363		15,355	5,319	20,674
	<b>\$ 301,728</b>	<b>\$ 24,017</b>	<b>\$ 325,745</b>	<b>\$ 310,567</b>	<b>\$ 28,366</b>	<b>\$ 338,933</b>	<b>\$ 15,165</b>	<b>\$ 209,068</b>	<b>\$ 18,668</b>	<b>\$ 227,736</b>

- 9 -



**Table of Contents**

The contractual maturities of our marketable debt securities classified as available-for-sale as of March 31, 2005 were as follows:

<u>Available-For-Sale</u>	<u>Fair Value</u>
Due within five years	\$ 10,116
Due after five years through ten years	1,002
Due after ten years	194,187
	<u>\$ 205,305</u>

The above table excludes \$96,423 of auction rate preferred equity securities that were classified as available-for-sale securities as of March 31, 2005. Our non-current investments that were classified as held-to-maturity securities as of March 31, 2005 had remaining contractual maturities between one and two years.

**6. Property and Equipment**

During the three months ended March 31, 2005, we purchased one facility for \$4,725 and expended \$4,859 as we continued building facilities on four other parcels of land.

**7. Earnings Per Common 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.

	<b>Average Shares Outstanding</b>	
	<b>for the Three Months Ended</b>	
	<b>March 31,</b>	
	<u>2005</u>	<u>2004</u>
	<b>(in thousands)</b>	
Basic	46,086	45,608
Diluted	47,079	46,763

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. Shares

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underlying outstanding stock options with exercise prices greater than the average market price of our common stock (1,075 shares at March 31, 2005 and 688 shares at March 31, 2004) 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 for the three months ended March 31, 2005 and 2004 are as follows:

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Service cost	\$ 1,800	\$ 1,765
Interest cost	725	570
Expected return on assets	(800)	(550)
Recognized net actuarial loss	325	250
Amortization of prior service cost	(22)	(25)
	\$ 2,028	\$ 2,010

In January 2005, we contributed \$11,795 to the Pension Plan. This amount represents the total amount we intend to contribute to the Pension Plan in 2005.

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**Table of Contents**

**9. Letters of Credit**

During the three months ended March 31, 2005, we continued to provide 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 March 31, 2005, the total face value of those surety bonds was \$8,397. In addition, we have continued to provide irrevocable letters of credit in the total amount of \$2,143 to our workers' compensation insurance providers to secure the payment of our workers' compensation claims.

**10. Contingencies**

On November 5, 1999, a qui tam action was filed 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 under the following caption: *United States ex rel. Dan Graves and Susan Newman v. ITT Educational Services, Inc., et al.* (the Graves Action). The Graves 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 \$10,000 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 Graves 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 Graves 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 (5<sup>th</sup> Circuit). On October 20, 2004, the 5<sup>th</sup> Circuit affirmed the district court's judgment that dismissed with prejudice all of the relators' claims against us and the other defendants in the Graves Action. On November 3, 2004, the relators filed a petition with the 5<sup>th</sup> Circuit requesting a rehearing *en banc* of the relators' appeal. On November 18, 2004, the 5<sup>th</sup> Circuit denied the relators' request for a rehearing. On or about February 17, 2005, the relators filed a petition with the U.S. Supreme Court requesting that the Court hear the relators' appeal of the 5<sup>th</sup> Circuit's affirmation of the district court's judgment dismissing the Graves Action. On April 18, 2005, the U.S. Supreme Court denied the relators' petition.

On March 4, 2005, we were served with a qui tam action that was filed on April 8, 2004 in the United States District Court for the Southern District of Indiana by a former employee (relator) on behalf of himself and the federal government under the following caption: *United States of America ex rel. Robert Olson v. ITT Educational Services, Inc. d/b/a ITT Technical Institute* (the Olson Action). The relator alleges that we violated the False Claims Act, 31 U.S.C. § 3729, *et seq.*, by knowingly making and using false records and statements relating to, among other things, student recruitment, admission, enrollment, attendance and grading, graduate placement and course materials in order to fraudulently participate in the federal student financial aid programs. The complaint seeks an unspecified judgment and attorney's fees and costs. We were served with the Olson Action after the DOJ declined to intervene in the litigation. We intend to defend ourselves vigorously against the allegations made in the complaint.

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.

## Table of Contents

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, graduation rates and graduates' salaries. 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 we cannot assure you 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 had 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. We cannot assure you, 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 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. 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.

On August 19, 2004, a consolidated complaint in a securities class action lawsuit was filed against us and ten of our current and former Directors and executive officers in the U.S. 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, as amended ( "Exchange 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. We cannot assure you, 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.

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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, ten 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. On December 1, 2004, the court dismissed the consolidated complaint without prejudice and gave the plaintiffs 30 days to replead their complaint. On January 3, 2005, the plaintiffs filed an amended consolidated complaint. The amended consolidated complaint alleges, among other things, that:

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

- 12 -

**Table of Contents**

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 amended 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, ten of our current and former Directors and PWC, in the U.S. 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 Exchange 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 Exchange 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. On December 8, 2004, the parties agreed to stay this action pending the entry of a final judgment in the *In Re ITT Educational Services, Inc. Derivative Litigation* action, except that the stay will be lifted if a subsequently filed shareholder derivative lawsuit is filed in the Southern District of Indiana and the defendants are unable to enter into a similar stay of that action. All of the individual defendants intend to defend themselves vigorously against the allegations in the complaint.



## Table of Contents

On November 17, 2004, a shareholder derivative lawsuit was filed against ten of our current and former Directors, in the Chancery Court of New Castle County, Delaware under the following caption: *Albert Reitan, derivatively on behalf of nominal defendant ITT Educational Services, Inc. v. Rand V. Araskog, et al.* The complaint alleges, among other things, that the defendants abdicated their fiduciary duty of good faith to us by making no effort to oversee our operations and business practices to ensure that we comply with all applicable laws, rules and regulations. The complaint seeks unspecified damages, equitable relief, attorneys' fees, accountants' fees, experts' fees, costs and expenses. On March 31, 2005, in response to the parties' request, the court issued an order staying this action until the entry of a final judgment in the *City of Austin Police Retirement System, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc. et al.* action. All of the defendants intend to defend themselves vigorously against the allegations in the complaint.

On July 7, 2004, we received a derivative demand letter pursuant to Del. Ct. Ch. R. 23.1 on behalf of Arthur Stein, 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 Mr. Stein 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 Mr. Stein that our Board has deferred its decision with respect to Mr. Stein's demand until the conclusion of the DOJ investigation of us, the inquiry initiated by the SEC into the allegations being investigated by the DOJ and the securities class action lawsuits filed against us, or until the receipt of additional information concerning the allegations made in the demand.

On October 26, 2004, a lawsuit was filed against us in the Chancery Court of New Castle County, Delaware under the following caption: *Arthur Stein v. ITT Educational Services, Inc.* The complaint alleges that we violated Section 220 of the Delaware General Corporation Law by refusing to allow Mr. Stein to inspect and make copies of our books and records relating to the misconduct alleged in his derivative demand letter described above. The complaint seeks an order compelling us to permit Mr. Stein to inspect and make copies of our books and records, and to pay his costs, expenses and attorney's fees to prosecute this action. We intend to defend the action vigorously.

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 we cannot assure you that the ultimate outcome of these or other actions will not have a material adverse effect on our financial condition or results of operations.

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.

11. **Restatement of Consolidated Financial Statements**

Our restricted cash results from our use of the U.S. Department of Education's (ED) electronic funds transfer system as part of our participation in the federal student financial aid programs under Title IV (the Title IV Programs) of the Higher Education

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**Table of Contents**

Act of 1965, as amended. All monies transferred to us from the ED by electronic funds transfer are subject to certain holding restrictions. We cannot use those funds until we apply them to our students' accounts, which typically occurs within three business days. We previously reported restricted cash with cash and cash equivalents in the beginning and ending balances reconciled on our Consolidated Statements of Cash Flows. SFAS No. 95, however, states that the beginning and ending balances reconciled on a statement of cash flows should include only the change in cash and cash equivalents during the period. To correct the positioning of restricted cash, we removed restricted cash from the beginning and ending balances reconciled and now report restricted cash under a separate caption in the cash flows from operating activities section on our Consolidated Statements of Cash Flows as a component of the adjustments to reconcile net income to net cash from operating activities. The effect of the change in how we report restricted cash on our Consolidated Statements of Cash Flows for:

the three months ended March 31, 2005, was to:

decrease the beginning balance in cash and cash equivalents by \$8,194; and

increase net cash flows from operating activities by \$8,194; and

the three months ended March 31, 2004, was to:

decrease the beginning balance in cash and cash equivalents by \$8,496; and

increase net cash flows from operating activities by \$8,496.

The change in how we report restricted cash on our Consolidated Statements of Cash Flows had no effect on any of our previously issued Consolidated Balance Sheets, Consolidated Statements of Income or Consolidated Statements of Shareholders' Equity. Our previously issued financial statements reported restricted cash under a separate caption in the current assets section on our Consolidated Balance Sheets, which is not being changed as part of the Restatement.

We have awarded non-qualified stock options to our employees and the non-employee members of our Board of Directors ( Stock Options ). In 2005 and prior periods, we followed the intrinsic value based method of accounting for the Stock Options in accordance with APB No. 25 and adopted the disclosure only provisions of SFAS No. 123. Effective January 1, 2006, we adopted SFAS No. 123R which supercedes APB Opinion No. 25. When a Stock Option is exercised, we receive a tax deduction in the amount that the fair market value of our common stock on the date of exercise exceeds the exercise price of the Stock Option, because that amount is taxable to the optionee. Pursuant to APB Opinion No. 25, however, we did not recognize any tax benefit resulting from a Stock Option exercise on our Consolidated Statements of Income. As a result, any tax benefit realized by us from a Stock Option exercise was reported under the capital surplus caption in the shareholders' equity section on our Consolidated Balance Sheets. We previously reported the amount of the tax benefit from Stock Option exercises under the exercise of stock options caption in the cash flows from financing activities section on our Consolidated Statements of Cash Flows. EITF Issue No. 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option, provides, however, that a company's income tax benefit from stock option exercises should be reported in the cash flows from operating activities section on its consolidated statements of cash flows. To correct this classification, we changed our reporting of the tax benefit from Stock Option exercises by removing those benefits from under the exercise of stock options caption in the cash flows from financing activities section on our Consolidated Statements of Cash Flows and reporting those benefits under a separate caption entitled, tax benefit from stock option exercises, in the cash flows from operating activities section on our Consolidated Statements of Cash Flows, as a component of the adjustments to reconcile net income to net cash from operating activities. The effect of the change in where we report the tax benefit from Stock Option exercises on our annual Consolidated Statements of Cash Flows for the three months ended March 31, 2005 and 2004 was to: (a) decrease cash flows from financing activities by \$2,005 in the three months ended March 31, 2005, and \$4,259 in the three months ended March 31, 2004; and (b) increase cash flows from operating activities by \$2,005 in the three months ended March 31, 2005 and \$4,259 in the three months ended March 31, 2004. The change in where we report the tax benefit from Stock Option exercises on our Consolidated

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Statements of Cash Flows had no effect on: (i) any of our previously issued Consolidated Balance Sheets, Consolidated Statements of Income or Consolidated Statements of Shareholders' Equity; or (ii) the cash and cash equivalents at beginning of period or the cash and cash equivalents at end of period that are reported on any of our previously issued Consolidated Statements of Cash Flows.

The impact of the Restatement on our Consolidated Statements of Cash Flows for the three months ended March 31, 2005 and 2004, is shown in the following table.

- 15 -

Table of Contents

## ITT EDUCATIONAL SERVICES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	RESTATED		AS PREVIOUSLY PRESENTED IN 2005 SEC FILINGS	
	For the Three Months Ended		For the Three Months Ended	
	March 31, 2005	March 31, 2004	March 31, 2005	March 31, 2004
<b>Cash flows from operating activities:</b>				
Net income	\$ 15,028	\$ 9,026	\$ 15,028	\$ 9,026
Adjustments to reconcile net income to net cash from operating activities:				
Depreciation and amortization	4,296	4,867	4,296	4,867
Provision for doubtful accounts	2,871	2,501	2,871	2,501
Deferred income taxes	(3,604)	(3,922)	(3,604)	(3,922)
Tax benefit from stock option exercises	2,005	4,259		
Changes in operating assets and liabilities:				
Restricted cash	8,194	8,496		
Short-term investments		(2,074)		(2,074)
Accounts receivable	(5,226)	(1,622)	(5,226)	(1,622)
Prepays and other assets	(9,482)	(3,488)	(9,482)	(3,488)
Direct marketing costs, net	(896)	(1,135)	(896)	(1,135)
Accounts payable and accrued liabilities	5,666	2,765	5,666	2,765
Deferred revenue	(6,129)	(2,679)	(6,129)	(2,679)
Net cash flows from operating activities	12,723	16,994	2,524	4,239
<b>Cash flows from investing activities:</b>				
Facility expenditures and land purchases	(9,584)		(9,584)	
Capital expenditures, net	(3,146)	(3,024)	(3,146)	(3,024)
Proceeds from sales and maturities of investments	193,747	240,986	193,747	240,986
Purchase of investments	(180,559)	(279,177)	(180,559)	(279,177)
Net cash flows from investing activities	458	(41,215)	458	(41,215)
<b>Cash flows from financing activities:</b>				
Purchase of treasury stock				
Exercise of stock options	3,005	4,235	5,010	8,494
Net cash flows from financing activities	3,005	4,235	5,010	8,494
Net change in cash and cash equivalents	16,186	(19,986)		
Net change in cash, cash equivalents and restricted cash			7,992	(28,482)

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Cash and cash equivalents at beginning of period	9,389	43,042		
	<u>          </u>	<u>          </u>		
Cash, cash equivalents and restricted cash at beginning of period			17,583	51,538
			<u>          </u>	<u>          </u>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 25,575</b>	<b>\$ 23,056</b>		
	<u>          </u>	<u>          </u>		
<b>Cash, cash equivalents and restricted cash at end of period</b>			<b>\$ 25,575</b>	<b>\$ 23,056</b>
			<u>          </u>	<u>          </u>

- 16 -

## **Table of Contents**

### **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 reflects the restatement of our Consolidated Financial Statements, as discussed in Note 11 of the Notes to Consolidated Financial Statements.

#### **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 safe harbor provision of the Private Securities Litigation Reform Act of 1995 and as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act. Forward-looking statements are made based on our management's current expectations and beliefs concerning future developments and their potential effects on us. You can identify these statements by the use of words such as "could," "should," "would," "may," "will," "project," "believe," "anticipate," "expect," "plan," "estimate," "forecast," "potential," "intend," "continue," and "contemplate," as well as similar words and expressions. Forward-looking statements involve risks and uncertainties and do not guarantee future performance. We cannot assure you that future developments affecting us will be those anticipated by our management. 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;*

*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 our 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 results of 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 results of operations; and*

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*the results of the securities class action, shareholder derivative and books and records inspection lawsuits filed against us, which, if adversely determined, could have a material adverse effect 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, including, without limitation, those discussed in Item 1. Business--Risk Factors of our Annual Report on Form 10-K/A as filed with the SEC for the year ended December 31, 2004. We undertake no obligation to update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.*

### **Overview**

You should keep in mind the following points as you read this report:

References in this document to we, us, our and ITT/ESI refer to ITT Educational Services, Inc. and its subsidiaries.

The terms ITT Technical Institute or institute (in singular or plural form) refer to an individual school owned and operated by ITT/ESI, including its learning sites, if any. The terms institution or campus group (in singular or plural form) mean a main campus and its additional locations, branch campuses and/or learning sites, if any.



**Table of Contents**

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/A as filed with the SEC for the year ended December 31, 2004 for discussion of, among other matters, the following items:

Cash receipts from financial aid programs

Nature of capital additions

Seasonality of revenue

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 revenue that may be derived from the Title IV Programs

Return of Title IV Program funds for withdrawn students

Default rates

Private loan programs

Investments

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

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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, shareholder derivative and books and records inspection lawsuits filed against us, if adversely determined, could have a material adverse effect on our financial condition and results of operations.

We are a leading provider of technology-oriented postsecondary degree programs in the United States based on revenue and student enrollment. As of March 31, 2005, we were offering associate, bachelor and master degree programs and non-degree diploma programs to more than 40,000 students. We currently have 78 institutes located in 31 states. Each of our institutes is (a) authorized by the applicable education authorities of the states in which it operates and recruits and (b) accredited by an accrediting commission recognized by the ED. We design our education programs, after consultation with employers, to help graduates prepare for careers in various fields involving their areas of study. As of March 31, 2005, more than 99% of our program offerings were degree programs, and we were seeking authorization to award a degree in the remaining programs. We have provided career-oriented education programs since 1969 under the ITT Technical Institute name, and our institutes have graduated over 185,000 students since 1976.

In 2004, we opened new institutes and began using learning sites. A learning site is an institute location where educational activities are conducted and student services are provided away from the institute's campus. We plan to open three or four new institutes and add up to four new learning sites to existing institutes in the remainder of 2005. In 2004, we developed several new residence and online bachelor and associate degree programs. At the end of 2004, all of our residence associate degree and bachelor degree programs were being taught on a three-day-per-week class schedule or under 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 through the Hybrid Delivery Model. In 2004, we expanded the use of the Hybrid Delivery Model to most of our institutes. In 2004, we also expanded our alliance with an international educator in China, pursuant to which more of our curricula are offered to students in China either by us through online programs offered over the Internet or by the international educator through residence programs under a license to use our curricula. We intend to continue expanding by opening new institutes, adding learning sites to existing institutes, offering a broader range of both residence and online programs at our existing institutes and pursuing new and expanded alliances with both domestic and international educators. We also intend to further expand our Hybrid Delivery Model by teaching more of the courses in each of our programs online over the Internet and fewer courses in residence on campus.

## **Table of Contents**

### **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, revenue 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/A as filed with the SEC for the year ended December 31, 2004.

*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 Revenue.* Tuition revenue is 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 revenue 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 included in the tuition and 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. Tool kit sales and the related cost of the tool kits are recognized at the beginning of each academic quarter. Academic fees (which are charged only one time to students on their first day of class attendance) and admission processing fees (which, prior to their discontinuance in 2003, 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. Administrative fees, which are charged to students when they withdraw or graduate from their programs of study at an institute, are recognized when the students withdraw or graduate from their programs of study.

More than 97% of our revenue represents tuition charges (which include the cost of textbooks and other course materials distributed to students) and less than 3% of our revenue represents 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 revenue is 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, if any. 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.

**Table of Contents**

*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 estimable 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. Although we believe our estimates are reasonable, deviations from our estimates could produce a materially different result.

**New Accounting Pronouncements**

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 APB Opinion 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*. In September 2004, the FASB issued FASB Staff Position EITF 03-1-1, which delays the effective date until additional guidance is issued for the application of the recognition and measurement provisions of EITF 03-1 to investments in securities that are impaired. The disclosure requirements of EITF 03-1, however, are effective for annual periods ending 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 for additional disclosures regarding our investments.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment* that revises SFAS No. 123, *Accounting for Stock-Based Compensation* and supercedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Under this revised standard, all share-based payments to employees, including grants of employee stock options, must be reflected in the financial statements using the fair value method with the related expenses recognized over the service period. SFAS No. 123R will be effective for fiscal years beginning after June 15, 2005 and allows for several alternative transition methods. We expect to adopt SFAS No. 123R in our 2006 fiscal year on a modified-prospective basis without restating prior periods, which will require that we recognize compensation expense for all stock option and other equity-based awards that vest or become exercisable after the effective date. We are currently evaluating the impact that SFAS No. 123R will have on our financial condition or results of operations.

**Results of Operations**

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

	<b>Three Months</b>	
	<b>Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>—</b>	<b>—</b>
Revenue	100.0%	100.0%
Cost of educational services	50.0	54.0
Student services and administrative expenses	30.8	29.2
Special legal and other investigation costs	4.8	6.9
	<b>—</b>	<b>—</b>
Operating income	14.4	9.9

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Interest income, net	1.1	0.5
Income before income taxes	15.5%	10.4%

The following table sets forth our total student enrollment as of the dates indicated:

Total Student Enrollment as of	2005		2004	
	Total Student Enrollment	Increase Over Prior Year	Total Student Enrollment	Increase Over Prior Year
March 31	41,557	8.8%	38,192	18.2%
June 30	Not applicable	Not applicable	38,810	16.0%
September 30	Not applicable	Not applicable	42,222	13.6%
December 31	Not applicable	Not applicable	40,876	10.2%

- 20 -

**Table of Contents**

A new student is any student who, in the academic quarter being measured, enrolls in and begins attending any program of study at an ITT Technical Institute:

for the first time at that institute;

after graduating from a different program of study at that institute in a prior academic quarter; or

after having withdrawn or been terminated from a program of study at that institute.

The following table sets forth our total new student enrollment for the periods indicated:

New Student Enrollment for the Three Months Ended	2005		2004	
	New Student Enrollment	Increase Over Prior Year	New Student Enrollment	Increase Over Prior Year
March 31	9,824	6.1%	9,255	28.0%
June 30	Not applicable	Not applicable	10,261	18.3%
September 30	Not applicable	Not applicable	14,534	14.5%
December 31	Not applicable	Not applicable	7,909	8.7%
<b>Total for the year</b>	Not applicable	Not applicable	<b>41,959</b>	<b>16.9%</b>

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 early March, mid-June, early September and late November. 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 immediately preceding academic quarter. A continuing student is any student who, in the academic quarter being measured, 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 immediately 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.

The following table sets forth the rates of our students' persistence for each quarter in 2005, 2004, and 2003:

Students Persistence for the Three Months Ended	2005	2004	2003
March 31	77.6%	78.0%	76.9%
June 30	Not applicable	74.8%	76.6%
September 30	Not applicable	71.3%	73.2%

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December 31

Not applicable

78.1%

80.2%

*Three Months Ended March 31, 2005 Compared with Three Months Ended March 31, 2004*

Revenue increased \$18.5 million, or 13.0%, to \$160.2 million in the three months ended March 31, 2005 from \$141.7 million in the three months ended March 31, 2004, primarily due to:

a 6.0% increase in tuition rates in March 2004 and a 5% increase in tuition rates in March 2005;

a 10.2% increase in the total student enrollment at December 31, 2004 compared to December 31, 2003; and

a 6.1% increase in new student enrollment at our institutes in the three months ended March 31, 2005 compared to the same period in 2004.

The increases in total and new student enrollment were primarily a result of:

the opening of new institutes;

an increased number of new programs of study offered by our institutes;

an increased number of responses to our marketing and advertising;

the availability of private student loans to supplement federal student financial aid;



**Table of Contents**

national demographic trends that are favorable to the postsecondary education industry; and

the use of the Hybrid Delivery Model at more institutes.

Cost of educational services increased \$3.6 million, or 4.7%, to \$80.1 million in the three months ended March 31, 2005 from \$76.5 million in the three months ended March 31, 2004. The principal causes of this increase included:

the costs required to service the increased enrollment; and

normal inflationary cost increases for wages and other costs of services.

Cost of educational services as a percentage of revenue decreased to 50.0% in the three months ended March 31, 2005 from 54.0% in the three months ended March 31, 2004. The primary causes of this decrease included:

expanded use of the Hybrid Delivery Model;

continued facility and faculty utilization efficiencies; and

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

Student services and administrative expenses increased \$7.7 million, or 18.7%, to \$49.2 million in the three months ended March 31, 2005 from \$41.5 million in the three months ended March 31, 2004. 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 (25.2%) to promote new program offerings.

Student services and administrative expenses increased to 30.8% of revenue in the three months ended March 31, 2005 compared to 29.2% of revenue in the three months ended March 31, 2004, primarily due to an increase in media advertising costs.

We recorded an incremental charge of \$7.7 million for legal costs associated with the Actions during the three months ended March 31, 2005. See Note 4 of the Notes to Consolidated Financial Statements set forth elsewhere in this report.

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Operating income increased \$9.0 million, or 64.2%, to \$23.1 million in the three months ended March 31, 2005 from \$14.1 million in the three months ended March 31, 2004. The operating margin increased to 14.4% of revenue in the three months ended March 31, 2005 from 9.9% in the three months ended March 31, 2004, primarily as a result of:

a \$2.0 million reduction in special legal and other investigation costs (resulting in a 2.1% increase in margin);

expanded use of the Hybrid Delivery Model;

continued facility and faculty utilization efficiencies; and

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

*Income Taxes.* Our combined effective federal and state income tax rate in 2005 was 39.5% compared to 39.0% in 2004, 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 Exchange Act.

We did not repurchase any outstanding shares of our common stock during the three months ended March 31, 2005 and 2004. As of March 31, 2005, our existing repurchase authorization permits us to repurchase an additional 4.2 million shares of our

**Table of Contents**

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 \$12.7 million in the three months ended March 31, 2005 compared to \$17.0 million in the three months ended March 31, 2004, primarily as a result of a \$5.1 million increase in our contribution to the Pension Plan in the three months ended March 31, 2005 compared to the same period in 2004. As of March 31, 2005, we had \$24.0 million of investments that we plan to hold until maturity. We intend to hold \$4.2 million of those investments beyond one year from the Consolidated Balance Sheet date of March 31, 2005.

Deferred revenue, which represents the cash received from students in excess of tuition earned, increased \$23.0 million to \$150.7 million at March 31, 2005 from \$127.7 million at March 31, 2004. This increase was primarily due to increased tuition revenue resulting from a greater number of students and higher tuition rates, and our students' increased use of supplemental private loans.

We purchased one facility for \$4.7 million during the three months ended March 31, 2005. We continued building facilities on four other parcels of land at a cost of \$4.9 million during the three months ended March 31, 2005. We have agreed to purchase three parcels of land for \$3.9 million (on which we intend to build facilities) and one facility for \$7.5 million in the remaining fiscal year ending December 31, 2005. We may purchase additional facilities during the remainder of 2005. Capital expenditures were \$3.1 million in the three months ended March 31, 2005 compared to \$3.0 million in the three months ended March 31, 2004.

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 March 31, 2005.

<b>Contractual Obligations</b>	<b>Payment Due by Period</b>				
	<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	<b>More than 5 Years</b>
	(In millions)				
Operating Lease Obligations	\$ 113.0	\$ 13.3	\$ 43.6	\$ 33.3	\$ 22.8
Purchase Obligations (1)					
<b>Total</b>	<b>\$ 113.0</b>	<b>\$ 13.3</b>	<b>\$ 43.6</b>	<b>\$ 33.3</b>	<b>\$ 22.8</b>

(1) Does not include agreements to:

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purchase three parcels of land for a cost of \$3.9 million;

purchase one facility for \$7.5 million;

continue building facilities on four parcels of land at a total cost not to exceed \$2.4 million; and

purchase custom course materials as needed over the next five years.

These agreements do not constitute contractual purchase obligations that require disclosure under the SEC's rules and regulations.

### **Off-Balance Sheet Arrangements**

As of March 31, 2005, 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 12 years and management expects that:

those leases will be renewed or replaced by other leases in the normal course of business;

we may purchase the facilities represented by those leases; or

we may purchase or build other facilities.

- 23 -

## **Table of Contents**

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 March 31, 2005, the total face amount of those surety bonds was \$8.4 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. In addition, we have provided irrevocable letters of credit in the total amount of \$2.1 million to our workers' compensation insurance providers to secure payment of our workers' compensation claims.

From 1994 through 1999, we entered into agreements with unaffiliated, private funding sources to provide supplemental loans to students to help pay the students' cost of education that federal and state financial aid sources did not cover. Some of these agreements required us to guarantee repayment of the supplemental student loans if the students fail to pay. The outstanding loans under these agreements at March 31, 2005 aggregated \$0.8 million, for which we have fully reserved for our guarantee obligation.

Certain of our current and former officers and Directors are or may become a party in certain of the Actions. 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 the Actions.

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

Our investments in marketable debt securities with remaining contractual maturity dates of 90 days or less are recorded in cash and cash equivalents at cost, which approximates market value. We have investments in marketable debt and auction rate preferred equity securities, which are classified as trading, available-for-sale or held-to-maturity, depending on our investment intentions with regard to those securities. Marketable debt securities classified as trading or available-for-sale securities that have remaining contractual maturity dates in excess of 90 days at the time of purchase are recorded at their market value. Marketable debt securities classified as held-to-maturity securities are recorded at their amortized cost, because we have the intent and ability to hold those investments until they mature. Auction rate preferred equity securities classified as available-for-sale securities are recorded at their market value. Investments that we intend to hold for more than one year are recorded as non-current investments.

We estimate that the market risk associated with our investments in marketable debt and auction rate preferred equity 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 marketable debt and auction rate preferred equity securities would not be material.

### **Item 4. CONTROLS AND PROCEDURES.**

(a) Evaluation of Disclosure Controls and Procedures.

We are responsible for establishing and maintaining 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: (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms; and (ii) accumulated and communicated to our management, including our principal executive and principal financial officers, to allow timely decisions regarding required disclosures. In designing and evaluating our DCP, we recognize that any controls and procedures, no matter how well designed and implemented, can provide only reasonable assurance of achieving the desired control objectives, and that our management's duties require it to make its best judgment regarding the design of our DCP.

As of March 31, 2005, we conducted 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 DCP pursuant to Rule 13a-15 of the Exchange Act. Based on that evaluation, our management concluded that our DCP were not effective as of March 31, 2005, as a result of a material weakness in our internal control over our financial reporting ( ICFR ),

## Table of Contents

as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act, with respect to accounting for cash flows from operating and financing activities. Specifically, the controls over the presentation of cash flows from (i) restricted cash and (ii) the tax benefit from stock option exercises were not effective, resulting in the restatement of our annual Consolidated Financial Statements for the years ended December 31, 2004, 2003 and 2002 and interim Consolidated Financial Statements for the three months ended March 31, June 30 and September 30, 2005 and 2004. In addition, this control deficiency could result in a misstatement of our cash flows from operating activities and cash flows from financing activities that would result in a material misstatement to our annual or interim Consolidated Financial Statements that would not be prevented or detected. Accordingly, our management has determined that this control deficiency constitutes a material weakness. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

### (b) Changes in Internal Control Over Financial Reporting.

There were no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II

### OTHER INFORMATION

#### **Item 1. LEGAL PROCEEDINGS.**

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 estimable 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.

On November 5, 1999, a qui tam action was filed 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 under the following caption: *United States ex rel. Dan Graves and Susan Newman v. ITT Educational Services, Inc., et al.* (the Graves Action). The Graves 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 \$10,000 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.

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On May 25, 2001, the DOJ declined to intervene in the Graves 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 Graves 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 ( 5<sup>th</sup> Circuit ). On October 20, 2004, the 5<sup>th</sup> Circuit affirmed the district court's judgment that dismissed with prejudice all of the relators' claims against us and the other defendants in the Graves Action. On November 3, 2004, the relators filed a petition with the 5<sup>th</sup> Circuit requesting a rehearing *en banc* of the relators' appeal. On November 18, 2004, the 5<sup>th</sup> Circuit denied the relators' request for a rehearing. On or about February 17, 2005, the relators filed a petition with the U.S. Supreme Court requesting that the Court hear the relators' appeal of the 5<sup>th</sup> Circuit's affirmation of the district court's judgment dismissing the Graves Action. On April 18, 2005, the U.S. Supreme Court denied the relators' petition.

- 25 -



## Table of Contents

On March 4, 2005, we were served with a qui tam action that was filed on April 8, 2004 in the United States District Court for the Southern District of Indiana by a former employee (relator) on behalf of himself and the federal government under the following caption: *United States of America ex rel. Robert Olson v. ITT Educational Services, Inc. d/b/a ITT Technical Institute* (the Olson Action). The relator alleges that we violated the False Claims Act, 31 U.S.C. § 3729, et seq., by knowingly making and using false records and statements relating to, among other things, student recruitment, admission, enrollment, attendance and grading, graduate placement and course materials in order to fraudulently participate in the federal student financial aid programs. The complaint seeks an unspecified judgment and attorney's fees and costs. We were served with the Olson Action after the DOJ declined to intervene in the litigation. We intend to defend ourselves vigorously against the allegations made in the complaint.

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, graduation rates and graduates' salaries. 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 we cannot assure you 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 had 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. We cannot assure you, 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 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. 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.

On August 19, 2004, a consolidated complaint in a securities class action lawsuit was filed against us and ten of our current and former Directors and executive officers in the U.S. District Court for the Southern District of Indiana under the following caption: *City of Austin Police*

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*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 Exchange 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

## Table of Contents

defend themselves vigorously against the allegations made in the complaint. We cannot assure you, 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, ten of our current and former Directors and 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. On December 1, 2004, the court dismissed the consolidated complaint without prejudice and gave the plaintiffs 30 days to replead their complaint. On January 3, 2005, the plaintiffs filed an amended consolidated complaint. The amended 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 amended 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, ten of our current and former Directors and PWC, in the U.S. 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);

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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 Exchange 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 Exchange 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;

**Table of Contents**

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. On December 8, 2004, the parties agreed to stay this action pending the entry of a final judgment in the *In Re ITT Educational Services, Inc. Derivative Litigation* action, except that the stay will be lifted if a subsequently filed shareholder derivative lawsuit is filed in the Southern District of Indiana and the defendants are unable to enter into a similar stay of that action. All of the individual defendants intend to defend themselves vigorously against the allegations in the complaint.

On November 17, 2004, a shareholder derivative lawsuit was filed against ten of our current and former Directors, in the Chancery Court of New Castle County, Delaware under the following caption: *Albert Reitan, derivatively on behalf of nominal defendant ITT Educational Services, Inc. v. Rand V. Araskog, et al.* The complaint alleges, among other things, that the defendants abdicated their fiduciary duty of good faith to us by making no effort to oversee our operations and business practices to ensure that we comply with all applicable laws, rules and regulations. The complaint seeks unspecified damages, equitable relief, attorneys' fees, accountants' fees, experts' fees, costs and expenses. On March 31, 2005, in response to the parties' request, the court issued an order staying this action until the entry of a final judgment in the *City of Austin Police Retirement System, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc. et al.* action. All of the 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 we cannot assure you 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 Arthur Stein, 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 Mr. Stein 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 Mr. Stein that our Board has deferred its decision with respect to Mr. Stein's demand until the conclusion of the DOJ investigation of us, the inquiry initiated by the SEC into the allegations being investigated by the DOJ and the securities class action lawsuits filed against us, or until the receipt of additional information concerning the allegations made in the demand.

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On October 26, 2004, a lawsuit was filed against us in the Chancery Court of New Castle County, Delaware under the following caption: *Arthur Stein v. ITT Educational Services, Inc.* The complaint alleges that we violated Section 220 of the Delaware General Corporation Law by refusing to allow Mr. Stein to inspect and make copies of our books and records relating to the misconduct alleged in his derivative demand letter described above. The complaint seeks an order compelling us to permit Mr. Stein to inspect and make copies of our books and records, and to pay his costs, expenses and attorney's fees to prosecute this action. We intend to defend the action vigorously.

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.

**Table of Contents**

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.

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.

**Table of Contents****Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

The following information is furnished as to our securities sold in the three months ended March 31, 2005 that were not registered under the Securities Act:

- (a) On January 1, 2005, we issued 420 treasury shares of our common stock to one non-employee director under the ESI Non-Employee Directors Deferred Compensation Plan (the Directors Deferred Compensation Plan ) as the stock portion of the semi-annual installment payment of his annual retainer.
- (b) On January 1, 2005, we credited 420 treasury shares of our common stock to the deferred share accounts of each of five non-employee directors under the Directors Deferred Compensation Plan as the stock portion of the semi-annual installment payment of their annual retainer for 2005. These shares of our common stock will be issued upon the termination of the non-employee director's service as a non-employee director for any reason, including retirement or death.

The transactions described in paragraphs (a) and (b) above are exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof.

The following table sets forth information regarding purchases made by us of shares of our common stock on a monthly basis in the three months ended March 31, 2005:

**Issuer Purchases of Equity Securities**

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)</b>
January 1, 2005 through January 31, 2005		\$		4,216,300
February 1, 2005 through February 28, 2005				4,216,300
March 1, 2005 through March 31, 2005				4,216,300
<b>Total</b>		\$		

- (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 March 31, 2005, 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 6. EXHIBITS.**



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.



**Table of Contents**

**INDEX TO EXHIBITS**

<b><u>Exhibit No.</u></b>	<b><u>Description</u></b>
10.48	Summary of Certain Director and Executive Compensation
10.49	Eighth Amendment of ESI Pension Plan
10.50	Fourth Amendment of ESI 401(k) 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

S-2