

ITT EDUCATIONAL SERVICES INC
Form 10-K
February 23, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
ANNUAL REPORT

(Mark One)

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

For the fiscal year ended **December 31, 2006**

OR

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

For the transition period from _____ to _____

Commission file number **1-13144**

ITT EDUCATIONAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

36-2061311

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

13000 North Meridian Street

Carmel, Indiana

(Address of principal executive offices)

46032-1404

(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

COMMON STOCK, \$.01 PAR VALUE

Name of each exchange on which registered

NEW YORK STOCK EXCHANGE, INC.

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

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Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

\$2,772,824,786

Aggregate market value of the voting stock held by nonaffiliates of the registrant based on the last sale price for such stock at June 30, 2006 (assuming solely for the purposes of this calculation that all Directors and executive officers of the registrant are affiliates).

41,083,403

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Number of shares of Common Stock, \$.01 par value, outstanding at January 31, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents have been incorporated by reference into this Annual Report on Form 10-K:

IDENTITY OF DOCUMENT

PARTS OF FORM 10-K INTO WHICH DOCUMENT IS INCORPORATED

Definitive Proxy Statement for the Annual Meeting
of Shareholders to be held May 8, 2007

PART III

ITT EDUCATIONAL SERVICES, INC.

Carmel, Indiana

Annual Report to Securities and Exchange Commission

December 31, 2006

PART I

Item 1. Business.

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 (the Securities Act) and Section 21E of the Securities Exchange Act of 1934 (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 those 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 of those regulations, 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;

our failure to comply with the extensive education laws and regulations and accreditation standards that we are subject to;

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;

our failure to maintain or renew required regulatory authorizations or accreditations of our institutes;

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

loss of access by our students to lenders for student loans; and

our ability to successfully defend litigation and other claims brought against us.

Readers are also directed to other risks and uncertainties discussed in Risk Factors and elsewhere in this Annual Report and those detailed from time to time in other documents we file with the U.S. Securities and Exchange Commission (SEC). We undertake no obligation to update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.

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.

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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.

Background

We are a Delaware corporation incorporated in 1946. Our principal executive offices are located at 13000 North Meridian Street, Carmel, Indiana 46032-1404, and our telephone number is (317) 706-9200. From 1966 until our initial public offering on December 27, 1994, we were wholly owned by ITT Corporation, an Indiana corporation, formerly a Delaware corporation and formerly known as ITT Industries, Inc. (Old ITT). On September 29, 1995, ITT Corporation, a Nevada corporation (ITT), succeeded to the interests of Old ITT in the beneficial ownership of 83.3% of our common stock. Public offerings of our common stock by ITT in June 1998 and February 1999 and our repurchase of 1,500,000 shares of our common stock from ITT in February 1999 completely eliminated ITT's beneficial ownership of any of our common stock.

Overview

We are a leading for-profit provider of postsecondary degree programs in the United States based on revenue and student enrollment. As of December 31, 2006, we were offering diploma, associate, bachelor and master degree programs to approximately 47,000 students. As of December 31, 2006, we had 87 institutes and nine learning sites of those institutes located in 33 states. All of our institutes are authorized by the applicable education authorities of the states in which they operate and recruit, and are accredited by an accrediting commission recognized by the U.S. Department of Education (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 December 31, 2006, all of our programs were degree programs, except for a few diploma programs offered at six institutes that are being converted to degree programs. We have provided career-oriented education programs since 1969 under the ITT Technical Institute name.

In 2006, we began operations at six new institutes and added five learning sites to existing institutes. A learning site is an institute location where educational activities are conducted and student services are provided away from the institute's campus. In 2007, we plan to begin operations at six to eight new locations. In 2006, we continued our efforts to diversify our program offerings by developing residence and online programs at different degree levels in technology and non-technology fields of study that we intend to offer at our institutes. Most of our residence associate degree and bachelor degree programs are being taught in residence on campus 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 may be taught either entirely online over the Internet or partially online over the Internet and partially in residence on campus (the Hybrid Delivery Model). In 2006, we also continued our alliance with an international educator in China, pursuant to which a number 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. Our expansion plans include:

- operating new institutes;
- adding learning sites to existing institutes;
- offering a broader range of both residence and online programs at our existing institutes; and
- increasing the number of our institutes that offer bachelor degree programs.

As of December 31, 2006, 59 of our institutes offered one or more bachelor degree programs of study.

Business Strategy

Our strategy is to pursue multiple opportunities for growth. We are implementing a growth strategy designed to increase revenue and operating efficiencies by increasing the number and types of program offerings and student enrollment at existing institutes, operating new institutes across the United States, adding learning sites to existing institutes and licensing the use of our curricula to third parties. The principal elements of this strategy include the following:

Enhance Results at the Institute Level.

Increase Enrollments at Existing Institutes. We intend to increase recruiting efforts aimed at enrolling more working adults at our existing institutes. In addition, we believe that current demographic and employment trends will allow us to enroll a greater number of high school graduates.

Broaden Availability of Current Program Offerings. We intend to continue expanding the number of program offerings at our existing institutes. Our objective is to offer multiple programs at each institute. Our 87 institutes provide significant potential for the introduction of existing programs at a broader number of institutes. We believe that introducing new programs at existing institutes will attract more students. In 2006, we added a total of 142 program offerings among 45 existing institutes, and in 2007 we intend to add at least 105 program offerings among approximately 60 existing institutes.

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Develop or Acquire Additional Programs. In 2006, we continued our efforts to diversify our program offerings by developing residence and online programs at different degree levels in both technology and non-technology fields of study. In 2007, we plan to continue developing additional residence and online programs at different degree levels in technology and non-technology fields of study to be offered at our institutes. The new degree programs are expected to involve a variety of disciplines and be at the associate and bachelor degree levels. We intend to develop both a residence and online version of many of the new programs. We believe that offering new programs and making our programs more convenient for students can attract a broader base of students, motivate current students to extend their studies and help us improve the utilization of our facilities.

Extend Total Program Duration. In 2006, we increased the number of our institutes that offer bachelor degree programs from 54 to 59. In 2007, we intend to increase the number of our institutes that offer bachelor degree programs to approximately 65. The average combined total program time that students are enrolled in one or more of our programs has increased over time as a result of:

a portion of the graduates of our associate degree programs enrolling in bachelor degree programs at our institutes; and
a portion of our new students beginning their studies in bachelor degree programs, instead of first completing associate degree programs.

We believe that the average combined total program time of our students will increase further as we:

increase the number of our institutes offering bachelor degree programs;
add additional bachelor degree programs at our institutes; and
expand our online curricula offerings to include additional master degree programs.

Improve Student Outcomes. We strive to improve the graduation and graduate employment rates of our undergraduate students by providing academic and career services and dedicating administrative resources to these services.

Geographically Expand Our Institutes and Program Offerings. We plan to add new institutes and learning sites of existing institutes at locations throughout the United States. Using our proprietary methodology, we determine locations for new institutes and learning sites based on a number of factors, including demographics and population and employment growth. The following table sets forth the number of new institutes and new learning sites that began operations in the years indicated:

	2006	2005	2004
New institutes	6	4	2
New learning sites	5	3	1
	11	7	3

We plan to begin operations at six to eight new locations in 2007. We will also continue to consider acquiring schools. We currently offer one or more of our online programs to students in 48 states and the District of Columbia. We intend to expand the number of our online programs offered in each state in 2007.

Increase Margins By Leveraging Fixed Costs at Institute and Headquarters Levels. Our efforts to optimize institute capacity and class size have allowed us to increase student enrollment without incurring a proportionate increase in fixed costs at our institutes. In addition, we have realized substantial operating efficiencies by centralizing management functions and implementing operational uniformity among our institutes.

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We will continue to seek to improve margins by increasing enrollments and revenue without incurring a proportionate increase in fixed costs, and by reducing our variable costs.

Programs of Study

As of December 31, 2006, we were offering:

- 25 degree programs in various fields of study;
- five diploma programs in various fields of study;
- at least one program involving information technology (IT) at 87 of our institutes;
- at least one program involving electronics technology at 87 of our institutes;
- at least one program involving drafting and design at 87 of our institutes,
- at least one program involving business at 71 of our institutes;
- at least one program involving criminal justice at 66 of our institutes; and
- at least one program involving health sciences at 24 of our institutes.

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The following table sets forth information regarding the programs of study we were offering as of December 31, 2006:

	Number of Institutes Offering the Programs at			
	December 31, 2006			
	<u>Master Degree</u>	<u>Bachelor Degree</u>	<u>Associate Degree</u>	<u>Diploma</u> (1)
School of Business				
Business Administration (2)	1 (3)	41	12	6
Business Administration Marketing Management option and Project Management option		1		
Business Administration Finance option, Human Resources Management option, Marketing option, Marketing Management option and Project Management option (3)		1		
Business Administration Project Management		1		
Business Accounting Technology (2)		12	9	
Business Accounting Technology Financial Accounting option and Internal Controls option		1		
Technical Project Management (2)		35		
School of Criminal Justice				
Criminal Justice (2)		50	16	4
Criminal Justice - Cybersecurity (2)		1		
School of Drafting and Design				
Computer Drafting and Design			81	1
Construction Management (2)		22		
Digital Entertainment and Game Design		44		
Graphic Design		2		
Multimedia (4)			82	
School of Electronics Technology				
Computer and Electronics Engineering Technology			86	1
Electronics and Communications Engineering Technology		52		
Industrial Automation Engineering Technology		5		
School of Information Technology				
Computer Network Systems (4)			86	1
Data Communication Systems Technology		22		
Information Systems Administration (3)			1	
Information Systems Security (2)		54		
Software Applications and Programming (4)			68	
Software Engineering Technology		17		
Web Development (4)			58	
School of Health Sciences				
Health Information Technology			24	

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- (1) We have submitted, or are in the process of submitting, the requisite applications to the applicable state education authorities for approval to offer the diploma programs identified in this column as associate degree programs at each of the affected ITT Technical Institutes.
- (2) Residence and online program. Our institute in Indianapolis is the only institute that presently offers online programs.
- (3) Online program. Our institute in Indianapolis is the only institute that presently offers online programs.
- (4) Depending on the location of the ITT Technical Institute, this program of study may have been approved by the applicable state education authority(ies) either as a separate program or as one of as many as four disciplines within one program of study. For purposes of this table, this program is considered to be a separate program of study at every ITT Technical Institute where it was taught.

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We design our programs to help graduates prepare for careers in various fields involving their education by offering students a broad-based foundation in a variety of skills used in those fields. Graduates of our IT programs have obtained a variety of entry-level positions in various fields involving IT, such as network administration, technical support, network technology and systems technology. Graduates of our drafting and design programs have obtained a variety of entry-level positions in various fields involving drafting and design, such as computer-aided drafting, electrical and electronics drafting, mechanical drafting, architectural and construction drafting, civil drafting, interior design, landscape architecture and multimedia communications. Graduates of our electronics technology programs have obtained a variety of entry-level positions in various fields involving electronics, such as electronics product design and fabrication, communications, computer technology, industrial electronics, instrumentation, telecommunications and consumer electronics. There is an insignificant number of graduates of those bachelor degree programs that have been offered for less than five years or associate degree programs that have been offered for less than three years, but we believe that the graduates of our:

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criminal justice programs should obtain a variety of entry-level positions involving criminal justice in both the private and public sectors;
business programs should obtain a variety of entry-level positions in various types of businesses involving the subject matter of their programs of study; and
health sciences programs should obtain a variety of entry-level positions involving the subject matter of their programs of study.

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, with new students beginning at the start of each academic quarter. Students taking a full-time course load can complete our diploma and associate degree programs in eight academic quarters, bachelor degree programs in 15 academic quarters and master degree program in seven academic quarters. We typically offer classes in most residence programs in:

3.5 to 5.5 hour sessions three days a week, Monday through Saturday, with all program courses taught entirely or partially in residence; or
two to three days a week, Monday through Saturday, with certain program courses taught entirely or partially online over the Internet most academic quarters.

At some of our institutes, we also offer classes in some residence programs in four to ten hour sessions one or two days a week on weekends, with certain program courses taught entirely online over the Internet most academic quarters. Depending on student enrollment, class sessions are generally available in the morning, afternoon and evening. The courses that are taught online over the Internet are delivered through an asynchronous learning network and have a prescribed schedule for completion of the coursework. The class schedule for our residence courses and the coursework completion schedule for our online courses generally provide students with the flexibility to maintain employment concurrently with their studies. Based on student surveys, we believe that a substantial majority of our students work at least part-time during their programs of study.

Most of our programs of study blend traditional academic content with applied learning concepts and have the objective of helping graduates begin to prepare for a changing economic and/or technological environment. A significant portion of most programs offered at our institutes involves practical study in a lab environment.

The learning objectives of most courses in each program of study are substantially the same among our institutes to provide greater uniformity and to better enable students to transfer, if necessary, to other institutes offering the same programs with less disruption to their education. We regularly review each curriculum to respond to changes in technology and industry needs. Each of our institutes establishes an advisory committee for each field of study, which is comprised of representatives of local employers. These advisory committees assist our institutes in assessing and updating curricula, equipment and laboratory design. In addition to courses directly related to a student's program of study, our programs also include general education courses, such as economics, mathematics, composition and sociology.

Tuition for a student entering an undergraduate residence program in December 2006 for 36 quarter credit hours (the minimum course load of a full-time student for an academic year at traditional two- and four-year colleges) is \$14,580 for all of our undergraduate residence programs, except as adjusted in some states to reflect applicable taxes and fees. We typically adjust the tuition for our programs of study at least annually. The majority of students attending residence programs at our institutes lived in that institute's metropolitan area prior to enrollment. We do not provide any student housing.

Student Recruitment

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We strive to attract students with the motivation and ability to complete the career-oriented educational programs offered by our institutes. To generate interest among potential students, we engage in a broad range of activities to inform potential students and their parents about our institutes and the programs they offer. These activities include television, Internet and other media advertising, direct mailings and high school presentations. We employ approximately 1,000 full- and part-time recruiting representatives to assist in local recruiting efforts.

Local recruiting representatives of an institute pursue expressions of interest from potential students for our residence programs of study by contacting prospective students and arranging for interviews at the campus or any learning site of that institute. Occasionally, we also pursue expressions of interest from students for our residence programs of study by contacting them and arranging for their attendance at a seminar providing information about the institute and its programs. We pursue expressions of interest from potential students for our online programs of study by providing program and resource information on our website and through telephone calls, electronic mail and the mail.

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Student recruitment activities are subject to substantial regulation at both the state and federal level and by our accrediting commission. Most states have bonding and licensing requirements that apply to many of our representatives and other employees involved in student recruitment. Our Director, Field Recruitment and Training and the District Directors of Recruitment oversee the implementation of recruitment policies and procedures. In addition, our compliance department generally reviews student recruiting practices at each of our institutes on at least an annual basis.

Student Admission and Retention

We strive to admit incoming students who have the ability to complete their chosen programs of study. We require all applicants for admission to any of our institutes' programs of study to have a high school diploma or a recognized equivalent. Depending on the program of study and the institute, applicants may also be required to pass an admission examination or possess a designated number of credit hours or degree with a specified overall cumulative grade point average from an accredited postsecondary educational institution. Our student demographics as of December 31, 2006, were as follows:

	<u>Approximate Percent of Student Census</u>
<u>Student Demographics</u>	
Age	
19 or less	17%
20 through 24	39%
25 through 30	24%
31 or over	20%
Gender	
Male	78%
Female	22%
Race	
Caucasian	55%
Minority (1)	45%

(1) Based on applicable federal classifications.

The faculty and staff at each of our institutes strive to help students overcome obstacles to the completion of their programs of study. As is the case in other postsecondary institutions, however, students often fail to complete their programs for a variety of personal, financial or academic reasons. Student withdrawals prior to program completion not only affect the students, they also have a negative regulatory, financial and marketing effect on the institute. To minimize student withdrawals, each of our institutes devotes staff resources to assist and advise students regarding academic and financial matters. We encourage academic advising and tutoring in the case of students experiencing academic difficulties. We also offer assistance and advice to students in our residence programs who are looking for part-time employment and housing.

Graduate Employment

We believe that the success of our graduates who begin their careers in fields involving their programs of study is critical to the ability of our institutes to continue to recruit students. We try to obtain data on the number of students employed following graduation. The reliability of such

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data depends largely on information that students and employers report to us. Based on this information, we believe that approximately 76% of the Employable Graduates (as defined below) from our institutes' programs during 2005 either obtained employment by April 30, 2006, or were already employed, in positions that required the direct or indirect use of skills taught in their programs of study. Employable Graduates include all of the graduates from our institutes, except for those graduates who:

have been admitted into other programs of study at postsecondary educational institutions that are scheduled to begin within one academic year following their graduation;

possessed visas that did not permit them to work in the United States following their graduation;

were personally suffering from a health condition that prevented them from working;

were actively engaged in U.S. military service; or

moved out of the Continental United States with a spouse or parent who was actively engaged in U.S. military service.

The definition of Employable Graduates is based on the information that our institutes are required to report to their accrediting commission, and this information is used, in part, by their accrediting commission to evaluate the student outcomes of our institutes.

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Each of our institutes employs personnel to offer its students and graduates career services. These persons assist in job searches, solicit employment opportunities from employers and provide information on job search techniques, where to access employer information, writing resumes and how to prepare for, appear at and conduct oneself during job interviews.

Based on information from graduates and employers who responded to our inquiries, we estimate that the reported annualized salaries initially following graduation averaged approximately \$28,000 for the Employable Graduates of our institutes programs who graduated in 2005 and obtained employment by April 30, 2006, or were already employed, in positions that required the direct or indirect use of skills taught in their programs of study. The calculation of this amount excludes any reported annualized initial salaries above \$60,000. The average annual salary initially following graduation for our Employable Graduates may vary significantly among our institutes depending on local employment conditions and each Employable Graduate's background, prior work experience and willingness to relocate. Initial employers of Employable Graduates from our institutes programs include small, medium and large companies and governmental agencies.

Faculty

We hire faculty members in accordance with criteria established by us, the accrediting commission that accredits our institutes and the state education authorities that regulate our institutes. We hire faculty with related work experience and/or academic credentials to teach most technical subjects. Faculty members at each institute typically include the chairperson for each school or program of study and various categories of instructors. As of December 31, 2006, our institutes employed a total of approximately 900 full-time and 2,100 adjunct faculty members.

Administration and Employees

Each of our institutes is administered by a director who has overall responsibility for the management of the institute. The administrative staff of each institute also includes a director of recruitment, a director of career services, a director of finance, a dean and a registrar. As of December 31, 2006, we:

employed approximately 200 people at our corporate headquarters in Carmel, Indiana;
had approximately 3,500 full-time and 2,200 part-time employees at our institutes; and
employed approximately 300 students as laboratory assistants and in other part-time positions.

None of our employees are represented by labor unions.

Our headquarters provides centralized services to all of our institutes in the following areas:

accounting	legal
marketing	regulatory
public relations	legislative affairs
curricula development	real estate

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management information systems

human resources

purchasing

compliance/internal audit

In addition, national managers of each of the following major institute functions reside at our headquarters and develop policies and procedures to guide these functions at our institutes:

recruiting

career services

finance

library

academic affairs

registration

Managers located at our headquarters monitor the operating results of each of our institutes and periodically conduct on-site reviews.

Competition

The postsecondary education market in the United States is highly fragmented and competitive, with no single private or public institution enjoying a significant market share. Our institutes compete for students with graduate, bachelor and associate degree-granting institutions, which include nonprofit public and private colleges and for-profit institutions, as well as with alternatives to higher education such as military service or immediate employment. We believe competition among educational institutions is based on:

the quality and reliability of the institution's programs and student services;

the perceived reputation of the institution and its programs and student services;

the cost of the institution's programs;

the employability of the institution's graduates;

the ability to provide easy and convenient access to the institution's programs and courses;

the quality and experience of the institution's faculty; and
the time required to complete the institution's programs.

Certain public and private colleges may offer programs similar to those offered by our institutes at a lower tuition cost due in part to government subsidies, foundation grants, tax deductible contributions, tax-exempt status or other financial resources not available to for-profit institutions. Other for-profit institutions offer programs that compete with those of our institutes. Certain of our competitors in both the public and private sectors have greater financial and other resources than we do.

Federal and Other Financial Aid Programs

In 2006, we indirectly derived approximately 61% of our revenue determined on an accrual accounting basis (or 57% determined on a cash accounting basis as defined by the ED's regulations) from the federal student financial aid programs under Title IV (the Title IV Programs) of the Higher Education Act of 1965, as amended (the HEA). Our institutes' students also rely on unaffiliated private loan programs, family contributions, personal savings, employment, state financial aid programs, scholarships and other resources to pay their educational expenses. The primary Title IV Programs from which the students at our institutes receive grants, loans and other aid to fund the cost of their education include:

the Federal Family Education Loan (the FFEL) program, which represented, in aggregate, approximately 50% of our revenue in 2006;
the Federal Pell Grant (the Pell) program, which represented, in aggregate, approximately 11% of our revenue in 2006; and
the Federal Work-Study (the Work-Study) program, which makes federal funds available to provide part-time employment to students and under which approximately 400 of our institutes' students were employed and approximately \$2,452,000 in student wages were paid by our institutes in 2006.

The Work-Study program requires our institutions to make a 25% matching contribution for all of the federal funds the institution receives from the ED under that program. In 2006, our 25% matching contribution amounted to approximately \$613,000.

In 2006, we also indirectly derived approximately 34% of our revenue from unaffiliated private student loan programs. We have no financial responsibility with respect to any loans made to students or their parents under the unaffiliated private loan programs, except for an immaterial amount of loans with respect to which our obligations are fully reserved.

Highly Regulated Industry

We are subject to extensive regulation by the ED, the state education authorities (the SEAs) and the Accrediting Council for Independent Colleges and Schools (the ACICS), the accrediting commission that accredits our institutes. The statutes, regulations and standards applied by the ED, the SEAs and the ACICS are periodically revised and the interpretations of existing requirements are periodically modified. We cannot predict with certainty how all of the statutes, regulations and standards applied by the ED, the SEAs and the ACICS will be interpreted.

At the federal level, the HEA and the regulations promulgated under the HEA by the ED set forth numerous, complex standards that institutions must satisfy in order to participate in Title IV Programs. To participate in Title IV Programs, an institution must:

receive and maintain authorization by the appropriate SEAs;
be accredited by an accrediting commission recognized by the ED; and
be certified as an eligible institution by the ED.

The purpose of these standards is to:

limit institutional dependence on Title IV Program funds;
prevent institutions with unacceptable student loan default rates from participating in Title IV Programs; and
in general, require institutions to satisfy certain criteria related to educational value, administrative capability and financial responsibility.

Most of the ED's requirements are applied on an institutional basis, with an institution defined by the ED as a main campus and its additional locations, if any. Twenty-nine of our 87 institutes are main campuses and the remaining 58 of our institutes are additional locations. Each of the nine learning sites of our institutes is also an additional location under the ED's regulations. The HEA requires each institution to periodically renew its certification by the ED to

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continue its participation in Title IV Programs. As of December 31, 2006, all 87 of our institutes and eight of the nine learning sites of our institutes participated in Title IV Programs. As of January 31, 2007, all nine learning sites participated in Title IV Programs.

As of December 31, 2006, we operated one or more institutes in 33 states and our institutes recruited students in the remaining 17 states and the District of Columbia. Each of our institutes must be authorized by the applicable SEAs to operate and grant degrees or diplomas to their students. The state laws and regulations that we must comply with in order to obtain authorization from the SEAs are numerous and complex. As of December 31, 2006, each of our institutes had received authorization from one or more SEAs. In addition, some states require an institute to be in operation for a period of up to two years before that institute can be authorized to grant degrees. Institutes that confer bachelor or master degrees must, in most cases, meet additional regulatory standards. Raising the curricula of our existing institutes to the bachelor and/or master degree level requires the approval of the applicable SEAs and the ACICS. State education laws and regulations affect our operations and may limit our ability to introduce degree programs or to obtain authorization to operate in some states. If any one of our institutes lost its state authorization, the institute would be unable to offer postsecondary education and we would be forced to close the institute. Closing one of our institutes for any reason could have a material adverse effect on our financial condition, results of operations and cash flows.

State authorization and accreditation by an accrediting commission recognized by the ED are required for an institution to become and remain eligible to participate in Title IV Programs. In addition, some states require institutions operating in the state to be accredited as a condition of state authorization. All of our institutes are accredited by the ACICS, which is an accrediting commission recognized by the ED. The HEA specifies a series of criteria that each recognized accrediting commission must use in reviewing institutions. For example, accrediting commissions must assess the length of each academic program offered by an institution in relation to the objectives of the degrees or diplomas offered. Further, accrediting commissions must evaluate each institution's success with respect to student achievement, as measured by rates of program completion, passing of state licensing examinations and graduate employment. During 2006, the ACICS evaluated nine of our institutes for initial grants of accreditation or the renewal of their current grants of accreditation. As of December 31, 2006, of those nine institutes, the ACICS had granted initial accreditation to three institutes and reaccredited six institutes. None of our institutes are on probation with the ACICS, but two institutes are subject to an outcomes review with respect to graduate placement and five institutes are subject to an outcomes review with respect to student retention by the ACICS. Under the ACICS standards, an institute that is subject to a financial or outcomes review must periodically report its results in those areas to the ACICS and obtain permission from the ACICS prior to applying to add a new program of study or establish a branch campus or learning site. We do not believe that these limitations will have a material adverse effect on our expansion plans.

The statutes, regulations and standards applied by the ED, the SEAs and the ACICS cover the vast majority of our operations, including our:

- education programs;
- facilities;
- instructional and administrative staff;
- administrative procedures;
- marketing;
- student recruiting; and
- financial operations and financial condition.

These requirements also affect our ability to:

- begin operations at, or acquire, new institutes and add learning sites;
- add new, or expand our existing, education programs; and
- change our corporate structure and ownership.

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Each of the institutes and learning sites that we added from 2004 through 2006 constitutes an additional location under the ED's regulations. The HEA requires a for-profit institution to operate for two years before it can qualify to participate in Title IV Programs. If an institution that is certified to participate in Title IV Programs establishes an additional location and receives all of the necessary SEA and accrediting commission approvals for that location, that additional location can participate in Title IV Programs immediately upon being reported to the ED, unless the institution will offer at least 50% of an entire educational program at that location and any one of the following restrictions applies, in which case the ED must approve the additional location before it can participate in Title IV Programs:

the institution is provisionally certified to participate in Title IV Programs;

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the institution receives Title IV Program funds under the ED's reimbursement or cash monitoring payment method;
the institution acquired the assets of another institution that provided educational programs at that location during the preceding year and participated in Title IV Programs during that year;
the institution would be subject to loss of eligibility to participate in Title IV Programs, because the additional location lost its eligibility to participate in Title IV Programs as a result of high FFEL/FDL cohort default rates; or
the ED previously notified the institution that it must apply for approval to establish an additional location.

The HEA and applicable regulations permit students to use Title IV Program funds only to pay the cost associated with enrollment in an eligible program offered by an institution participating in Title IV Programs. Generally, an institution that is eligible to participate in Title IV Programs may add a new educational program without the ED's approval, if that new program: (a) leads to an associate level or higher degree and the institution already offers programs at that level; or (b) prepares students for gainful employment in the same or a related occupation as an educational program that has previously been designated as an eligible program at the institution and meets minimum length requirements. Otherwise, the institution must obtain the ED's approval before it may disburse Title IV Program funds to students enrolled in the new program. If an institution erroneously determines that a new educational program is eligible for Title IV Program funding, the institution would likely be liable for repayment of the Title IV Program funds provided to students in that educational program. Based on our current understanding of how the ED regulations will be applied, we do not believe that these limitations will have a material adverse effect on our expansion plans.

The ACICS accreditation standards generally permit an institution's main campus to establish branch campuses, and both the institution's main campus and branch campuses to establish learning sites. Our institutes that are treated as branch campuses under the ACICS accreditation standards are treated as additional locations of the main campus under the ED's regulations. Any locations of one of our main or branch campuses that are located away from the main or branch campus are treated as learning sites of that main or branch campus under the ACICS accreditation standards, but the ED's regulations treat each learning site as an additional location of the main campus.

The laws and regulations in most of the states in which our institutes are located treat each of our institutes as a separate, unaffiliated institution and do not distinguish between main campuses and additional locations or branch campuses, although many states recognize other institute locations within the state where educational activities are conducted and/or student services are provided as learning sites, teaching sites, satellite campuses or otherwise. In some states, the requirements to obtain state authorization limit our ability to establish new institutes, add learning sites and offer new programs.

The HEA and its implementing regulations require each institution to periodically reapply to the ED for continued certification to participate in Title IV Programs. The ED recertifies each institution deemed to be in compliance with the HEA and the ED's regulations for a period of six years or less. Before that period ends, the institution must apply again for recertification. The current ED certifications of our institutes range from four years to six years and expire over the period March 31, 2007 to December 31, 2011.

The ED may place an institution on provisional certification for a period of three years or less, if it finds that the institution does not fully satisfy all the eligibility and certification standards. If an institution successfully participates in Title IV Programs during its period of provisional certification but fails to satisfy the full certification criteria, the ED may renew the institution's provisional certification. The ED may revoke an institution's provisional certification without advance notice, if the ED determines that the institution is not fulfilling all material requirements. If the ED revokes an institution's provisional certification, the institution may not apply for reinstatement of its eligibility to participate in Title IV Programs for at least 18 months. If the ED does not recertify the institution following the expiration of its provisional certification, the institution loses eligibility to participate in Title IV Programs until the institution reapplies to participate and the ED certifies the institution to participate. The ED may also more closely review an institution that is provisionally certified, if it applies for approval to operate a new location or offer a new program of study that requires approval, or makes some other significant change affecting its eligibility. Provisional certification does not otherwise limit an institution's access to Title IV Program funds. None of our campus groups are provisionally certified to participate in Title IV Programs.

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The internal audit function of our compliance department reviews our institutes' compliance with Title IV Program requirements and conducts an annual compliance review of each of our institutes. The review addresses numerous compliance areas, including:

student tuition refunds and return of Title IV Program funds;

student academic progress;

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student admission;
graduate employment;
student attendance;
student financial aid applications;
implementation of prior audit recommendations; and
a general review of student recruiting practices relating to student presentations and the execution and completion of enrollment agreements.

Each of our institutes' administration of Title IV Program funds must also be audited annually by an independent accounting firm, and the resulting audit report must be submitted to the ED for review.

Due to the highly regulated nature of the postsecondary education industry, we are subject to audits, reviews, inquiries, complaints, investigations, claims of non-compliance or lawsuits by federal and state governmental agencies, the ACICS, present and former students and employees, shareholders and other third parties, which may allege violations of statutes, regulations or accreditation standards or common law causes of action (collectively, "Claims"). If the results of any Claims are unfavorable to us, we may be required to pay money damages or be subject to fines, penalties, injunctions, operational limitations, loss of eligibility to participate in federal or state financial aid programs, debarments, additional oversight and reporting, other civil and criminal penalties or other censure that could have a material adverse effect on our financial condition, results of operations and cash flows. Even if we satisfactorily resolve the issues raised by a Claim, we may have to expend significant financial and management resources, which could have a material adverse effect on our financial condition, results of operations and cash flows. Adverse publicity regarding a Claim could also negatively affect our business.

See "Risk Factors Risks Related to Our Highly Regulated Industry" for a discussion of particular risks associated with our highly regulated industry.

Shareholder Information

We make the following materials available free of charge through our website at www.ittesi.com as soon as reasonably practicable after such materials are electronically filed with or furnished to the SEC under the Exchange Act:

our annual reports on Form 10-K and all amendments thereto;
our quarterly reports on Form 10-Q and all amendments thereto;
our current reports on Form 8-K and all amendments thereto; and
various other filings that we make with the SEC.

We also make the following materials available free of charge through our website at www.ittesi.com:

our Corporate Governance Guidelines;

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the charter for each of the Audit, Compensation, and Nominating and Corporate Governance Committees of our Board of Directors; and
our Code of Business Conduct and Ethics (Code).

We will provide a copy of the following materials without charge to anyone who makes a written request to our Investor Relations Department at ITT Educational Services, Inc., 13000 North Meridian Street, Carmel, Indiana 46032-1404 or by e-mail through our website at www.ittesi.com:

our annual report on Form 10-K for the year ended December 31, 2006, excluding certain of its exhibits;

our Corporate Governance Guidelines;

the charter for each of the Audit, Compensation, and Nominating and Corporate Governance Committees of our Board of Directors; and
the Code.

We also intend to promptly disclose on our website at www.ittesi.com any amendments that we make to, or waivers for our Directors or executive officers that we grant from, the Code.

Item 1A. Risk Factors.

In addition to the other information contained in this report, you should consider carefully the following risk factors in evaluating us and our business before making an investment decision with respect to any shares of our common stock. This report contains certain statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act (and Section 21E of the Exchange Act). These forward-looking statements are based on the beliefs of, as well as assumptions made by and information currently available to, our

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management. All statements which are not statements of historical fact are intended to be forward-looking statements. The forward-looking statements contained in this report reflect our or our management's current views and are subject to certain risks, uncertainties and assumptions, including, but not limited to, those set forth in the following Risk Factors. Should one or more of those risks or uncertainties materialize or should underlying assumptions prove incorrect, our actual results, performance or achievements in 2007 and beyond could differ materially from those expressed in, or implied by, those forward-looking statements.

Risks Related to Our Highly Regulated Industry

Failure of our institutes to comply with the extensive regulatory requirements for school operations could result in financial penalties, restrictions on our operations, loss of federal and state financial aid funding for our students or loss of our authorization to operate our institutes. In 2006, we indirectly derived approximately 61% of our revenue determined on an accrual accounting basis (or approximately 57% determined on a cash accounting basis as defined by the ED regulations) from Title IV Programs. To participate in Title IV Programs, an institution must receive and maintain authorization by the appropriate SEAs, be accredited by an accrediting commission recognized by the ED and be certified as an eligible institution by the ED. As a result, our institutes are subject to extensive regulation by the ED, the SEAs and the ACICS, which is an accrediting commission recognized by the ED. These regulatory requirements cover the vast majority of our operations, including our:

- education programs;
- facilities;
- instructional and administrative staff;
- administrative procedures;
- marketing;
- student recruitment;
- financial operations and financial condition;
- operation of new institutes and addition of learning sites;
- addition of new, or expansion of existing, education programs; and
- changes in corporate structure and ownership.

Most ED requirements are applied on an institutional basis, with an institution defined by the ED as a main campus and its additional locations, if any. Under the ED's definition, we have 29 such institutions. We currently operate one or more institutes in 33 states and our institutes recruit students in the remaining 17 states and the District of Columbia. The ED, the SEAs and the ACICS periodically revise their requirements and modify their interpretations of existing requirements. We cannot predict with certainty how all of the requirements applied by these agencies will be interpreted or whether all of our institutes will be able to comply with all of the requirements in the future.

If our institutes failed to comply with any of these regulatory requirements, these agencies could:

- impose monetary fines or penalties on our institutes;
- terminate or limit our institutes' operations or ability to grant degrees and diplomas;
- restrict or revoke our institutes' accreditation;
- limit, terminate or suspend our institutes' eligibility to participate in Title IV Programs or state financial aid programs;
- require our institutes to repay funds received under Title IV Programs or state financial aid programs;
- require us to post a letter of credit with the ED;

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subject our institutes to heightened cash monitoring by the ED;

transfer our institutes from the ED's advance system of receiving Title IV Program funds to its reimbursement system, under which a school must disburse its own funds to students and document the students' eligibility for Title IV Program funds before receiving such funds from the ED; and

subject us or our institutes to other civil or criminal penalties.

Each of these sanctions could adversely affect our financial condition, results of operations and cash flows and impose significant operating restrictions on us. If any of our institutes lost its state authorization, the institute would be unable to offer postsecondary education and we would be forced to close the institute. If any of our institutes lost its accreditation, it would lose its eligibility to participate in Title IV Programs. If any of our institutes lost its eligibility to participate in Title IV Programs, and we could not arrange for alternative financing sources for the students attending that institute, we could be forced to close the institute. Closing any of our institutes could have a material adverse effect on our financial condition, results of operations and cash flows. See Business Highly Regulated Industry.

The following are some of the specific risk factors related to our highly regulated industry:

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Action by the U.S. Congress to revise the laws governing the federal student financial aid programs or reduce funding for those programs could reduce our student population and increase our costs of operation. Political and budgetary concerns significantly affect Title IV Programs. The U.S. Congress must reauthorize the HEA approximately every six years, which last occurred in 1998. In addition, the U.S. Congress can change the laws affecting Title IV Programs in the annual federal appropriations bills and other laws it enacts between the HEA reauthorizations. In 2005 and 2006, the U.S. Congress temporarily extended the provisions of the HEA, pending completion of the formal reauthorization process, and also enacted other laws affecting Title IV Programs. We believe that, in 2007, the U.S. Congress will either complete its reauthorization of the HEA or further extend the provisions of the HEA. Numerous changes to the HEA are likely to result from any further reauthorization and, possibly, from any extension of the existing provisions of the HEA, but at this time we cannot predict all of the changes that the U.S. Congress will ultimately make. In January 2007, the political party to which a majority of the members of both houses of the U.S. Congress are affiliated changed from the Republican party to the Democratic party. As a result, it is possible that the Democrat-controlled U.S. Congress will revise provisions of the HEA in significantly different ways than were being considered by the Republican-controlled U.S. Congress in 2005 and 2006. Since a significant percentage of our revenue is indirectly derived from Title IV Programs, any action by the U.S. Congress that significantly reduces Title IV Program funding or the ability of our institutes or students to participate in Title IV Programs could have a material adverse effect on our financial condition, results of operations and cash flows.

If one or more of our institutes lost its eligibility to participate in Title IV Programs, or if the U.S. Congress significantly reduced the amount of available Title IV Program funding, we would try to arrange or provide alternative sources of financial aid for the students at the affected institutes. We cannot assure you that one or more private organizations would be willing to provide loans to students attending those institutes or that the interest rate and other terms of such loans would be as favorable as for Title IV Program loans. In addition, the private organizations could require us to guarantee all or part of this assistance and we might incur other additional costs. If we provided more direct financial assistance to our students, we would incur additional costs and assume increased credit risks.

Legislative action may also increase our administrative costs and burden and require us to modify our practices in order for our institutes to comply fully with the legislative requirements, which could have a material adverse effect on our financial condition or results of operations.

One or more of our institutes may lose its eligibility to participate in Title IV Programs, if its student loan default rates are too high. Under the HEA, an institution may lose its eligibility to participate in some or all Title IV Programs, if the rates at which the institution's students default on their federal student loans exceed specified percentages. The ED calculates these rates on an institutional basis, based on the number of students who have defaulted, not the dollar amount of such defaults. The ED calculates an institution's cohort default rate on an annual basis as the rate at which borrowers scheduled to begin repayment on their loans in one year default on those loans by the end of the next year. Each institution participating in the FFEL and/or the FDL programs receives a FFEL/FDL cohort default rate for each federal fiscal year based on defaulted FFEL and FDL program loans. A federal fiscal year is October 1 through September 30. An institution whose FFEL/FDL cohort default rate is:

- 25% or greater for three consecutive federal fiscal years loses eligibility to participate in the FFEL, FDL and Pell programs for the remainder of the federal fiscal year in which the ED determines that the institution has lost its eligibility and for the two subsequent federal fiscal years; or
- greater than 40% for one federal fiscal year loses eligibility to participate in the FFEL and FDL programs for the remainder of the federal fiscal year in which the ED determines that the institution has lost its eligibility and for the two subsequent federal fiscal years.

An institution can appeal this loss of eligibility. During the pendency of any such appeal, the institution remains eligible to participate in the FFEL, FDL and Pell programs. If an institution continues its participation in the FFEL and/or FDL programs during the pendency of any such appeal and the appeal is unsuccessful, the institution must pay the ED the amount of interest, special allowance, reinsurance and any related payments paid by the ED (or which the ED is obligated to pay) with respect to the FFEL and FDL program loans made to the institution's students or their parents that would not have been made if the institution had not continued its participation (the Direct Costs). If a substantial number of our campus groups were subject to losing their eligibility to participate because of their FFEL/FDL cohort default rates, the potential amount of the Direct Costs for which we would be liable if our appeals were unsuccessful would prevent us from continuing some or all of the affected campus groups' participation in the FFEL and/or FDL programs during the pendency of those appeals, which could have a material adverse effect on our financial condition, results of operations and cash flows.

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The following table sets forth the range of our campus groups' FFEL/FDL cohort default rates for the federal fiscal years indicated:

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<u>Federal Fiscal Year</u>	<u>FFEL/FDL Cohort Default Rate Range</u>
2005 (a)	6.2% to 13.1%
2004 (b)	5.8% to 12.7%
2003	4.5% to 10.2%
2002	2.1% to 12.0%
(a)	The most recent year for which the ED has published FFEL/FDL preliminary cohort default rates.
(b)	The most recent year for which the ED has published FFEL/FDL official cohort default rates.

If an institution's FFEL/FDL cohort default rate is 25% or greater in any of the three most recent federal fiscal years, or if its cohort default rate for loans under the Federal Perkins Loan (the Perkins) program exceeds 15% for any federal award year, the ED may place that institution on provisional certification status. A federal award year is July 1 through June 30. We no longer participate in the Perkins program and our students have not received any loans under the Perkins program since 2002.

The servicing and collection efforts of student loan lenders and guaranty agencies help to control our FFEL/FDL cohort default rates. We are not affiliated with any student loan lenders or guaranty agencies. We supplement their efforts by attempting to contact students to advise them of their responsibilities and any deferment or forbearance for which they may qualify.

If any of our campus groups lost its eligibility to participate in FFEL, FDL and Pell programs and we could not arrange for alternative financing sources for the students attending the institutes in that campus group, we would probably have to close those institutes, which could have a material adverse effect on our financial condition, results of operations and cash flows.

We may be required to post a letter of credit or accept other limitations in order to continue our institutes' participation in Title IV Programs, state authorization and accreditation, if we or our institutes do not meet the financial standards of the ED, the SEAs or the ACICS. The ED, the SEAs and the ACICS prescribe specific financial conditions and operations that an institution must satisfy to participate in Title IV Programs, operate in a state and be accredited. The ED evaluates institutions for compliance with its standards each year, based on the institution's annual audited financial statements, as well as following any change of control of the institution and when the institution is reviewed for recertification by the ED. The most significant financial responsibility measurement is the institution's composite score, which is calculated by the ED based on three ratios:

the equity ratio, which measures the institution's capital resources, ability to borrow and financial viability;

the primary reserve ratio, which measures the institution's ability to support current operations from expendable resources; and

the net income ratio, which measures the institution's ability to operate at a profit.

The ED assigns a strength factor to the results of each of these ratios on a scale from negative 1.0 to positive 3.0, with negative 1.0 reflecting financial weakness and positive 3.0 reflecting financial strength. The ED then assigns a weighting percentage to each ratio and adds the weighted scores for the three ratios together to produce a composite score for the institution. The composite score must be at least 1.5 for the institution to be deemed financially responsible by the ED without the need for further oversight. Our campus groups' composite score, based on our fiscal year consolidated financial statements at the parent company level, was 2.2 in 2006 and 3.0 in 2005. The decrease in our composite score in 2006 was due to our repurchase in 2006 of 5.6 million shares of our common stock for \$363.0 million. In December 2006, we borrowed \$150 million under a revolving credit facility to allow us to continue repurchasing shares of our common stock while maintaining compliance with the ED's financial responsibility standards. See Notes 3 and 4 of the Notes to Consolidated Financial Statements.

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In evaluating an institution's compliance with the financial responsibility standards, the ED may examine the financial statements of the individual institution, the institution's parent company, or any party related to the institution. Historically, the ED has evaluated the financial condition of our institutions on a consolidated basis based on our financial statements at the parent company level. If the ED determines that an institution does not satisfy the ED's financial responsibility standards, the institution may establish its financial responsibility on one of several alternative bases, including posting a letter of credit in an amount equal to a specified percentage of the total Title IV Program funds received by the institution during the institution's most recently completed fiscal year and, in some cases, agreeing to receive Title IV Program funds under an arrangement other than the ED's standard advance funding

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arrangement while being provisionally certified. The requirement to post a letter of credit or other sanctions by the ED could increase our cost of regulatory compliance and adversely affect our results of operations or cash flows.

One or more of our institutes may have to post a letter of credit or be subject to other sanctions, if it does not correctly calculate and timely return Title IV Program funds for, or refund monies paid by or on behalf of, students who withdraw before completing their program of study. The HEA and its implementing regulations impose limits on the amount of Title IV Program funds withdrawing students can use to pay their education costs (the Return Policy). The Return Policy permits a student to use only a pro rata portion of the Title IV Program funds that the student would otherwise be eligible to use, if the student withdraws during the first 60% of any period of enrollment. For our institutes, a period of enrollment is generally an academic quarter. The institution must calculate and return to the appropriate lenders or the ED any Title IV Program funds that the institution receives on behalf of a withdrawing student in excess of the amount the student can use for such period of enrollment. The institution must return those unearned funds in a timely manner which, prior to July 2006, was generally within 30 days of the date the institution determined that the student had withdrawn. Beginning in July 2006, an institution generally has up to 45 days after it determines a student's withdrawal date to return unearned funds. If the unearned funds are not properly calculated and timely returned, we may have to post a letter of credit in favor of the ED or be otherwise sanctioned by the ED. An institution is required to post a letter of credit with the ED in an amount equal to 25% of the total dollar amount of unearned Title IV Program funds that the institution was required to return with respect to withdrawn students during its most recently completed fiscal year, if the institution is found in an audit or program review to have untimely returned unearned Title IV Program funds with respect to 5% or more of the students in the audit or program review sample of withdrawn students, in either of its two most recently completed fiscal years. No audit or review has found that any of our institutes was violating the ED's standard on the timely return of unearned Title IV Program funds. The requirement to post a letter of credit or other sanctions by the ED could increase our cost of regulatory compliance and adversely affect our results of operations.

The standards of most of the SEAs and the ACICS limit a student's obligation to an institution for tuition and fees, if a student withdraws from the institution (the Refund Policy). The specific standards vary among the SEAs. Depending on when during an academic quarter a student withdraws and the applicable Refund Policy, in many instances the student remains obligated to the ITT Technical Institute for some or all of the student's education costs that were paid by the Title IV Program funds returned under the Return Policy. In these instances, many withdrawing students are unable to pay all of their education costs, unless the students have access to other sources of financial aid. We have arranged for an unaffiliated private funding source to offer eligible students loans that can help replace any Title IV Program funds that are returned if any of those students withdraw. We believe that other unaffiliated private funding sources would also be willing to make these types of loans available to our students, but we cannot assure you of this. If these types of loans were unavailable, we could be unable to collect a significant portion of many withdrawing students' education costs that would have been paid by the Title IV Program funds that were returned, which, in the aggregate, could have a material adverse effect on our results of operations and cash flows.

One or more of our institutes may lose its eligibility to participate in Title IV Programs, if the percentage of its revenue derived from those programs is too high. Under a provision of the HEA commonly referred to as the 90/10 Rule, a for-profit institution becomes ineligible to participate in Title IV Programs if, on a cash accounting basis, the institution derives more than 90% of its applicable revenue for a fiscal year from Title IV Programs. If any of our campus groups violated the 90/10 Rule for any fiscal year, it would be ineligible to participate in Title IV Programs as of the first day of the following fiscal year and would be unable to apply to regain its eligibility until the next fiscal year. Furthermore, if one of our campus groups violated the 90/10 Rule and became ineligible to participate in Title IV Programs but continued to disburse Title IV Program funds, the ED would require the institution to repay, with limited exceptions, all Title IV Program funds disbursed by the institution after the effective date of the loss of eligibility. For our 2006 fiscal year, none of our campus groups derived more than 66% of its revenue on a cash accounting basis from Title IV Programs, with a range from approximately 50% to approximately 66%. We regularly monitor compliance with this requirement to minimize the risk that any of our campus groups would derive more than the maximum allowable percentage of its applicable revenue from Title IV Programs for any fiscal year. If a campus group appeared likely to approach the maximum percentage threshold, we would consider making changes in student financing to comply with the 90/10 Rule, but we cannot assure you that we would be able to do this in a timely manner or at all. If any of our campus groups lost its eligibility to participate in Title IV Programs and we could not arrange for alternative financing sources for the students attending the institutes in that campus group, we would probably have to close those institutes, which could have a material adverse effect on our financial condition, results of operations and cash flows.

Failure by one or more of our institutes to satisfy the ED's administrative capability requirements could result in financial penalties, limitations on the institute's participation in Title IV Programs, loss of Title IV Program funds for its students or the repayment of Title IV Program funds received by its students. To participate in Title IV

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Programs, an institution must satisfy criteria of administrative capability prescribed by the ED. The most significant of these criteria require that the institution:

- demonstrate a reasonable relationship between the length of its programs and the entry-level job requirements of the relevant fields of employment;
- comply with all of the applicable Title IV Program regulations prescribed by the ED;
- have capable and sufficient personnel to administer the institution's participation in Title IV Programs;
- define and measure the satisfactory academic progress of its students within parameters specified by the ED;
- provide adequate financial aid counseling to its students who receive Title IV Program funds; and
- timely submit all required reports and financial statements to the ED.

If the ED determines that an institution is not capable of adequately administering its participation in any of the Title IV Programs, the ED could:

- impose monetary fines or penalties on the institution;
- require the institution to repay funds received under Title IV Programs;
- restrict the institution's receipt of Title IV Program funds; and
- limit or terminate the institution's eligibility to participate in Title IV Programs.

Each of these sanctions could adversely affect our financial condition, results of operations and cash flows and impose significant operating restrictions on us. In addition, an institution is deemed by the ED to lack administrative capability if its FFEL/FDL cohort default rate equals or exceeds 25% for any of the three most recent federal fiscal years for which such rates have been published, or if its Perkins cohort default rate exceeds 15% for any federal award year. If an institution's administrative capability is impaired solely because its FFEL/FDL and/or Perkins cohort default rates exceed the percentages specified above, the institution can continue to participate in Title IV Programs, but the ED may place the institution on provisional certification. See "*We cannot operate new institutes, add learning sites or offer new programs if they are not timely approved by our regulators, and we may have to repay Title IV Program funds disbursed to students enrolled at any of those locations or in any of those programs if we do not obtain prior approval.*"

We are subject to sanctions if we pay impermissible commissions, bonuses or other incentive payments to individuals involved in certain recruiting, admission or financial aid activities. An institution participating in Title IV Programs may not provide any commission, bonus or other incentive payment based directly or indirectly on success in securing enrollments or financial aid to any person or entity engaged in any student recruitment or admission activity or in making decisions regarding the awarding of Title IV Program funds. The ED's regulations set forth 12 types of activities and payment arrangements that an institution may carry out without violating this HEA provision (the "Safe Harbors"). One of the Safe Harbors permits the payment of fixed compensation, such as a fixed annual salary or hourly wage, so long as the fixed compensation is not adjusted up or down more than twice during any 12-month period, and any adjustment to the fixed compensation is not based solely on the number of students recruited, admitted, enrolled or awarded financial aid. We believe that we have compensated the applicable employees in accordance with this Safe Harbor and other Safe Harbors, but the law and regulations governing this requirement do not establish clear criteria for compliance in all circumstances, and the ED has stated that it will no longer entertain a request by an institution or company for the ED to review and assess its individual compensation plan. If the ED determined that an institution's compensation practices violated these standards, the ED could subject the institution to monetary fines or penalties or other sanctions. Any substantial fine or penalty or other sanction could have a material adverse effect on our financial condition, results of operations and cash flows.

We cannot operate new institutes, add learning sites or offer new programs if they are not timely approved by our regulators, and we may have to repay Title IV Program funds disbursed to students enrolled at any of those locations or in any of those programs if we do not obtain prior approval. Our expansion plans assume that we will be able to continue to obtain the necessary ED, ACICS and SEA approvals to establish

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new institutes, add learning sites to our existing institutes and expand the program offerings at our existing institutes in a timely manner. If we are unable to obtain the approvals from the ED, the