

ITT EDUCATIONAL SERVICES INC
Form 10-Q
April 27, 2004

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2004

OR

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

For the transition period from _____ to _____

Commission file number 1-13144

ITT EDUCATIONAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

**13000 North Meridian Street
Carmel, Indiana**

(Address of principal executive offices)

36-2061311

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

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

45,715,429

Number of shares of Common Stock, \$.01 par value, outstanding at March 31, 2004.

ITT EDUCATIONAL SERVICES, INC.

Indianapolis, Indiana

Quarterly Report to Securities and Exchange Commission

March 31, 2004

PART I

FINANCIAL INFORMATION

EXPLANATORY NOTE

FAILURE TO OBTAIN A REVIEW OF THE INTERIM FINANCIAL STATEMENTS

As we previously disclosed in our 2004 Annual Meeting Notice and Proxy Statement, our Board of Directors has appointed a Special Committee to conduct an investigation, which investigation is separate and independent from the investigation being conducted by us and our management, into the facts and circumstances alleged to be the subject matter underlying, and in any way related to, the current investigations by the United States Department of Justice (DOJ), the Office of the Attorney General for the State of California (CAG) and the class action lawsuits that have been filed against us and other defendants named therein. The Special Committee has hired outside counsel to assist it in its investigation. We have been advised by our independent auditor, PricewaterhouseCoopers LLP, that it will be unable to complete its review of our quarterly results prior to the completion of the Special Committee s investigation and its review of the results of that investigation. Accordingly, our independent auditor has not reviewed the accompanying unaudited consolidated financial statements as of March 31, 2004 and for the three-month period then ended in accordance with Rule 10-01(d) of Regulation S-X promulgated by the Securities and Exchange Commission (SEC). We cannot predict the outcome of the Special Committee s investigation.

Since the unaudited consolidated financial statements contained in this report have not been reviewed by our independent auditor, we may be deemed not to be current in our filings required under the Securities Exchange Act of 1934, as amended. Upon the completion of the review by our independent auditor, we intend to file an amendment to this report, which will include a discussion of any material changes from the unreviewed financial statements contained in this filing. We understand that completion of a review of the unaudited consolidated financial statements and the filing of the amendment will make this report current, although it will not be deemed timely for purposes of the rules governing eligibility to use registration statements on Forms S-2 and S-3.

Item 1. FINANCIAL STATEMENTS.

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Consolidated Statements of Income (unaudited) for the three months ended March 31, 2004 and 2003

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

Consolidated Statements of Cash Flows (unaudited) for the three months ended March 31, 2004 and 2003

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

Notes to Consolidated Financial Statements

ITT EDUCATIONAL SERVICES, INC.
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)
(unaudited)

| | Three Months Ended March 31, | |
|--|---------------------------------|------------|
| | 2004 | 2003 |
| Revenues | \$ 141,730 | \$ 119,000 |
| Costs and Expenses | | |
| Cost of educational services | 76,493 | 68,333 |
| Student services and administrative expenses | 41,449 | 36,998 |
| Special legal costs | 9,700 | |
| Total costs and expenses | 127,642 | 105,331 |
| Operating income | 14,088 | 13,669 |
| Interest income, net | 709 | 448 |
| Income before income taxes | 14,797 | 14,117 |
| Income taxes | 5,771 | 5,435 |
| Net income | \$ 9,026 | \$ 8,682 |
| Earnings per common share (basic): | \$ 0.20 | \$ 0.19 |
| Earnings per common share (diluted): | \$ 0.19 | \$ 0.19 |

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

| | March 31, 2004 (unaudited) | December 31, 2003 | March 31, 2003 (unaudited) |
|--|-------------------------------|-------------------|-------------------------------|
| Assets | | | |
| Current assets | | | |
| Cash and cash equivalents | \$ 186,428 | \$ 168,273 | \$ 106,451 |
| Restricted cash | | 8,496 | |
| Short-term investments | 58,855 | 63,938 | 28,264 |
| Accounts receivable, net | 8,519 | 9,398 | 9,162 |
| Deferred and prepaid income tax | 6,846 | 2,906 | 2,609 |
| Prepays and other current assets | 6,972 | 3,635 | 8,232 |
| Total current assets | 267,620 | 256,646 | 154,718 |
| Property and equipment, net | 79,660 | 81,503 | 66,566 |
| Direct marketing costs | 11,979 | 10,844 | 10,555 |
| Investments | 20,674 | 13,467 | |
| Other assets | 961 | 810 | 1,707 |
| Total assets | \$ 380,894 | \$ 363,270 | \$ 233,546 |
| Liabilities and Shareholders' Equity | | | |
| Current liabilities | | | |
| Accounts payable | \$ 36,627 | \$ 36,543 | \$ 24,695 |
| Accrued compensation and benefits | 12,335 | 16,986 | 4,900 |
| Other accrued liabilities | 25,878 | 18,444 | 9,306 |
| Deferred revenue | 127,685 | 130,364 | 98,323 |
| Total current liabilities | 202,525 | 202,337 | 137,224 |
| Deferred income tax | 4,709 | 4,691 | 5,318 |
| Minimum pension liability | 7,012 | 7,012 | 8,041 |
| Other liabilities | 3,004 | 3,106 | 2,038 |
| Total liabilities | 217,250 | 217,146 | 152,621 |
| 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 | 540 | 540 | 540 |
| Capital surplus | 57,097 | 52,688 | 45,014 |
| Retained earnings | 228,397 | 221,400 | 181,999 |
| Accumulated comprehensive income | (4,263) | (4,263) | (4,888) |
| Treasury stock, 8,353,475, 8,638,535, and 9,293,599 shares, at cost | (118,127) | (124,241) | (141,740) |
| Total shareholders' equity | 163,644 | 146,124 | 80,925 |
| Total liabilities and shareholders' equity | \$ 380,894 | \$ 363,270 | \$ 233,546 |

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

| | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2004 | 2003 |
| Cash flows provided by (used for) operating activities: | | |
| Net income | \$ 9,026 | \$ 8,682 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,867 | 5,416 |
| Provision for doubtful accounts | 2,501 | 2,002 |
| Deferred taxes | (3,922) | (1,507) |
| Increase/decrease in operating assets and liabilities: | | |
| Short-term investments | (2,074) | (2,593) |
| Accounts receivable | (1,622) | (2,191) |
| Direct marketing costs | (1,135) | 54 |
| Accounts payable and accrued liabilities | 2,765 | (493) |
| Prepays and other assets | (3,488) | (3,094) |
| Deferred revenue | (2,679) | (4,674) |
| Net cash provided by (used for) operating activities | 4,239 | 1,602 |
| Cash flows provided by (used for) investing activities: | | |
| Facility purchases | | (7,641) |
| Capital expenditures, net | (3,024) | (1,757) |
| Proceeds from maturities of held-to-maturity investments | 23,156 | |
| Purchase of held-to-maturity investments | (23,206) | |
| Net cash provided by (used for) investing activities | (3,074) | (9,398) |
| Cash flows provided by (used for) financing activities: | | |
| Purchase of treasury stock | | (27,958) |
| Exercise of stock options | 8,494 | 11,168 |
| Net cash provided by (used for) financing activities | 8,494 | (16,790) |
| Net increase (decrease) in cash, cash equivalents and restricted cash | 9,659 | (24,586) |
| Cash, cash equivalents and restricted cash at beginning of period | 176,769 | 131,037 |
| Cash, cash equivalents and restricted cash at end of period | \$ 186,428 | \$ 106,451 |

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands)

| | Common Stock | | Capital Surplus | Retained Earnings | Compre- hensive Income | Accumulated Other Compre- hensive Income/(Loss) | Treasury Stock | | Total |
|--|--------------|--------|--------------------|----------------------|------------------------------|---|----------------|--------------|------------|
| | Shares | Amount | | | | | Shares | Amount | |
| Balance as of December 31, 2002 | 54,069 | \$ 540 | \$ 40,393 | \$ 184,409 | | \$ (4,888) | (8,986) | \$ (131,430) | \$ 89,024 |
| Exercise of stock options | | | | (21,867) | | | 1,425 | 35,906 | 14,039 |
| Tax benefit from exercise of stock options | | | 12,295 | | | | | | 12,295 |
| Purchase of treasury stock | | | | | | | (1,078) | (28,726) | (28,726) |
| Issue treasury stock for board of directors plan | | | | | | | 1 | 9 | 9 |
| Comprehensive income: | | | | | | | | | |
| Net income for 2003 | | | | 58,858 | \$ 58,858 | | | | 58,858 |
| Other comprehensive income, net of tax: | | | | | | | | | |
| Minimum pension liability adjustment | | | | | 625 | 625 | | | 625 |
| Other comprehensive income | | | | | 625 | | | | 625 |
| Comprehensive income | | | | | \$ 59,483 | | | | |
| Balance as of December 31, 2003 | 54,069 | 540 | 52,688 | 221,400 | | (4,263) | (8,638) | (124,241) | 146,124 |
| For the three months ended March 31, 2004 (unaudited): | | | | | | | | | |
| Exercise of stock options | | | 150 | (2,029) | | | 285 | 6,114 | 4,235 |
| Tax benefit from exercise of stock options | | | 4,259 | | | | | | 4,259 |
| Net income | | | | 9,026 | | | | | 9,026 |
| Balance as of March 31, 2004 | 54,069 | \$ 540 | \$ 57,097 | \$ 228,397 | | \$ (4,263) | (8,353) | \$ (118,127) | \$ 163,644 |

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

ITT EDUCATIONAL SERVICES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2004

(Dollar amounts in thousands, unless otherwise stated)

1. **Basis of Presentation**

As we previously disclosed in our 2004 Annual Meeting Notice and Proxy Statement, our Board of Directors has appointed a Special Committee to conduct an investigation, which investigation is separate and independent from the investigation being conducted by us and our management, into the facts and circumstances alleged to be the subject matter underlying, and in any way related to, the current investigations of us by the DOJ and CAG and the class action lawsuits that have been filed against us and other defendants named therein. The Special Committee has hired outside counsel to assist it in its investigation. We have been advised by our independent auditor, PricewaterhouseCoopers LLP, that it will be unable to complete its review of our quarterly results prior to the completion of the Special Committee's investigation and its review of the results of that investigation. Accordingly, our independent auditor has not reviewed the accompanying unaudited consolidated financial statements as of March 31, 2004 and for the three-month period then ended in accordance with Rule 10-01(d) of Regulation S-X promulgated by the SEC. We cannot predict the outcome of the Special Committee's investigation.

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

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

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

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

| | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2004 | 2003 |
| Net income as reported | \$ 9,026 | \$ 8,682 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method for stock options, net of tax | (1,922) | (1,161) |
| Proforma net income | \$ 7,104 | \$ 7,521 |
| Earnings per share: | | |
| Basic as reported | \$ 0.20 | \$ 0.19 |
| Basic proforma | \$ 0.16 | \$ 0.17 |
| Diluted as reported | \$ 0.19 | \$ 0.19 |
| Diluted proforma | \$ 0.15 | \$ 0.16 |

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

| | Three Months Ended March 31, | |
|---------------------------|---------------------------------|------|
| | 2004 | 2003 |
| Risk free interest rates | 3.2% | 2.7% |
| Expected lives (in years) | 5 | 5 |
| Volatility | 57% | 57% |
| Dividend yield | None | None |

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

3. New Accounting Pronouncements

In December 2003, the Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Standards (SFAS) No. 132 revised (SFAS No. 132R), Employers' Disclosures about Pensions and Other Postretirement Benefits. The provisions of SFAS No. 132R do not change the measurement and recognition provisions of SFAS No. 87, Employers' Accounting for Pensions, SFAS No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, and SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. SFAS No. 132R adds interim period and annual financial statement disclosures. See Note 7, which presents the additional interim disclosures required by SFAS No. 132R.

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

4. **Special Legal Costs**

Consistent with our accounting policy for contingent liabilities (pursuant to which we accrue probable legal costs associated with a claim or a potential claim), we recorded a charge of \$9,700 in the three months ended March 31, 2004 for estimated legal costs associated with the investigation of us being conducted by the DOJ, the inquiry initiated by the SEC into the allegations being investigated by the DOJ, and the securities class action and shareholder derivative lawsuits filed against us, certain of our current and former executive officers and each of our Directors (collectively, the Actions), as described below in Note 9. During the three months ended March 31, 2004, we paid \$159 of those legal costs, and the remaining \$9,541 are included in Other accrued liabilities as of March 31, 2004. We believe that it is probable that we will incur at least \$9,700 in legal costs related to these matters. Due to the uncertainty regarding the outcomes of these matters, however, we cannot estimate the maximum amount of costs that we could potentially incur with respect to these matters. In accordance with the financial accounting standards for loss contingencies, we have accrued what we believe to be the minimum amount of costs that is probable we will incur, since we are unable to estimate with any greater certainty any other amount. 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.

5. **Investments**

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

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

| | As of Mar 31, 2004 | | | As of Dec 31, 2003 | | | As of Mar 31, 2003 | | |
|---------------------------|--------------------|------------------|------------|--------------------|------------------|------------|--------------------|------------------|------------|
| | Trading securities | Held-to-maturity | Total | Trading securities | Held-to-maturity | Total | Trading securities | Held-to-maturity | Total |
| Cash and cash equivalents | \$ 186,428 | \$ | \$ 186,428 | \$ 168,273 | \$ | \$ 168,273 | \$ 106,451 | \$ | \$ 106,451 |
| Short-term investments | 15,165 | 43,690 | 58,855 | 13,347 | 50,591 | 63,938 | 28,264 | | 28,264 |
| Non-current investments | | 20,674 | 20,674 | | 13,467 | 13,467 | | | |
| | \$ 201,593 | \$ 64,364 | \$ 265,957 | \$ 181,620 | \$ 64,058 | \$ 245,678 | \$ 134,715 | \$ | \$ 134,715 |

6. **Earnings Per Share**

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

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Average Shares Outstanding
(in thousands)
Three Months Ended
March 31,

| | 2004 | 2003 |
|---------|--------|--------|
| Basic | 45,608 | 45,014 |
| Diluted | 46,763 | 46,042 |

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.

7. **Employee Pension Benefits**

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

| | For the Three Months Ended March 31, | | | |
|------------------------------------|---|-------|------|-------|
| | 2004 | | 2003 | |
| Service cost | \$ | 1,765 | \$ | 1,470 |
| Interest cost | | 570 | | 445 |
| Expected return on assets | | (550) | | (392) |
| Recognized net actuarial loss | | 250 | | 248 |
| Amortization of prior service cost | | (25) | | (22) |
| Net periodic pension cost | \$ | 2,010 | \$ | 1,749 |

In January 2004, we contributed \$6,700 to the Pension Plan. This amount represents the total amount we are required to contribute to the Pension Plan in 2004. The Excess Plan is a non-qualified, unfunded retirement plan and, therefore, we do not currently plan to make any contributions to it in 2004.

8. **Letter of Credit**

During the three months ended March 31, 2004, we provided a \$7,000 irrevocable standby letter of credit to one of our insurers to secure the surety bonds issued by that insurer which are required as part of our normal course of operations by various education authorities that regulate us. The letter of credit is collateralized by our investments.

9. **Contingencies**

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

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Among the legal actions currently pending is *United States ex rel. Dan Graves and Susan Newman v. ITT Educational Services, Inc., et al.* This action is a qui tam action that was filed on November 5, 1999 in the United States District Court for the Southern District of Texas by two former employees (relators) on behalf of themselves and the federal government (the Qui Tam Action). The Qui Tam Action alleges, among other things, violations of the False Claims Act, 31 U.S.C. § 3730, by us, one of our employees and our independent auditor 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 government for an alleged submission to the federal government of a false claim for payment. A qui tam action is always filed under seal and remains under seal until the DOJ decides whether to intervene in the litigation. Whenever a relator files a qui tam action, the DOJ typically initiates an investigation in order to determine whether to intervene in the litigation. If the DOJ intervenes, it has primary control over the litigation. If the DOJ declines to intervene, the relator may pursue the litigation on behalf of the federal government and, if successful, receives a portion of the federal government s recovery.

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On May 25, 2001, the DOJ declined to intervene in the Qui Tam Action. On March 31, 2002, the court dismissed all of the claims against all of the defendants for failure to allege facts sufficient to support the claims and gave the relators 20 days to file an amended complaint. The relators filed an amended complaint on April 22, 2002 against all of the defendants. On March 31, 2003, the court issued a final judgment in the Qui Tam Action dismissing with prejudice all of the relators' claims against us and all of the other defendants for failure to state a claim. On April 28, 2003, the relators filed a notice of appeal to the United States Court of Appeals for the Fifth Judicial Circuit. While we cannot assure you of the ultimate outcome of any litigation involving us, we do not believe that this action will result in a judgment or settlement that will have a material adverse effect on our financial condition, results of operations or cash flows.

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, we, 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 have been told that the DOJ is investigating claims alleging, among other matters, falsification of records relating to student attendance, grades and academic progress and graduate job placement statistics, and fraudulent misrepresentations regarding the transferability of credits. We, our Directors and our executive officers are cooperating with the DOJ in its investigation. There can be no assurance, however, that the ultimate outcome of the DOJ investigation will not have a material adverse effect on our financial condition or results of operations.

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

In October 2002, the CAG informed us that it had initiated an investigation of our ITT Technical Institutes in California. We believe that the CAG's investigation is in response to one or more qui tam actions filed against us under the state and/or federal False Claims Acts. The CAG has not asserted any claims against us, and we have not been informed of the specific matters that the CAG is investigating. Based on the information that the CAG has requested, however, we believe that the CAG is investigating, among other matters, whether one or more of our California ITT Technical Institutes: (a) falsified records relating to student attendance, grades and academic progress; (b) falsified student grade point average calculations used to qualify students for financial aid under the State's Cal Grant Program; and (c) 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.

We and three of our executive officers have been named as defendants in the following 12 securities class action lawsuits: *Richard Darquea, Individually and On Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.*; *Eastside Investors, Individually and On Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.*; *Roger Segalla, on behalf of himself and all others similarly situated v. ITT Educational Services, Inc., et al.*; *Allan Coffin, Individually and On Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.*; *Muriel & Wilbur Shapiro, Individually and On Behalf Of All Others Similarly Situated v. ITT Educational Services, Inc., et al.*; *Linda A. Lowson, individually and on behalf of herself and all others similarly situated v. ITT Educational Services, Inc., et al.*; *Linda D. Dudek, Individually and On Behalf Of All Others Similarly Situated v. ITT Educational Services, Inc., et al.*; *Richard Murad, Individually and On Behalf Of All Others Similarly Situated v. ITT Educational Services, Inc., et al.*; *Thomas D. and Cheryl K. Bejgrowicz, Individually and On Behalf Of All Others Similarly Situated v. ITT Educational Services, Inc., et al.*; *Irene Rosen, On Behalf of Herself and All Others Similarly Situated v. ITT Educational Services, Inc., et al.*; *William E. Norton, Individually and On Behalf of All Others Similarly Situated v. ITT*

Educational Services, Inc., et al.; Barbara R. Ritchie, On Behalf of Herself and All Others Similarly Situated v. ITT Educational Services, Inc., et al.; and *James Shandrom, on behalf of himself and all others similarly situated v. ITT Educational Services, Inc., et al.* Seven of those lawsuits were filed on February 26, 2004, February 27, 2004, March 3, 2004, March 29, 2004, April 1, 2004, April 16, 2004 and April 23, 2004, respectively, in the United States District Court for the Southern District of Indiana, and six were filed on March 9, 2004, March 24, 2004, March 29, 2004, March 29, 2004, March 30, 2004 and March 31, 2004, respectively, in the United States District Court for the District of Columbia. The complaints allege, among other things, that the defendants violated Sections 10(b) and 20(a) of the 1934 Act, and Rule 10b-5 promulgated thereunder, by employing devices, schemes and artifices to defraud, making untrue statements of material fact and/or omitting to state material facts necessary to make statements not misleading and engaging in acts, practices and a course of business which operated as a fraud and deceit on the purchasers of our securities in an effort to maintain artificially high market prices for our stock. The putative class periods in such actions are from April 17, 2003 through February 24, 2004 in nine of the actions, from October 16, 2003 through February 25, 2004 in two of the actions, from October 17, 2002 through February 24, 2004 in one of the actions and from October 17, 2002 through March 9, 2004 in one of the actions. The plaintiffs seek, among other things, an award of unspecified compensatory damages, interest, costs and attorney's fees and, in one of the actions, unspecified extraordinary equitable and/or injunctive relief. All of the defendants intend to defend themselves vigorously against the allegations made in the complaints. There can be no assurance, however, that the ultimate outcome of these 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.

In addition to the lawsuits described in the immediately preceding paragraph, on or about February 27, 2004, the following two purported shareholder derivative lawsuits were filed against four of our current and former executive officers and each of our Directors in the Superior Court of Hamilton County, Indiana: *Joseph DeVita, Derivatively on Behalf of ITT Educational Services, Inc. v. Rene R. Champagne, et al. and ITT Educational Services, Inc., nominally*; and *Alexander Solano, Derivatively on Behalf of ITT Educational Services, Inc. v. Rene R. Champagne, et al. and ITT Educational Services, Inc., nominally*. The derivative lawsuits allege, among other things, that the individual defendants breached their fiduciary duties to ITT/ESI, abused their ability to control and influence ITT/ESI, grossly mismanaged ITT/ESI, caused ITT/ESI to waste corporate assets and were unjustly enriched, and that certain individual defendants engaged in unlawful insider trading, each of which caused ITT/ESI to suffer significant damages. Both complaints seek undisclosed damages, extraordinary equitable and/or injunctive relief, disgorgement of profits, costs and attorney's fees. On March 30, 2004, both lawsuits were consolidated into one lawsuit under the following caption: *In Re ITT Educational Services, Inc. Derivative Litigation*. All of the defendants intend to defend themselves vigorously against the allegations in the complaints. Although the derivative action is brought nominally on behalf of ITT/ESI, we expect to incur defense costs and other expenses in connection with the derivative lawsuit, and there can be no assurance that the ultimate outcome of these or other actions will not have a material adverse effect on our financial condition or results of operations.

The current and former executive officers named in all, or one or more, of the securities class action and shareholder derivative lawsuits described above include Rene R. Champagne, Martin A. Grossman, Thomas W. Lauer, Kevin M. Modany and Omer E. Waddles.

Certain of our present 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.

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

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

Cash receipts from financial aid programs

Nature of capital additions

Seasonality of revenues

Components of income statement captions

Federal regulations regarding:

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

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

Return of Title IV Program funds for withdrawn students

Default rates

College Advantage Loan Program (CALP)

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

Critical Accounting Policies and Estimates

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

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

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

Recognition of Revenues. Tuition revenues are recorded on a straight-line basis over the length of the applicable course. If a student withdraws from an institute, the standards of most state education authorities that regulate our institutes, the accrediting commission that accredits our institutes and our own internal policy limit a student's obligation for tuition and fees to the institute depending on when a student withdraws during an academic quarter (Refund Policies). The terms of the Refund Policies vary by state, and the limitations imposed by the Refund Policies are generally based on the portion of the academic quarter that has elapsed at the time the student withdraws. The greater the portion of the

academic quarter that has elapsed at the time the student withdraws, the greater the student's obligation is to the institute for the tuition and fees related to that academic quarter. We record revenues net of any refunds paid as a result of any applicable Refund Policy. On an individual student basis, tuition earned in excess of cash received is recorded as accounts receivable, and cash received in excess of tuition earned is recorded as deferred revenue.

Textbook sales and the related cost of the textbooks are recognized at the beginning of each academic quarter with respect to students who are attending courses in which textbooks are charged separately from tuition. For those students who are attending courses in which the cost of textbooks is included in the tuition, the cost of the textbooks is amortized on a straight-line basis over the applicable course length and the deferral of textbook costs is recorded in prepaids and other current assets. Academic fees (which are charged only one time to students on their first day of class attendance) and admission processing fees (which are charged only one time to students upon being evaluated for admission to their programs of study) are recognized as revenue on a straight-line basis over the average course length of 24 months. If a student withdraws from an institute, all unrecognized revenue relating to his or her fees, net of any refunds paid as a result of any applicable Refund Policy, is recognized upon the student's departure.

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

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

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

New Accounting Pronouncements

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In December 2003, the FASB issued SFAS No. 132 revised (SFAS No. 132R), Employers Disclosures about Pensions and Other Postretirement Benefits. The provisions of SFAS No. 132R do not change the measurement and recognition provisions of SFAS No. 87, Employers Accounting for Pensions, SFAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, and SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions. SFAS No. 132R adds interim period and annual financial statement disclosures. See Note 7 of the Notes to Consolidated Financial Statements set forth elsewhere in this report, which presents the additional interim disclosures required by SFAS No. 132R.

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

parties. FIN 46 is effective for variable interest entities in which we hold a variable interest. We do not hold variable interests in variable interest entities and, therefore, FIN 46 will not have an impact 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 revenues for the periods indicated.

| | For the Three Months Ended March 31, | |
|--|---|--------|
| | 2004 | 2003 |
| Revenues | 100.0% | 100.0% |
| Cost of educational services | 54.0% | 57.4% |
| Student services and administrative expenses | 29.2% | 31.1% |
| Special legal costs | 6.9% | 0.0% |
| Operating income | 9.9% | 11.5% |
| Interest income, net | 0.5% | 0.4% |
| Income before income taxes | 10.4% | 11.9% |

The following table sets forth our total student enrollment:

| Total Student Enrollment as of: | 2004 | | 2003 | | 2002 Total Student Enrollment |
|------------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|--|
| | Total Student Enrollment | Increase Over Prior Year | Total Student Enrollment | Increase Over Prior Year | |
| March 31 | 38,192 | 18.2% | 32,313 | 4.3% | 30,986 |
| June 30 | Not applicable | Not applicable | 33,443 | 6.0% | 31,557 |
| September 30 | Not applicable | Not applicable | 37,159 | 9.9% | 33,799 |
| December 31 | Not applicable | Not applicable | 37,076 | 13.6% | 32,631 |

The following table sets forth our total new student enrollment:

| New Student Enrollment for the Three Months Ended: | 2004 | | 2003 | | 2002 New Student Enrollment |
|--|------------------------------|--------------------------------|------------------------------|--------------------------------|--------------------------------------|
| | New Student Enrollment | Increase Over Prior Year | New Student Enrollment | Increase Over Prior Year | |
| March 31 | 9,255 | 28.0% | 7,233 | 6.1% | 6,818 |
| June 30 | Not applicable | Not applicable | 8,677 | 14.6% | 7,573 |
| September 30 | Not applicable | Not applicable | 12,693 | 19.1% | 10,660 |
| December 31 | Not applicable | Not applicable | 7,277 | 27.4% | 5,710 |

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| | | | | | |
|--------------------|----------------|----------------|--------|-------|--------|
| Total for the year | Not applicable | Not applicable | 35,880 | 16.6% | 30,761 |
|--------------------|----------------|----------------|--------|-------|--------|

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

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

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

Three Months Ended March 31, 2004 Compared with Three Months Ended March 31, 2003

Revenues increased \$22.7 million, or 19.1%, to \$141.7 million in the three months ended March 31, 2004 from \$119.0 million in the three months ended March 31, 2003, primarily due to:

- a 5.0% increase in tuition rates in March 2003 and a 6.0% increase in tuition rates in March 2004;

- a 13.6% increase in the total student enrollment at December 31, 2003 compared to December 31, 2002; and

a 28.0% increase in new student enrollment at our institutes in the three months ended March 31, 2004 compared to the same period in 2003, which is primarily a result of:

- opening new institutes;

- an increased number of institutes offering bachelor degree programs;

- an increased number of responses to our marketing and advertising;

- operational changes that increased the percentage of new student enrollments arising from those responses;

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

- the use of the Hybrid Delivery Model at more institutes.

Cost of educational services increased \$8.2 million, or 11.9%, to \$76.5 million in 2004 from \$68.3 million in 2003. The principal causes of this increase included:

- the costs required to service the increased enrollment;

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

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

Cost of educational services as a percentage of revenues decreased to 54.0% in 2004 from 57.4% in 2003. The primary causes of this decrease include:

continued facility and faculty utilization efficiencies;

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

new and renegotiated vendor contracts; and

a net reduction of occupancy costs resulting from our purchase of 6 facilities in 2003 that we had previously leased.

Student services and administrative expenses increased \$4.4 million, or 12.0%, to \$41.4 million in the three months ended March 31, 2004 from \$37.0 million in the three months ended March 31, 2003. Student services and administrative expenses decreased to 29.2% of revenues in the three months ended March 31, 2004 compared to 31.1% of revenues in the three months ended March 31, 2003, primarily due to:

revenues increasing at a greater percentage (19.1%) than media advertising expenses (13.8%);

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

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

Special legal costs of \$9.7 million were accrued in the three months ended March 31, 2004 for our estimated legal costs associated with the Actions. See Note 4 of the Notes to Consolidated Financial Statements set forth elsewhere in this report.

Operating income increased \$0.4 million, or 3.1%, to \$14.1 million in the three months ended March 31, 2004 from \$13.7 million in the three months ended March 31, 2003. The operating margin decreased to 9.9% of revenues in the three months ended March 31, 2004 from 11.5% in the three months ended March 31, 2003, primarily as a result of the \$9.7 million Special legal costs accrual, offset by:

continued facility and faculty utilization efficiencies;

new and renegotiated vendor contracts; and

a net reduction of occupancy costs resulting from our purchase of 6 facilities in 2003.

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

Financial Condition, Liquidity and Capital Resources

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

On January 20, 2004, our Board of Directors approved an amendment to our Restated Certificate of Incorporation to increase the number of authorized shares of our common stock from 150,000,000 to 350,000,000 (Amendment). If the Amendment is approved by our shareholders at our 2004 annual meeting of shareholders, it will become effective upon the filing of a Certificate of Amendment with the Delaware Secretary of State.

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

The following table sets forth the repurchase of outstanding shares of our common stock during the three months ended March 31, 2004 and 2003:

**Three Months
Ended March 31,**

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| | 2004 | 2003 |
|--|------|-----------|
| Number of shares repurchased | | 1,050,000 |
| Total cost of shares repurchased (in millions) | \$ | 28.0 |
| Average cost per share | \$ | 26.63 |

All of the repurchased shares of our common stock became treasury shares upon repurchase and most of the repurchased shares continue to be held as treasury shares. As of March 31, 2004, our existing repurchase authorization permits us to repurchase an additional 4,216,300 shares of our common stock. We may elect to repurchase additional shares of our common stock from time to time in the future, depending on market conditions and other considerations. The purpose of the stock repurchase program is to help us achieve our long-term goal of enhancing shareholder value.

Net cash provided by operating activities was \$4.2 million in the three months ended March 31, 2004 compared to \$1.6 million in the three months ended March 31, 2003. As of March 31, 2004, we have \$64.4 million of investments that we plan to hold until maturity. The maturity dates extend beyond one year for \$20.7 million of those investments.

Deferred revenue, which represents the cash received from students in excess of tuition earned, increased \$29.4 million to \$127.7 million at March 31, 2004 from \$98.3 million at March 31, 2003. This increase was primarily due to

our students increased usage of supplemental private loans and increased tuition revenue resulting from higher tuition rates and a larger number of students.

Deferred income taxes increased \$3.9 million to \$6.8 million at March 31, 2004 from \$2.9 million at December 31, 2003, primarily due to the accrual of Special legal costs associated with the Actions.

We did not purchase any facilities during the three months ended March 31, 2004. We may purchase facilities during the remainder of 2004. We have agreed to purchase two parcels of land for \$2.8 million on which we intend to build facilities. Capital expenditures were \$3.0 million in the three months ended March 31, 2004 compared to \$1.8 million in the three months ended March 31, 2003. We expect that our capital expenditures (excluding land and facilities purchases) will total approximately \$20.0 million to \$25.0 million in 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

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The following table sets forth the specified contractual obligations as of March 31, 2004.

| Contractual Obligations | Total | Less than 1 Year | Payment due by period | | |
|-----------------------------|----------|---------------------|-----------------------|--------------|----------------------|
| | | | 1-3 Years | 3-5 Years | More than 5 Years |
| (In millions) | | | | | |
| Operating Lease Obligations | \$ 146.7 | \$ 26.4 | \$ 47.0 | \$ 37.7 | \$ 35.6 |
| Purchase Obligations | \$ 5.0 | \$ 0.6 | \$ 4.4 | | |
| Total | \$ 151.7 | \$ 27.0 | \$ 51.4 | \$ 37.7 | \$ 35.6 |

Off-Balance Sheet Arrangements

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As of March 31, 2004, we leased our non-owned facilities under operating lease agreements. A majority of the operating leases contain renewal options that can be exercised after the initial lease term. Renewal options are generally for periods of one to five years. All operating leases will expire over the next 13 years and management expects that those leases will be renewed or replaced by other leases in the normal course of business, or that we will purchase the facilities represented by those leases or other facilities where we can operate our institutes. There are no material restrictions imposed by the lease agreements, and we have not entered into any significant guarantees related to the leases. We are required to make additional payments under the operating lease terms for taxes, insurance and other operating expenses incurred during the operating lease period.

As part of our normal course of operations, one of our insurers issues surety bonds for us that are required by various education authorities that regulate us. We are obligated to reimburse our insurer for any of those surety bonds that are paid by the insurer. As of March 31, 2004, the total outstanding amount of those surety bonds was \$10.7 million. During the three months ended March 31, 2004, we also 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.

We do not have any off-balance sheet arrangements, except for the operating lease agreements, the surety bonds and the standby letter of credit disclosed above, or any other significant long-term obligations, lines of credit, guarantees, standby repurchase obligations or other commercial commitments. There are no commitments or guarantees that provide for the potential issuance of shares of our common stock, other than pursuant to the terms of the stock option plans for our employees and non-employee directors.

Forward-Looking Statements

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

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

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

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

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

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

our ability to implement our growth strategies;

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

loss of lender access to our students for student loans;

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

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

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

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

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

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

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

Item 4. CONTROLS AND PROCEDURES.

We are responsible for establishing and maintaining a set of disclosure controls and procedures (DCP) that are designed to ensure that information required to be disclosed by us in the reports filed by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. In addition, we are responsible for establishing and maintaining adequate internal control over our financial reporting (IC) that is designed to provide reasonable assurances that our records are maintained in reasonable detail to accurately and fairly reflect transactions, our transactions are properly authorized, our assets are safeguarded against unauthorized or improper acquisition, use or disposition, and our transactions are properly recorded and reported to permit the preparation of our financial statements in conformity with generally accepted accounting principles. As of the end of our first fiscal quarter of 2004, we conducted an evaluation, under the framework of the Committee of Sponsoring Organizations of the Treadway Commission and the supervision (and with the participation) of our management, including our Chairman and Chief Executive Officer, President and Chief Operating Officer and Senior Vice President and Chief Financial Officer, of the effectiveness of the design and operation of our DCP pursuant to Rule 13a-15 of the Exchange Act. Based on that evaluation, our Chairman and Chief Executive Officer, President and Chief Operating Officer and Senior Vice President and Chief Financial Officer concluded that our DCP are effective.

There were no changes in our IC during our first fiscal quarter of 2004 that materially affected or are reasonably likely to materially affect our IC, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART II

OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS.

The information set forth in Note 9 of the Notes to Consolidated Financial Statements set forth elsewhere in this report is incorporated herein by reference.

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

Item 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES.

The following information is furnished as to our securities sold during the three months ended March 31, 2004 that were not registered under the Securities Act of 1933, as amended (the Securities Act).

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On January 1, 2004, we credited 425 treasury shares of our common stock to the deferred share accounts of each of three non-employee directors and 106 treasury shares of our common stock to the deferred share account of one other non-employee director under the ESI Non-Employee Director Deferred Compensation Plan as the stock portion of the semi-annual installment payment of their annual retainer. 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 transaction described in the preceding paragraph is 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 during the first quarter of 2004:

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1) |
|--|----------------------------------|------------------------------|--|--|
| January 1, 2004 through January 31, 2004 | | \$ | | 4,216,300 |
| February 1, 2004 through February 29, 2004 | | | | 4,216,300 |
| March 1, 2004 through March 31, 2004 | | | | 4,216,300 |
| Total | | \$ | | |

(1) On October 17, 2002, we announced that our Board of Directors on October 15, 2002 authorized us to repurchase 5.0 million shares of our common stock (the 2002 Repurchase Program). As of March 31, 2003, 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 AND REPORTS ON FORM 8-K.

(a) 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 such exhibits, and is incorporated herein by reference.

(b) Reports on Form 8-K.

On January 22, 2004, we furnished a Current Report on Form 8-K dated January 22, 2004 to report, under Item 12 of Form 8-K, our results of operations and financial condition for our fiscal quarter and year ended December 31, 2003.

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On March 3, 2004, we furnished a Current Report on Form 8-K dated March 3, 2004 to report, under Item 9 of Form 8-K, that, in light of the pending DOJ investigation of us and resulting shareholder class action lawsuits, we were unable to confirm the internal goals and other projections for our 2004 fiscal year that we had previously disclosed.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ITT Educational Services, Inc.

Date: April 27, 2004

By: /s/ Kevin M. Modany
Kevin M. Modany
Senior Vice President and Chief Financial Officer
(Duly Authorized Officer and Principal Financial Officer)

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INDEX TO EXHIBITS

| Exhibit No. | Description |
|--------------------|---|
| 10.40 | Sixth Amendment of ESI Pension Plan |
| 10.41 | Third Amendment of ESI 401(k) Plan |
| 10.42 | Second Amendment to the 1999 Outside Directors Stock Option 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 | President and Chief Operating Officer's Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 |
| 31.3 | 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 | President and Chief Operating Officer's Certification Pursuant to 18 U.S.C. Section 1350 |
| 32.3 | Chief Financial Officer's Certification Pursuant to 18 U.S.C. Section 1350 |