

ITT EDUCATIONAL SERVICES INC
Form 10-K
February 24, 2006
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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, 2005

OR

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

For the transition period from _____ to _____

Commission file number 1-13144

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.)

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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	Name of each exchange on which registered
COMMON STOCK, \$.01 PAR VALUE	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. 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

\$2,444,722,853

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, 2005 (assuming solely for the purposes of this calculation that all Directors and executive officers of the registrant are affiliates).

45,692,678

Number of shares of Common Stock, \$.01 par value, outstanding at January 31, 2006.

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
PART III

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Definitive Proxy Statement for the Annual Meeting of
Shareholders to be held May 9, 2006

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ITT EDUCATIONAL SERVICES, INC.

Carmel, Indiana

Annual Report to Securities and Exchange Commission

December 31, 2005

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 these statements by the use of words such as could, should, would, may, will, project, believe, anticipate, expect, plan, estimate, forecast, potential, intend, continue, and contemplate, as well as similar words and expressions. Forward-looking statements involve risks and uncertainties and do not guarantee future performance. We cannot assure you that future developments affecting us will be those anticipated by our management. Among the factors that could cause actual results to differ materially are the following:

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

changes in federal and state governmental regulations with respect to education and accreditation standards, or the interpretation or enforcement 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;

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

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

Readers are also directed to other risks and uncertainties discussed in 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.

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

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

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

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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, formerly a Delaware corporation and now known as ITT Industries, Inc., an Indiana corporation (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, 2005, we were offering associate, bachelor and master degree programs to more than 42,000 students. We currently have 81 institutes located in 32 states. All of our institutes are (a) authorized by the applicable education authorities of the states in which they operate and recruit and (b) 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, 2005, all of our program offerings were degree programs. We have provided career-oriented education programs since 1969 under the ITT Technical Institute name.

In 2005, we opened four new institutes and added three 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 the remainder of 2006, we plan to open up to six new institutes and add up to six new learning sites to existing institutes. In 2005, we developed several new residence and online bachelor and associate degree programs and continued our efforts to diversify our program offerings by developing programs in non-technology fields of study. Most of our residence associate degree and bachelor degree programs are being taught on a three-day-per-week class schedule or under our hybrid education delivery model, pursuant to which certain program courses are taught in residence on campus and others are taught either entirely online over the Internet or partially online over the Internet and partially in residence on campus (the Hybrid Delivery Model). In 2005, 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. We intend to continue expanding by:

opening new institutes;

adding learning sites to existing institutes;

offering a broader range of both residence and online programs at our existing institutes; and

pursuing new and expanded alliances with both domestic and international educators.

We also intend to further expand our Hybrid Delivery Model by teaching more of the courses in each of our residence programs either entirely or partially online over the Internet and fewer courses entirely in residence on campus.

In 2005, 54 of our institutes offered one or more bachelor degree programs of study. We intend to further increase the number of our institutes that offer both associate and 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, opening new institutes across the United States, adding learning sites to existing institutes, licensing the use of our curricula to third parties and offering our curricula in international markets. The principal elements of this strategy include the following:

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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 recent 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 81 institutes provide significant potential for the introduction of existing programs to a broader number of institutes. We believe that introducing new programs at existing institutes will attract more students. In 2005, we added a total of 101 program offerings among 35 existing institutes, and in 2006 we intend to add a total of approximately 80 program offerings among approximately 25 existing institutes.

Develop or Acquire Additional Programs. We plan to introduce both residence and online programs in additional technology and non-technology fields of study and at different levels. In 2005, we developed:

three new residence bachelor degree programs;

six new online bachelor degree programs or new concentrations within existing online bachelor degree programs;

one new residence associate degree program; and

one new online associate degree program.

In 2006, we intend to begin offering the bachelor and associate degree programs and concentrations developed in 2005. We also intend to develop additional degree programs and concentrations in 2006 and begin offering those programs and concentrations at one or more of our institutes. The new degree programs and concentrations are expected to involve a variety of disciplines, such as electronics and business, and be at the associate, bachelor and master degree levels. We intend to develop both a residence and online version of many of the new programs planned for 2006, and we expect that most, if not all, of the residence versions of these programs will be taught under our Hybrid Delivery Model. We believe that introducing 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 2005, we increased the number of our institutes that offer bachelor degree programs from 52 to 54. In 2006, we intend to increase the number of our institutes that offer bachelor degree programs to 58. The average combined total program time that graduates of one or more of our programs were enrolled 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;

a portion of our new students beginning their studies in bachelor degree programs, instead of first completing associate degree programs;

a decrease in the average number of credit hours taken each academic quarter by full-time students in our residence degree programs of study as a consequence of our conversion to a three-day-per-week class schedule (from a five-day-per-week class schedule) in those programs;

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the elimination of shorter, non-degree programs; and

the increased duration of some of our associate degree programs from 18 months to 24 months.

We expect 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 those services.

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Geographically Expand Our Institutes and Program Offerings. We plan to open new institutes and add learning sites to 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. We opened three new institutes in 2003. In 2004, we opened two new institutes and added one learning site to an existing institute. In 2005, we opened four new institutes and added three learning sites to existing institutes. We plan to open up to six new institutes and add up to six new learning sites to existing institutes in the remainder of 2006. 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 2006. We also intend to expand the international offering of our curricula either by us through online programs offered over the Internet or by international educators through residence programs under a license to use our curricula.

Increase Margins By Leveraging Fixed Costs at Institute and Headquarters Levels. Our efforts to optimize school capacity and class size have allowed us to increase student enrollment without incurring a proportionate increase in fixed costs at our institutes. We believe that our online programs and Hybrid Delivery Model will help us to improve the utilization of our facilities by eliminating student usage of our facilities with respect to our online program offerings and reducing student usage of our facilities with respect to our Hybrid Delivery Model. In addition, we have realized substantial operating efficiencies by centralizing management functions and implementing operational uniformity among our institutes. 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, 2005, we were offering:

18 degree programs in various fields of study;

at least one program involving information technology (IT) at 81 of our institutes;

at least one program involving electronics technology at 81 of our institutes;

at least one program involving drafting and design at 80 of our institutes,

at least one program involving business at 61 of our institutes; and

at least one program involving criminal justice at 56 of our institutes.

The table below sets forth information regarding the programs of study we were offering as of December 31, 2005.

	Number of Institutes Offering the Programs at		
	Master Degree	December 31, 2005	
		Bachelor Degree	Associate Degree
School of Business			
Business Administration (1)	1(2)	48	9
Business Administration Project Management (1)		2	
Business Accounting Technology (1)		13	5

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Technical Project Management (1)	39	
School of Criminal Justice		
Criminal Justice (1)	47	14
Criminal Justice - Cybersecurity (1)	1	
School of Drafting and Design		
Computer Drafting and Design		76
Digital Entertainment and Game Design	47	
Multimedia (3)		80
School of Electronics Technology		
Computer and Electronics Engineering Technology		81
Electronics and Communications Engineering Technology	51	
Industrial Automation Engineering Technology	6	
School of Information Technology		
Computer Network Systems (3)		81
Data Communication Systems Technology	25	
Information Systems Security (1)	52	
Software Applications and Programming (3)		73
Software Engineering Technology	18	
Web Development (3)		69

(1) Residence and online programs. Our institute in Indianapolis is the only institute that presently offers online programs.

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- (2) Online program.
- (3) 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.

As of December 31, 2005, approximately 35% of our students were enrolled in IT programs, approximately 28% were enrolled in drafting and design programs, approximately 25% were enrolled in electronics technology programs, approximately 7% were enrolled in criminal justice programs and approximately 5% were enrolled in business programs. 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. Graduates of our criminal justice programs are expected to obtain a variety of entry-level positions involving criminal justice in both the private and public sectors. Graduates of our business programs are expected to obtain a variety of entry-level positions in various types of businesses 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 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:

four to five hour sessions three days a week, Monday through Saturday; or

two to three days a week, Monday through Saturday, under the Hybrid Delivery Model with one course taught entirely, or two courses each taught 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 under the Hybrid Delivery Model. Depending on student enrollment, class sessions are generally available in the morning, afternoon and evening. The portion of our courses that is taught online over the Internet is delivered through an asynchronous learning network and has 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 content of most courses in each program of study is substantially standardized 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 has established 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 2005 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 \$13,896 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.

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Student Recruitment

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 visits.

We centrally coordinate and develop our advertising. We direct our television advertising at both the national market and the local markets in which our institutes are located. Our television commercials generally include a toll-free telephone number and a website address for direct responses and information about the location of our institutes in the area. We place our Internet advertising on websites visited by different groups of potential postsecondary students. We centrally receive and track responses to our television and Internet advertising and forward them to the appropriate institute representatives to contact prospective students and schedule interviews. We target our direct mail campaigns at different groups of potential postsecondary students, including, among others, high school students and working adults. We centrally receive and track responses to direct mail campaigns and forward them to the appropriate institute representatives to contact prospective students and schedule interviews.

We employ a director of recruitment at each of our institutes, who reports to the director of that institute. We centrally establish recruiting policies and procedures, as well as standards for hiring and training recruiting representatives. We implement these policies, procedures and standards at the local level. We employ approximately 800 full- and part-time recruiting representatives to assist in local recruiting efforts. These representatives perform most of their services in student recruitment offices located at the institute and any associated learning site. Our recruiting representatives, along with other employees, also make presentations to students at high schools. These presentations promote our institutes and obtain information about high school juniors and seniors who may be interested in attending our institutes.

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. We have designed these interviews to establish a prospective student's qualifications, academic background, interests, motivation and goals for the future. Occasionally, we also pursue expressions of interest from students for our residence programs of study by contacting them and arranging for their attendance at an informational 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.

Student recruitment activities are subject to substantial regulation at both the state and federal level. Most states have bonding and licensing requirements that apply to many of our representatives and other employees involved in student recruitment. Our Vice President, Recruitment and the District Directors of Recruitment oversee the implementation of recruitment policies and procedures. In addition, our compliance department generally reviews student recruiting practices relating to student presentations and the execution and completion of enrollment agreements at each of our institutes on 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, 2005, were as follows:

Student Demographics	Approximate Percent of Student Census
Age	
19 or less	19%
20 through 24	39%
25 through 30	23%
31 or over	19%
Gender	
Male	80%

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Female	20%
Race	
Caucasian	55%
Minority (1)	45%

(1) Based on applicable federal classifications.

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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. In addition, we consider factors relating to student retention in the performance evaluation of all of our instructors and most of the managers of our institutes.

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 data depends largely on information that students and employers report to us. Based on this information, we believe that approximately 71% of the Employable Graduates (as defined below) from our institutes' programs during 2004 obtained employment by April 30, 2005, 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.

Each of our institutes employs personnel to offer its students and graduates career services. These persons assist in job searches and solicit employment opportunities from employers. In addition, certain courses in our undergraduate programs of study include instruction on job search techniques, the use of relevant reference materials, the composition of resumes and letters of introduction and the appropriate preparation, appearance and conduct for 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 \$27,453 for the Employable Graduates of our institutes' programs who graduated in 2004 and obtained employment by April 30, 2005, or were already employed, in fields involving skills taught in their programs of study. The calculation of this amount excludes any

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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.

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. Our institutes currently employ a total of approximately 1,200 full-time and 1,400 part-time or 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. We employ approximately 200 people at our corporate headquarters in Carmel, Indiana. As of December 31, 2005, we had approximately 3,800 full-time and 1,900 part-time employees at our institutes and corporate headquarters. In addition, we currently employ 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

marketing

public relations

curricula development

management information systems

purchasing

legal

regulatory

legislative affairs

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real estate

human resources

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

finance

academic affairs

career services

library

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.

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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 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 2005, we indirectly derived approximately 63% of our revenue determined on an accrual accounting basis (or 61% 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. Students at our institutes receive grants, loans and other aid to fund the cost of their education under the following Title IV Programs:

the Federal Family Education Loan (the FFEL) program, which accounted in aggregate for approximately 52% of our revenue in 2005;

the Federal Pell Grant (the Pell) program, which accounted in aggregate for approximately 11% of our revenue in 2005;

the William D. Ford Federal Direct Loan (the FDL) program, which accounted in aggregate for a negligible portion of our revenue in 2005;

the Federal Work-Study (the Work-Study) program, which makes federal funds available to provide part-time employment to students and under which approximately 300 of our institutes' students were employed and \$2,456,081 in student wages were paid by our institutes in 2005; and

the Federal Supplemental Educational Opportunity Grant (the SEOG) program, which accounted in aggregate for a negligible portion of our revenue in 2005.

The Work-Study and SEOG programs each require our institutions to make a 25% matching contribution for all of the federal funds the institution receives from the ED under those programs. In 2005, our 25% matching contribution amounted to \$614,020 for the Work-Study program and \$77,576 for the SEOG program.

In 2005, we indirectly derived approximately 3% of our revenue from state student financial aid programs. In 2005, we also indirectly derived approximately 30% of our revenue from unaffiliated, private loan programs that were made available to eligible students at various ITT Technical Institutes to help fund a portion of the students' cost of education. We have no financial responsibility with respect to any loans made to students or their parents under those programs, except for \$692,000 of loans made in the mid-1990's for which we have guaranteed repayment to the lender if the borrowers fail to pay. We have reserved \$692,000 for our guarantee obligation with respect to those loans and, as a result, we do not believe that such guarantee will result in a material adverse effect on our financial condition, results of operations or cash flows.

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 thereunder by the ED set forth numerous and 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 those standards is to limit institutional dependence on Title IV Program funds, prevent institutions with

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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 81 institutes are main campuses and the remaining 52 of our institutes

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are additional locations. Each of the learning sites of our institutes is also an additional location under the ED's regulations. The HEA requires each institution that participates in Title IV Programs to periodically renew its certification by the ED to continue its participation. All of our ITT Technical Institutes currently participate in Title IV Programs.

At the state level, we currently operate one or more institutes in 32 states and our institutes recruit students in the remaining 18 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. Currently, each of our institutes has 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 such 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 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 job placement. During 2005, the ACICS evaluated 19 of our institutes for initial grants of accreditation or the renewal of their current grants of accreditation. As of the end of 2005, of those 19 institutes, the ACICS had granted initial accreditation to four institutes and reaccredited 15 institutes. None of our institutes are on probation with the ACICS, but four institutes are subject to graduate placement reporting and three institutes are subject to student retention reporting by the ACICS. Under the ACICS standards, an institute that is subject to a financial or outcomes review (including graduate placement and student retention reporting) must periodically report its results in such 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 loss of accreditation by one of our existing institutes or the failure of a new institute to obtain full accreditation:

would make only the affected institute ineligible to participate in Title IV Programs, if the affected institute was an additional location;

would make the entire campus group ineligible to participate in Title IV Programs, if the affected institute was a main campus; and

could have a material adverse effect on our financial condition, results of operations and cash flows.

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, recruiting, financial operations and financial condition. Those requirements also affect our ability to open or acquire additional institutes and learning sites, add new, or expand our existing, education programs and change our corporate structure and ownership. If our institutes failed to comply with any of the statutes, regulations or standards applied by the ED, the SEAs or the ACICS, those authorities 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;

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limit, terminate or suspend our institutes' eligibility to participate in Title IV Programs or any state financial aid programs;

require our institutes to repay funds received under Title IV Program 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