ITT EDUCATIONAL SERVICES INC
Form 10-Q
July 26, 2013
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

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	**36-2061311**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
13000 North Meridian Street Carmel, Indiana	**46032-1404**
(Address of principal executive offices)	**(Zip Code)**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

23,368,853

Number of shares of Common Stock, $.01 par value, outstanding at June 30, 2013

Table of Contents

ITT EDUCATIONAL SERVICES, INC.

Carmel, Indiana

Quarterly Report to Securities and Exchange Commission

June 30, 2013

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements.

Index

Table of Contents

ITT EDUCATIONAL SERVICES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share data)

	As of		
	June 30, 2013 (unaudited)	**December 31, 2012**	**June 30, 2012 (unaudited)**
Assets			
Current assets:			
Cash and cash equivalents	$ 185,408	$ 246,342	$ 167,234
Restricted cash	776	601	751
Accounts receivable, net	123,076	77,313	73,675
Deferred income taxes	29,131	44,547	16,859
Prepaid expenses and other current assets	19,788	16,162	14,571
Total current assets	358,179	384,965	273,090
Property and equipment, net	179,095	189,890	198,175
Deferred income taxes	52,759	56,112	36,016
Other assets	39,440	41,263	49,360
Total assets	$ 629,473	$ 672,230	$ 556,641
Liabilities and Shareholders Equity			
Current liabilities:			
Accounts payable	$ 63,719	$ 63,304	$ 80,777
Accrued compensation and benefits	26,219	21,023	25,711
Other current liabilities	41,521	86,722	19,454
Deferred revenue	113,891	135,900	121,873
Total current liabilities	245,350	306,949	247,815
Long-term debt	120,000	140,000	150,000
Other liabilities	84,191	98,327	74,615
Total liabilities	449,541	545,276	472,430
Shareholders equity:			
Preferred stock, $.01 par value, 5,000,000 shares authorized, none issued	0	0	0
Common stock, $.01 par value, 300,000,000 shares authorized, 37,068,904 issued	371	371	371
Capital surplus	204,731	206,703	198,812
Retained earnings	1,011,061	959,072	925,781
Accumulated other comprehensive (loss)	(7,787)	(7,930)	(9,147)
Treasury stock, 13,700,051; 13,744,395 and 13,749,764 shares, at cost	(1,028,444)	(1,031,262)	(1,031,606)
Total shareholders equity	179,932	126,954	84,211
Total liabilities and shareholders equity	$ 629,473	$ 672,230	$ 556,641

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

Table of Contents

ITT EDUCATIONAL SERVICES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Amounts in thousands, except per share data)

(unaudited)

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Revenue	$ 259,936	$ 329,825	$ 547,647	$ 671,619
Costs and expenses:				
Cost of educational services	123,828	140,940	249,049	275,881
Student services and administrative expenses	100,903	111,467	207,185	217,733
Loss related to private student loan programs	0	0	3,464	0
Total costs and expenses	224,731	252,407	459,698	493,614
Operating income	35,205	77,418	87,949	178,005
Interest income	172	502	206	1,183
Interest (expense)	(1,113)	(1,254)	(2,265)	(1,801)
Income before provision for income taxes	34,264	76,666	85,890	177,387
Provision for income taxes	13,405	30,664	33,901	70,314
Net income	$ 20,859	$ 46,002	$ 51,989	$ 107,073
Earnings per share:				
Basic	$ 0.89	$ 1.97	$ 2.22	$ 4.39
Diluted	$ 0.89	$ 1.96	$ 2.21	$ 4.36
Weighted average shares outstanding:				
Basic	23,414	23,390	23,406	24,405
Diluted	23,550	23,529	23,516	24,583

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

Table of Contents

ITT EDUCATIONAL SERVICES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net Income	$ 20,859	$ 46,002	$ 51,989	$ 107,073
Other comprehensive income, net of tax:				
Net actuarial pension loss amortization, net of income tax of $182, $259, $393 and $531	286	404	619	827
Prior service (credit) amortization, net of income tax of $151, $152, $302 and $303	(238)	(237)	(476)	(474)
Unrealized gains (losses) on available-for-sale securities, net of income tax of $0, $0, $0 and $0	0	2	0	(21)
Other comprehensive income, net of tax	48	169	143	332
Comprehensive Income	$ 20,907	$ 46,171	$ 52,132	$ 107,405

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

Table of Contents

ITT EDUCATIONAL SERVICES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(unaudited)

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Cash flows from operating activities:				
Net income	$ 20,859	$ 46,002	$ 51,989	$ 107,073
Adjustments to reconcile net income to net cash flows from operating activities:				
Depreciation and amortization	7,351	7,695	14,643	15,115
Provision for doubtful accounts	19,038	19,006	38,923	34,607
Deferred income taxes	3,123	(6,334)	16,334	(10,076)
Excess tax benefit from stock option exercises	0	(574)	0	(1,379)
Stock-based compensation expense	2,301	4,272	5,394	8,755
Settlement cost	0	0	(46,000)	0
Other	71	96	365	(243)
Changes in operating assets and liabilities:				
Restricted cash	(57)	372	(175)	1,377
Accounts receivable	(38,037)	(38,270)	(84,686)	(60,176)
Accounts payable	6	3,113	415	1,901
Other operating assets and liabilities	(311)	(15,400)	(11,004)	6,766
Deferred revenue	(6,737)	(58,274)	(22,009)	(104,670)
Net cash flows from operating activities	7,607	(38,296)	(35,811)	(950)
Cash flows from investing activities:				
Facility expenditures and land purchases	(360)	(253)	(460)	(385)
Capital expenditures, net	(1,955)	(7,117)	(3,373)	(11,635)
Proceeds from sales and maturities of investments and repayment of notes	107	117,216	322	216,171
Purchase of investments and note advances	0	0	(1,241)	(63,545)
Net cash flows from investing activities	(2,208)	109,846	(4,752)	140,606
Cash flows from financing activities:				
Excess tax benefit from stock option exercises	0	574	0	1,379
Proceeds from exercise of stock options	0	3,423	0	8,091
Debt issue costs	0	0	0	(1,525)
Proceeds from revolving borrowings	0	0	0	175,000
Repayment of revolving borrowings	(30,000)	(25,000)	(20,000)	(175,000)
Repurchase of common stock and shares tendered for taxes	(3)	(61,789)	(371)	(209,360)
Net cash flows from financing activities	(30,003)	(82,792)	(20,371)	(201,415)
Net change in cash and cash equivalents	(24,604)	(11,242)	(60,934)	(61,759)
Cash and cash equivalents at beginning of period	210,012	178,476	246,342	228,993
Cash and cash equivalents at end of period	$ 185,408	$ 167,234	$ 185,408	$ 167,234

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

Table of Contents

ITT EDUCATIONAL SERVICES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(Dollars and shares in thousands)

	Common Stock		Capital	Retained	Accumulated Other Comprehensive	Common Stock in Treasury		
	Shares	Amount	Surplus	Earnings	Income/(Loss)	Shares	Amount	Total
Balance as of December 31, 2011	37,069	$ 371	$ 189,573	$ 827,675	($ 9,479)	(10,969)	($ 839,341)	$ 168,799
For the six months ended June 30, 2012 (unaudited):								
Net income				107,073				107,073
Other comprehensive income					332			332
Equity award vesting and exercises				(8,966)		266	17,057	8,091
Tax benefit from equity awards			930					930
Stock-based compensation			8,309					8,309
Common shares repurchased						(3,026)	(207,918)	(207,918)
Issuance of shares for Directors compensation				(1)		1	38	37
Shares tendered for taxes						(22)	(1,442)	(1,442)
Balance as of June 30, 2012	37,069	371	198,812	925,781	(9,147)	(13,750)	(1,031,606)	84,211
For the six months ended December 31, 2012 (unaudited):								
Net income				33,392				33,392
Other comprehensive income					1,217			1,217
Equity award vesting and exercises				(101)		6	355	254
Tax benefit from equity awards			(12)					(12)
Stock-based compensation			7,903					7,903
Shares tendered for taxes							(11)	(11)
Balance as of December 31, 2012	37,069	371	206,703	959,072	(7,930)	(13,744)	(1,031,262)	126,954
For the six months ended June 30, 2013 (unaudited):								
Net income				51,989				51,989
Other comprehensive income					143			143
Equity award vesting and exercises			(3,189)			66	3,189	0
Tax benefit from equity awards			(4,177)					(4,177)
Stock-based compensation			5,394					5,394
Shares tendered for taxes						(22)	(371)	(371)
Balance as of June 30, 2013	37,069	$ 371	$ 204,731	$ 1,011,061	($ 7,787)	(13,700)	($ 1,028,444)	$ 179,932

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

ITT EDUCATIONAL SERVICES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Dollars in thousands, except per share data and unless otherwise stated)

1. The Company and Basis of Presentation

We are a leading proprietary provider of postsecondary degree programs in the United States based on revenue and student enrollment. As of June 30, 2013, we were offering master, bachelor and associate degree programs to approximately 59,000 students at ITT Technical Institute and Daniel Webster College locations. In addition, we offered one or more of our online programs to students who are located in 48 states. As of June 30, 2013, we had 149 college locations (including 147 campuses and two learning sites) in 39 states. All of our college locations are authorized by the applicable education authorities of the states in which they operate and are accredited by an accrediting commission recognized by the U.S. Department of Education (ED). We have provided career-oriented education programs since 1969 under the ITT Technical Institute name and since June 2009 under the Daniel Webster College name. Our corporate headquarters are located in Carmel, Indiana.

The accompanying unaudited condensed consolidated financial statements include our wholly-owned subsidiaries accounts and have been prepared in accordance with generally accepted accounting principles in the United States of America for interim periods and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Certain information and footnote disclosures, including significant accounting policies, normally included in a complete presentation of financial statements prepared in accordance with those principles, rules and regulations have been omitted. The Condensed Consolidated Balance Sheet as of December 31, 2012 was derived from audited financial statements but, as presented in this report, may not include all disclosures required by accounting principles generally accepted in the United States. Arrangements where we may have a variable interest in another party are evaluated in accordance with the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC or Codification) 810, Consolidation (ASC 810), to determine whether we would be required to include the financial results of the other party in our consolidated financial statements. Based on our most recent evaluation, we were not required to include the financial results of any variable interest entity in our condensed consolidated financial statements. See Note 8 Variable Interests, for additional discussion of our variable interests.

In the opinion of our management, the financial statements contain all adjustments necessary to fairly state our financial condition and results of operations. The interim financial information should be read in conjunction with the audited consolidated 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, 2012.

2. New Accounting Guidance

In February 2013, the FASB issued Accounting Standards Update (ASU) No. 2013-02, which is included in the Codification under ASC 220, Other Comprehensive Income (ASC 220). This update requires an entity to report the effect, by component, of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income. This guidance is effective for interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance requires that we provide additional disclosures regarding the amounts reclassified out of accumulated other comprehensive income during the reporting period. We have included these disclosures in the footnotes to our condensed consolidated financial statements.

In October 2012, the FASB issued ASU No. 2012-04, which makes technical corrections, clarifications and limited-scope improvements to various topics throughout the Codification. The amendments in this ASU that do not have transition guidance are effective upon issuance and the amendments that are subject to transition guidance are effective for our interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

In July 2012, the FASB issued ASU No. 2012-02, which is included in the Codification under ASC 350, Intangibles Goodwill and Other (ASC 350). This update allows an entity to first assess qualitative factors to determine whether it must perform a quantitative impairment test. An entity would be required to calculate the fair value of an indefinite-lived intangible asset, if the entity determines, based on a qualitative assessment, that it is more likely than not that the indefinite-lived asset is impaired. This guidance is effective for impairment tests performed for our interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-11, which is included in the Codification under ASC 210, Balance Sheet (ASC 210). This update provides for enhanced disclosures to help users of financial statements evaluate the effect or potential effect of netting arrangements on an entity s financial position. In January 2013, the FASB issued ASU No. 2013-01, which clarifies the scope of the disclosures required under ASU No. 2011-11. Both of these updates are effective for interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

Table of Contents

3. Fair Value

Fair value for financial reporting is defined as the price that would be received upon the sale of an asset or paid upon the transfer of a liability in an orderly transaction between market participants at the measurement date. The fair value measurement of our financial assets utilized assumptions categorized as observable inputs under the accounting guidance. Observable inputs are assumptions based on independent market data sources.

The following table sets forth information regarding the fair value measurement of our financial assets as of June 30, 2013:

		Fair Value Measurements at Reporting Date Using		
		(Level 1)	(Level 2)	(Level 3)
Description	**As of June 30, 2013**	**Quoted Prices in Active Markets for Identical Assets**	**Significant Other Observable Inputs**	**Significant Unobservable Inputs**
Cash equivalents:				
Money market fund	$ 184,470	$ 184,470	$ 0	$ 0
Other assets:				
Money market fund	8,625	8,625	0	0
	$ 193,095	$ 193,095	$ 0	$ 0

We used quoted prices in active markets for identical assets as of the measurement date to value our financial assets that were categorized as Level 1.

The carrying amounts for cash and cash equivalents, restricted cash, accounts receivable, accounts payable, other current liabilities and deferred revenue approximate fair value, because of the immediate or short-term maturity of these financial instruments.

Each of the carrying value and the estimated fair value of the notes receivable and other receivables included in Prepaid expenses and other current assets or Other assets on our Condensed Consolidated Balance Sheet was approximately $10,200 as of June 30, 2013, $9,600 as of December 31, 2012 and $19,000 as of June 30, 2012. We estimated the fair value of the notes receivable and other receivables by discounting the future cash flows using current rates for similar arrangements. The assumptions used in this estimate are considered unobservable inputs. Fair value measurements that utilize significant unobservable inputs are categorized as Level 3 measurements under the accounting guidance.

Each of the carrying value and estimated fair value of our long-term debt was approximately $120,000 as of June 30, 2013, $140,000 as of December 31, 2012 and $150,000 as of June 30, 2012. The fair value of our long-term debt was estimated by discounting the future cash flows using current rates for similar loans with similar characteristics and remaining maturities. We utilized inputs that were observable or were principally derived from observable market data to estimate the fair value of our long-term debt. Fair value measurements that utilize significant other observable inputs are categorized as Level 2 measurements under the accounting guidance.

4. Equity Compensation

On May 7, 2013, our shareholders approved the ITT Educational Services, Inc. Amended and Restated 2006 Equity Compensation Plan (the Amended 2006 Plan). Prior to May 7, 2013, we adopted and our shareholders approved the 2006 ITT Educational Services Inc. Equity Compensation Plan (the Original 2006 Plan). The Amended 2006 Plan increased the maximum number of shares of our common stock that may be issued pursuant to awards under the plan to 7,350,000, an increase of 3,350,000 over the 4,000,000 maximum under the Original 2006 Plan.

The stock-based compensation expense and related income tax benefit recognized in our Condensed Consolidated Statements of Income in the periods indicated were as follows:

	Three Months Ended June 30,	Six Months Ended June 30,

	2013	2012	2013	2012
Stock-based compensation expense	$ 2,301	$ 4,272	$ 5,394	$ 8,755
Income tax (benefit)	($ 886)	($ 1,645)	($ 2,077)	($ 3,371)

We did not capitalize any stock-based compensation cost in the three or six months ended June 30, 2013 or 2012.

As of June 30, 2013, we estimated that pre-tax compensation expense for unvested stock-based compensation grants in the amount of approximately $21,700, net of estimated forfeitures, will be recognized in future periods. This expense will be recognized over the remaining service period applicable to the grantees which, on a weighted-average basis, is approximately 2.0 years.

Table of Contents

The stock options granted, forfeited, exercised and expired in the period indicated were as follows:

	Six Months Ended June 30, 2013				
	# of Shares	Weighted Average Exercise Price	Aggregate Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (1)
Outstanding at beginning of period	1,574,604	$ 84.90	$ 133,691		
Granted	154,000	$ 19.31	2,974		
Forfeited	(16,668)	$ 75.11	(1,252)		
Exercised	0	$ 0.00	0		
Expired	(286,494)	$ 62.38	(17,871)		
Outstanding at end of period	1,425,442	$ 82.46	$ 117,541	2.9	$ 784
Exercisable at end of period	1,135,937	$ 92.16	$ 104,687	2.6	$ 0

(1) The aggregate intrinsic value of the stock options was calculated by identifying those stock options that had a lower exercise price than the closing market price of our common stock on June 28, 2013 and multiplying the difference between the closing market price of our common stock and the exercise price of each of those stock options by the number of shares subject to those stock options that were outstanding or exercisable, as applicable.

The following table sets forth information regarding the stock options granted and exercised in the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Shares subject to stock options granted	154,000	0	154,000	156,500
Weighted average grant date fair value per share	$ 9.16	$ 0	$ 9.16	$ 31.36
Shares subject to stock options exercised	0	93,911	0	197,965
Intrinsic value of stock options exercised	$ 0	$ 2,299	$ 0	$ 4,788
Proceeds received from stock options exercised	$ 0	$ 3,423	$ 0	$ 8,091
Tax benefits realized from stock options exercised	$ 0	$ 733	$ 0	$ 1,597

The intrinsic value of a stock option is the difference between the fair market value of the stock and the option exercise price.

The fair value of each stock option grant was estimated on the date of grant using the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Risk-free interest rates	0.7%	Not applicable	0.7%	0.7%
Expected lives (in years)	4.6	Not applicable	4.6	4.5
Volatility	60%	Not applicable	60%	51%
Dividend yield	None	Not applicable	None	None

The following table sets forth the number of restricted stock units (RSUs) that were granted, forfeited and vested in the period indicated:

	Six Months Ended June 30, 2013	
	# of RSUs	Weighted Average Grant Date Fair Value
Unvested at beginning of period	413,645	$ 75.35
Granted	514,317	$ 19.86
Forfeited	(55,303)	$ 64.23
Vested	(66,334)	$ 89.76
Unvested at end of period	806,325	$ 39.53

The total fair market value of the RSUs that vested and were settled in shares of our common stock was $174 in the three months ended June 30, 2013 and $1,782 in the three months ended June 30, 2012. The total fair market value of the RSUs that vested and were settled in shares of our common stock was $1,177 in the six months ended June 30, 2013 and $4,536 in the six months ended June 30, 2012. In the six months ended June 30, 2012, 48,935 RSUs vested and were settled in cash for $3,073.

Table of Contents

5. Stock Repurchases

As of June 30, 2013, approximately 7.8 million shares remained available for repurchase under the share repurchase program (the Repurchase Program) authorized by our Board of Directors. The terms of the 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 Securities Exchange Act of 1934, as amended (the Exchange Act). Unless earlier terminated by our Board of Directors, the Repurchase Program will expire when we repurchase all shares authorized for repurchase thereunder.

The following table sets forth information regarding the shares of our common stock that we repurchased in the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Number of shares	0	928,500	0	3,025,700
Total cost	$ 0	$ 61,261	$ 0	$ 207,918
Average cost per share	$ 0	$ 65.98	$ 0	$ 68.72

6. Debt

On March 21, 2012, we entered into a credit agreement (the Credit Agreement) that provides for a $325,000 senior revolving credit facility (the Revolver). The Credit Agreement also provides that we may seek additional revolving commitments or term loan commitments in an aggregate principal amount not to exceed $125,000. The lenders under the Credit Agreement are not under any obligation to provide any such additional revolving commitments or term loan commitments. The Credit Agreement has a maturity date of March 21, 2015.

A portion of the borrowings under the Revolver were used to prepay the entire outstanding indebtedness under a prior credit agreement which was terminated on March 21, 2012. In addition to the prepayment of the outstanding indebtedness under the prior credit agreement, borrowings under the Credit Agreement are used for general corporate purposes.

Borrowings under the Credit Agreement bear interest, at our option, at the London Interbank Offered Rate (LIBOR) plus an applicable margin or at an alternative base rate, as defined under the Credit Agreement, plus an applicable margin. The applicable margin for borrowings under the Revolver is determined based on the ratio of our total Indebtedness (as defined in the Credit Agreement and which primarily includes outstanding borrowings, recorded contingent liabilities related to our guarantee obligations, letters of credit and surety bonds) to EBITDA (as defined in the Credit Agreement) (the Leverage Ratio) as of the end of each fiscal quarter. We also pay a commitment fee on the amount of the unutilized commitments under the Credit Agreement. The amount of the commitment fee is determined based on the Leverage Ratio as of the end of each fiscal quarter.

The Credit Agreement contains, among other things, covenants, representations and warranties and events of default customary for credit facilities. The Credit Agreement is secured by a pledge of the equity interests of our subsidiaries and is guaranteed by one of our subsidiaries. We are required to maintain compliance with a maximum Leverage Ratio, a minimum interest coverage ratio, a minimum liquidity amount and several ratios related to the ED s regulations. We were in compliance with those requirements as of June 30, 2013.

As of June 30, 2013, the borrowings under the Credit Agreement totaled $120,000. The effective interest rate on our borrowings was approximately 3.30% per annum in the three months ended June 30, 2013 and approximately 2.70% per annum in the three months ended June 30, 2012. In the six months ended June 30, 2013, the effective interest rate on our borrowings was approximately 3.30% per annum compared to approximately 2.10% per annum in the six months ended June 30, 2012. The commitment fee under the Credit Agreement was 0.40% as of June 30, 2013.

The following table sets forth the interest expense (including the facility fee and commitment fee) that we recognized on our borrowings under the Credit Agreement and under the prior credit agreement in the periods indicated:

Three Months Ended June 30,		Six Months Ended June 30,	
2013	2012	2013	2012

$ 973	$ 1,115	$ 1,986	$ 1,662

7. <u>Investments</u>

We did not hold any available-for-sale investments as of June 30, 2013, December 31, 2012 or June 30, 2012.

Table of Contents

The following table sets forth the components of investment income included in Interest income in our Condensed Consolidated Statements of Income in the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Interest income on investments	$ 24	$ 75	$ 58	$ 216
Realized net gains on the sale of investments	0	26	0	40
Total investment income	$ 24	$ 101	$ 58	$ 256

8. Variable Interests

On January 20, 2010, we entered into agreements with unrelated third parties to establish the PEAKS Private Student Loan Program (PEAKS Program), which is a private education loan program for our students. Under the PEAKS Program, an unaffiliated lender originated private education loans to our eligible students and, subsequently, sold those loans to an unaffiliated trust that purchased, owns and collects private education loans (PEAKS Trust). The PEAKS Trust issued senior debt in the aggregate principal amount of $300,000 (PEAKS Senior Debt) to investors. The lender disbursed the proceeds of the private education loans to us for application to the students account balances with us that represented their unpaid education costs. We transferred a portion of the amount of each private education loan disbursed to us under the PEAKS Program to the PEAKS Trust in exchange for a subordinated note issued by the PEAKS Trust (Subordinated Note). No new private education loans were or will be originated under the PEAKS Program after July 2011, but immaterial amounts related to loans originated prior to that date were disbursed by the lender through March 2012.

The Subordinated Note is non-interest bearing and has been recorded net of an unamortized discount based on an imputed interest rate of 9.0% in Other assets on our Condensed Consolidated Balance Sheets. In the three and six months ended June 30, 2012, the discount was amortized and recognized in Interest income on our Condensed Consolidated Statements of Income over the term of the Subordinated Note. We did not recognize any interest income related to the amortization of the Subordinated Note discount on our Condensed Consolidated Statements of Income in the three or six months ended June 30, 2013. The maturity date of the Subordinated Note is in March 2026. The face value of the Subordinated Note was approximately $73,000 as of June 30, 2013 and December 31, 2012 and $73,700 as of June 30, 2012.

The PEAKS Trust utilized the proceeds from the issuance of the PEAKS Senior Debt and the Subordinated Note to purchase the private education loans made by the lender to our students. The assets of the PEAKS Trust (which include, among other assets, the private education loans owned by the PEAKS Trust) serve as collateral for, and are intended to be the principal source of, the repayment of the PEAKS Senior Debt and the Subordinated Note. The PEAKS Trust is required to maintain assets having an aggregate value that exceeds the outstanding balance of the PEAKS Senior Debt. As of June 30, 2013, the value of the assets of the PEAKS Trust satisfied this requirement.

We guarantee payment of the principal and interest owed on the PEAKS Senior Debt, the administrative fees and expenses of the PEAKS Trust and the required ratio of assets of the PEAKS Trust to outstanding PEAKS Senior Debt (PEAKS Guarantee). We made guarantee and other payments related to the PEAKS Program to the PEAKS Trust of:

$3,290 in the three months ended June 30, 2013;

$259 in the three months ended June 30, 2012;

$6,384 in the six months ended June 30, 2013; and

$259 in the six months ended June 30, 2012.

See Note 11 Contingencies, for further discussion of the PEAKS Guarantee.

We did not explicitly or implicitly provide any financial or other support to the PEAKS Trust during the three or six months ended June 30, 2013 or 2012 that we were not contractually required to provide, and we do not intend to provide any such support to the PEAKS Trust in the foreseeable future, other than what we are contractually required to provide.

The PEAKS Trust is a variable interest entity as defined under ASC 810. We held variable interests in the PEAKS Trust as of June 30, 2013 as a result of the Subordinated Note and PEAKS Guarantee. To determine whether we were the primary beneficiary of the PEAKS Trust, we:

- assessed the risks that the PEAKS Trust was designed to create and pass through to its variable interest holders;
- identified the variable interests in the PEAKS Trust;
- identified the other variable interest holders and their involvement in the activities of the PEAKS Trust;
- identified the activities that most significantly impact the PEAKS Trust s economic performance;
- determined whether we have the power to direct those activities; and
- determined whether we have the right to receive the benefits from, or the obligation to absorb the losses of, the PEAKS Trust that could potentially be significant to the PEAKS Trust.

Table of Contents

We determined that the activities of the PEAKS Trust that most significantly impact the economic performance of the PEAKS Trust involve:

- establishing the underwriting criteria of, and the interest rates and fees charged on, the private education loans acquired by the PEAKS Trust; and
- the servicing (which includes the collection) of the private education loans owned by the PEAKS Trust.

To make that determination, we analyzed various possible scenarios of student loan portfolio performance to evaluate the potential economic impact on the PEAKS Trust. In our analysis, we made what we believe are reasonable assumptions based on historical data for the following key variables:

- the composition of the credit profiles of the borrowers;
- the interest rates and fees charged on the loans;
- the default rates and the timing of defaults associated with similar types of loans; and
- the prepayment and the speed of repayment associated with similar types of loans.

Based on our analysis, we concluded that we are not the primary beneficiary of the PEAKS Trust, because we do not have the power to direct the activities that most significantly impact the economic performance of the PEAKS Trust. As a result, we are not required under ASC 810 to include the financial results of the PEAKS Trust in our condensed consolidated financial statements for the three or six months ended June 30, 2013. Our conclusion that we are not the primary beneficiary of the PEAKS Trust did not change from the prior reporting period. Therefore, there was no effect on our condensed consolidated financial statements.

On February 20, 2009, we entered into agreements with an unaffiliated entity (the 2009 Entity) to create a program that made private education loans available to our students to help pay the students cost of education that student financial aid from federal, state and other sources did not cover (the 2009 Loan Program). Under the 2009 Loan Program, an unaffiliated lender originated private education loans to our eligible students and, subsequently, sold those loans to the 2009 Entity. The 2009 Entity purchased the private education loans from the lender utilizing funds received from its owners in exchange for participation interests in the private education loans acquired by the 2009 Entity. The lender disbursed the proceeds of the private education loans to us for application to the students account balances with us that represented their unpaid education costs. No new private education loans were or will be originated under the 2009 Loan Program after December 31, 2011, but immaterial amounts related to loans originated prior to that date were disbursed by the lender through June 2012.

In connection with the 2009 Loan Program, we entered into a risk sharing agreement (the 2009 RSA) with the 2009 Entity. Under the 2009 RSA, we guarantee the repayment of any private education loans that are charged off above a certain percentage of the private education loans made under the 2009 Loan Program, based on the annual dollar volume. We made payments to the 2009 Entity related to our guarantee obligations under the 2009 RSA, net of recoveries, in the amount of:

- $77 in the three months ended June 30, 2013;
- $389 in the three months ended June 30, 2012;

- $280 in the six months ended June 30, 2013; and

- $581 in the six months ended June 30, 2012.

We asserted the right to offset amounts owed to us by the 2009 Entity under a revolving promissory note (the Revolving Note) related to our guarantee obligations under the 2009 RSA, net of recoveries, of $7,438 in the three months ended June 30, 2013 and $7,976 in the six months ended June 30, 2013. Approximately $6,800 of the amount that we claimed as an offset against the Revolving Note in each of the three and six months ended June 30, 2013 related to our election under the 2009 RSA to discharge our guarantee obligations with respect to certain defaulted private education loans under the 2009 Loan Program. We recorded all of the amounts claimed as offsets in Other current liabilities on our Condensed Consolidated Balance Sheet as of June 30, 2013. See Note 11 Contingencies, for further discussion of the 2009 RSA.

In addition, we have made advances to the 2009 Entity under the Revolving Note. We did not make any advances in the three or six months ended June 30, 2013 or 2012 to the 2009 Entity under the Revolving Note that we were not contractually required to make. Certain of the assets of the 2009 Entity serve as collateral for the Revolving Note. The Revolving Note bears interest, is subject to customary terms and conditions and is currently due and payable in full. The amount owed to us under the Revolving Note, excluding the offsets described above, was approximately $8,200 as of June 30, 2013, $8,300 as of December 31, 2012 and $8,700 as of June 30, 2012.

The advances under the Revolving Note were primarily used by the 2009 Entity to purchase additional private education loans under the 2009 Loan Program that otherwise may not have been originated. We have no immediate plans to significantly increase the amount of advances that we make to the 2009 Entity under the Revolving Note.

The 2009 Entity is a variable interest entity as defined under ASC 810. We held variable interests in the 2009 Entity as of June 30, 2013 as a result of the Revolving Note and 2009 RSA. To determine whether we were the primary beneficiary of the 2009 Entity, we:

- assessed the risks that the 2009 Entity was designed to create and pass through to its variable interest holders;

- identified the variable interests in the 2009 Entity;
- identified the other variable interest holders and their involvement in the activities of the 2009 Entity;
- identified the activities that most significantly impact the 2009 Entity s economic performance;
- determined whether we have the power to direct those activities; and
- determined whether we have the right to receive the benefits from, or the obligation to absorb the losses of, the 2009 Entity that could potentially be significant to the 2009 Entity.

To identify the activities of the 2009 Entity that most significantly impact the economic performance of the 2009 Entity, we analyzed various possible scenarios of private education loan portfolio performance. In our analysis, we made what we believe are reasonable assumptions based on historical data for the following key variables:

- the composition of the credit profiles of the borrowers;
- the interest rates and fees charged on the loans;
- the default rates and the timing of defaults associated with similar types of loans; and
- the prepayment and the speed of repayment associated with similar types of loans.

We determined that the activities of the 2009 Entity that most significantly impact its economic performance involve:

- establishing the underwriting criteria of, and the interest rates and fees charged on, the private education loans acquired by the 2009 Entity; and
- the servicing (which includes the collection) of the private education loans owned by the 2009 Entity.

Based on our analysis, we concluded that we are not the primary beneficiary of the 2009 Entity, because we do not direct those activities. As a result, we are not required under ASC 810 to include the financial results of the 2009 Entity in our condensed consolidated financial statements for the three or six months ended June 30, 2013. Our conclusion that we are not the primary beneficiary of the 2009 Entity did not change from the prior reporting period. Therefore, there was no effect on our condensed consolidated financial statements.

In the three months ended December 31, 2012, we determined that the Subordinated Note and the Revolving Note were impaired and recorded an impairment charge in the aggregate amount of $15,200. The aggregate carrying value of the Subordinated Note and the Revolving Note was approximately $2,700 as of June 30, 2013, $2,900 as of December 31, 2012 and $19,000 as of June 30, 2012 and was included on our Condensed Consolidated Balance Sheet in Prepaid expenses and other current assets as of June 30, 2013 and in Other assets as of December 31, 2012 and June 30, 2012. The accrual of interest (in the case of the Revolving Note) and the accretion of discount (in the case of the Subordinated Note) is discontinued when, in our opinion, the borrower may be unable to make payments owed under the note as they become due. We did not recognize any interest income related to the Subordinated Note or the Revolving Note in our Condensed Consolidated Statements of Income during the time that the Subordinated Note and Revolving Note were impaired, which included the three and six months ended June 30, 2013.

9. Earnings Per Common Share

Earnings per common share for all periods have been calculated in conformity with ASC 260, Earnings Per Share. This data is based on historical net income and the weighted average number of shares of our common stock outstanding during each period as set forth in the following table:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(In thousands)			
Shares:				
Weighted average number of shares of common stock outstanding	23,414	23,390	23,406	24,405
Shares assumed issued (less shares assumed purchased for treasury) for stock-based compensation	136	139	110	178
Outstanding shares for diluted earnings per share calculation	23,550	23,529	23,516	24,583

A total of approximately 1.6 million shares in the three and six months ended June 30, 2013 and 1.5 million shares in the three and six months ended June 30, 2012 were excluded from the calculation of our diluted earnings per common share, because the effect was anti-dilutive.

Table of Contents

10. Employee Pension Benefits

The following table sets forth the components of net periodic pension benefit of the ESI Pension Plan and ESI Excess Pension Plan for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Interest cost	$ 425	$ 502	$ 877	$ 1,032
Expected return on assets	(1,076)	(1,110)	(2,173)	(2,257)
Recognized net actuarial loss	468	663	1,012	1,358
Amortization of prior service (credit)	(389)	(389)	(778)	(777)
Net periodic pension (benefit)	($ 572)	($ 334)	($ 1,062)	($ 644)

The benefit accruals under the ESI Pension Plan and ESI Excess Pension Plan were frozen effective March 31, 2006. As a result, no service cost has been included in the net periodic pension benefit.

We did not make any contributions to the ESI Pension Plan or the ESI Excess Pension Plan in the three or six months ended June 30, 2013 or 2012. We do not expect to make any material contributions to the ESI Pension Plan or the ESI Excess Pension Plan in 2013.

The following table sets forth the changes in the components of Accumulated other comprehensive loss on our Condensed Consolidated Balance Sheet in the six months ended June 30, 2013:

	Defined Benefit Pension Items		
	Accumulated Other Comprehensive Income (Loss)	Income Tax Benefit (Expense)	Accumulated Other Comprehensive Income (Loss) Net of Income Tax
Balance at January 1, 2013	($ 13,058)	$ 5,128	($ 7,930)
Amortization of:			
Actuarial (gains)/losses	1,012	(393)	619
Prior service costs (credits)	(778)	302	(476)
Balance at June 30, 2013	($ 12,824)	$ 5,037	($ 7,787)

The reclassification of prior service costs/credits and actuarial gains/losses from Accumulated other comprehensive loss are included in the computation of net periodic pension cost (benefit). Net periodic pension cost (benefit) was included in compensation expense in Cost of educational services and Student services and administrative expenses on our Condensed Consolidated Statements of Income in the six months ended June 30, 2013.

11. Contingencies

As part of our normal 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 June 30, 2013, the total face amount of those surety bonds was approximately $24,200.

We are also subject to various claims and contingencies, including those related to litigation, business transactions, guarantee arrangements and employee-related matters, among others. We record a liability for those claims and contingencies, if it is probable that a loss will result and the amount of the loss can be reasonably estimated. Although we believe that our estimates related to any claims and contingencies are reasonable, we cannot make any assurances with regard to the accuracy of our estimates, and actual results could differ materially. As of June 30, 2013, our recorded liability for these claims and contingencies was approximately $76,686, the substantial majority of which pertained to our guarantee obligations under the 2009 RSA and PEAKS Program (collectively, the RSAs). As of June 30, 2013, $33,946 of the recorded liability was included in Other current liabilities and $42,740 was included in Other liabilities on our Condensed Consolidated Balance Sheet. The $33,946 included in Other current liabilities as of June 30, 2013 included $7,976 that we claimed as an offset against amounts owed to us under the Revolving Note.

See *Guarantees* below for further discussion of the amounts we claimed as offsets under the Revolving Note. The $42,740 included in Other liabilities as of June 30, 2013 represents our estimate of the loss that we believe we will realize over the next seven to ten years related to our estimated guarantee obligations under the RSAs.

Table of Contents

The following table sets forth the activity with respect to our recorded liability related to our claims and contingencies in the periods indicated:

	Six Months Ended June 30,	
	2013	2012
Balance as of January 1	$ 123,439	$ 36,028
Increases (decreases) from:		
Additional reserves	5,195	6,381
Payments, net	(52,671)	(845)
Estimated recovery	723	0
Balance as of June 30	$ 76,686	$ 41,564

We had guaranteed the repayment of private education loans made by a lender to our students in 2007 and early 2008 (the 2007 RSA) that the lender charged off above a certain percentage of the total dollar volume of private education loans made under the 2007 RSA. In January 2013, we paid $46,000 in a settlement to absolve us from any further obligations with respect to our guarantee obligations under the 2007 RSA. The liability for this settlement was included in Other current liabilities on our Condensed Consolidated Balance Sheet as of December 31, 2012.

We also considered whether additional losses for claims and contingencies were reasonably possible, could be estimated and might be material to our financial condition, results of operations or cash flows. In order to estimate the possible range of losses under the RSAs, we made certain assumptions with respect to the performance of the private education loans made under the RSAs over the life of those loans. The life of a private education loan made under the RSAs may be in excess of ten years from the date of disbursement. Therefore, our estimate of the possible range of losses under the RSAs was based on assumptions for periods in excess of ten years, and those assumptions included, among other things, the following:

- the timing and rate at which the private education loans will be paid;
- the changes in the variable interest rates due on the private education loans;
- the amounts that will be recovered on the private education loans that have defaulted; and
- the fees and expenses associated with servicing the private education loans.

The assumptions have changed, and may continue to change, significantly over time as actual results become known, which would affect our estimated range of possible losses related to the RSAs. With respect to our guarantee obligations under the RSAs, we believe that it is reasonably possible that we may incur losses in an estimated range of $8,000 less than to $38,000 greater than the recorded liability for those contingencies. As with any estimate, as facts and circumstances change, the recorded liability and estimated range of reasonably possible losses could change significantly. With respect to legal proceedings, we determined that we cannot provide an estimate of the possible losses, or the range of possible losses, in excess of the amount, if any, accrued, for various reasons, including but not limited to some or all of the following:

- there are significant factual issues to be resolved;
- there are novel or unsettled legal issues presented;

the proceedings are in the early stages;

there is uncertainty as to the likelihood of a class being certified or decertified or the ultimate size and scope of the class;

there is uncertainty as to the outcome of pending appeals or motions; and

in many cases, the plaintiffs have not specified damages in their complaint or in court filings.

Litigation. We are subject to various litigation in the ordinary course of our business. We cannot assure you of the ultimate outcome of any litigation involving us. Although we believe that our estimates related to any litigation are reasonable, deviations from our estimates could produce a materially different result. Any litigation alleging violations of education or consumer protection laws and/or regulations, misrepresentation, fraud or deceptive practices may also subject our affected campuses to additional regulatory scrutiny. The following is a description of pending litigation that falls outside the scope of litigation incidental to the ordinary course of our business.

On December 22, 2008, we were served with a qui tam action that was filed on July 3, 2007 in the United States District Court for the Southern District of Indiana by a former employee (relator) on behalf of herself and the federal government under the following caption: *United States of America ex rel. Debra Leveski v. ITT Educational Services, Inc.* (the Leveski Litigation). We were served with the Leveski Litigation after the U.S. Department of Justice declined to intervene in the litigation. On June 3, 2008, the relator filed an amended complaint in the Leveski Litigation. On September 23, 2009, the court dismissed the Leveski Litigation without prejudice and gave the relator an opportunity to replead her complaint. On October 8, 2009, the relator filed a second amended complaint. In the second amended complaint, the relator alleges that we violated the False Claims Act, 31 U.S.C. § 3729, *et seq*., and the Higher Education Act of 1965, as amended (the HEA) by compensating our sales representatives and financial aid administrators with commissions, bonuses or other incentive payments based directly or indirectly on success in securing enrollments or federal financial aid. The relator alleges that all of our revenue derived from the federal student financial aid programs from July 3, 2001 through July 3, 2007 was generated as a result of our violating the HEA. The relator seeks various forms of recovery on behalf of herself and the federal government, including:

treble the amount of unspecified funds paid to us for federal student grants;

Table of Contents

treble the amount of unspecified default payments, special allowance payments and interest received by lenders with respect to federal student loans received by our students;

all civil penalties allowed by law; and

attorney s fees and costs.

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

On August 8, 2011, the district court granted our motion to dismiss all of the relator s claims in the Leveski Litigation for lack of subject-matter jurisdiction and issued a judgment for us. On February 16, 2012, the relator in the Leveski Litigation filed a Notice of Appeal with the 7th Circuit Court of Appeals regarding the final judgment entered by the district court dismissing all claims against us. On March 26, 2012, the district court in the Leveski Litigation awarded us approximately $395 in sanctions against the relator s attorneys for filing a frivolous lawsuit. Relator s attorneys also appealed this award to the 7th Circuit Court of Appeals. On July 8, 2013, the 7th Circuit Court of Appeals reversed the district court s dismissal of the Leveski Litigation for lack of subject-matter jurisdiction and the award of sanctions against relator s attorneys. In addition, the 7th Circuit Court of Appeals remanded the Leveski Litigation back to the district court for further proceedings.

We have defended, and intend to continue to defend, ourselves vigorously against the allegations made in the complaint.

On March 11, 2013, a complaint in a securities class action lawsuit was filed against us and two of our current executive officers in the United States District Court for the Southern District of New York under the following caption: *William Koetsch, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* (the Koetsch Litigation). The complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by:

our failure to properly account for the 2009 RSA and PEAKS Program;

our failure to maintain proper internal controls to ensure that risk-sharing agreements were properly recorded;

making false statements or failing to disclose adverse facts known about us;

deceiving the investing public regarding our prospects and business;

artificially inflating the price of our common stock; and

causing the plaintiff and other putative class members to purchase our common stock at inflated prices.

The putative class period in this action is from April 20, 2010 through February 23, 2013. The plaintiff seeks, among other things, the designation of this action as a class action, and an award of unspecified compensatory damages, interest, costs and attorney s fees. All of the defendants intend to defend themselves vigorously against the allegations made in the complaint.

On April 17, 2013, a complaint in a securities class action lawsuit was filed against us and two of our current executive officers in the United States District Court for the Southern District of New York under the following caption: *Massachusetts Laborers Annuity Fund, Individually* *and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* (the MLAF Litigation). The complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by:

- our failure to properly account for the 2007 RSA, 2009 RSA and PEAKS Program;
- our failure to establish adequate reserves associated with our guarantee obligations under the 2007 RSA, 2009 RSA and PEAKS Program, which caused us to misrepresent our earnings, liabilities, net income and financial condition throughout the putative class period;
- making false and misleading statements;
- engaging in a scheme to deceive the market and a course of conduct that artificially inflated the price of our common stock;
- operating as a fraud or deceit on purchasers of our common stock by misrepresenting our liabilities related to the 2007 RSA, 2009 RSA and PEAKS Program, financial results and business prospects;
- artificially inflating the price of our common stock; and
- causing the putative class members to purchase our common stock at artificially inflated prices.

The putative class period in this action is from April 24, 2008 through February 25, 2013. The plaintiff seeks, among other things, the designation of this action as a class action, and an award of unspecified compensatory damages, interest, costs, attorney s fees and equitable/injunctive or other relief as the Court deems just and proper. All of the defendants intend to defend themselves vigorously against the allegations made in the complaint.

Table of Contents

On May 8, 2013, a complaint in a shareholder derivative lawsuit was filed against two of our current executive officers and all of our current Directors in the United States District Court for the Southern District of New York under the following caption: *Sasha Wilfred, Derivatively on Behalf of Nominal Defendant ITT Educational Services, Inc. v. Kevin M. Modany, et al.* (the Wilfred Litigation). The complaint alleges, among other things, that from April 24, 2008 through February 25, 2013, the defendants violated state law, including breaching their fiduciary duties to us, grossly mismanaging us, wasting our corporate assets and being unjustly enriched, by:

- causing or allowing us to disseminate to our shareholders materially misleading and inaccurate information relating to a series of risk-sharing agreements through SEC filings, press releases, conference calls, and other public statements and disclosures;
- willfully ignoring obvious and pervasive problems with our internal controls and practices and procedures, and failing to make a good faith effort to correct these problems or prevent their recurrence;
- violating and breaching fiduciary duties of care, loyalty, reasonable inquiry, oversight, good faith and supervision;
- causing or allowing us to misrepresent material facts regarding our financial position and business prospects; and
- abandoning their responsibilities and duties with regard to prudently managing our businesses in a manner imposed upon them by law.

The complaint seeks:

- unspecified damages;
- restitution;
- disgorgement of all profits, benefits and other compensation obtained by the individual defendants;
- an order directing us to take all necessary actions to reform and improve our corporate governance and internal procedures; and
- costs and disbursements, including attorneys , accountants and experts fees, costs and expenses.

All of the individual defendants intend to defend themselves vigorously against the allegations in the complaint. Although the derivative action is brought nominally on behalf of us, we expect to incur defense costs and other expenses in connection with the derivative lawsuit.

There can be no assurance that the ultimate outcome of the Leveski Litigation, Koetsch Litigation, MLAF Litigation, Wilfred Litigation or other actions (including other actions under federal or state securities laws) will not have a material adverse effect on our financial condition, results of operations or cash flows.

The current officers named in the Koetsch Litigation, the MLAF Litigation and the Wilfred Litigation include Daniel M. Fitzpatrick and Kevin M. Modany.

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

Guarantees. We entered into the PEAKS Guarantee in connection with the PEAKS Program. Under the PEAKS Guarantee, we guarantee payment of the principal and interest owed on the PEAKS Senior Debt, the administrative fees and expenses of the PEAKS Trust and the required ratio of assets of the PEAKS Trust to outstanding PEAKS Senior Debt. The PEAKS Senior Debt bears interest at a variable rate based on the LIBOR plus an applicable margin and matures in January 2020. The PEAKS Guarantee agreement contains, among other things, representations and warranties and events of default customary for guarantees. In addition, under the PEAKS Program, some or all of the holders of the PEAKS Senior Debt could require us to purchase their PEAKS Senior Debt in certain limited circumstances that pertain to our continued eligibility to participate in the federal student financial aid programs under Title IV (the Title IV Programs) of the HEA. We believe that the likelihood of those limited circumstances occurring is remote. Our guarantee and purchase obligations under the PEAKS Program remain in effect until the PEAKS Senior Debt and the PEAKS Trust s fees and expenses are paid in full. At such time, we will be entitled to repayment of the amount of any payments made under the PEAKS Guarantee to the extent that funds are remaining in the PEAKS Trust. Payments made under the PEAKS Guarantee that we expect to recover, net of accrued discount, were approximately $7,500 as of June 30, 2013 and $6,700 as of December 31, 2012 and are included in Other assets on our Condensed Consolidated Balance Sheet.

The maximum future payments that we could be required to make under the PEAKS Guarantee include:

- up to $257,000 in principal of PEAKS Senior Debt, which was the approximate outstanding principal balance of the PEAKS Senior Debt as of June 30, 2013;
- accrued interest on the PEAKS Senior Debt;
- the fees and expenses of the PEAKS Trust; and
- amounts by which the ratio of assets of the PEAKS Trust to outstanding PEAKS Senior Debt falls below the required level.

We are not able to estimate the undiscounted maximum potential amount of future payments that we could be required to make under the PEAKS Guarantee, because those payments will be affected by:

- the repayment performance of the private education loans made under the PEAKS Program, the proceeds from which will be used to repay the PEAKS Senior Debt and to pay the fees and expenses of the PEAKS Trust and the performance of which also affects the ratio of assets of the PEAKS Trust to outstanding PEAKS Senior Debt;
- the fact that those loans will consist of a large number of loans of individually immaterial amounts;
- the fact that the interest rate on the PEAKS Senior Debt is a variable rate based on the LIBOR plus a margin; and
- the amount of fees and expenses of the PEAKS Trust, much of which is based on the principal balance of the private education loans held by the PEAKS Trust.

No new private education loans were or will be originated under the PEAKS Program after July 2011, but immaterial amounts related to loans originated prior to that date were disbursed by the lender through March 2012.

We entered into the 2009 RSA in connection with the 2009 Loan Program. Under the 2009 RSA, we guarantee the repayment of the principal amount (including capitalized origination fees) and accrued interest payable on any private education loans that are charged off above a certain percentage of the private education loans made under the 2009 Loan Program, based on the annual dollar volume. The total initial principal amount of private education loans that the 2009 Entity purchased under the 2009 Loan Program was approximately $141,000. No new private education loans were or will be originated under the 2009 Loan Program after December 31, 2011, but immaterial amounts related to loans originated prior to that date were disbursed by the lender through June 2012. Our obligations under the 2009 RSA will remain in effect until all private education loans made under the 2009 Loan Program are paid in full or charged off. The standard repayment term for a private education loan made under the 2009 Loan Program is ten years, with repayment generally beginning six months after a student graduates or three months after a student withdraws or is terminated from his or her program of study.

Pursuant to the 2009 RSA, we are required to maintain collateral to secure our guarantee obligation in an amount equal to a percentage of the outstanding balance of private education loans disbursed to our students under the 2009 Loan Program. As of June 30, 2013, the total collateral maintained in a restricted bank account was not material. This amount is included in Other assets on our Condensed Consolidated Balance Sheet as of June 30, 2013. The 2009 RSA also requires that we comply with certain covenants, including that we maintain certain financial ratios which are measured on a quarterly basis. We were in compliance with these covenants as of June 30, 2013.

We made guarantee and other payments related to the RSAs in the aggregate amount, net of recoveries, of approximately:

- $3,367 in the three months ended June 30, 2013;
- $648 in the three months ended June 30, 2012;
- $6,664 in the six months ended June 30, 2013; and
- $840 in the six months ended June 30, 2012.

We asserted the right to offset amounts owed to us by the 2009 Entity under the Revolving Note related to the 2009 RSA, net of recoveries, of $7,438 in the three months ended June 30, 2013 and $7,976 in the six months ended June 30, 2013. Approximately $6,800 of the amount that we claimed as an offset against the Revolving Note in each of the three and six months ended June 30, 2013 related to our election under the 2009

RSA to discharge our guarantee obligations with respect to certain defaulted private education loans under the 2009 Loan Program. We recorded all of the amounts claimed as offsets in Other current liabilities on our Condensed Consolidated Balance Sheet as of June 30, 2013.

At the end of each reporting period, we assess whether we should recognize a contingent liability related to our guarantee obligations under the RSAs and, if so, in what amount. Our recorded liability for our guarantee obligations under the RSAs is included in Other current liabilities and Other liabilities on our Condensed Consolidated Balance Sheets.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

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 Exchange Act. Forward-looking statements are made based on our management s current expectations and beliefs concerning future developments and their potential effects on us. You can identify those statements by the use of words such as could, should, would, may, will, project, believe, anticipate, expect, plan, estimate, forecast, potential, intend, continue and contemplate, as well as similar words and expressions. Forward-looking statements involve risks and uncertainties and do not guarantee future performance. We cannot assure you that future developments affecting us will be those anticipated by our management. Among the factors that could cause actual results to differ materially from those expressed in our forward-looking statements are the following:

- *changes in federal and state governmental laws and regulations with respect to education and accreditation standards, or the interpretation or enforcement of those laws and 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;*

Table of Contents

- *business conditions and growth in the postsecondary education industry and in the general economy;*
- *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 campuses;*
- *our ability to implement our growth strategies;*
- *our failure to maintain or renew required federal or state authorizations or accreditations of our campuses or programs of study;*
- *receptivity of students and employers to our existing program offerings and new curricula;*
- *loss of access by our students to lenders for education loans;*
- *our ability to collect internally funded financing from our students;*
- *our exposure under our guarantees related to private student loan programs; and*
- *our ability to successfully defend litigation and other claims brought against us.*

Readers are also directed to other risks and uncertainties discussed in other documents we file with the SEC, including, without limitation, those discussed in Item 1A. Risk Factors. of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 filed with the SEC, in Part II, Item 1A. Risk Factors of our Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2013 and in Part II, Item 1A. Risk Factors of this Quarterly Report on Form 10-Q. We undertake no obligation to update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.

Overview

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

- References in this document to we, us, our and ITT/ESI refer to ITT Educational Services, Inc. and its subsidiaries.
- The terms ITT Technical Institute or Daniel Webster College (in singular or plural form) refer to an individual school or campus owned and operated by ITT/ESI, including its learning sites, if any. The term institution (in singular or plural form) means a main campus and its additional locations, branch campuses and/or learning sites, if any.

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 for the fiscal year ended December 31, 2012 filed with the SEC for discussion of, among other matters, the following items:

- cash receipts from financial aid programs;
- nature of capital additions;
- seasonality of revenue;
- components of income statement captions;
- federal regulations regarding:
  - timing of receipt of funds from the Title IV Programs;
  - percentage of applicable revenue that may be derived from the Title IV Programs;
  - return of Title IV Program funds for withdrawn students; and
  - default rates;
- private loan programs;
- investments; and
- repurchase of shares of our common stock.

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

In this management s discussion and analysis of financial condition and results of operations, when we discuss factors that contributed to a change in our financial condition or results of operations, we disclose the primary factors that materially contributed to that change in the order of significance.

Background

We are a leading proprietary provider of postsecondary degree programs in the United States based on revenue and student enrollment. As of June 30, 2013, we were offering master, bachelor and associate degree programs to approximately 59,000 students. As of June 30, 2013, we had 149 college locations (including 147 campuses and two learning sites) in 39 states. In addition, we offered one or more of our online programs to students who are located in 48 states. All of our college locations are authorized by the applicable education authorities of the states in which they operate, and are accredited by an accrediting

Table of Contents

commission recognized by the ED. We design our education programs, after consultation with employers and other constituents, to help graduates prepare for careers in various fields involving their areas of study. We have provided career-oriented education programs since 1969 under the ITT Technical Institute name and since June 2009 under the Daniel Webster College name.

Our strategy is to pursue multiple opportunities for growth. We are implementing a growth strategy designed to:

- improve the academic outcomes of our students;
- increase the value proposition of our education programs for our students; and
- increase access to high-quality, career-based education.

We intend to pursue this strategy by:

- increasing student enrollment in existing programs at existing campuses;
- increasing the number and types of program and other educational offerings that are delivered in residence and/or online;
- increasing our students engagement in their programs of study;
- enhancing the relevancy of our educational offerings;
- assessing student achievement and learning;
- improving the flexibility and convenience of how our institutions deliver their educational offerings;
- increasing our students access to financial aid;
- helping our graduates obtain entry-level employment involving their fields of study at higher starting annual salaries;
- operating new campuses across the United States and new institutions in international markets;
- adding learning sites to existing campuses; and
- investing in other education-related opportunities.

Critical Accounting Policies and Estimates

The preparation of our condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenue, expenses, and contingent assets and liabilities. Actual results may differ from those estimates and judgments under different assumptions or conditions. We have discussed the critical accounting policies that we believe affect our more significant estimates and judgments used in the preparation of our consolidated financial statements in the Management s Discussion and Analysis of Financial Condition and Results of the Operations Critical Accounting Policies and Estimates section of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 filed with the SEC. There have been no material changes to those critical accounting policies or the underlying accounting estimates or judgments.

New Accounting Guidance

In February 2013, the FASB issued ASU No. 2013-02, which is included in the Codification under ASC 220. This update requires an entity to report the effect, by component, of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income. This guidance is effective for interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance requires that we provide additional disclosures regarding the amounts reclassified out of accumulated other comprehensive income during the reporting period. We have included these disclosures in the footnotes to our condensed consolidated financial statements.

In October 2012, the FASB issued ASU No. 2012-04, which makes technical corrections, clarifications and limited-scope improvements to various topics throughout the Codification. The amendments in this ASU that do not have transition guidance are effective upon issuance and the amendments that are subject to transition guidance are effective for our interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

In July 2012, the FASB issued ASU No. 2012-02, which is included in the Codification under ASC 350. This update allows an entity to first assess qualitative factors to determine whether it must perform a quantitative impairment test. An entity would be required to calculate the fair value of an indefinite-lived intangible asset, if the entity determines, based on a qualitative assessment, that it is more likely than not that the indefinite-lived asset is impaired. This guidance is effective for impairment tests performed for our interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-11, which is included in the Codification under ASC 210. This update provides for enhanced disclosures to help users of financial statements evaluate the effect or potential effect of netting arrangements on an entity s financial position. In January 2013, the FASB issued ASU No. 2013-01, which clarifies the scope of the disclosures required under ASU No. 2011-11. Both of these updates are effective for interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

Table of Contents

Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of educational services	47.6%	42.7%	45.5%	41.1%
Student services and administrative expenses	38.8%	33.8%	37.8%	32.4%
Loss related to private student loan programs	0.0%	0.0%	0.6%	0.0%
Operating income	13.5%	23.5%	16.1%	26.5%
Interest (expense), net	(0.4%)	(0.3%)	(0.4%)	(0.1%)
Income before provision for income taxes	13.2%	23.2%	15.7%	26.4%

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

Total Student Enrollment as of:	2013 Total Student Enrollment	2013 (Decrease) To Prior Year	2012 Total Student Enrollment	2012 (Decrease) To Prior Year
March 31	61,039	(14.2%)	71,123	(15.4%)
June 30	58,617	(11.7%)	66,397	(15.7%)
September 30	Not applicable	Not applicable	65,662	(17.1%)
December 31	Not applicable	Not applicable	61,059	(16.6%)

Total student enrollment includes all new and continuing students. A continuing student is any student who, in the academic term being measured, is enrolled in a program of study at one of our campuses and was enrolled in the same program at any of our campuses at the end of the immediately preceding academic term. A new student is any student who, in the academic term being measured, enrolls in and begins attending any program of study at one of our campuses:

- for the first time at that campus;
- after graduating in a prior academic term from a different program of study at that campus; or
- after having withdrawn or been terminated from a program of study at that campus.

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

New Student Enrollment in the Three	2013 New Student Enrollment	2013 Increase (Decrease) To Prior Year	2012 New Student Enrollment	2012 (Decrease) To Prior Year

Months Ended:				
March 31	17,412	(3.6%)	18,067	(17.0%)
June 30	16,883	7.5%	15,698	(9.5%)
September 30	Not applicable	Not applicable	19,298	(15.8%)
December 31	Not applicable	Not applicable	13,398	(11.4%)
Total for the year	Not applicable	Not applicable	66,461	(13.9%)

We believe that the 7.5% increase in new student enrollment in the three months ended June 30, 2013 compared to the three months ended June 30, 2012 was primarily due to:

- an increase in the number of prospective students who inquired about our programs of study;
- an increase in the rate at which prospective students who applied for enrollment actually began attending classes in their programs of study; and
- increased availability to and use by our students of institutional scholarships and awards, which have the effect of reducing the students cost of our programs of study.

We believe that the 3.6% decrease in new student enrollment in the three months ended March 31, 2013 compared to the three months ended March 31, 2012 was primarily due to:

- changes that we made to program offerings at select campuses which resulted in a more significant decline in new student enrollment in the criminal justice programs of study compared to our other curricula; and
- a decrease in new student enrollment in our bachelor degree programs.

Table of Contents

We believe that the decrease in new student enrollment in the three months ended March 31, 2013 compared to the three months ended March 31, 2012 was also due to our prospective students :

- greater sensitivity to the cost of postsecondary education; and
- uncertainty about the value of a postsecondary education due to the prolonged economic and labor market disruptions.

A continued decline in total student enrollment, and further declines in new student enrollment similar to those that we experienced prior to the three months ended June 30, 2013, could have a material adverse effect on our business, financial condition, revenue and other results of operations and cash flows. We have taken a number of steps in an attempt to reverse the declines in total and new student enrollment, including, without limitation:

- introducing an institutional scholarship program, called the Opportunity Scholarship, which is intended to help reduce the cost of an ITT Technical Institute education and increase student access to our programs of study; and
- refining our marketing, advertising and communications to focus more on the student value proposition and outcomes of an ITT Technical Institute education.

At the vast majority of our campuses, we generally organize the academic schedule for programs of study offered on the basis of four 12-week academic quarters in a calendar year. The academic quarters typically begin in early March, mid-June, early September and late November or early December. To measure the persistence of our students, the number of continuing students in any academic term is divided by the total student enrollment in the immediately preceding academic term.

The following table sets forth the rates of our students persistence as of the dates indicated:

	Student Persistence as of:			
Year	**March 31**	**June 30**	**September 30**	**December 31**
2011	73.5%	73.1%	71.5%	73.4%
2012	72.4%	71.3%	69.8%	72.6%
2013	71.5%	68.4%	Not applicable	Not applicable

We believe that the decrease in student persistence as of June 30, 2013 compared to June 30, 2012 was primarily due to:

- an increase in the number of graduates at the end of the academic quarter that began in March 2013 compared to the end of the same academic quarter in the prior year; and
- a slight decrease in student retention in the three months ended June 30, 2013 compared to the same prior year period, primarily attributed to lower student retention in a few courses that are delivered in the early portions of certain associate degree programs of study.

The increase in the number of graduates at the end of the academic quarter that began in March 2013 was primarily due to two, instead of one, graduating classes of students comprised of:

- the first graduation class of the associate degree programs of study that we introduced in 2011, which reduce from eight to seven the number of academic quarters required for a full-time student to graduate; and the last graduation class of full-time students of the associate degree programs of study that required eight academic quarters for a full-time student to graduate.

We believe that the decrease in student persistence as of March 31, 2013 compared to March 31, 2012 was primarily due to the number of graduates in the three months ended March 31, 2013 compared to the three months ended March 31, 2012 decreasing at a lesser rate than the decline in total student enrollment as of December 31, 2012 compared to December 31, 2011.

Three Months Ended June 30, 2013 Compared with Three Months Ended June 30, 2012. Revenue decreased $69.9 million, or 21.2%, to $259.9 million in the three months ended June 30, 2013 compared to $329.8 million in the three months ended June 30, 2012. The primary factors that contributed to this decrease included:

- a 14.2% decrease in total student enrollment as of March 31, 2013 compared to March 31, 2012;
- an 11.7% decrease in total student enrollment as of June 30, 2013 compared to June 30, 2012; and
- a $30.1 million increase in institutional scholarships and awards provided to our students in the three months ended June 30, 2013 compared to the same prior year period.

The increase in institutional scholarships and awards was primarily due to the introduction of the Opportunity Scholarship at the vast majority of the ITT Technical Institute campuses in the academic quarter that began in March 2013.

Cost of educational services decreased $17.1 million, or 12.1%, to $123.8 million in the three months ended June 30, 2013 compared to $140.9 million in the three months ended June 30, 2012. The primary factors that contributed to this decrease included:

- a decrease in compensation and benefit costs, resulting from fewer employees; and
- a decrease in course supply expenses, due to lower student enrollments.

Cost of educational services as a percentage of revenue increased 490 basis points to 47.6% in the three months ended June 30, 2013 compared to 42.7% in the three months ended June 30, 2012. The primary factor that contributed to this increase was a decline in revenue, which was partially offset by decreases in compensation and benefit costs and course supply expenses.

Table of Contents

Student services and administrative expenses decreased $10.6 million, or 9.5%, to $100.9 million in the three months ended June 30, 2013 compared to $111.5 million in the three months ended June 30, 2012. The principal causes of this decrease were decreases in compensation and benefit costs and media advertising expenses.

Student services and administrative expenses increased to 38.8% of revenue in the three months ended June 30, 2013 compared to 33.8% of revenue in the three months ended June 30, 2012. The principal cause of this increase was a decline in revenue, which was partially offset by decreases in compensation and benefit costs and media advertising expenses. Bad debt expense as a percentage of revenue increased to 7.3% in the three months ended June 30, 2013 compared to 5.8% in the three months ended June 30, 2012, primarily as a result of an increase in student account balances that were determined to be uncollectible.

Operating income decreased $42.2 million, or 54.5%, to $35.2 million in the three months ended June 30, 2013 compared to $77.4 million in the three months ended June 30, 2012, primarily as a result of the impact of the factors discussed above in connection with revenue, cost of educational services, and student services and administrative expenses. Our operating margin decreased to 13.5% in the three months ended June 30, 2013 compared to 23.5% in the three months ended June 30, 2012, primarily as a result of the impact of the factors discussed above.

Interest income decreased $0.3 million, or 65.7%, to $0.2 million in the three months ended June 30, 2013 compared to $0.5 million in the three months ended June 30, 2012, primarily due to discontinuing the amortization of the discount on the Subordinated Note that we issued in connection with the PEAKS Program. See Note 8 of the Notes to Condensed Consolidated Financial Statements for a discussion of the Subordinated Note. Interest expense decreased $0.1 million, or 11.2%, to $1.1 million in the three months ended June 30, 2013 compared to $1.3 million in the three months ended June 30, 2012, primarily due to a decrease in our weighted average outstanding borrowings under the Credit Agreement, which was partially offset by an increase in the effective interest rate on the Revolver.

Our combined federal and state effective income tax rate was 39.1% in the three months ended June 30, 2013 compared to 40.0% in the three months ended June 30, 2012. The effective income tax rate was higher in the three months ended June 30, 2012 primarily due to the settlement of certain income tax audits during that time period.

Six Months Ended June 30, 2013 Compared with Six Months Ended June 30, 2012. Revenue decreased $124.0 million, or 18.5%, to $547.6 million in the six months ended June 30, 2013 compared to $671.6 million in the six months ended June 30, 2012. The primary factors that contributed to this decrease included:

- a 14.2% decrease in total student enrollment as of March 31, 2013 compared to March 31, 2012;
- a 16.6% decrease in total student enrollment as of December 31, 2012 compared to December 31, 2011;
- an 11.7% decrease in total student enrollment as of June 30, 2013 compared to June 30, 2012; and
- a $30.9 million increase in institutional scholarships and awards provided to our students in the six months ended June 30, 2013 compared to the same prior year period.

The increase in institutional scholarships and awards was primarily due to the introduction of the Opportunity Scholarship at the vast majority of the ITT Technical Institute campuses in the academic quarter that began in March 2013.

Cost of educational services decreased $26.8 million, or 9.7%, to $249.0 million in the six months ended June 30, 2013 compared to $275.9 million in the six months ended June 30, 2012. The primary factors that contributed to this decrease included:

- a decrease in compensation and benefit costs, resulting from fewer employees; and a decrease in course supply expenses, due to lower student enrollments.

Cost of educational services as a percentage of revenue increased 440 basis points to 45.5% in the six months ended June 30, 2013 compared to 41.1% in the six months ended June 30, 2012. The primary factor that contributed to this increase was a decline in revenue, which was partially offset by decreases in compensation and benefit costs and course supply expenses.

Student services and administrative expenses decreased $10.5 million, or 4.8%, to $207.2 million in the six months ended June 30, 2013 compared to $217.7 million in the six months ended June 30, 2012. The principal causes of this decrease were decreases in compensation and benefit costs and expenses related to student scholarships, which were partially offset by an increase in bad debt expense.

Student services and administrative expenses increased to 37.8% of revenue in the six months ended June 30, 2013 compared to 32.4% of revenue in the six months ended June 30, 2012. The principal causes of this increase were a decline in revenue and an increase in bad debt expense, which were partially offset by decreases in compensation and benefit costs and expenses related to student scholarships. Bad debt expense as a percentage of revenue increased to 7.1% in the six months ended June 30, 2013 compared to 5.2% in the six months ended June 30, 2012, primarily as a result of an increase in student account balances that were determined to be uncollectible.

Operating income decreased $90.1 million, or 50.6%, to $87.9 million in the six months ended June 30, 2013 compared to $178.0 million in the six months ended June 30, 2012, primarily as a result of the impact of the factors discussed above in connection with revenue, cost of educational services, and student services and administrative expenses. Our operating margin decreased to 16.1% in the six months ended June 30, 2013 compared to 26.5% in the six months ended June 30, 2012, primarily as a result of the impact of the factors discussed above.

Interest income decreased $1.0 million, or 82.6%, to $0.2 million in the six months ended June 30, 2013 compared to $1.2 million in the six months ended June 30, 2012, primarily due to discontinuing the amortization of the discount on the Subordinated Note that we issued in connection with the PEAKS Program. See Note 8 of the Notes to Condensed Consolidated Financial Statements for a discussion of the Subordinated Note. Interest expense increased $0.5 million, or 25.8%, to $2.3 million in the six months ended June 30, 2013 compared to $1.8 million in the six months ended June 30, 2012, primarily due to an increase in the effective interest rate on the Revolver, which was partially offset by a decrease in our weighted average outstanding borrowings under the Credit Agreement.

Our combined federal and state effective income tax rate was 39.5% in the six months ended June 30, 2013 compared to 39.6% in the six months ended June 30, 2012.

Financial Condition, Liquidity and Capital Resources

Cash and cash equivalents were $185.4 million as of June 30, 2013 compared to $246.3 million as of December 31, 2012 and $167.2 million as of June 30, 2012. Cash and cash equivalents as of June 30, 2013 decreased $60.9 million compared to December 31, 2012, primarily due to a payment of $46.0 million made in January 2013 in a settlement to absolve us from any further obligations with respect to our guarantee obligations under the 2007 RSA and a net repayment of $20.0 million in outstanding borrowings under the Revolver. Cash and cash equivalents as of June 30, 2013 increased $18.2 million compared to June 30, 2012, primarily due to cash generated from operating activities which was partially offset by a net repayment of $30.0 million in outstanding borrowings under the Revolver and approximately $10.1 million of capital and facility expenditures.

We are required to recognize the funded status of our defined benefit postretirement plans on our balance sheet. We recorded an asset of $8.8 million for the ESI Pension Plan, a non-contributory defined benefit pension plan commonly referred to as a cash balance plan, and a liability of $0.3 million for the ESI Excess Pension Plan, a nonqualified, unfunded retirement plan, on our Condensed Consolidated Balance Sheet as of June 30, 2013.

We do not expect to make any material contributions to the ESI Pension Plan or the ESI Excess Pension Plan in 2013. In 2012, we did not make any contributions to either the ESI Pension Plan or the ESI Excess Pension Plan.

Operations. Net cash generated from operating activities was $7.6 million in the three months ended June 30, 2013 compared to net cash used in operating activities of $38.3 million in the three months ended June 30, 2012. The $45.9 million increase in net cash flows from operating activities was primarily due to lower income tax and compensation-related payments, which were partially offset by a decrease in funds received as a result of lower student enrollments.

Net cash used in operating activities was $35.8 million in the six months ended June 30, 2013 compared to net cash used in operating activities of $1.0 million in the six months ended June 30, 2012. The $34.8 million decrease in net cash flows from operating activities was primarily due to a decrease in funds received as a result of lower student enrollments and the settlement payment to absolve us from any further obligations with respect to our guarantee obligations under the 2007 RSA, which were partially offset by lower income tax and compensation-related payments.

Accounts receivable less allowance for doubtful accounts was $123.1 million as of June 30, 2013 compared to $73.7 million as of June 30, 2012. Days sales outstanding increased 22.8 days to 43.1 days at June 30, 2013 compared to 20.3 days at June 30, 2012. Our accounts receivable balance and days sales outstanding increased as of June 30, 2013, primarily due to:

- an increase in internal student financing as a result of a decrease in the amount of funds received from private education loans made to our students by third-party lenders;

- a delay in the receipt of certain federal financial aid funds resulting from internal processing issues in the six months ended June 30, 2013; and

- to a lesser extent, changes implemented to the Federal Pell Grant Program that eliminated multiple awards in a twelve-month period and adjusted the lifetime limits, both of which began to impact our students in 2012.

Investing. In the three months ended June 30, 2013, we spent $0.4 million to renovate, expand and construct buildings compared to $0.3 million for similar expenditures in the three months ended June 30, 2012. In the six months ended June 30, 2013, we spent $0.5 million to renovate, expand or construct buildings compared to $0.4 million for similar expenditures in the six months ended June 30, 2012.

Capital expenditures, excluding facility and land purchases and facility construction, totaled:

- $2.0 million in the three months ended June 30, 2013 compared to $7.1 million in the three months ended June 30, 2012; and

- $3.4 million in the six months ended June 30, 2013 compared to $11.6 million in the six months ended June 30, 2012.

These expenditures consisted primarily of classroom and laboratory equipment (such as computers and electronic equipment), classroom and office furniture, software and leasehold improvements.

Table of Contents

We plan to continue to upgrade our current facilities and equipment in 2013. Cash generated from operations is expected to be sufficient to fund our capital expenditure requirements.

Financing. On March 21, 2012, we entered into the Credit Agreement that provides for a Revolver in the amount of $325.0 million. The Credit Agreement also provides that we may seek additional revolving commitments or term loan commitments in an aggregate principal amount not to exceed $125.0 million. The lenders under the Credit Agreement are not under any obligation to provide any such additional revolving commitments or term loan commitments. The Credit Agreement has a maturity date of March 21, 2015.

A portion of the borrowings under the Revolver were used to prepay the entire outstanding indebtedness under a prior credit agreement which was terminated on March 21, 2012. In addition to the prepayment of the outstanding indebtedness under the prior credit agreement, borrowings under the Credit Agreement are used for general corporate purposes.

Borrowings under the Credit Agreement bear interest, at our option, at LIBOR plus an applicable margin or at an alternative base rate, as defined under the Credit Agreement, plus an applicable margin. The applicable margin for borrowings under the Revolver is determined based on the Leverage Ratio as of the end of each fiscal quarter. We also pay a commitment fee on the amount of the unutilized commitments under the Credit Agreement. The amount of the commitment fee is determined based on the Leverage Ratio as of the end of each fiscal quarter.

The Credit Agreement contains, among other things, covenants, representations and warranties and events of default customary for credit facilities. The Credit Agreement is secured by a pledge of the equity interests of our subsidiaries and is guaranteed by one of our subsidiaries. We are required to maintain compliance with a maximum Leverage Ratio, a minimum interest coverage ratio, a minimum liquidity amount and several ratios related to the ED s regulations. We were in compliance with those requirements as of June 30, 2013.

As of June 30, 2013, the borrowings under the Credit Agreement totaled $120.0 million. The effective interest rate on our borrowings was approximately 3.30% per annum for the three months ended June 30, 2013 and approximately 2.70% per annum for the three months ended June 30, 2012. In the six months ended June 30, 2013, the effective interest rate on our borrowings was approximately 3.30% per annum compared to approximately 2.10% per annum in the six months ended June 30, 2012. The commitment fee under the Credit Agreement was 0.40% as of June 30, 2013.

Our Board of Directors has authorized us to repurchase shares of our common stock in the open market or through privately negotiated transactions in accordance with Rule 10b-18 of the Exchange Act under the Repurchase Program. The following table sets forth information regarding our share repurchase activity in the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Number of shares repurchased	0	928,500	0	3,025,700
Total cost of shares repurchased (in millions)	$ 0	$ 61.3	$ 0	$ 207.9
Average cost per share	$ 0	$ 65.98	$ 0	$ 68.72

Approximately 7.8 million shares remained available for repurchase under the Repurchase Program as of June 30, 2013. Pursuant to the Board s stock repurchase authorization, we may repurchase additional shares of our common stock from time to time in the future depending on market conditions and other considerations.

We believe that cash generated from operations will be adequate to satisfy our working capital, loan repayment and capital expenditure requirements for the foreseeable future. We also believe that any reduction in cash and cash equivalents that may result from their use to purchase facilities, construct facilities, repay loans or repurchase shares of our common stock will not 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.

Student Financing Update. During the fourth quarter of 2012, we introduced an institutional scholarship program, called the Opportunity Scholarship, which is intended to help reduce the cost of an ITT Technical Institute education and increase student access to our programs of study. As of June 30, 2013, the Opportunity Scholarship was being offered to students at all of the ITT Technical Institute campuses. We believe that the Opportunity Scholarship will reduce our students need and use of private education loans, as well as decrease the internal student financing that we provide to our students. As an institutional scholarship, our revenue is reduced by the amount of the Opportunity Scholarship awarded. In addition, no cash payments are received and students will not be obligated to make payments to us of the amounts awarded under the Opportunity Scholarship. Therefore, we believe that the amounts receivable from students to us, as well as our revenue, should decrease in

2013, if the Opportunity Scholarship continues to be rolled-out to, and utilized by, the majority of our students, as expected.

Our revenue decreased in the three months and six months ended June 30, 2013 compared to the same periods in the prior year, partially as a result of the increase in institutional scholarships and awards provided to our students. In the three months ended June 30, 2013, our revenue decreased by $30.1 million compared to the three months ended June 30, 2012 as a result of the increase in institutional scholarships and awards. In the six months ended June 30, 2013, our revenue decreased by $30.9 million compared to the six months ended June 30, 2012 as a result of the increase in institutional scholarships and awards. The increase in institutional scholarships and awards in the three and six months ended June 30, 2013 was primarily due to the introduction of the Opportunity Scholarship at the vast majority of the ITT Technical Institute campuses in the academic quarter than began in March 2013.

Table of Contents

Based on the amount of Opportunity Scholarships that we estimate may be awarded in 2013, we believe that the Opportunity Scholarships, as well as, to a lesser extent, other factors, will have the effect of reducing our revenue per student by approximately 4.0 to 6.0 percent in the full year 2013 compared to 2012, and may result in our bad debt expense as a percentage of revenue being at the high end of the range of approximately 4% to 6% in the full year 2013.

As previously discussed, the two private education loan programs that provided the vast majority of the private education loans to our students in 2011 and 2010 expired in 2011. As a result, in 2012 and in the six months ended June 30, 2013, we increased the amount of internal student financing that we provided to our students. The internal student financing that we provide to our students consists of non-interest bearing, unsecured credit extended to our students and is included in Accounts receivable, net on our Condensed Consolidated Balance Sheets. As of June 30, 2013, our accounts receivable less allowance for doubtful accounts increased $49.4 million, or 67.1%, to $123.1 million compared to $73.7 million as of June 30, 2012, primarily due to the increase in the amount of internal financing that we provided to our students since the private education loan programs expired in 2011.

The internal student financing provided to a student is generally due and payable by the student at the end of the student s academic year (which is generally nine months) or enrollment, whichever occurs first. In contrast, we typically received the proceeds of a student s private education loan at the beginning of the student s academic year. Both the delay in our receipt of internal student financing payments compared to our receipt of private education loan proceeds and the increased amount of internal student financing that we provide to our students as a result of the expiration of the two primary private education loan programs utilized by our students have negatively impacted our liquidity and cash flows from operating activities. The increased amount of internal student financing that we provided to our students as a result of the expiration of the two primary private education loan programs utilized by our students has also exposed us to greater credit risk. In addition, we have the risk of collection with respect to our internal student financing which resulted in an increase in our bad debt expense as a percentage of revenue in the three months ended June 30, 2013 to 7.3% compared to 5.8% in the three months ended June 30, 2012. The 22.8-day increase in our days sales outstanding to 43.1 days as of June 30, 2013 compared to 20.3 days as of June 30, 2012 was primarily attributable to:

- the increase in internal student financing caused by a decrease in the amount of funds received from private education loans made to our students by third-party lenders;

- a delay in the receipt of certain federal financial aid funds resulting from internal processing issues in the six months ended June 30, 2013; and

- to a lesser extent, changes implemented to the Federal Pell Grant Program that eliminated multiple awards in a twelve-month period and adjusted the lifetime limits, both of which began to impact our students in 2012.

We plan to continue the roll-out of the Opportunity Scholarship which we believe will reduce the amount of internal student financing that we provide to our students. The increased use of institutional scholarships and awards by our students and any additional internal student financing provided to our students could result in a continuation of the adverse factors that are described above, including a material adverse effect on our financial condition and cash flows.

Contractual Obligations

The following table sets forth our specified contractual obligations as of June 30, 2013:

		Payments Due by Period			
Contractual Obligations	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
			(In thousands)		
Operating lease obligations	$ 159,049	$ 48,128	$ 72,626	$ 29,416	$ 8,879
Long-term debt, including scheduled interest payments (a)	$ 127,396	$ 4,173	$ 123,223	$ 0	$ 0
Claims and contingencies (b)	$ 25,970	$ 25,970	$ 0	$ 0	$ 0

Total	$ 312,415	$ 78,271	$ 195,849	$ 29,416	$ 8,879

(a) The long-term debt represents the Revolver under the Credit Agreement and assumes that the $120.0 million outstanding balance under the Revolver as of June 30, 2013 will be outstanding at all times through the date of maturity. The amounts shown include the principal payments that will be due upon maturity as well as interest payments and commitment fees. Interest payments and commitment fees have been calculated based on their scheduled payment dates using the interest rate charged on our borrowings and the rate charged on unutilized commitments as of June 30, 2013.

(b) The $26.0 million in the Claims and contingencies line item consists of the $33.9 million recorded liability for claims and contingencies that was included in Other current liabilities on our Condensed Consolidated Balance Sheet as of June 30, 2013, less approximately $8.0 million that we claimed as an offset against amounts owed to use under the Revolving Note. This is an estimate of the amount of claims and contingencies that we believe we will pay during the next 12

Table of Contents

months, the substantial majority of which relate to our guarantee obligations under the RSAs. The recorded liability for claims and contingencies of $42.7 million, which was included in Other liabilities on our Condensed Consolidated Balance Sheet as of June 30, 2013, is not included in the table above, because we cannot reasonably predict the timing of possible payments that we believe we will make after June 30, 2014 related to our claims and contingencies, the substantial majority of which relate to our guarantee obligations under the RSAs. See Note 11 of the Notes to Condensed Consolidated Financial Statements for additional information on our claims and contingencies as of June 30, 2013.

The table above does not reflect unrecognized tax benefits of $20.6 million and accrued interest related to unrecognized tax benefits of $6.1 million, because we cannot reasonably predict the timing of the resolution of the related tax positions.

Off-Balance Sheet Arrangements

As of June 30, 2013, 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 11 years and management believes that:

- those leases will be renewed or replaced by other leases in the normal course of business;
- we may purchase the facilities represented by those leases; or
- we may purchase or build other replacement facilities.

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 terms of certain operating leases 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 June 30, 2013, the total face amount of those surety bonds was approximately $24.2 million.

On January 20, 2010, we entered into the PEAKS Program. Under the PEAKS Program, an unaffiliated lender originated private education loans to our eligible students and, subsequently, sold those loans to the PEAKS Trust. The PEAKS Trust issued the PEAKS Senior Debt to investors. The assets of the PEAKS Trust (which include, among other assets, the student loans held by the PEAKS Trust) serve as collateral for, and are intended to be the principal source of, the repayment of the PEAKS Senior Debt. The PEAKS Trust is required to maintain assets having an aggregate value that exceeds the outstanding balance of the PEAKS Senior Debt, which requirement we guarantee. As of June 30, 2013, the value of the assets of the PEAKS Trust satisfied this requirement. The PEAKS Senior Debt bears interest at a variable rate based on the LIBOR plus a margin and matures in January 2020. As of June 30, 2013, the outstanding principal balance of the PEAKS Senior Debt was approximately $257.0 million.

In connection with the PEAKS Program, the lender disbursed the proceeds of the private education loans to us for application to the students account balances with us that represented their unpaid education costs. We transferred to the PEAKS Trust a portion of the amount of each private student loan disbursed to us under the PEAKS Program, in exchange for the Subordinated Note. The Subordinated Note does not bear interest, and principal is due on the Subordinated Note following the repayment of the PEAKS Senior Debt, the payment of fees and expenses of the PEAKS Trust and the reimbursement of the amount of any payments made by us under the PEAKS Guarantee. The PEAKS Trust utilized the proceeds from the issuance of the PEAKS Senior Debt and the Subordinated Note to purchase the student loans from the lender.

Under the PEAKS Guarantee, we guarantee payment of the principal and interest owed on the PEAKS Senior Debt, the administrative fees and expenses of the PEAKS Trust and the required ratio of assets of the PEAKS Trust to outstanding Senior Debt. The PEAKS Guarantee contains, among other things, representations and warranties and events of default customary for guarantees. In addition, under the PEAKS Program, some or all of the holders of the PEAKS Senior Debt could require us to purchase their PEAKS Senior Debt in certain limited circumstances that pertain to our continued eligibility to participate in the Title IV Programs. We believe that the likelihood of those limited circumstances occurring is remote. Our guarantee and purchase obligations under the PEAKS Program remain in effect until the PEAKS Senior Debt and the PEAKS Trust s fees and expenses are paid in full. At such time, we will be entitled to repayment of the amount of any payments made under our guarantee and payment of the Subordinated Note, in each case only to the extent of available funds remaining in the PEAKS Trust.

We entered into the PEAKS Program to offer our students another source of private education loans that they could use to help pay their education costs owed to us and to supplement the limited amount of private education loans available to our students under other private education loans programs, including the 2009 Loan Program. Under the PEAKS Program, our students had access to a greater amount of private education loans, which resulted in a reduction in the amount of internal financing that we provided to our students in 2010 and 2011. No new private education loans were or will be originated under the PEAKS Program after July 2011, but immaterial amounts related to loans originated prior to that date were disbursed by the lender through March 2012.

On February 20, 2009, we entered into the 2009 Loan Program. In connection with the 2009 Loan Program, we entered into the 2009 RSA. Under the 2009 RSA, we guarantee the repayment of the principal amount (including capitalized origination fees) and accrued interest payable on any private education loans that are charged off above a certain percentage of the private education loans made under the 2009 Loan Program, based on the annual dollar volume. The total initial principal amount of private education loans that the 2009 Entity purchased under the 2009 Loan Program was approximately $141.0 million. No new private education loans were or will be made under the 2009 Loan Program after December 31, 2011, but immaterial amounts related to loans originated prior to that date were disbursed by the lender through June 2012. Our obligations under the 2009 RSA will remain in effect until all private education loans made under the 2009 Loan Program are paid in full or charged off. The standard repayment term for a private education loan made under the 2009 Loan Program is ten years, with repayment generally beginning six months after a student graduates or three months after a student withdraws or is terminated from his or her program of study.

Pursuant to the 2009 RSA, we are required to maintain collateral to secure our guarantee obligation in an amount equal to a percentage of the outstanding balance of private education loans disbursed to our students under the 2009 Loan Program. As of June 30, 2013, the total collateral maintained in a restricted bank account was not material. The 2009 RSA also requires that we comply with certain covenants, including that we maintain certain financial ratios which are measured on a quarterly basis. We were in compliance with these covenants as of June 30, 2013.

In addition, beginning in the second quarter of 2009, we have made advances to the 2009 Entity under the Revolving Note. We made the advances, which bear interest, so that the 2009 Entity could use those funds primarily to provide additional funding for the private education loans, instead of retaining the funds ourselves and providing internal student financing, which is non-interest bearing. The Revolving Note bears interest at a rate based on the prime rate plus an applicable margin. Certain of the assets of the 2009 Entity serve as collateral for the Revolving Note. The Revolving Note is subject to customary terms and conditions and is currently due and payable in full.

In the three months ended June 30, 2013, we made guarantee and other payments related to the RSAs in the aggregate amount, net of recoveries, of approximately $3.4 million. We also asserted the right to offset approximately $7.4 million, net of recoveries, of the amount owed to us by the 2009 Entity under the Revolving Note. Approximately $6.8 million of the amount that we claimed as an offset against the Revolving Note related to our election under the 2009 RSA to discharge our guarantee obligations with respect to certain defaulted private education loans under the 2009 Loan Program. We recorded all of the amounts claimed as offsets in Other current liabilities on our Condensed Consolidated Balance Sheet as of June 30, 2013. See Notes 8 and 11 of the Notes to Condensed Consolidated Financial Statements for further discussion of the RSAs.

At the end of each reporting period, we assess whether we should recognize a contingent liability related to the various claims and contingencies that we are subject to, including those related to litigation, business transactions, guarantee arrangements and employee-related matters, among others. We record a liability for those claims and contingencies, if it is probable that a loss will result and the amount of the loss can be reasonably estimated. Although we believe that our estimates related to any claims and contingencies are reasonable, we cannot make any assurances with regard to the accuracy of our estimates, and actual results could differ materially. As of June 30, 2013, our recorded liability for these claims and contingencies was approximately $76.7 million, the substantial majority of which pertained to our guarantee obligations under the RSAs. Approximately $33.9 million of the recorded liability was included in Other current liabilities and approximately $42.7 million was included in Other liabilities on our Condensed Consolidated Balance Sheet as of June 30, 2013. We believe that the $42.7 million loss included in Other liabilities as of June 30, 2013 will be realized over the next seven to ten years related to our estimated guarantee obligations under the RSAs.

We review various factors and make certain assumptions when determining the amount to recognize as a contingent liability with respect to the guarantee arrangements under the RSAs at the end of each reporting period. The principal factor that we review is the repayment performance of the private education loans under each of the RSAs. As each portfolio of private education loans matures, additional data related to the performance of the loans and other information regarding the loans becomes available to us that we utilize to estimate the related contingent liability. In certain reporting periods, there have been disruptions in the servicing of a portion of the private education loans under the RSAs, which we believe has negatively impacted the repayment performance of those private education loans. We cannot predict with any certainty the extent to which the servicing disruptions may affect the repayment performance of those loans in future periods, or whether other servicing disruptions will occur in the future. If additional servicing disruptions occur or other factors negatively impact the repayment performance of the private education loans under the RSAs in the future, the contingent liability associated with those guarantees would increase and we could be required to pay additional material amounts under our guarantee obligations which could have a material adverse effect on our financial condition, results of operations and cash flows.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

In the normal course of our business, we are subject to fluctuations in interest rates that could impact the cost of our financing activities. Our primary interest rate risk exposure results from changes in short-term interest rates and the LIBOR.

Changes in the LIBOR would affect the borrowing costs associated with our revolving credit facilities. We estimate that the market risk can best be measured by a hypothetical 100 basis point increase in the LIBOR. If such a hypothetical increase in the LIBOR were to occur, the effect on our results from operations and cash flow would not have been material for the three and six months ended June 30, 2013.

Table of Contents

Item 4. Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures.
We are responsible for establishing and maintaining disclosure controls and procedures (DCP) that are designed to ensure that information required to be disclosed by us in the reports filed by us under the Exchange Act is: (a) recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms; and (b) accumulated and communicated to our management, including our principal executive and principal financial officers, to allow timely decisions regarding required disclosures. In designing and evaluating our DCP, we recognize that any controls and procedures, no matter how well designed and implemented, can provide only reasonable assurance of achieving the desired control objectives, and that our management s duties require it to make its best judgment regarding the design of our DCP. As of the end of our second fiscal quarter of 2013, we conducted an evaluation, under the supervision (and with the participation) of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our DCP pursuant to Rule 13a-15 of the Exchange Act. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our DCP were effective at the reasonable assurance level as of June 30, 2013.

(b) Changes in Internal Control Over Financial Reporting.
There were no changes in our internal control over financial reporting that occurred during our most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings.

We are subject to various claims and contingencies in the ordinary course of our business, including those related to litigation, business transactions, employee-related matters and taxes, among others. 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 campuses to additional regulatory scrutiny.

On December 22, 2008, we were served with a qui tam action in the Leveski Litigation that was filed on July 3, 2007 in the United States District Court for the Southern District of Indiana by a former employee (relator) on behalf of herself and the federal government under the following caption: *United States of America ex rel. Debra Leveski v. ITT Educational Services, Inc.* We were served with the Leveski Litigation after the U.S. Department of Justice declined to intervene in the litigation. On June 3, 2008, the relator filed an amended complaint in the Leveski Litigation. On September 23, 2009, the court dismissed the Leveski Litigation without prejudice and gave the relator an opportunity to replead her complaint. On October 8, 2009, the relator filed a second amended complaint. In the second amended complaint, the relator alleges that we violated the False Claims Act, 31 U.S.C. § 3729, *et seq*., and the HEA by compensating our sales representatives and financial aid administrators with commissions, bonuses or other incentive payments based directly or indirectly on success in securing enrollments or federal financial aid. The relator alleges that all of our revenue derived from the federal student financial aid programs from July 3, 2001 through July 3, 2007 was generated as a result of our violating the HEA. The relator seeks various forms of recovery on behalf of herself and the federal government, including:

- treble the amount of unspecified funds paid to us for federal student grants;
- treble the amount of unspecified default payments, special allowance payments and interest received by lenders with respect to federal student loans received by our students;

all civil penalties allowed by law; and

attorney s fees and costs.

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

On August 8, 2011, the district court granted our motion to dismiss all of the relator s claims in the Leveski Litigation for lack of subject-matter jurisdiction and issued a judgment for us. On February 16, 2012, the relator in the Leveski Litigation filed a Notice of Appeal with the 7^{th} Circuit Court of Appeals regarding the final judgment entered by the district court dismissing all claims against us. On March 26, 2012, the district court in the Leveski Litigation awarded us approximately $0.4 million in sanctions against the relator s attorneys for filing a frivolous lawsuit. Relator s attorneys also appealed this award to the 7^{th} Circuit Court of Appeals. On July 8, 2013, the 7^{th} Circuit Court of Appeals reversed the district court s dismissal of the Leveski Litigation for lack of subject-matter jurisdiction and the award of sanctions against relator s attorneys. In addition, the 7^{th} Circuit Court of Appeals remanded the Leveski Litigation back to the district court for further proceedings.

Table of Contents

We have defended, and intend to continue to defend, ourselves vigorously against the allegations made in the complaint.

On March 11, 2013, a complaint in the Koetsch Litigation was filed against us and two of our current executive officers in the United States District Court for the Southern District of New York under the following caption: *William Koetsch, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* The complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by:

- our failure to properly account for the 2009 RSA and PEAKS Program;
- our failure to maintain proper internal controls to ensure that risk-sharing agreements were properly recorded;
- making false statements or failing to disclose adverse facts known about us;
- deceiving the investing public regarding our prospects and business;
- artificially inflating the price of our common stock; and
- causing the plaintiff and other putative class members to purchase our common stock at inflated prices.

The putative class period in this action is from April 20, 2010 through February 23, 2013. The plaintiff seeks, among other things, the designation of this action as a class action, and an award of unspecified compensatory damages, interest, costs and attorney s fees. All of the defendants intend to defend themselves vigorously against the allegations made in the complaint.

On April 17, 2013, a complaint in the MLAF Litigation was filed against us and two of our current executive officers in the United States District Court for the Southern District of New York under the following caption: *Massachusetts Laborers Annuity Fund, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* The complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by:

- our failure to properly account for the 2007 RSA, 2009 RSA and PEAKS Program;
- our failure to establish adequate reserves associated with our guarantee obligations under the 2007 RSA, 2009 RSA and PEAKS Program, which caused us to misrepresent our earnings, liabilities, net income and financial condition throughout the putative class period;
- making false and misleading statements;
- engaging in a scheme to deceive the market and a course of conduct that artificially inflated the price of our common stock;
- operating as a fraud or deceit on purchasers of our common stock by misrepresenting our liabilities related to the 2007 RSA, 2009 RSA and PEAKS Program, financial results and business prospects;

- artificially inflating the price of our common stock; and
- causing the putative class members to purchase our common stock at artificially inflated prices.

The putative class period in this action is from April 24, 2008 through February 25, 2013. The plaintiff seeks, among other things, the designation of this action as a class action, and an award of unspecified compensatory damages, interest, costs, attorney s fees and equitable/injunctive or other relief as the Court deems just and proper. All of the defendants intend to defend themselves vigorously against the allegations made in the complaint.

On May 8, 2013, a complaint in the Wilfred Litigation was filed against two of our current executive officers and all of our current Directors in the United States District Court for the Southern District of New York under the following caption: *Sasha Wilfred, Derivatively on Behalf of Nominal Defendant ITT Educational Services, Inc. v. Kevin M. Modany, et al.* The complaint alleges, among other things, that from April 24, 2008 through February 25, 2013, the defendants violated state law, including breaching their fiduciary duties to us, grossly mismanaging us, wasting our corporate assets and being unjustly enriched, by:

- causing or allowing us to disseminate to our shareholders materially misleading and inaccurate information relating to a series of risk-sharing agreements through SEC filings, press releases, conference calls, and other public statements and disclosures;
- willfully ignoring obvious and pervasive problems with our internal controls and practices and procedures, and failing to make a good faith effort to correct these problems or prevent their recurrence;
- violating and breaching fiduciary duties of care, loyalty, reasonable inquiry, oversight, good faith and supervision;
- causing or allowing us to misrepresent material facts regarding our financial position and business prospects; and
- abandoning their responsibilities and duties with regard to prudently managing our businesses in a manner imposed upon them by law.

The complaint seeks:

- unspecified damages;
- restitution;
- disgorgement of all profits, benefits and other compensation obtained by the individual defendants;
- an order directing us to take all necessary actions to reform and improve our corporate governance and internal procedures; and
- costs and disbursements, including attorneys , accountants and experts fees, costs and expenses.

All of the individual defendants intend to defend themselves vigorously against the allegations in the complaint.

Although the derivative action is brought nominally on behalf of us, we expect to incur defense costs and other expenses in connection with the derivative lawsuit.

There can be no assurance that the ultimate outcome of the Leveski Litigation, Koetsch Litigation, MLAF Litigation, Wilfred Litigation or other actions (including other actions under federal or state securities laws) will not have a material adverse effect on our financial condition, results of operations or cash flows.

The current officers named in the Koetsch Litigation, the MLAF Litigation and the Wilfred Litigation include Daniel M. Fitzpatrick and Kevin M. Modany.

Certain of our current and former officers and Directors are or may become a party in 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 1A. Risk Factors.

You should carefully consider the risks and uncertainties we describe in this Report, our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 and our Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2013 before deciding to invest in, or retain, shares of our common stock. These are not the only risks and uncertainties that we face. Additional risks and uncertainties that we do not currently know about, we currently believe are immaterial or we have not predicted may also harm our business operations or adversely affect us. If any of these risks or uncertainties actually occurs, our business, financial condition, results of operations, cash flows or stock price could be materially adversely affected. Except as set forth below and in Part II, Item 1A. of our Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2013, there have been no material changes from the risk factors discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Government and regulatory agencies and third parties may bring investigations, claims or actions against us based on alleged violations of the extensive regulatory requirements applicable to our campuses, which could require us to pay monetary damages, receive other sanctions and expend significant resources to defend those claims or actions. Due to the highly regulated nature of the postsecondary education industry, we are subject to investigations and claims of non-compliance with regulatory standards and other actions brought by regulatory agencies, students, shareholders and other parties. If the results of any of those investigations and claims are unfavorable to us, we may be required to pay money damages or be subject to fines, penalties, injunctions, operational limitations, loss of eligibility to participate in federal or state financial aid programs, debarments, additional oversight and reporting, or other civil and criminal sanctions. Those sanctions could have a material adverse effect on our financial condition, results of operations and cash flows. Even if we satisfactorily resolve the issues raised by those types of investigations and claims, we may have to divert significant financial and management resources from our ongoing business operations to address and defend those investigations and claims, which could have a material adverse effect on our financial condition, results of operations and cash flows. Adverse publicity regarding any of those investigations and claims could also negatively affect our business and the market price of our common stock. See Business Highly Regulated Industry in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

On May 18, 2012, we received a Civil Investigative Demand (CID) from the U.S. Consumer Financial Protection Bureau (CFPB). The CFPB s CID provides that the purpose of the investigation is, in part, to determine whether for-profit post-secondary companies, student loan origination and servicing providers, or other unnamed persons have engaged or are engaging in unlawful acts or practices relating to the advertising, marketing, or origination of private student loans. The CFPB s CID contains broad requests for production of documents, answers to interrogatories and written reports related to private education loans made to our students and many other aspects of our business. We have provided documentation and other information to the CFPB, while preserving our rights to object to its inquiry. In August 2012, we filed a petition with the CFPB to set aside or modify the CFPB s CID. We believe that our acts and practices relating to private education loans are lawful.

On October 30, 2012, we received a CID from the Massachusetts Office of the Attorney General (MAG). The MAG s CID provides that the MAG is investigating allegations that we may have violated Massachusetts General Laws, Chapter 93A, Section 2(a) by engaging in unfair or deceptive practices in connection with marketing and advertising job placement and student outcomes, the recruitment of students, and the financing of education. The MAG s CID contains broad requests for production of documents related to our students in Massachusetts, including the financial aid available to those students, our recruitment of those students, the career services that we offer to those students, our marketing and advertising, the retention and graduation rates of those students and many other aspects of our business. We are cooperating with the MAG in its investigation, and we have provided documentation, communications and other information to the MAG in response to the CID. We believe that our acts and practices relating to our students in Massachusetts are lawful.

Table of Contents

On February 8, 2013, we received a subpoena from the SEC. In a letter accompanying the subpoena, the SEC states that it is conducting an investigation of us. The SEC s subpoena requests the production of documents and communications that, among other things, relate to our actions and accounting associated with: (a) agreements that we entered into with the 2009 Entity to create the 2009 Loan Program, including, without limitation, the 2009 RSA; and (b) agreements that we entered into to create the PEAKS Program. On May 9, 2013, we received a second subpoena from the SEC requesting the production of certain communications related to the same subject matter as the subpoena received on February 8, 2013. We are cooperating with the SEC in its investigation, and we have provided documentation, communications and other information to the SEC in response to both subpoenas. There can be no assurance, however, that the ultimate outcome of the SEC investigation will not have a material adverse effect on our financial condition or results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The following table sets forth information regarding purchases made by us of shares of our common stock on a monthly basis in the three months ended June 30, 2013:

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)
April 1, 2013 through April 30, 2013	0	$	0	7,771,025
May 1, 2013 through May 31, 2013	0		0	7,771,025
June 1, 2013 through June 30, 2013	0		0	7,771,025
Total	0	$	0	

(1) The shares that remained available for repurchase under the Repurchase Program were 7,771,025 as of June 30, 2013. Our Board of Directors has authorized us to repurchase the following number of shares of our common stock pursuant to the Repurchase Program:

Number of Shares	Board Authorization Date
2,000,000	April 1999
2,000,000	April 2000
5,000,000	October 2002
5,000,000	April 2006
5,000,000	April 2007
5,000,000	January 2010
5,000,000	October 2010
5,000,000	July 2011
5,000,000	April 2012

The terms of the 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 Repurchase Program will expire when we repurchase all shares authorized for repurchase thereunder.

Item 6. Exhibits.

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

Table of Contents

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: July 26, 2013

By: /s/ Daniel M. Fitzpatrick

Daniel M. Fitzpatrick

Executive Vice President, Chief Financial Officer

(Duly Authorized Officer, Principal Financial Officer

and Principal Accounting Officer)

INDEX TO EXHIBITS

Exhibit No.	Description
3.1	Restated Certificate of Incorporation, as Amended to Date (incorporated herein by reference from the same exhibit number to ITT/ESI s 2005 second fiscal quarter report on Form 10-Q)
3.2	Restated By-Laws, as Amended to Date (incorporated herein by reference from the same exhibit number to ITT/ESI s Current Report on Form 8-K filed on July 22, 2011)
10.1	First Amendment of ESI 401(k) Plan
10.2	ITT Educational Services, Inc. Amended and Restated 2006 Equity Compensation Plan (incorporated herein by reference from Exhibit 10.1 to ITT/ESI s Current Report on Form 8-K filed on May 7, 2013)
10.3	Form of Nonqualified Stock Option Agreement under the ITT Educational Services, Inc. Amended and Restated 2006 Equity Compensation Plan (incorporated herein by reference from Exhibit 10.2 to ITT/ESI s Current Report on Form 8-K filed on May 7, 2013)
10.4	Form of Restricted Stock Unit Award Agreement under the ITT Educational Services, Inc. Amended and Restated 2006 Equity Compensation Plan (incorporated herein by reference from Exhibit 10.3 to ITT/ESI s Current Report on Form 8-K filed on May 7, 2013)
10.5	Form of Restricted Stock Award Agreement under the ITT Educational Services, Inc. Amended and Restated 2006 Equity Compensation Plan (incorporated herein by reference from Exhibit 10.4 to ITT/ESI s Current Report on From 8-K filed on May 7, 2013)
31.1	Chief Executive Officer s Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934
31.2	Chief Financial Officer s Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934
32.1	Chief Executive Officer s Certification Pursuant to 18 U.S.C. Section 1350
32.2	Chief Financial Officer s Certification Pursuant to 18 U.S.C. Section 1350
101	The following materials from ITT Educational Services, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, formatted in XBRL (eXtensible Business Reporting language):
	(i) Condensed Consolidated Balance Sheets; (ii) Condensed Consolidated Statements of Income; (iii) Condensed Consolidated Statements of Comprehensive Income; (iv) Condensed Consolidated Statements of Cash Flows; (v) Condensed Consolidated Statements of Shareholders Equity; and (vi) Notes to Condensed Consolidated Financial Statements