

ITT Educational Services, Inc.
Florida Single Audit Act and Additional Information
For the Year Ended December 31, 2012

ITT Educational Services, Inc.
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For the Year Ended December 31, 2012

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
ITT Educational Services, Inc.:

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of ITT Educational Services, Inc. and its subsidiaries (the "Company") at December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control Over Financial Reporting appearing on page 32. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States) and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 22, 2013 on our tests of compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters for the year ended December 31, 2012. The purpose of that report is to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The accompanying Note 15 on the Company's calculation of its Title IV 90/10 revenue test is required by the U.S. Department of Education and is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, the accompanying Note 15 on the Company's calculation of its Title IV 90/10 revenue test is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

PricewaterhouseCoopers LLP

February 22, 2013

ITT EDUCATIONAL SERVICES, INC.
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share data)

	As of December 31,	
	2012	2011
Assets		
Current assets:		
Cash and cash equivalents	\$246,342	\$228,993
Short-term investments	0	148,488
Restricted cash	601	2,128
Accounts receivable, less allowance for doubtful accounts of \$15,663 and \$9,175	77,313	48,106
Deferred income taxes	44,547	9,759
Prepaid expenses and other current assets	16,162	18,814
Total current assets	384,965	456,288
Property and equipment, net	189,890	201,257
Deferred income taxes	56,112	33,267
Other assets	41,263	38,006
Total assets	\$672,230	\$728,818
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$63,304	\$78,876
Accrued compensation and benefits	21,023	21,438
Other current liabilities	86,722	18,190
Deferred revenue	135,900	226,543
Total current liabilities	306,949	345,047
Long-term debt	140,000	150,000
Other liabilities	98,327	64,972
Total liabilities	545,276	560,019
Commitments and contingent liabilities (Note 14)		
Shareholders' equity:		
Preferred stock, \$.01 par value, 5,000,000 shares authorized, none issued	0	0
Common stock, \$.01 par value, 300,000,000 shares authorized, 37,068,904 issued	371	371
Capital surplus	206,703	189,573
Retained earnings	959,072	827,675
Accumulated other comprehensive (loss)	(7,930)	(9,479)
Treasury stock, 13,744,395 and 10,969,425 shares, at cost	(1,031,262)	(839,341)
Total shareholders' equity	126,954	168,799
Total liabilities and shareholders' equity	\$672,230	\$728,818

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

	Year Ended December 31,		
	2012	2011	2010
Revenue	\$1,287,209	\$1,499,949	\$1,596,529
Costs and expenses:			
Cost of educational services	539,223	553,065	537,855
Student services and administrative expenses	422,345	439,808	445,125
Settlement cost	21,750	0	0
Loss related to private student loan programs	71,102	0	0
Total costs and expenses	<u>1,054,420</u>	<u>992,873</u>	<u>982,980</u>
Operating income	232,789	507,076	613,549
Interest income	1,348	2,902	2,504
Interest (expense)	(3,723)	(1,825)	(1,918)
Income before provision for income taxes	230,414	508,153	614,135
Provision for income taxes	89,949	200,401	239,969
Net income	<u>\$140,465</u>	<u>\$307,752</u>	<u>\$374,166</u>
Earnings per share:			
Basic	\$5.88	\$11.22	\$11.28
Diluted	\$5.85	\$11.13	\$11.17
Weighted average shares outstanding:			
Basic	23,880	27,429	33,165
Diluted	23,999	27,655	33,501

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

ITT EDUCATIONAL SERVICES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)

	Year Ended December 31,		
	2012	2011	2010
Net Income	\$140,465	\$307,752	\$374,166
Other comprehensive income (loss), net of tax:			
Net actuarial pension (loss) gain, net of income tax of \$242, \$3,709 and \$1,300	379	(5,795)	(2,028)
Net actuarial pension loss amortization, net of income tax of \$1,062, \$704 and \$749	1,656	1,099	1,168
Prior service credit, net of income tax of \$0, \$0 and \$4,058	0	0	6,312
Prior service cost (credit) amortization, net of income tax of \$607, \$607 and \$0	(948)	(948)	28
Pension settlement loss, net of income tax of \$309, \$470, and \$0	483	734	0
Unrealized gains (losses) on available-for-sale securities, net of income tax of \$0, \$0 and \$0	(21)	(60)	104
Other comprehensive income (loss), net of tax	1,549	(4,970)	5,584
Comprehensive Income	<u>\$142,014</u>	<u>\$302,782</u>	<u>\$379,750</u>

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

ITT EDUCATIONAL SERVICES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

	Year Ended December 31,		
	2012	2011	2010
Cash flows from operating activities:			
Net income	\$140,465	\$307,752	\$374,166
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	29,350	27,886	26,797
Provision for doubtful accounts	78,307	61,308	86,935
Deferred income taxes	(58,640)	(8,991)	(14,557)
Excess tax benefit from stock option exercises	(1,382)	(1,166)	(3,383)
Stock-based compensation expense	16,658	17,074	15,813
Settlement cost	21,750	0	0
Asset impairment	15,166	0	0
Other	6,992	(1,936)	468
Changes in operating assets and liabilities:			
Restricted cash	1,527	(1,873)	1,636
Accounts receivable	(107,514)	(40,477)	(70,446)
Accounts payable	(15,572)	10,956	6,645
Other operating assets and liabilities	68,890	35,118	62,057
Deferred revenue	(90,643)	(17,819)	72,429
Net cash flows from operating activities	<u>105,354</u>	<u>387,832</u>	<u>558,560</u>
Cash flows from investing activities:			
Facility expenditures and land purchases	(1,046)	(4,053)	(6,118)
Capital expenditures, net	(17,204)	(26,847)	(26,811)
Proceeds from sales and maturities of investments and repayment of notes	217,301	337,032	385,306
Purchase of investments and note advances	(75,887)	(352,195)	(451,594)
Net cash flows from investing activities	<u>123,164</u>	<u>(46,063)</u>	<u>(99,217)</u>
Cash flows from financing activities:			
Excess tax benefit from stock option exercises	1,382	1,166	3,383
Proceeds from exercise of stock options	8,345	5,599	7,893
Debt issue costs	(1,525)	0	0
Proceeds from revolving borrowings	175,000	0	0
Repayment of revolving borrowings	(185,000)	0	0
Repurchase of common stock and shares tendered for taxes	(209,371)	(283,320)	(435,628)
Net cash flows from financing activities	<u>(211,169)</u>	<u>(276,555)</u>	<u>(424,352)</u>
Net change in cash and cash equivalents	17,349	65,214	34,991
Cash and cash equivalents at beginning of period	228,993	163,779	128,788
Cash and cash equivalents at end of period	<u><u>\$246,342</u></u>	<u><u>\$228,993</u></u>	<u><u>\$163,779</u></u>
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Income taxes (net of refunds)	\$139,919	\$196,387	\$259,788
Interest	\$3,047	\$1,842	\$1,914
Non-cash financing activities:			
Issuance of treasury stock for Directors' compensation	\$37	\$30	\$ 30

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

ITT EDUCATIONAL SERVICES, INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Dollars and shares in thousands)

	<u>Common Stock</u>		<u>Capital Surplus</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Common Stock in Treasury</u>		<u>Total</u>
	<u>Shares</u>	<u>Amount</u>				<u>Shares</u>	<u>Amount</u>	
Balance as of December 31, 2009	54,069	\$541	\$154,495	\$1,006,903	(\$10,093)	(18,623)	(\$995,261)	\$156,585
Net income				374,166				374,166
Other comprehensive income, net of income tax					5,584			5,584
Exercise of stock options and equity awards				(13,631)		214	21,524	7,893
Tax benefit from exercise of stock options and equity award vesting			3,627					3,627
Stock-based compensation			15,813					15,813
Common shares repurchased						(5,658)	(434,656)	(434,656)
Issuance of shares for Directors' compensation				1		1	29	30
Shares tendered for taxes						(10)	(972)	(972)
Common shares retired	(17,000)	(170)		(842,761)		17,000	842,931	0
Balance as of December 31, 2010	37,069	371	173,935	524,678	(4,509)	(7,076)	(566,405)	128,070
Net income				307,752				307,752
Other comprehensive (loss), net of income tax					(4,970)			(4,970)
Exercise of stock options and equity awards				(4,756)		155	10,355	5,599
Tax benefit from exercise of stock options and equity award vesting			1,190					1,190
Stock-based compensation			14,448					14,448
Common shares repurchased						(4,040)	(282,701)	(282,701)
Issuance of shares for Directors' compensation				1		1	29	30
Shares tendered for taxes						(9)	(619)	(619)
Balance as of December 31, 2011	37,069	371	189,573	827,675	(9,479)	(10,969)	(839,341)	168,799
Net income				140,465				140,465
Other comprehensive income, net of income tax					1,549			1,549
Exercise of stock options and equity awards				(9,067)		272	17,412	8,345
Tax benefit from exercise of stock options and equity award vesting			918					918
Stock-based compensation			16,212					16,212
Common shares repurchased						(3,026)	(207,918)	(207,918)
Issuance of shares for Directors' compensation				(1)		1	38	37
Shares tendered for taxes						(22)	(1,453)	(1,453)
Balance as of December 31, 2012	37,069	\$371	\$206,703	\$959,072	(\$7,930)	(13,744)	(\$1,031,262)	\$126,954

ITT Educational Services, Inc.

Notes to Consolidated Financial Statements, continued

December 31, 2012

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

1. **Business and Significant Accounting Policies**

Business. We are a leading proprietary provider of postsecondary education in the United States based on revenue and student enrollment. As of December 31, 2012, we were offering master, bachelor and associate degree programs to approximately 61,000 students and 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. We have provided career-oriented education programs since 1969 under the “ITT Technical Institute” name and since June 2009 under the “Daniel Webster College” (“DWC”) name. Our corporate headquarters are located in Carmel, Indiana.

Basis of Presentation. The 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 (“GAAP”) and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). All significant intercompany balances and transactions are eliminated upon consolidation. 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 CodificationTM (“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. As of December 31, 2012, we were not required to include the financial results of any variable interest entity in our consolidated financial statements.

Use of Estimates. The preparation of these consolidated financial statements, in accordance with GAAP, includes estimates and assumptions that are determined by our management. Actual results could differ materially from the estimates. Significant accounting estimates and assumptions are used for, but not limited to:

- the allowance for doubtful accounts;
- useful lives of tangible and intangible assets;
- asset impairments;
- fair value;
- self insurance;
- pension liabilities;
- stock-based compensation;
- guarantees;
- unrecognized tax benefits; and
- litigation exposures.

Cash Equivalents. Highly liquid investments purchased with an original maturity of three months or less are considered cash equivalents.

Restricted Cash. The funds from the federal student financial aid programs under Title IV (“Title IV Programs”) of the Higher Education Act of 1965, as amended (“HEA”), and certain other monies transferred to us by electronic funds transfer, are subject to holding restrictions before they can be drawn into our cash account. The funds subject to these holding periods are identified as restricted cash until they are applied to the students’ accounts. We also maintain an escrow account for a guarantee obligation to an unaffiliated third party under a private education loan program for our students. The funds in this escrow account are considered restricted cash and classified as other assets. The balance in this escrow account as of December 31, 2012 and December 31, 2011 was not material.

Investments. We classify our investments in marketable securities as available-for-sale or held-to-maturity depending on our investment intentions with regard to those securities on the date of acquisition. Investments classified as available-for-sale are recorded at their market value. Investments are classified as either current or non-current based on the maturity date of each security.

The cost of securities sold is based on the specific identification method.

Accounts Receivable and Allowance for Doubtful Accounts. We extend unsecured credit to our students for tuition and fees and we record a receivable for the tuition and fees earned in excess of the payment received from or on behalf of a student. The individual student balances of these receivables are insignificant. We record an allowance for doubtful accounts with respect to accounts receivable based on the students’ credit profiles and our historical collection experience related to amounts owed by our students with similar credit profiles. If our collection trends were to differ significantly from our historical collection experience, we would make a corresponding adjustment to our allowance for doubtful accounts.

ITT Educational Services, Inc.

Notes to Consolidated Financial Statements, continued

December 31, 2012

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

When a student is no longer enrolled in a program of study at one of our campuses, we increase the allowance for doubtful accounts related to the former student's receivable balance to reflect the amount we estimate will not be collected. The amount that we estimate will not be collected is based on a review of the historical collection experience for each campus, adjusted as needed to reflect other facts and circumstances. We review the collection activity after a student withdraws or graduates from a campus and will write off the accounts receivable, if we conclude that collection of the balance is not probable.

Property and Equipment. Property and equipment is recorded on our consolidated financial statements at cost, less accumulated depreciation and amortization. Maintenance and repairs are expensed as incurred. Expenditures that extend the useful lives of our assets are capitalized.

Developed or purchased software is capitalized in accordance with ASC 350, "Intangibles – Goodwill and Other." Facility construction costs are capitalized as incurred, with depreciation commencing when the facility is placed in service. We capitalize interest on our real estate construction projects in accordance with ASC 835, "Interest."

Provisions for depreciation and amortization of property and equipment have generally been made using the straight-line method over the following ranges of useful lives:

<u>Type of Property and Equipment</u>	<u>Estimated Useful Life</u>
Furniture and equipment	3 to 10 years
Leasehold, building and land improvements	3 to 14 years
Buildings	20 to 40 years

We amortize leasehold improvements using the straight-line method over the shorter of the life of the improvement or the term of the underlying lease. Land is not depreciated.

Asset Impairment. We regularly review our long-lived assets (which are primarily property and equipment) and notes receivable for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. We evaluate each note receivable individually for impairment.

If we determine that the carrying amount of a long-lived asset exceeds the total amount of the estimated undiscounted future cash flows from that asset, we would determine the fair value of that asset. If the fair value is less than the net book value of the long-lived asset, we recognize an impairment loss in the amount of the difference. We base our impairment analyses of long-lived assets on our current business strategy, expected growth rates and estimates of future economic and regulatory conditions.

We consider a note receivable to be impaired when, based on current information or events, it is probable that we will be unable to collect all amounts of principal and interest owed on the underlying note according to the terms of the note. If the present value of the expected future cash flows from the note receivable discounted at the underlying note's effective interest rate is less than the carrying value of the underlying note, we recognize an impairment loss in the amount of the difference.

Insurance Liabilities. We record liabilities and related expenses for medical, workers compensation and other insurance in accordance with the contractual terms of the insurance policies. We record the total liabilities that are estimable and probable as of the reporting date for our insurance liabilities that we self-insure. The accounting for our self-insured arrangements involves estimates and judgments to determine the liability to be recorded for reported claims and claims incurred but not reported. We consider our historical experience in determining the appropriate insurance reserves to record. If our current insurance claim trends were to differ significantly from our historic claim experience, however, we would make a corresponding adjustment to our insurance reserves.

Contingent Liabilities. We are subject to various claims and contingencies in the ordinary course of our business, including those related to litigation, business transactions, guarantee obligations and employee-related matters, among others. When we are aware of a claim or potential claim, we assess the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, we record a liability for the loss. The liability recorded includes probable and estimable legal costs associated with the claim or potential claim. If the loss is not probable or the amount of the loss cannot be reasonably estimated, we disclose the claim if the likelihood of a potential loss is reasonably possible and the amount involved is material.

Treasury Stock. Repurchases of outstanding shares of our common stock are recorded at cost. Treasury stock issued in fulfillment of stock-based compensation awards or other obligations is accounted for under the last in, first out

ITT Educational Services, Inc.

Notes to Consolidated Financial Statements, continued

December 31, 2012

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

method. We record “losses” from the sale of treasury stock that exceed previous net “gains” from the sale of treasury stock as a charge to retained earnings.

The retirement of shares of our common stock held in treasury are accounted for under the first in, first out method. We reduce common stock in the amount of the par value of the shares retired and we reduce retained earnings in the amount of the difference between the cost of the treasury shares and their par value.

Recognition of Revenue. Tuition revenue is recorded on a straight-line basis over the length of the applicable course to the extent that we consider the collectability of that revenue to be reasonably assured. If a student withdraws from an institution, the standards of most state education authorities that regulate our institutions, the accrediting commissions that accredit our institutions and our own internal policy limit a student’s obligation for tuition and fees to the institution depending on when a student withdraws during an academic term (“Refund Policies”). The terms of the Refund Policies vary by state, and the limitations imposed by the Refund Policies are generally based on the portion of the academic term that has elapsed at the time the student withdraws. Generally, the greater the portion of the academic term that has elapsed at the time the student withdraws, the greater the student’s obligation is to the institution for the tuition and fees related to that academic term. We record revenue net of any refunds that result from any applicable Refund Policy. On an individual student basis, tuition earned in excess of cash received is recorded as accounts receivable, and cash received in excess of tuition earned is recorded as deferred revenue.

We do not charge a separate fee for textbooks that students use in their programs of study. We record the cost of these textbooks in prepaid expenses and other current assets and amortize the cost of textbooks on a straight-line basis over the applicable course length. Tool kit sales, and the related cost, are recognized when the student receives the tool kit. Academic fees (which are charged only one time to students on their first day of class attendance) are recognized as revenue on a straight-line basis over the average program length. If a student withdraws from an institution, all unrecognized revenue relating to his or her fees, net of any refunds that result from any applicable Refund Policy, is recognized upon the student’s departure. An administrative fee is charged to a student and recognized as revenue when the student withdraws or graduates from a program of study at an institution.

We report 12 weeks of tuition revenue in each of our four fiscal quarters. We standardized the number of weeks of revenue reported in each fiscal quarter, because the timing of student breaks in a calendar quarter can fluctuate from quarter to quarter each year. The total number of weeks of school during each year is 48.

Advertising Costs. We expense all advertising costs as incurred.

Equity-Based Compensation. Stock-based compensation cost for our equity instruments exchanged for employee and director services is measured at the date of grant, based on the calculated fair value of the grant and is recognized as an expense on a straight-line basis over the period of time that the grantee must provide services to us before the stock-based compensation is fully vested. The vesting period is generally the period set forth in the agreement granting the stock-based compensation. Under the terms of our stock-based compensation plans, some grants immediately vest in full when the grantee’s employment or service terminates, and, for grants made prior to November 24, 2010, when he or she retires. As a result, in certain circumstances, the period of time that the grantee must provide services to us in order for that stock-based compensation to fully vest may be less than the vesting period set forth in the agreement granting the stock-based compensation. In these instances, compensation expense will be recognized over this shorter period.

We use a binomial option pricing model to determine the fair value of stock options granted and we use the market price of our common stock to determine the fair value of restricted stock and restricted stock units (“RSUs”) granted. The binomial option pricing model takes into account the variables defined below:

- “Volatility” is a statistical measure of the extent to which the stock price is expected to fluctuate during a period and combines our historical stock price volatility and the implied volatility as measured by actively traded stock options.
- “Expected life” is the weighted average period that those stock options are expected to remain outstanding, based on the historical patterns of our stock option exercises, as adjusted to reflect the current position-level demographics of the stock option grantees.
- “Risk-free interest rate” is based on interest rates for terms that are similar to the expected life of the stock options.
- “Dividend yield” is based on our historical and expected future dividend payment practices.

We generally issue shares of our common stock from treasury shares upon the exercise of stock options or vesting of RSUs. As of December 31, 2012, 13,744,395 shares of our common stock were held in treasury. Our Board of

ITT Educational Services, Inc.

Notes to Consolidated Financial Statements, continued

December 31, 2012

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

Directors has authorized us to repurchase outstanding shares of our common stock, but we are unable to determine at this point how many shares we will repurchase over the next 12 months. See Note 5 for additional disclosures regarding our stock repurchases.

Operating Leases. We lease our non-owned facilities under operating lease agreements. Common provisions within our operating lease agreements include:

- renewal options, which can be exercised after the initial lease term;
- rent escalation clauses;
- tenant improvement allowances; and
- rent holidays.

We record the rent expense associated with each operating lease agreement evenly over the term of the lease. The difference between the amount of rent expense recorded and the amount of rent actually paid is recorded as either prepaid or accrued rent, which is included in Other assets or Other liabilities, on our Consolidated Balance Sheets.

Income Taxes. We account for income taxes using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for expected future tax consequences of temporary differences that currently exist between the tax bases and financial reporting bases of our assets and liabilities.

We follow the guidance under ASC 740, "Income Taxes," which prescribes a single, comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on its tax returns. This guidance requires us to evaluate whether it is more likely than not, based on the technical merits of a tax position, that the benefits resulting from the position will be realized by us.

We record interest and penalties related to unrecognized tax benefits in income tax expense.

2. New Accounting Guidance

In October 2012, the FASB issued Accounting Standards Update ("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 will be effective for our interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance will not have a material impact on our consolidated financial statements.

In August 2012, the FASB issued ASU No. 2012-03, which amends and corrects various sections in the Codification pursuant to Staff Accounting Bulletin ("SAB") No. 114, SEC Release No. 33-9250 and ASU No. 2010-22. The amendments and corrections in this ASU are effective upon issuance. The adoption of this guidance did not have a material impact on our 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 will not have a material impact on our consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-12, which is included in the Codification under ASC 220, "Comprehensive Income" ("ASC 220"). This update defers the effective date of ASU No. 2011-05 for changes that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. None of the other requirements in ASU 2011-05 are affected by this update. This guidance became effective for our interim and annual reporting periods beginning January 1, 2012. The adoption of this guidance did not have a material impact on our consolidated financial statements.

Also in December 2011, the FASB issued ASU No. 2011-11, which is included in the Codification under ASC 210, "Balance Sheet." 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. This guidance is effective for interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance will not have a material impact on our consolidated financial statements.

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In September 2011, the FASB issued ASU No. 2011-08, which is included in the Codification under ASC 350. This update allows an entity to assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. This guidance became effective for our interim and annual reporting periods beginning January 1, 2012. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, which is included in the Codification under ASC 220. This update requires total comprehensive income, the components of net income and the components of other comprehensive income to be presented either in a single continuous statement or in two separate but consecutive statements. This guidance became effective for our interim and annual reporting periods beginning January 1, 2012. Prior to January 1, 2012, we presented total Comprehensive income and the components of Other comprehensive income in our Consolidated Statements of Shareholders' Equity. After December 31, 2011, we have presented total Comprehensive income and the components of Other comprehensive income in our Consolidated Statements of Comprehensive Income.

In May 2011, the FASB issued ASU No. 2011-04, which is included in the Codification under ASC 820, "Fair Value Measurements" ("ASC 820"). This update provides guidance and clarification about the application of existing fair value measurements and disclosure requirements. This guidance became effective for our interim and annual reporting periods beginning January 1, 2012. The adoption of this guidance did not have a material impact on our consolidated financial statements.

3. Fair Value and Credit Risk of Financial Instruments

ASC 820 defines fair value for financial reporting 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 ASC 820. 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 December 31, 2012:

Description	As of December 31, 2012	Fair Value Measurements at Reporting Date Using		
		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Cash equivalents:				
Money market fund	\$154,661	\$154,661	\$0	\$0
Other assets:				
Money market fund	8,622	8,622	0	0
	<u>\$163,283</u>	<u>\$163,283</u>	<u>\$0</u>	<u>\$0</u>

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The following table sets forth information regarding the fair value measurement of our financial assets as of December 31, 2011:

Description	As of December 31, 2011	Fair Value Measurements at Reporting Date Using		
		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Cash equivalents:				
Money market funds	\$228,287	\$228,287	\$0	\$0
Short-term investments:				
U.S. Treasury obligations	100,517	100,517	0	0
Government agency obligations	31,351	0	31,351	0
Corporate obligations	16,620	0	16,620	0
Other assets:				
Money market fund	7,576	7,576	0	0
	<u>\$384,351</u>	<u>\$336,380</u>	<u>\$47,971</u>	<u>\$0</u>

We used quoted prices in active markets for identical assets as of the measurement dates to value our financial assets that were categorized as Level 1. For assets that were categorized in Level 2, we used:

- quoted prices for similar assets in active markets;
- quoted prices for identical or similar assets in markets that were not active or in which little public information had been released;
- inputs other than quoted prices that were observable for the assets; or
- inputs that were principally derived from or corroborated by observable market data by correlation or other means.

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. Investments classified as available-for-sale are recorded at their market value.

Each of the carrying value and the estimated fair value of the notes receivable and other receivables included in Other assets on our Consolidated Balance Sheet was approximately \$9,600 as of December 31, 2012 and approximately \$19,000 as of December 31, 2011. 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 the estimated fair value of our long-term debt was approximately \$140,000 as of December 31, 2012 and \$150,000 as of December 31, 2011. 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.

Financial instruments that potentially subject us to credit risk consist primarily of accounts receivable, interest-bearing investments and notes receivable. There is no concentration of credit risk of our accounts receivable, as the total is comprised of a large number of individual balances owed by students whose credit profiles vary and who are located throughout the United States. Our interest-bearing investments generally consist of high-quality securities issued by various entities and major financial institutions. Certain of the assets of the party to whom we issued one of the notes receivable serve as collateral for the repayment of the note.

4. Equity Compensation Plans

We have adopted the following equity compensation plans, referred to collectively as the "Plans":

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- *2006 ITT Educational Services, Inc. Equity Compensation Plan* – Awards may be granted to our employees and directors under the 2006 ITT Educational Services, Inc. Equity Compensation Plan, as amended (“2006 Equity Compensation Plan”) in the form of stock options (incentive and nonqualified), stock appreciation rights (“SARs”), restricted stock, RSUs, performance shares, performance units and other stock-based awards as defined in the plan. The maximum number of shares of our common stock that may be issued pursuant to awards under this plan is 4,000,000. Each share underlying stock options and SARs granted and not forfeited or terminated, reduces the number of shares available for future awards by one share. The delivery of a share in connection with a “full-value award” (i.e., an award of restricted stock, RSUs, performance shares, performance units or any other stock-based award with value denominated in shares) reduces the number of shares remaining for other awards by three shares. As of December 31, 2012, restricted stock, RSUs and nonqualified stock options have been awarded under this plan.
- *1999 Outside Directors Stock Option Plan* – A maximum of 500,000 shares of our common stock were available to be issued upon the exercise of nonqualified stock options granted to non-employee directors under the 1999 Outside Directors Stock Option Plan (“1999 Directors Stock Plan”).
- *1997 ITT Educational Services, Inc. Incentive Stock Plan* – A maximum of 8,100,000 shares of our common stock were available to be issued upon the exercise of stock options and pursuant to other forms of awards under the 1997 ITT Educational Services, Inc. Incentive Stock Plan (“1997 Stock Plan”), but no more than 20% of the total number of shares on a cumulative basis could have been used for restricted stock or performance share awards. A maximum of 1.5% of our outstanding shares of common stock could have been issued annually, with any unissued shares available to be issued in later years.

No additional awards have been or will be granted after May 9, 2006 under the 1999 Directors Stock Plan or the 1997 Stock Plan.

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

	Year Ended December 31,		
	2012	2011	2010
Stock-based compensation expense	\$16,658	\$17,074	\$15,813
Income tax (benefit)	(\$6,414)	(\$6,574)	(\$6,089)

We did not capitalize any stock-based compensation cost in the years ended December 31, 2012, 2011 and 2010.

As of December 31, 2012, we estimated that pre-tax compensation expense for unvested stock-based compensation grants in the amount of approximately \$19,300, 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 1.8 years.

Stock Options. Under the Plans, the stock option exercise price may not be less than 100% of the fair market value of our common stock on the date of grant. The maximum term of any stock option granted under the 2006 Equity Compensation Plan may not exceed seven years from the date of grant, and those stock options will be exercisable at such times and under conditions as determined by the Compensation Committee of our Board of Directors, subject to the limitations contained in the plan.

Under the 1999 Directors Stock Plan, the stock options granted typically vested and became exercisable on the first anniversary of the grant. The maximum term of any stock option granted under the 1999 Directors Stock Plan was: (a) 10 years from the date of grant for any stock options granted prior to January 25, 2005; and (b) seven years from the date of grant for any stock options granted on or after January 25, 2005.

Under the 1997 Stock Plan, the stock options granted typically vested and became exercisable in three equal annual installments commencing with the first anniversary of the date of grant. The maximum term of any stock option granted under the 1997 Stock Plan was 10 years and two days from the date of grant.

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

Year Ended December 31, 2012

	# of Shares	Weighted Average Exercise Price	Aggregate Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value ⁽¹⁾
Outstanding at beginning of period	1,765,881	\$79.24	\$139,922		
Granted	156,500	\$75.16	11,763		
Forfeited	(13,334)	\$90.52	(1,207)		
Exercised	(202,820)	\$41.14	(8,345)		
Expired	(131,623)	\$64.14	(8,442)		
Outstanding at end of period	1,574,604	\$84.90	\$133,691	3.1 years	\$0
Exercisable at end of period	1,223,431	\$85.19	\$104,220	2.6 years	\$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 December 31, 2012 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:

Year Ended December 31,

	2012	2011	2010
Shares subject to stock options granted	156,500	159,500	305,000
Weighted average grant date fair value	\$31.36	\$28.90	\$43.59
Shares subject to stock options exercised	202,820	118,410	179,079
Intrinsic value of stock options exercised	\$4,802	\$3,095	\$8,920
Proceeds received from stock options exercised	\$8,345	\$5,599	\$7,893
Tax benefits realized from stock options exercised	\$1,602	\$1,190	\$3,385

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:

Year Ended December 31,

	2012	2011	2010
Risk-free interest rates	0.7%	1.8%	2.2%
Expected lives (in years)	4.5	4.7	4.6
Volatility	51%	48%	43%
Dividend yield	None	None	None

Restricted Stock Units. Under the 2006 Equity Compensation Plan, RSUs awarded are subject to a restriction period of at least: (a) for awards made prior to November 24, 2010, three years in the case of a time-based period of restriction and one year in the case of a performance-based period of restriction; and (b) for awards made after November 24, 2010, one year. All RSUs awarded under the 2006 Equity Compensation Plan that were not vested as of December 31, 2012 have a time-based restriction period that ranges from ending on the first to the third anniversary of the date of grant.

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

	<u>Year Ended December 31, 2012</u>	
	<u># of RSUs</u>	<u>Weighted Average Grant Date Fair Value</u>
Unvested at beginning of period	314,006	\$79.44
Granted	275,256	\$73.87
Forfeited	(57,791)	\$75.58
Vested	(117,826)	\$82.67
Unvested at end of period	<u>413,645</u>	<u>\$75.35</u>

In the year ended December 31, 2012:

- 48,935 RSUs vested and were settled in cash for \$3,073; and
- 68,891 RSUs vested and were settled in shares of our common stock having a fair market value of \$4,568.

The total fair market value of the RSUs that vested and were settled in shares of our common stock was \$2,454 in the year ended December 31, 2011 and \$3,593 in the year ended December 31, 2010.

5. Stock Repurchases

As of December 31, 2012, 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:

	<u>Year Ended December 31,</u>	
	<u>2012</u>	<u>2011</u>
Number of shares	3,025,700	4,040,000
Total cost	\$207,918	\$282,701
Average cost per share	\$68.72	\$69.98

6. 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:

	<u>Year Ended December 31,</u>		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
	<u>(In thousands)</u>		
Shares:			
Weighted average number of shares of common stock outstanding	23,880	27,429	33,165
Shares assumed issued (less shares assumed purchased for treasury) for stock-based compensation	119	226	336
Outstanding shares for diluted earnings per share calculation	<u>23,999</u>	<u>27,655</u>	<u>33,501</u>

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A total of approximately 1,688,000 shares for fiscal year 2012, approximately 1,113,000 shares for fiscal year 2011 and approximately 788,000 shares for fiscal year 2010 were excluded from the calculation of our diluted earnings per common share, because the effect was anti-dilutive.

7. Debt

We were a party to a Second Amended and Restated Credit Agreement dated as of January 11, 2010, as amended (the "Prior Credit Agreement"), to borrow up to \$150,000 under two revolving credit facilities: one in the maximum principal amount of \$50,000; and the other in the maximum principal amount of \$100,000. The borrowings under each credit facility could have been secured or unsecured at our election, provided that we had not defaulted under the Prior Credit Agreement.

Borrowings under the Prior Credit Agreement bore interest, at our option, at the London Interbank Offered Rate ("LIBOR") plus an applicable margin or at an alternative based rate, as defined under the Prior Credit Agreement. We paid a facility fee equal to 0.25% per annum on the daily amount of the commitment (whether used or unused) under the Prior Credit Agreement.

On March 21, 2012, we entered into a credit agreement (the "New Credit Agreement") that provides for a \$325,000 senior revolving credit facility (the "Revolver"). The New 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 New Credit Agreement are not under any obligation to provide any such additional revolving commitments or term loan commitments. The New 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 the Prior Credit Agreement. The Prior Credit Agreement was also terminated on March 21, 2012. In addition to the prepayment of the outstanding indebtedness under the Prior Credit Agreement, borrowings under the New Credit Agreement will be used for general corporate purposes.

Borrowings under the New Credit Agreement bear interest, at our option, at LIBOR plus an applicable margin or at an alternative base rate, as defined under the New 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 New Credit Agreement and which primarily includes outstanding borrowings, reserves for our guarantee obligations, letters of credit and surety bonds) to EBITDA (as defined in the New 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 New Credit Agreement. The amount of the commitment fee is determined based on the Leverage Ratio as of the end of each fiscal quarter.

The New Credit Agreement contains, among other things, covenants, representations and warranties and events of default customary for credit facilities. The New 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 December 31, 2012.

As of December 31, 2012, the borrowings under the New Credit Agreement totaled \$140,000. The effective interest rate on our borrowings was approximately 2.40% per annum in the year ended December 31, 2012, approximately 1.20% per annum in the year ended December 31, 2011 and approximately 1.30% per annum in the year ended December 31, 2010. The commitment fee under the New Credit Agreement was 0.35% as of December 31, 2012.

We recognized interest expense on our borrowings of \$3,303 in the year ended December 31, 2012, \$1,825 in the year ended December 31, 2011 and \$1,912 in the year ended December 31, 2010.

8. Financial Aid Programs

We participate in various Title IV Programs of the HEA. In 2012, approximately 80% of our revenue determined on a cash accounting basis under the calculation of the provision of the HEA commonly referred to as the "90/10 Rule" was from funds distributed under these programs.

We administer the Title IV Programs in separate accounts as required by government regulation. We are required to administer the funds in accordance with the requirements of the HEA and the ED's regulations and must use due diligence in approving and disbursing funds and servicing loans. In the event we do not comply with federal requirements, or if student loan default rates rise to a level considered excessive by the federal government, we could

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lose our eligibility to participate in Title IV Programs or could be required to repay funds determined to have been improperly disbursed. Our management believes that we are in substantial compliance with the federal requirements.

9. Investments

Our available-for-sale investments were classified as short-term investments on our December 31, 2012 and 2011 Consolidated Balance Sheets. The following table sets forth the aggregate fair value, amortized cost basis and the net unrealized gains and losses included in accumulated other comprehensive income (loss) of our available-for-sale investments as of the dates indicated:

	As of:					
	December 31, 2012			December 31, 2011		
	Aggregate Fair Value	Amortized Cost	Net Unrealized Gains (Losses)	Aggregate Fair Value	Amortized Cost	Net Unrealized Gains (Losses)
Available-for-Sale Investments:						
U.S. Treasury obligations	\$0	\$0	\$0	\$100,517	\$100,480	\$37
Government agency obligations	0	0	0	31,351	31,354	(3)
Corporate obligations	0	0	0	16,620	16,633	(13)
	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>	<u>\$148,488</u>	<u>\$148,467</u>	<u>\$21</u>

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

	Year Ended December 31,		
	2012	2011	2010
Realized net gains on the sale of investments	\$40	\$325	\$96
Interest income on investments	292	414	731
Total investment income	<u>\$332</u>	<u>\$739</u>	<u>\$827</u>

10. Property and Equipment

The following table sets forth our property and equipment, net, as of the dates indicated:

	As of December 31,	
	2012	2011
Furniture and equipment	\$171,534	\$167,743
Buildings and building improvements	134,303	131,243
Land and land improvements	39,609	39,609
Leasehold improvements	21,447	18,055
Software	8,620	8,620
Construction in progress	1,177	6,000
	<u>\$376,690</u>	<u>\$371,270</u>
Less: Accumulated depreciation and amortization	(186,800)	(170,013)
Property and equipment, net	<u>\$189,890</u>	<u>\$201,257</u>

Software includes purchased and internally developed software.

The following table sets forth the depreciation and amortization expense for the assets listed above in the periods indicated:

	Year Ended December 31,		
	2012	2011	2010
Depreciation and amortization expense	\$29,320	\$27,856	\$26,764

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11. 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 Consolidated Balance Sheets. The discount is amortized and recognized in Interest income on our Consolidated Statements of Income over the term of the Subordinated Note. The maturity date of the Subordinated Note is in March 2026. The face value of the Subordinated Note was approximately \$73,000 as of December 31, 2012 and approximately \$78,000 as of December 31, 2011.

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 December 31, 2012, the value of the assets of the PEAKS Trust satisfied this requirement.

We guarantee payment of the principal, interest and certain call premiums 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”). No call premiums are due on the PEAKS Senior Debt after January 2013. We made guarantee and other payments related to the PEAKS Program to the PEAKS Trust of \$15,104 in the year ended December 31, 2012, of which approximately \$14,600 was made in the three months ended December 31, 2012. See Note 14 – Commitments and 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 fiscal year ended December 31, 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 December 31, 2012 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.

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.

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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 consolidated financial statements for the fiscal year ended December 31, 2012. 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 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 represent 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 paid \$1,756 in guarantee obligations, net of recoveries, related to the 2009 RSA in the year ended December 31, 2012. See Note 14 – Commitments and Contingencies, for further discussion of the 2009 RSA.

In addition, we have made advances to the 2009 Entity under a revolving promissory note (the “Revolving Note”). We did not make any advances in the fiscal year ended December 31, 2012 to the 2009 Entity under the Revolving Note that we were not contractually required to make. We made advances of approximately \$550 in the fiscal year ended December 31, 2011 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 may be repaid at any time without penalty prior to its 2026 maturity date. The amount owed to us under the Revolving Note was approximately \$8,300 as of December 31, 2012 and approximately \$9,300 as of December 31, 2011.

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, but we may decide to do so in the foreseeable future.

The 2009 Entity is a variable interest entity as defined under ASC 810. We held variable interests in the 2009 Entity as of December 31, 2012 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.

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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 consolidated financial statements for the fiscal year ended December 31, 2012. 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 consolidated financial statements.

We evaluate the Subordinated Note and the Revolving Note individually for impairment when circumstances indicate that their carrying values may not be recoverable. We consider a note to be impaired when, based on current information or events, it is probable that we will be unable to collect all amounts of principal and interest owed on the note according to the terms of the note. The accrual of interest (or 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 determined the amount of impairment with respect to the Subordinated Note and the Revolving Note by computing the present value of the expected future cash flows (discounted at the note's effective interest rate) and comparing the result to the carrying value of the note. We recorded an impairment charge in the aggregate amount of \$15,200 with respect to the Subordinated Note and the Revolving Note in the three months ended December 31, 2012, which equaled the amount that the carrying value of those notes exceeded the present value of the expected future cash flows from those notes. The aggregate carrying value of the Subordinated Note and Revolving Note prior to recording the impairment charge was approximately \$18,100. The aggregate carrying value of the Subordinated Note and the Revolving Note was approximately \$2,900 as of December 31, 2012 and is included in Other assets on our Consolidated Balance Sheet. We did not recognize any interest income related to the Subordinated Note or the Revolving Note in our Consolidated Statements of Income during the time that the Subordinated Note and the Revolving Note were impaired.

12. Income Taxes

The following table sets forth the components of the provision for income taxes in the periods indicated:

	Year Ended December 31,		
	2012	2011	2010
Current income tax expense:			
U.S. federal	\$126,585	\$174,264	\$216,839
State and local	22,004	35,128	37,687
Total	\$148,589	\$209,392	\$254,526
Deferred income tax (benefit):			
U.S. federal	(\$50,214)	(\$7,564)	(\$12,244)
State and local	(8,426)	(1,427)	(2,313)
Total	(\$58,640)	(\$8,991)	(\$14,557)
Total provision for income taxes	\$89,949	\$200,401	\$239,969

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The following table sets forth the components of our deferred income tax assets (liabilities) as of the dates indicated:

	As of December 31,	
	2012	2011
Deferral of book costs	(\$1,810)	(\$1,934)
Property and equipment	(6,416)	(9,742)
Pension	(2,712)	(1,674)
Other	(2,308)	(2,159)
Gross deferred tax (liabilities)	<u>(\$13,246)</u>	<u>(\$15,509)</u>
Deferred revenue	\$14,687	\$5,400
Accounts receivable	6,073	3,581
Legal accrual	2,018	1,980
Compensation and benefits	1,643	1,316
Stock-based compensation	22,680	20,255
Operating leases	735	724
Legal settlement accrual	17,834	0
Other assets	18,772	11,575
Other contingent liabilities	29,463	13,704
Gross deferred tax assets	<u>\$113,905</u>	<u>\$58,535</u>
Net deferred income tax asset	<u>\$100,659</u>	<u>\$43,026</u>

The difference between the U.S. federal statutory income tax rate and our effective income tax rate as a percentage of income in the periods indicated is reconciled in the following table:

	Year Ended December 31,		
	2012	2011	2010
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	3.4%	4.0%	3.6%
Other	0.6%	0.4%	0.5%
Effective income tax rate	<u>39.0%</u>	<u>39.4%</u>	<u>39.1%</u>

The following table sets forth the activity with respect to our unrecognized tax benefits in the period indicated:

	Year Ended December 31,		
	2012	2011	2010
Balance as of January 1	\$22,050	\$22,888	\$13,274
Increases (decreases) from:			
Tax positions taken during a prior period	195	1,042	522
Tax positions taken during the current period	759	2,434	9,461
Settlements with taxing authorities	(1,027)	(2,487)	(78)
Lapse of statute of limitations	(1,287)	(1,827)	(291)
Balance as of December 31	<u>\$20,690</u>	<u>\$22,050</u>	<u>\$22,888</u>

The amount of unrecognized tax benefits that, if recognized, would have affected our effective tax rate as of December 31, 2012 was \$9,649. We do not expect the amount of our unrecognized tax benefits to significantly increase or decrease during the next 12 months. The amount of interest and penalties related to unrecognized tax benefits accrued on our Consolidated Balance Sheets was \$5,699 as of December 31, 2012 and \$5,177 as of December 31, 2011. In each of the years ended December 31, 2012, 2011 and 2010, the amount of interest expense and penalties related to our unrecognized tax benefits that we recognized in our Consolidated Statements of Income was not material.

We file income tax returns in the United States (federal) and in various state and local jurisdictions. As of December 31, 2012, we were no longer subject to federal, state or local income tax examinations for tax years prior to 2009, except in nine states where we are still subject to income tax examinations for tax year 2008 and one state where we are still subject to income tax examination for the tax years 2005 through 2007.

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13. Employee Benefit Plans

Employee Pension Benefits. Our ESI Pension Plan, a non-contributory defined benefit pension plan, commonly referred to as a cash balance plan, covers substantially all of our employees who began their employment with us prior to June 2, 2003. This plan provides benefits based on an employee's annual earnings times an established percentage of pay determined by the employee's age and years of benefit service. Effective June 2, 2003, we closed participation in the ESI Pension Plan to all new employees. Employees who begin their employment with us on or after June 2, 2003 do not participate in the ESI Pension Plan.

Our ESI Excess Pension Plan, a nonqualified, unfunded retirement plan, covers a select group of our management. The purpose of the ESI Excess Pension Plan is to restore benefits earned, but not available, to eligible employees under the ESI Pension Plan due to federal statutory limitations on the amount of benefits that can be paid and compensation that may be recognized under a tax-qualified retirement plan.

The benefit accruals under the ESI Pension Plan and the ESI Excess Pension Plan for all participants in those plans were frozen effective March 31, 2006, such that no further benefits accrue under those plans after March 31, 2006. Participants in those plans, however, continue to be credited with vesting service and interest according to the terms of the ESI Pension Plan and the ESI Excess Pension Plan.

Effective January 1, 2011, we changed the rates at which interest is credited under the ESI Pension Plan and ESI Excess Pension Plan. This change resulted in the recognition of \$10,370 of prior service credits in other comprehensive income in the year ended December 31, 2010.

The information presented below is based on an actuarial valuation date as of December 31 for 2012 and 2011.

The following table sets forth the change in projected benefit obligation for the periods indicated:

	Year Ended December 31,	
	2012	2011
Projected benefit obligation at beginning of year	\$54,485	\$49,878
Service cost	0	0
Actuarial loss	3,180	5,215
Interest cost	2,062	2,405
Benefits paid	(2,481)	(3,013)
Plan amendments	0	0
Projected benefit obligation at end of year	\$57,246	\$54,485
Fair value of plan assets at end of year	64,390	58,839
Funded status at end of year	\$7,144	\$4,354

Our accumulated benefit obligation was \$57,246 at December 31, 2012 and \$54,485 at December 31, 2011.

The following table sets forth the funded status of our defined benefit plans that was recognized on our Consolidated Balance Sheets as of the dates indicated:

	As of December 31,	
	2012	2011
Non-current assets	\$7,459	\$4,641
Non-current (liabilities)	(315)	(287)
Total	\$7,144	\$4,354

The weighted-average assumptions used to determine benefit obligations as of December 31, 2012 and 2011 are as follows:

	2012	2011
Discount rate	3.25%	4.00%
Rate of compensation increase	N/A	N/A

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The following table sets forth the change in plan assets for the periods indicated:

	Year Ended December 31,	
	2012	2011
Fair value of plan assets at beginning of year	\$58,839	\$61,385
Actual return on plan assets	8,032	467
Employer contributions	0	0
Benefits paid	(2,481)	(3,013)
Fair value of plan assets at end of year	<u>\$64,390</u>	<u>\$58,839</u>

The following tables set forth the fair value of total plan assets by major asset category as of the dates indicated:

Asset Category	Total	Fair Value Measurements as of December 31, 2012		
		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Cash and cash equivalents	\$1,078	\$1,078	\$0	\$0
Fixed income securities (a)	17,318	17,318	0	0
Equity securities:				
Domestic large cap	29,594	29,594	0	0
Mid cap value/growth (a)	9,090	9,090	0	0
Small cap value/growth (a)	5,137	5,137	0	0
Foreign equities	2,173	2,173	0	0
Total	<u>\$64,390</u>	<u>\$64,390</u>	<u>\$0</u>	<u>\$0</u>

(a) Mutual funds.

Asset Category	Total	Fair Value Measurements as of December 31, 2011		
		(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Cash and cash equivalents	\$573	\$573	\$0	\$0
Fixed income securities (a)	19,000	19,000	0	0
Equity securities:				
Domestic large cap	25,424	25,424	0	0
Mid cap value/growth (a)	7,744	7,744	0	0
Small cap value/growth (a)	4,343	4,343	0	0
Foreign equities	1,755	1,755	0	0
Total	<u>\$58,839</u>	<u>\$58,839</u>	<u>\$0</u>	<u>\$0</u>

(a) Mutual funds.

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

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The following table sets forth the amounts in Accumulated other comprehensive loss on our Consolidated Balance Sheets that have not been recognized as components of net periodic benefit cost as of the dates indicated.

	As of December 31,	
	2012	2011
Net actuarial (loss)	(\$20,191)	(\$24,322)
Prior service credit	7,133	8,688
Total accumulated other comprehensive (loss)	(\$13,058)	(\$15,634)
Income tax benefit	5,128	6,134
Total accumulated other comprehensive (loss), net of tax	(\$7,930)	(\$9,500)

The following table sets forth the components of net periodic pension (benefit) cost in the periods indicated:

	Year Ended December 31,		
	2012	2011	2010
Interest cost	\$2,062	\$2,405	\$3,048
Expected return on assets	(4,231)	(4,756)	(4,401)
Recognized net actuarial loss	2,718	1,803	1,917
Amortization of prior service (credit) cost	(1,555)	(1,555)	28
Settlement loss	792	1,204	0
Total net periodic pension (benefit) cost	(\$214)	(\$899)	\$592

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 cost or benefit.

The following table sets forth the amounts related to changes in plan assets and projected benefit obligations that were recognized in other comprehensive (income) loss in the periods indicated:

	Year Ended December 31,		
	2012	2011	2010
Net actuarial (gain) loss	(\$621)	\$9,504	\$3,328
Amortization of net actuarial loss	(2,718)	(1,803)	(1,917)
Prior service cost (credit)	0	0	(10,370)
Amortization of prior service cost (credit)	1,555	1,555	(28)
Settlement	(792)	(1,204)	0
Other comprehensive (income) loss	(\$2,576)	\$8,052	(\$8,987)
Total recognized in net periodic pension (benefit) cost and other comprehensive (income) loss	(\$2,790)	\$7,153	(\$8,395)

The amortization of any prior service cost is determined using a straight-line amortization of the cost over the average remaining service period for employees expected to receive benefits under the pension plans. The estimated net actuarial loss that is expected to be amortized from accumulated other comprehensive loss and recognized in net periodic pension cost for the year ended December 31, 2013 is \$2,176 and the estimated prior service credit that is expected to be amortized from accumulated other comprehensive loss and recognized in net periodic pension benefit for the year ended December 31, 2013 is \$1,555.

The weighted-average assumptions used to determine net periodic pension cost in the years ended December 31, 2012, 2011 and 2010 are as follows:

	2012	2011	2010
Discount rate	4.00%	5.00%	5.50%
Expected long-term return on plan assets	7.50%	8.00%	8.00%
Rate of compensation increase	N/A	N/A	N/A

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The following table sets forth the benefit payments that we expect to pay from the pension plans in the periods indicated:

<u>Year</u>	<u>Amount</u>
Fiscal 2013	\$3,479
Fiscal 2014	\$3,684
Fiscal 2015	\$3,587
Fiscal 2016	\$4,452
Fiscal 2017	\$4,292
Fiscal 2018 – 2022	\$17,609

We invest plan assets based on a total return on investment approach, pursuant to which the plan assets include a diversified blend of equity and fixed income investments toward a goal of maximizing the long-term rate of return without assuming an unreasonable level of investment risk. We determine the level of risk based on an analysis of plan liabilities, the extent to which the value of the plan assets satisfies the plan liabilities and our financial condition. Our investment policy includes target allocations ranging from 30% to 70% for equity investments, 20% to 60% for fixed income investments and 0% to 50% for cash equivalents. The equity portion of the plan assets represents growth and value stocks of small, medium and large companies. We measure and monitor the investment risk of the plan assets both on a quarterly basis and annually when we assess plan liabilities.

We use a building block approach to estimate the long-term rate of return on plan assets. This approach is based on the capital market principle that the greater the volatility, the greater the return over the long term. An analysis of the historical performance of equity and fixed income investments, together with current market factors such as the inflation and interest rates, are used to help us make the assumptions necessary to estimate a long-term rate of return on plan assets. Once this estimate is made, we review the portfolio of plan assets and make adjustments thereto that we believe are necessary to reflect a diversified blend of equity and fixed income investments that is capable of achieving the estimated long-term rate of return without assuming an unreasonable level of investment risk. We also compare the portfolio of plan assets to those of other pension plans to help us assess the suitability and appropriateness of the plan investments.

We determine our discount rate by performing a yield curve analysis based on a portfolio of high-quality fixed income investments with various maturities. Our expected future benefit payments are discounted to their present value at the appropriate yield curve rate to generate the overall discount rate for pension obligations.

In 2012 and 2011, we made no contributions to the ESI Excess Pension Plan or the ESI Pension Plan. We do not expect to make any contributions to either the ESI Pension Plan or the ESI Excess Pension Plan in 2013.

Retirement Savings Plan. Our ESI 401(k) Plan, a defined contribution plan, covers substantially all of our employees. All of our contributions under the ESI 401(k) Plan are in the form of cash to plan investment options directed by the participant.

Our ESI Excess Savings Plan, a nonqualified, unfunded deferred compensation plan, covers a select group of our management. The plan provided for salary deferral of contributions that the participants were unable to make under the ESI 401(k) Plan and our contributions that could not be paid under the ESI 401(k) Plan due to federal statutory limits on the amount that an employee could contribute under a defined contribution plan. Effective for plan years beginning on and after January 1, 2008, we froze the ESI Excess Savings Plan, such that employees may no longer make salary deferrals and we will no longer make contributions under the ESI Excess Savings Plan. Amounts previously credited to an employee under the ESI Excess Savings Plan will, however, continue to accrue interest in accordance with the terms of the ESI Excess Savings Plan until those amounts are distributed pursuant to the plan's terms.

The costs of providing the benefits under the ESI 401(k) Plan and ESI Excess Savings Plan (including certain administrative costs of the plans) were:

- \$4,597 in the year ended December 31, 2012;
- \$5,308 in the year ended December 31, 2011; and
- \$5,063 in the year ended December 31, 2010.

14. Commitments and 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 December 31, 2012, the total face amount of those surety bonds was approximately \$27,300.

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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 December 31, 2012, our recorded liability for these claims and contingencies was \$123,439, the substantial majority of which pertained to our guarantee obligations under the 2009 RSA and PEAKS Program (collectively, the “RSAs”) and \$46,000 of which pertained to the settlement of our guarantee obligations under the Risk Sharing Loan Program Agreement between Sallie Mae, Inc. (“SMI”) and us dated July 17, 2007 (the “2007 RSA”). As of December 31, 2012, \$66,205 of the recorded liability was included in Other current liabilities and \$57,234 was included in Other liabilities on our Consolidated Balance Sheet.

The Other current liabilities balance of \$66,205 as of December 31, 2012 included \$46,000 that we paid in January 2013 to dismiss the lawsuit filed against us in the Circuit Court of Fairfax County, Virginia under the following caption: *Sallie Mae, Inc. v. ITT Educational Services, Inc.* (the “SLM Litigation”) and absolve us from any further obligations with respect to our guarantee under the 2007 RSA. See “—Litigation” below. The \$57,234 included in Other liabilities as of December 31, 2012 represents our estimate of the amount that we believe we will pay over the next seven to ten years for our estimated guarantee obligations under the RSAs.

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

	Year Ended December 31,	
	2012	2011
Balance as of January 1	\$36,028	\$12,905
Increases (decreases) from:		
Additional reserves	97,618	23,500
Payments, net	(16,875)	(377)
Estimated recovery	6,668	0
Balance as of December 31	<u>\$123,439</u>	<u>\$36,028</u>

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 may 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 \$12,000 less than to \$40,000 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:

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- 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 July 27, 2011, a complaint in a breach of contract lawsuit was filed against us in the SLM Litigation. On April 13, 2012, an amended complaint was filed in the SLM Litigation. On October 24, 2012, a second amended complaint was filed in the SLM Litigation. The second amended complaint alleged, among other things, that we breached the terms of the 2007 RSA by failing to pay SMI all amounts owed by us under the 2007 RSA. The second amended complaint sought:

- \$25,888;
- pre- and post-judgment interest;
- attorney's fees; and
- such other amounts that may have come due under the 2007 RSA during the pendency of the lawsuit.

On December 28, 2012, we agreed to pay SMI \$46,000 to dismiss the SLM Litigation and absolve us from any further obligations with respect to our guaranty under the 2007 RSA. We paid this amount in January 2013, and the SLM Litigation was dismissed with prejudice on February 1, 2013.

On November 3, 2010, 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: *Operating Engineers Construction Industry and Miscellaneous Pension Fund, Individually and On Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* (the "Securities Litigation"). On January 21, 2011, the court named the Wyoming Retirement System as the lead plaintiff in the Securities Litigation. On April 1, 2011, an amended complaint was filed in the Securities Litigation under the following caption: *In re ITT Educational Services, Inc. Securities and Shareholder Derivative Litigation.* The amended complaint alleged, among other things, that:

- the defendants violated Section 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by creating and implementing a systemically predatory business model that operated as a fraud or deceit on purchasers of our common stock during the class period by misrepresenting our financials and future business prospects;
- the defendants' misrepresentations and material omissions caused our common stock to trade at artificially inflated prices throughout the class period; and
- the market's expectations were ultimately corrected on August 13, 2010 when the ED published the loan repayment rate of our students under a formula contained in proposed regulations published by the ED on July 26, 2010.

The putative class period in this action was from October 23, 2008 through August 13, 2010. The plaintiff sought, among other things, the designation of this action as a class action, and an award of unspecified compensatory damages, interest, costs, expenses, attorneys' fees and expert fees.

On November 12, 2010, a complaint in a shareholder derivative lawsuit was filed against three of our current executive officers, eight of our current Directors and one of our former Directors in the United States District Court for the Southern District of New York under the following caption: *Antonio Cosing, Derivatively and On Behalf of ITT Educational Services, Inc. v. Kevin M. Modany, et al.* (the "Cosing Lawsuit"). The complaint alleged, among other things, that from October 23, 2008 through August 13, 2010, the defendants breached their fiduciary duties to us, abused their ability to control and influence us, grossly mismanaged us, caused us to waste corporate assets and were unjustly enriched, by making false and misleading statements and engaging in fraudulent business practices. The complaint sought, among other things, unspecified damages, equitable and/or injunctive relief, restitution, disgorgement of profits,

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

benefits and other compensation, an order directing us to reform our corporate governance and internal procedures, costs, disbursements and attorneys' fees. On December 14, 2010, the Cosing Lawsuit was consolidated into the Securities Litigation.

On December 3, 2010, another complaint in a shareholder derivative lawsuit was filed against two of our current executive officers, eight of our current Directors and one of our former Directors in the United States District Court for the Southern District of New York under the following caption: *J. Kent Gregory, derivatively on behalf of ITT Educational Services, Inc. v. Kevin M. Modany, et al.* (the "Gregory Lawsuit"). The complaint alleged, among other things, that the defendants breached their fiduciary duties to us, were unjustly enriched by us and misappropriated information about us, by making false and misleading statements and engaging in fraudulent business practices. The complaint sought, among other things, unspecified damages, restitution, disgorgement of profits, benefits and other compensation, an order directing us to reform our corporate governance and internal procedures, costs, disbursements and attorneys' fees. The Gregory Lawsuit was consolidated into the Cosing lawsuit on December 13, 2010 and further consolidated into the Securities Litigation on December 14, 2010.

On March 30, 2012, all of the claims alleged in the Securities Litigation were dismissed with prejudice, including the claims in the Cosing Lawsuit and Gregory Lawsuit.

On November 22, 2010, another complaint in a shareholder derivative lawsuit was filed against seven of our current and former officers, eight of our current Directors and one of our former Directors in the United States District Court for the Southern District of Indiana under the following caption: *Roger B. Orensteen, derivatively on behalf of ITT Educational Services, Inc. v. Kevin M. Modany, et al.* (the "Orensteen Lawsuit"). The complaint alleged, among other things, that, from January 2008 through August 2010, the defendants violated Sections 10(b) and 20(a) of the Exchange Act, breached their fiduciary duties to us, abused their ability to control and influence us, grossly mismanaged us, caused us to waste corporate assets and were unjustly enriched, by making false and misleading statements and engaging in fraudulent business practices. The complaint sought, among other things, unspecified damages, restitution, disgorgement of profits, benefits and other compensation, an order directing us to reform our corporate governance and internal procedures, costs, disbursements and attorneys' fees. On June 27, 2012, the Orensteen Lawsuit was dismissed without prejudice.

There can be no assurance that the ultimate outcome of derivative actions, federal or state securities law claims or other actions would not have a material adverse effect on our financial condition, results of operations or cash flows.

Lease Commitments. We lease 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 we expect 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 operating lease terms for taxes, insurance and other operating expenses incurred during the operating lease period.

Rent expense under our operating leases was:

- \$50,817 in the year ended December 31, 2012;
- \$47,833 in the year ended December 31, 2011; and
- \$43,777 in the year ended December 31, 2010.

Future minimum rental payments required under our operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31, 2012 are as follows:

2013	\$48,323
2014	44,781
2015	33,695
2016	20,894
2017	11,667
2018 and thereafter	10,046
	<u>\$169,406</u>

ITT Educational Services, Inc.
Notes to Consolidated Financial Statements, continued
December 31, 2012

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

Future minimum rental payments related to equipment leases are not significant.

Guarantees. We entered into the PEAKS Guarantee in connection with the PEAKS Program. Under the PEAKS Guarantee, we guarantee payment of the principal, interest and certain call premiums 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. No call premiums are due on the PEAKS Senior Debt after January 2013. 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 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 the PEAKS Guarantee to the extent that funds are remaining in the PEAKS Trust.

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

- up to \$270,500 in principal of PEAKS Senior Debt, which was the approximate outstanding principal balance of the PEAKS Senior Debt as of December 31, 2012;
- accrued interest on the PEAKS Senior Debt;
- certain call premiums associated with the PEAKS Senior Debt (which are no longer in effect after January 2013);
- 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 the private education loans disbursed to our students under the 2009 Loan Program. As of December 31, 2012, the total collateral maintained in a restricted bank account was not material. This amount is included in Other assets on our Consolidated Balance Sheet as of December 31, 2012. The 2009 RSA

ITT Educational Services, Inc.
Notes to Consolidated Financial Statements, continued
December 31, 2012

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

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 December 31, 2012.

We entered into the 2007 RSA with a different lender for certain private education loans that were made to our students in 2007 and early 2008. We guaranteed the repayment of any private education loans that the lender charges off above a certain percentage of the total dollar volume of private education loans made under the 2007 RSA. The 2007 RSA was terminated effective February 22, 2008, such that no private education loans have been or will be made under the 2007 RSA after that date. Based on information that we received from the lender, we believe that the total original principal amount of private education loans made under the 2007 RSA, net of amounts refunded under those loans, was approximately \$180,000. On December 28, 2012, we agreed to pay \$46,000 to the lender to absolve us from any further obligations with respect to our guarantee obligations under the 2007 RSA. We paid this amount in January 2013.

In the year ended December 31, 2012, we made guarantee and other payments, net of recoveries, of approximately \$16,900 related to the RSAs. 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 Consolidated Balance Sheets.

15. Percentage of Revenues Derived by Title IV Programs

We participate in various federal student financial aid programs under Title IV Programs. In accordance with the regulatory provisions, we are required to disclose in the footnotes the percentage of revenues derived by Title IV Programs, including the figures used to calculate that percentage. Management is responsible for our compliance with those requirements. We calculated each of our institutes (which includes the main campus and its related additional locations) for 2012 on a cash basis in accordance with the regulations as follows:

(\$ in thousands)

	00732900	03071800	00473100	
	Indianapolis	Spokane	Daniel Webster College	TOTAL
Adjusted Student Title IV Revenue				
Subsidized Loan	\$ 308,564	\$ 5,475	\$ 3,850	\$ 317,889
Unsubsidized Loan	422,390	6,963	143	429,496
Plus Loan	44,817	792	3,273	48,882
Federal Pell Grant	308,794	5,819	812	315,425
FSEOG	667	-	54	721
ACG	(4)	4	-	-
Smart	(25)	25	-	-
Student Title IV Revenue	1,085,203	19,078	8,132	1,112,413
Revenue Adjustment	(232,247)	(4,133)	(1,388)	(237,768)
Adjusted Student Title IV Revenue	\$ 852,956	\$ 14,945	\$ 6,744	\$ 874,645
Student Non-Title IV Revenue				
Grant funds for the student from non-federal public agencies or private sources independent of the institution	\$ -	\$ -	\$ -	\$ -
Funds provided for the student under a contractual arrangement with a government agency for the purpose of providing job training	-	-	-	-
Student payments	218,940	7,774	4,600	231,314
Student Non-Title IV Revenue	\$ 218,940	\$ 7,774	\$ 4,600	\$ 231,314
Revenue from Other Sources (Total for the Fiscal Year)				
Activities conducted by the Institution that are necessary for education and training	\$ -	\$ -	\$ -	\$ -
Funds paid to the Institution by, or on behalf of, students for education and training in qualified non-Title IV eligible programs	-	-	-	-
Net present value of institutional loans disbursed to students	-	-	-	-
Total Revenue from Other Sources	\$ -	\$ -	\$ -	\$ -
Total Revenue (Adjusted Student Title IV Revenue + Adjusted Non-Title IV Revenue + Total Revenue from Other Sources)	\$ 1,071,896	\$ 22,719	\$ 11,344	\$ 1,105,959
Title IV Revenue percentage	79.57%	65.78%	59.45%	79.08%

Management's Report on Internal Control Over Financial Reporting

We are responsible for establishing and maintaining adequate internal control over our financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act ("ICFR"). Our ICFR is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of our records that in reasonable detail accurately and fairly reflect our transactions and asset dispositions;
- provide reasonable assurance that our transactions are recorded as necessary to permit the preparation of our financial statements in accordance with generally accepted accounting principles;
- provide reasonable assurance that our receipts and expenditures are being made only in accordance with authorizations of our management and Board of Directors (as appropriate); and
- provide reasonable assurance regarding the prevention or timely detection of any unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Reasonable assurance, as defined in Section 13(b)(7) of the Exchange Act, is the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs in devising and maintaining a system of internal accounting controls.

Due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we assessed the effectiveness of our ICFR as of December 31, 2012. Our assessment included extensive documenting, evaluating and testing of the design and operating effectiveness of our ICFR. In making this assessment, our management used the criteria for *Internal Control-Integrated Framework* set forth by The Committee of Sponsoring Organizations of the Treadway Commission. These criteria are in the areas of control environment, risk assessment, control activities, information and communication, and monitoring. Based on our assessment using these criteria, our management concluded that we maintained effective ICFR as of December 31, 2012.

The effectiveness of our ICFR as of December 31, 2012 has been audited by PricewaterhouseCoopers LLP, our independent registered public accounting firm, as stated in its accompanying report.

**Schedule of Expenditures of State of Florida Financial Assistance
For the Year Ended December 31, 2012**

State Agency/ State Project	Catalog of State of Florida Financial Assistance Number	Grant Code	State of Florida Expenditures
Department of Education and Commissioner of Education			
Florida Student Assistance Grant	48.054	99970	\$ 993,199
Florida Bright Futures Scholarship Program*	48.059	97040	\$ 20,418
			<hr/>
Total Expenditures of State of Florida Financial Aid			\$ 1,013,617
			<hr/>

*Florida Bright Futures Scholarship Program includes the Florida Academic Scholars Award, Florida Medallion Scholars Award, and the Florida Gold Seal Vocational Scholars Award. There were no expenditures for the Florida Academic Scholars Award in 2012.

The accompanying note is an integral part of the schedule of expenditures.

**Note to Schedule of Expenditures of State of Florida Financial Assistance
For the Year Ended December 31, 2012**

1. Basis of Presentation

The accompanying Schedule of Expenditures of State of Florida Financial Assistance (the "Schedule") summarizes the expenditures of ITT Educational Services, Inc. (the "Company") under programs of the State of Florida for the year ended December 31, 2012 as required by Chapter 6A-20.0021, Florida Administrative Code. Because the Schedule presents only a selected portion of the operations of the Company, it is not intended to and does not present the financial position or results of operations of the Company. The Company schools that were recipients of the Financial Assistance during 2012 include the Tampa, Miami, Fort Lauderdale, Jacksonville, St. Petersburg, Fort Myers, Tallahassee, Lake Mary, Orlando, and Bradenton campuses. This schedule is prepared on the accrual basis of accounting.

For the purposes of the Schedule, state financial assistance includes all grants, contracts, and similar agreements entered into directly between the Company and agencies and departments of the State of Florida.



Report of Independent Registered Public Accounting Firm on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

To the Board of Directors of
ITT Educational Services, Inc.:

We have audited the consolidated financial statements of ITT Educational Services, Inc. (the "Company") as of and for the year ended December 31, 2012 and the effectiveness of the Company's internal control over financial reporting as of December 31, 2012 and have issued our report thereon dated February 22, 2013. We conducted our audit of the Company's financial statements and the effectiveness of the Company's internal control over financial reporting in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States) and in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Company's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Company's Board of Directors, management, the Florida Department of Education, and the Auditor General's Office and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

February 22, 2013



Report of Independent Registered Public Accounting Firm on Compliance For Each Major State of Florida Financial Assistance Program; Report on Internal Control Over Compliance; and Report on Schedule of Expenditures of State of Florida Financial Assistance

To the Board of Directors of
ITT Educational Services, Inc.:

Report on Compliance for Each State of Florida Program

We have audited ITT Educational Services, Inc.'s (the Company) compliance with the types of compliance requirements described in the Florida Single Audit Act State Projects Compliance Supplement that are applicable to each of its major State of Florida programs for the year ended December 31, 2012. The Company's major State of Florida programs under audit are identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs and Status of Prior Year Findings and Questioned Costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major state programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of the Company's major State of Florida programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and *Chapter 10.650, Rules of the State of Florida Auditor General*. Those standards and Chapter 10.650, *Rules of the State of Florida Auditor General* require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major state program occurred. An audit includes examining, on a test basis, evidence about the Company's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major State of Florida program. However, our audit does not provide a legal determination of the Company's compliance.

Basis for Qualified Opinion on the Florida Bright Futures Scholarship Program

As described in the accompanying Schedule of Findings and Questioned Costs, the Company did not comply with requirements regarding the Florida Bright Futures Scholarship Program (Catalog # 48.059) as described in finding numbers 12-4 and 12-6 for Calculation and number 12-5 for Eligibility. Compliance with such requirements is necessary, in our opinion, for the Company to comply with the requirements applicable to that program.

Qualified Opinion on the Florida Bright Futures Scholarship Program

In our opinion, except for the noncompliance described in the Basis for Qualified Opinion paragraph, the Company complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on the Florida Bright Futures Scholarship Program for the year ended December 31, 2012.



Unmodified Opinion on the Florida Student Assistance Grant

In our opinion, the Company complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on the Florida Student Assistance Grant (Catalog #48.054), as identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs for the year ended December 31, 2012.

Other Matters

The results of our auditing procedures disclosed other instances of noncompliance, which are required to be reported in accordance with *Chapter 10.650, Rules of the State of Florida Auditor General* and which are described in the accompanying Schedule of Findings and Questioned Costs as audit findings numbers 12-1 through 12-3 for the Florida Student Assistance Grant. Our opinion on this major State of Florida program is not modified with respect to these matters.

The Company's response to the noncompliance findings identified in our audit is described in the accompanying Schedule of Findings and Questioned Costs. The Company's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

Report on Internal Control Over Compliance

Management of the Company is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered the Company's internal control over compliance with the types of requirements that could have a direct and material effect on each major state program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major state program and to test and report on internal control over compliance in accordance with *Chapter 10.650, Rules of the State of Florida Auditor General*, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be material weaknesses.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a state program on a timely basis. *A material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a state program will not be prevented, or detected and corrected, on a timely basis. We consider the deficiencies in internal control over compliance described in the accompanying Schedule of Findings and Questioned Costs as items #12-4, #12-5 and #12-6 for the Florida Bright Futures Scholarship Program to be material weaknesses. We did not identify any material weaknesses for the Florida Student Assistance Grant program.

A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a state program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.



The Company's responses to the internal control over compliance findings identified in our audit are described in the accompanying Schedule of Findings and Questioned Costs. The Company's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of *Chapter 10.650, Rules of the State of Florida Auditor General*. Accordingly, this report is not suitable for any other purpose.

Report on Schedule of Expenditures of State of Florida Financial Assistance

We have audited the financial statements of the Company as of and for the year ended December 31, 2012, and have issued our report thereon dated February 22, 2013, which contained an unmodified opinion on those financial statements. Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying Schedule of Expenditures of State of Florida Financial Assistance, as presented on page 33, is presented for purposes of additional analysis as required by Chapter 6A-20.0021 of the Florida Administrative Code and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statement and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Schedule of Expenditures of Sates of Florida Financial Assistance is fairly stated in all material respects in relation to the financial statements as a whole.

PricewaterhouseCoopers LLP

June 24, 2013

ITT Educational Services, Inc.
Summary of Population, Sample Tested, and Test Results for
Florida Financial Assistance Programs
For the Year Ended December 31, 2012

Our examination was performed for the calendar year 2012 and included award recipients as follows:

	Description of Category	Number of Students	Percent of Population	Amount of Awards	Percent of Population
FSAG (1)	Population	913	100.0%	\$ 993,199	100.0%
	Sample Tested	50	5.5%	\$ 113,673	11.4%
	Test Results (4)	4	0.4%	\$ 1,461	0.1%
FMSA (2)	Population	12	100.0%	\$ 14,489	100.0%
	Sample Tested	12	100.0%	\$ 14,489	100.0%
	Test Results (5)	6	50.0%	\$ 2,877	19.9%
FGSVSA (3)	Population	4	100.0%	\$ 5,879	100.0%
	Sample Tested	4	100.0%	\$ 5,879	100.0%
	Test Results (6)	1	25.0%	\$ 153	2.6%

- (1) Represents the population and sample tested for the Florida Student Assistance Grant, (FSAG).
- (2) Represents the population and sample tested for the Florida Medallion Scholars Award, (FMSA).
- (3) Represents the population and sample tested for the Florida Gold Seal Vocational Scholars Award, (FGSVSA).
- (4) Our testing identified four instances among three finding types at three institutions. See pages 41-42, Part III for additional information regarding Findings #12-1, #12-2 and #12-3, including the written findings, recommendations, and management's responses.
- (5) Our testing identified seven instances (six students) among two finding types at two institutions. See page 43, Part III, for additional information regarding Findings #12-4 and #12-5, including the written findings, recommendations, and management's responses.
- (6) Our testing identified one instance in which the institution did not award the correct funding amount to an eligible student. See page 44, Part III, for additional information regarding Finding #12-6 including the written finding, recommendation, and management's response.

Note: There were no Florida Academic Scholars Awards disbursed during 2012.

ITT Educational Services, Inc.
Summary of Advances, Disbursements, and Refunds for
Florida Financial Assistance Programs
For the Year Ended December 31, 2012

Below is a summary of the payment activity between ITT and the State of Florida for the year ended December 31, 2012:

State Agency/State Project	Catalog of State of Florida		State of Florida Advances	Awards Disbursed by ITT	Advances Refunded to Florida	Net Amount Due to Florida
	Financial Assistance Number	Grant Code				
Department of Education and Commissioner of Education						
Florida Student Assistance Grant (1)	48.054	99970	\$ 1,029,839	\$ 993,199	\$ -	\$ 58,053
Florida Bright Futures Scholarship Program	48.059	97040	\$ 23,995	\$ 20,418	\$ 3,628	\$ -

(1) Statutes require undisbursed advances for the Florida Student Assistance Grant to be returned by June 1. At December 31, 2012, all undisbursed advances relating to the 2011-2012 school year had been refunded to the State of Florida.

ITT Educational Services, Inc.
Schedule of Findings and Questioned Costs
For the Year Ended December 31, 2012

Part I – Summary of Results

1. The report of independent auditors on the Company's financial statements expressed an unqualified opinion.
2. No instance of noncompliance considered material to Company's financial statements was disclosed by the audit.
3. The independent auditors report on compliance with requirements applicable to major State of Florida projects expressed a modified opinion.
4. The audit resulted in 12 exceptions that resulted in six types of findings as discussed in Part III below.
5. The Company’s major State of Florida projects under audit were:

State Project	CSFA Number
Florida Student Assistance Grant	48.054
Florida Bright Futures Scholarship Program (1)	48.059

(1) Florida Bright Futures Scholarship Program includes the Florida Academic Scholars Award, Florida Medallion Scholars Award, and the Florida Gold Seal Vocational Scholars Award.

6. A threshold of \$300,000 was used to distinguish between Type A and Type B programs as those terms are defined in Chapter 10.650. However, as required by the Florida Department of Education, we have also audited the State of Florida Bright Futures Scholarship Program as noted in #5 above.

Part II – Financial Statement Findings Section

No findings to report.

Part III – State Project Findings and Questioned Costs Section

The following audit findings were reportable for the year ended December 31, 2012. A management letter is not presented as there are no items related to state financial assistance that would be considered more than inconsequential, other than those included in this report.

Finding #12-1 (FSAG, Catalog #48.054: Total population - 913 student, \$993,199)

Our audit identified one institution which failed to notify one student of the Florida Student Assistance Grant he was to receive for the school year. The student was appropriately awarded the correct amount, but the Florida State Code 1009.52 4(b) states that a payment of Florida postsecondary student assistance grants shall be transmitted to the president of the eligible institution, or to his or her representative, in advance of the registration period and institutions shall notify students of the amount of the awards. The finding was the result of improper completion of the cost summary and payment addendum to the enrollment agreement by financial aid personnel. The Company uses the cost summary and payment addendum as the award letter. In response to the finding, management issued an award letter to the student to provide notification of the award.

Recommendation

To avoid such issues in the future, management should seek to refine the review process in place to ensure that all students receiving this award are notified in advance. While the school usually places the award on the cost summary presented to the student, this may not occur if the award is granted at a date after the

ITT Educational Services, Inc.

Schedule of Findings and Questioned Costs

For the Year Ended December 31, 2012

student signs up for classes. In such situations, management should implement a process that ensures the student still receives the required notification.

Management's View

Management discussed the importance of ensuring the student receives a cost summary prior to the award being granted. To avoid this from happening in the future the process has been changed so that the Director of Finance will check to be sure the cost summary has been given to the student prior to the award being made.

Finding #12-2 (FSAG, Catalog #48.054: Total population - 913 students, \$993,199)

Our audit identified one institution which reported \$1,649 of student funding to the State. However, the institution only disbursed \$845 to the applicable student, resulting in questioned costs of \$804. This student met all eligibility requirements for the award. Florida State Code 1009.52 2(d) states each participating institution shall report to the department by the established date, the eligible students to whom grant monies are disbursed each academic term. Each institution shall also report to the department necessary demographic and eligibility data for such students. This finding was the result of a clerical error in which the institution did not disburse the proper amount of funding to the eligible student.

Recommendation

Currently the institution performs a reconciliation of funds received from the State to funds disbursed to students on an annual basis. Going forward, management should consider performing this reconciliation on at least a quarterly basis in order to ensure similar errors are caught and corrected in a more timely manner. Further, the institution should disburse \$804 to the affected student to correct the underaward.

Management's View

Management understands the importance of having the state grant funds reconciled. Going forward we will reconcile the state grant program on a more frequent basis. This should resolve the issue. ITT understands the importance of proper reporting to the state.

Finding #12-3 (FSAG, Catalog #48.054: Total population - 913 students, \$993,199)

Our audit identified two students at two institutions which disbursed awards to students which had not been reported to the State, resulting in \$657 in questioned costs. Florida State Code 1009.52 2(d) states each participating institution shall report, to the department by the established date, the eligible students to whom grant monies are disbursed each academic term. Each institution shall also report to the department necessary demographic and eligibility data for such students.

Recommendation

Currently, students are entered manually into the State's reconciling database by ITT staff. These findings were the result of clerical input errors, in that the students' disbursements were not properly input into the system. Going forward, management should perform a more extensive comparison of student disbursements and the reconciliation provided to the State in order to detect such input errors. Management should also considering performing the reconciliation process on at least a quarterly basis to ensure that similar errors are caught and corrected in a more timely manner. Further, the Company should report these awards to the State currently.

Management's View

Going forward management will perform reconciliation on a more frequent basis. During the reconciliation process we will perform an extensive comparison of the student disbursements and the reconciliation provided by the state. ITT understands the importance of proper reporting to the state.

ITT Educational Services, Inc.

Schedule of Findings and Questioned Costs

For the Year Ended December 31, 2012

Finding #12-4 (FMSA, Catalog #48.059: Total population -12 students, \$14,489)

Our audit identified five instances at two institutions, where the institution failed to award funds received from the State of Florida to eligible students, resulting in \$1,627 in questioned costs. These students met all Bright Futures eligibility requirements. This was caused by a clerical error in the calculation of award amount due to each student which resulted in the students not being awarded the full amount of Bright Futures funding for which they qualified based on the number of credit hours completed by each student.

Recommendation

The institutions should ensure the applicable students are made whole by disbursing the remaining amount of the award to the students. Further, management should emphasize the need for exercising proper due diligence in calculating awards. To avoid such clerical issues in the future, management should seek to refine the review process in place to ensure the accuracy of the student award amounts before they are certified and sent to the State.

Management's View

Management has ensured that the applicable students were made whole. The Directors of Finance will retrain their staff to ensure that accurate awards are made to the students. This will ensure that the accuracy of the student awards before it is sent to the state.

Finding #12-5 (FMSA, Catalog #48.059: Total population -12 students, \$14,489)

Our audit identified two instances at one institution in which the institution properly calculated the awards and reported them to the State, but failed to disburse those same amounts to the students, resulting in questioned costs of \$1,250. These students met all eligibility requirements for the Bright Futures Award. Florida State Code 1009.52 2(d) states each participating institution shall report, to the department by the established date, the eligible students to whom grant monies are disbursed each academic term. Each institution shall also report to the department necessary demographic and eligibility data for such students. This error was not identified because management only completes a reconciliation of funds received on an annual basis, at the end of the academic year. Thus, management was not aware of the funding due to the students. In response to the finding, management disbursed the appropriate funding to the students' accounts.

Recommendation

Currently the institution performs a reconciliation of funds received from the State to funds disbursed to students on an annual basis. Going forward, management should consider performing this reconciliation on at least a quarterly basis in order to ensure similar errors are caught and corrected in a more timely manner. Further, as it relates to the underawards, the institution should disburse the remaining amounts to the affected students.

Management's View

Management understands the importance of properly disbursing the state grant award and disbursing the same amount to the student. Going forward we will reconcile the state grant program on a more frequent basis. This should resolve the issue and ensure what is awarded to the student is also reported to the state.

ITT Educational Services, Inc.
Schedule of Findings and Questioned Costs
For the Year Ended December 31, 2012

Finding #12-6 (FGSVA, Catalog #48.059: Total population -4 students, \$5,879)

Our audit identified one institution that failed to award funds received from the State to an eligible student, resulting in \$153 in questioned costs. This student met all Bright Futures eligibility requirements, but the student was not awarded the full disbursements for which he was eligible to receive based on the number of credit hours completed. This was the result of a clerical error in the calculation of the award amount.

Recommendation

The institution should ensure the student is made whole by disbursing the remaining eligible funding. Further, management should emphasize the need for exercising proper due diligence in the calculation and disbursement of the awards. To avoid such clerical issues in the future, management should seek to refine the review process in place to ensure the accuracy of the student award amounts before they are certified and sent to the State.

Management's View

Management has ensured that the applicable student was made whole. The Directors of Finance will retrain their staff to ensure that accuracy of the calculation and disbursement of the awards. This will ensure that the accuracy of the student awards before they are certified and sent to the state.

ITT Educational Services, Inc.

Status of Prior Year Findings and Questioned Costs

For the Year Ended December 31, 2012

Status of Prior Year Findings:

Finding #11-1 (FASA, Catalog #48.054: Total population - 1 student, \$2,748)

PwC identified one institution which failed to award funds based on the predetermined rate per credit hour established by the State of Florida, resulting in a \$56 underaward to the student's account. This was caused by a clerical error in which the institution did not request the proper amount of funding. Upon recognition of the error, the window for requesting additional funding had already closed. This resulted in a difference in the amount disbursed to the eligible student and the amount for which he was eligible. Florida State Code 1009.534 (5) states a student is eligible for an award equal to the amount specified by the State.

Status

The directors of Finance were advised to review the State Grant reconciliation report to determine the proper identification and awarding of state grant eligibility and awarding. Management has determined it will perform reconciliation process on a more frequent basis which should resolve this problem.

Finding #11-2 (FMSA, Catalog #48.059: Total population - 19 students, \$22,608)

PwC identified one institution that credited the improper amount of funds to two students, resulting in questioned costs of \$1,253. These students met all of the Bright Futures eligibility requirements, but funding was calculated on a full-time basis for students who were only enrolled in classes part-time. This was caused by a clerical error which resulted in the students being awarded Bright Futures funding exceeding that for which they qualified. Florida State Code 1009.53 (6) states a student enrolled in 6 to 8 semester credit hours can receive up to 50% of the maximum award; a student enrolled in 9 to 11 credits can receive up to 75% of the maximum award; and a student enrolled in 12 or more credits may receive up to the full award.

Status

The Finance staff members at the ITT Technical Institutes in Florida were advised to perform a thorough and comprehensive review of eligibility requirements for each student receiving a State Grant award prior to certifying and sending that award to the state. Particular emphasis was placed on the importance of reviewing enrollment status in each quarter for eligible students to ensure that students are receiving the proper amount of State Grant funding based on the number of credit hours taken.

Finding #11-3 (FMSA, Catalog #48.059: Total population - 19 students, \$22,608)

PwC identified one institution that awarded funds received from the State of Florida to one ineligible student, resulting in \$2,116 in questioned costs. This was caused by a clerical error in which the student's Florida financial aid history was not reviewed prior to awarding Florida funds. This resulted in financial aid being disbursed to a student who had graduated more than 3 years prior to the initial award. Florida State Code 1009.531 (2)(a) states that a student is eligible to accept an initial award for 3 years following high school graduation.

Status

The Finance staff members at the ITT Technical Institutes in Florida were advised to carefully review the Florida financial aid history prior to the awarding of any State Grant funds. We understand the requirement that a student is only eligible to accept an initial award for three (3) years following high school graduation.

Finding #11-4 (FMSA, Catalog #48.059: Total population - 19 students, \$22,608)

PwC identified one institution that awarded funds received from the State of Florida to one ineligible student who had graduated from high school more than seven years previous. The institution subsequently identified the award made in error and credited the student's account. However, the institution erroneously credited the student's account for \$152 more than the original award, resulting in \$152 in questioned costs.

ITT Educational Services, Inc.
Status of Prior Year Findings and Questioned Costs
For the Year Ended December 31, 2012

This was caused by a clerical error. Florida State Code 1009.531 (2)(a) states a student is eligible to accept a renewal award for 7 years following high school graduation.

Status

The Finance staff members at the ITT Technical Institutes in Florida were advised to carefully review the Florida financial aid history prior to the awarding of any State Grant funds. We understand the requirement that a student is only eligible to accept a renewal award for seven (7) years following high school graduation. The Directors of Finance at ITT Technical Institutes in Florida are responsible for ensuring that corrections and adjustments made due to errors are accurate. They have been advised to review all errors identified by Finance staff to ensure that the corrective actions are appropriate and for the accurate amounts. ITT Technical Institute ensured that the student is made whole for this error.