

**ITT Educational Services, Inc.**  
**Florida Single Audit Act and Additional Information**  
**For the Year Ended December 31, 2013**

**ITT Educational Services, Inc.**  
**Schedule of Findings and Questioned Costs**  
**December 31, 2013**

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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 at December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the Company did not maintain, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) because material weaknesses in internal control over financial reporting related to (i) the application of consolidation accounting to variable interest entities, (ii) the assessment of the completeness and accuracy of student loan data underlying estimates made in the valuation of the PEAKS Trust student loan receivables, (iii) controls over the estimation and review of contingent loss estimates related to the guarantee obligation under the 2009 RSA and (iv) the timely identification and communication of information relevant to the private loan programs to those members of management responsible for the Company's financial reporting processes existed as of that date. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis. The material weaknesses referred to above are described in the accompanying Management's Report on Internal Control Over Financial Reporting. We considered these material weaknesses in determining the nature, timing, and extent of audit tests applied in our audit of the December 31, 2013 consolidated financial statements, and our opinion regarding the effectiveness of the Company's internal control over financial reporting does not affect our opinion on those consolidated financial statements. 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 referred to above. 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.

As discussed in Note 17 to the consolidated financial statements, the Company is subject to risks and uncertainties including litigation, governmental investigations and increasing liquidity pressures that could affect amounts reported in the Company's financial statements in future periods.

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In accordance with *Government Auditing Standards*, we have also issued our report dated October 15, 2014, except for Note 18 of the consolidated financial statements, as to which the date is October 27, 2014, on our tests of compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters for the year ended December 31, 2013. 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. The definition of a *material weakness* is presented above. We consider the deficiencies as identified above and as described in Findings 2013-1 through 2013-4 in the accompanying Schedule of Findings and Questioned Costs (Section I) to be material weaknesses.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency described in Finding 2013-5 in the accompanying Schedule of Findings and Questioned Costs (Section I) to be a significant deficiency.

The Company's response to the findings identified in our audit is described in the accompanying Schedule of Findings and Questioned Costs (Section I). The Company's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

As described in the accompanying Management's Report on Internal Control Over Financial Reporting, management has excluded the PEAKS Trust from its assessment of internal control over financial reporting as of December 31, 2013, because beginning on February 28, 2013, the Company became the primary beneficiary of the PEAKS Trust. We have also excluded the PEAKS Trust from our audit of internal control over financial reporting. The PEAKS Trust is a controlled variable interest entity whose assets and total revenues represent 11% and 1%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2013.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP  
Indianapolis, Indiana

October 15, 2014, except for Note 18, as to which the date is October 27, 2014

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

	As of December 31,	
	2013	2012
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 215,771	\$ 243,465
Restricted cash	5,636	3,478
Accounts receivable, less allowance for doubtful accounts of \$9,174 and \$15,663	99,530	78,928
PEAKS Trust student loans, less allowance for loan losses of \$0 and \$0	7,730	0
Deferred income taxes	77,549	44,547
Prepaid expenses and other current assets	28,400	16,162
Total current assets	434,616	386,580
Property and equipment, net	168,509	189,890
PEAKS Trust student loans, excluding current portion, less allowance for loan losses of \$29,349 and \$0	76,479	0
Deferred income taxes	68,324	57,471
Other assets	58,923	41,263
Total assets	\$ 806,851	\$ 675,204
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Current portion of long-term debt	\$ 50,000	\$ 0
Current portion of PEAKS Trust senior debt	157,883	0
Accounts payable	58,021	63,304
Accrued compensation and benefits	18,107	21,023
Other current liabilities	42,136	106,796
Deferred revenue	147,630	135,900
Total current liabilities	473,777	327,023
Long-term debt	0	140,000
PEAKS Trust senior debt, excluding current portion	71,341	0
Other liabilities	146,087	82,416
Total liabilities	691,205	549,439
Commitments and contingent liabilities (Note 16)		
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	200,040	197,113
Retained earnings	940,449	967,473
Accumulated other comprehensive income (loss)	3,146	(7,930)
Treasury stock, 13,698,716 and 13,744,395 shares, at cost	(1,028,360)	(1,031,262)
Total shareholders' equity	115,646	125,765
Total liabilities and shareholders' equity	\$ 806,851	\$ 675,204

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

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

	Year Ended December 31,		
	2013	2012	2011
<b>Revenue</b>	\$ 1,072,311	\$ 1,286,633	\$ 1,499,977
<b>Costs and expenses:</b>			
Cost of educational services	486,353	538,350	553,065
Student services and administrative expenses	397,541	400,856	414,156
Asset impairment	0	15,166	0
Legal and other investigation costs	6,923	873	0
Loss related to loan program guarantees	90,964	101,025	23,500
Provision for PEAKS Trust student loan losses	29,349	0	0
Total costs and expenses	1,011,130	1,056,270	990,721
<b>Operating income</b>	61,181	230,363	509,256
(Loss) on consolidation of PEAKS Trust	(73,248)	0	0
Interest income	108	1,348	2,902
Interest (expense)	(25,277)	(3,723)	(1,825)
<b>Income (loss) before provision for income taxes</b>	(37,236)	227,988	510,333
Provision for income taxes	(10,212)	89,018	201,247
<b>Net income (loss)</b>	\$ (27,024)	\$ 138,970	\$ 309,086
<b>Earnings (loss) per share:</b>			
Basic	\$ (1.15)	\$ 5.82	\$ 11.27
Diluted	\$ (1.15)	\$ 5.79	\$ 11.18
<b>Weighted average shares outstanding:</b>			
Basic	23,412	23,880	27,429
Diluted	23,412	23,999	27,655

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

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

	<u>Year Ended December 31,</u>		
	<u>2013</u>	<u>2012</u>	<u>2011</u>
<b>Net income (loss)</b>	\$ (27,024)	\$ 138,970	\$ 309,086
<b>Other comprehensive income (loss), net of tax:</b>			
Net actuarial pension (loss) gain, net of income tax of \$6,811, \$242 and \$3,709	10,755	379	(5,795)
Net actuarial pension loss amortization, net of income tax of \$790, \$1,062 and \$704	1,247	1,656	1,099
Prior service cost (credit) amortization, net of income tax of \$604, \$607 and \$607	(951)	(948)	(948)
Pension settlement (loss), net of income tax of \$17, \$309 and \$470	25	483	734
Unrealized gains (losses) on available-for-sale securities, net of income tax of \$0, \$0 and \$0	0	(21)	(60)
Other comprehensive income (loss), net of tax	<u>11,076</u>	<u>1,549</u>	<u>(4,970)</u>
<b>Comprehensive income (loss)</b>	<u><u>\$ (15,948)</u></u>	<u><u>\$ 140,519</u></u>	<u><u>\$ 304,116</u></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,		
	2013	2012	2011
<b>Cash flows from operating activities:</b>			
Net income (loss)	\$ (27,024)	\$ 138,970	\$ 309,086
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	27,252	29,350	27,886
Provision for doubtful accounts	67,640	56,818	35,655
Deferred income taxes	(54,425)	(59,999)	(8,991)
Excess tax benefit from stock option exercises	0	(1,382)	(1,166)
Stock-based compensation expense	11,638	16,658	17,074
Settlement cost	(46,000)	21,750	0
Asset impairment	0	15,166	0
Accretion of discount on PEAKS Trust student loans	(12,996)	0	0
Accretion of discount on PEAKS Trust senior debt	4,926	0	0
Provision for PEAKS Trust student loan losses	29,349	0	0
Loss on consolidation of PEAKS Trust	73,248	0	0
Other	315	6,992	(1,936)
Changes in operating assets and liabilities, net of acquisition:			
Restricted cash	(455)	3,794	(942)
Accounts receivable	(87,225)	(87,138)	(17,004)
PEAKS Trust student loans	11,554	0	0
Accounts payable	(5,574)	(15,572)	10,956
Other operating assets and liabilities	74,203	72,857	35,964
Deferred revenue	11,299	(90,643)	(17,819)
Net cash flows from operating activities	<u>77,725</u>	<u>107,621</u>	<u>388,763</u>
<b>Cash flows from investing activities:</b>			
Facility expenditures and land purchases	(679)	(1,046)	(4,053)
Capital expenditures, net	(4,468)	(17,204)	(26,847)
Acquisition of company, net of cash acquired	(7,150)	0	0
Proceeds from sales and maturities of investments and repayment of notes	461	217,301	337,032
Purchase of investments and note advances	(1,242)	(75,887)	(352,195)
Net cash flows from investing activities	<u>(13,078)</u>	<u>123,164</u>	<u>(46,063)</u>
<b>Cash flows from financing activities:</b>			
Excess tax benefit from stock option exercises	0	1,382	1,166
Proceeds from exercise of stock options	0	8,345	5,599
Debt issue costs	0	(1,525)	0
Proceeds from revolving borrowings	0	175,000	0
Repayment of revolving borrowings	(90,000)	(185,000)	0
Repayment of PEAKS Trust senior debt	(1,946)	0	0
Repurchase of common stock and shares tendered for taxes	(395)	(209,371)	(283,320)
Net cash flows from financing activities	<u>(92,341)</u>	<u>(211,169)</u>	<u>(276,555)</u>
Net change in cash and cash equivalents	(27,694)	19,616	66,145
Cash and cash equivalents at beginning of period	<u>243,465</u>	<u>223,849</u>	<u>157,704</u>
<b>Cash and cash equivalents at end of period</b>	<u><u>\$215,771</u></u>	<u><u>\$ 243,465</u></u>	<u><u>\$ 223,849</u></u>
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Income taxes (net of refunds)	\$ 61,131	\$ 139,919	\$ 196,387
Interest	\$ 3,310	\$ 3,047	\$ 1,842
Non-cash operating activities:			
Consolidation of PEAKS Trust assets	\$113,819	0	0
Consolidation of PEAKS Trust liabilities	471	0	0
Non-cash financing activities:			
Issuance of treasury stock for Directors' compensation	\$ 0	\$ 37	\$ 30
Consolidation of PEAKS Trust senior debt	226,096	0	0

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>	
<b>Balance as of December 31, 2010</b>	37,069	\$ 371	\$ 170,966	\$ 526,619	(\$ 4,509)	(7,076)	(\$ 566,405)	\$ 127,042
Net income				309,086				309,086
Other comprehensive (loss), net of income tax					(4,970)			(4,970)
Equity award vesting and exercises			(2,397)	(2,359)		155	10,355	5,599
Tax benefit from equity awards			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)
<b>Balance as of December 31, 2011</b>	37,069	371	184,207	833,347	(9,479)	(10,969)	(839,341)	169,105
Net income				138,970				138,970
Other comprehensive income, net of income tax					1,549			1,549
Equity award vesting and exercises			(4,224)	(4,843)		272	17,412	8,345
Tax benefit from equity awards			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)
<b>Balance as of December 31, 2012</b>	37,069	371	197,113	967,473	(7,930)	(13,744)	(1,031,262)	125,765
Net income (loss)				(27,024)				(27,024)
Other comprehensive income, net of income tax					11,076			11,076
Equity award vesting and exercises			(3,297)			68	3,297	0
Tax benefit from equity awards			(5,414)					(5,414)
Stock-based compensation			11,638					11,638
Shares tendered for taxes						(23)	(395)	(395)
<b>Balance as of December 31, 2013</b>	37,069	\$ 371	\$ 200,040	\$ 940,449	\$ 3,146	(13,699)	(\$ 1,028,360)	\$ 115,646

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

**ITT EDUCATIONAL SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in thousands, except per share data and unless otherwise stated)**

**1. Business and Significant Accounting Policies**

**Business.** ITT Educational Services, Inc. is a leading proprietary provider of postsecondary degree programs in the United States based on revenue and student enrollment. References in these Notes to “we”, “us” and “our” refer to ITT Educational Services, Inc., its wholly-owned subsidiaries and the variable interest entity (“VIE”) of which it is the primary beneficiary, unless the context requires or indicates otherwise. As of December 31, 2013, we were offering:

- master, bachelor and associate degree programs to approximately 57,000 students at ITT Technical Institute and Daniel Webster College locations; and
- short-term information technology and business learning solutions for individuals.

In addition, we offered one or more of our online education programs to students who are located in all 50 states. As of December 31, 2013, we had 149 college locations (including 147 campuses and two learning sites) in 39 states and one training facility. All of our college locations are authorized by the applicable education authorities of the states in which they operate and are accredited by an accrediting commission recognized by the U.S. Department of Education (“ED”). We have provided career-oriented education programs since 1969 under the “ITT Technical Institute” name and since June 2009 under the “Daniel Webster College” name. In August 2013, we acquired all of the membership interests of Cable Holdings, LLC (“Cable Holdings”), an education company that offers short-term information technology and business learning solutions for individuals. See Note 4 – Acquisitions, for additional discussion of the acquisition of Cable Holdings. Our corporate headquarters are located in Carmel, Indiana.

**Basis of Presentation.** The accompanying consolidated financial statements include the accounts of our wholly-owned subsidiaries and the VIE that we consolidate, and have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Arrangements where we may have a variable interest in another party are evaluated in accordance with the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification<sup>TM</sup> (“ASC” or “Codification”) 810, “Consolidation” (“ASC 810”), to determine whether we would be required to consolidate the other party in our consolidated financial statements. See Note 10 – Variable Interest Entities, for a further discussion of those entities in which we held a variable interest and the consolidation of one of those entities in our consolidated financial statements as of December 31, 2013. All significant intercompany balances and transactions are eliminated upon consolidation.

**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 of the assets and liabilities of the PEAKS Trust upon consolidation;
- the provision for PEAKS Trust student loan losses;
- 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. In addition, funds held for students from Title IV Programs that result in a credit balance on a student’s account are also reflected as restricted cash on our Consolidated Balance Sheet. The amount of these funds included in restricted cash on our Consolidated Balance Sheet as of December 31, 2013 was \$2,433.

Beginning on February 28, 2013, we consolidated a VIE in our consolidated financial statements. Funds held by this VIE are classified as restricted cash on our Consolidated Balance Sheet, because those funds can only be used to satisfy the obligations of the VIE. Funds held by the VIE included in restricted cash on our Consolidated Balance Sheet as of December 31, 2013 were \$2,593.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in thousands, except per share data and unless otherwise stated)**

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 was approximately \$8,626 as of December 31, 2013 and approximately \$8,622 as of December 31, 2012.

**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. We did not hold any investments in marketable securities as of December 31, 2013 or December 31, 2012.

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 institutions' 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 average student receivable balance is 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.

When a student is no longer enrolled in an education program 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 our campuses, adjusted as needed to reflect other facts and circumstances. We review the collection activity after a student withdraws or graduates from an education program and write off the accounts receivable, if we conclude that collection of the balance is not probable.

**PEAKS Trust Student Loans.** Beginning on February 28, 2013, we consolidated the VIE, which is a trust (the "PEAKS Trust") that purchased, owns and collects private education loans (the "PEAKS Trust Student Loans") made under the PEAKS Private Student Loan Program (the "PEAKS Program"), in our consolidated financial statements (the "Consolidation"). Certain of the PEAKS Trust Student Loans had evidence of credit deterioration since the date those loans were originated and, therefore, we determined that, at the date of the Consolidation, it was probable that all contractually required payments under those loans would not be collected. We recorded those loans at fair value at the date of the Consolidation. We also recorded at fair value PEAKS Trust Student Loans that did not individually have evidence of deteriorated credit quality at the date of the Consolidation, because we determined that the application of an expected cash flow model provided the most reasonable presentation and this accounting treatment was consistent with the American Institute of Certified Public Accountants' (the "AICPA") December 18, 2009 Confirmation Letter (the "Confirmation Letter"). No allowance for loan losses was recorded at the date of the Consolidation, because all of the PEAKS Trust Student Loans were recorded at fair value and future credit losses are considered in the estimate of fair value. Cash flows from PEAKS Trust Student Loans expected to be collected within the next 12 months have been classified as current in our consolidated balance sheet. The remaining balance is classified as non-current.

We aggregated the individual PEAKS Trust Student Loans into 24 separate pools of loans, based on common risk characteristics of the individual loans, which included:

- the fiscal quarter in which the PEAKS Trust Student Loan was originated; and
- the consumer credit score of the borrower.

Loans that did not have evidence of deteriorated credit quality were not aggregated in the same pools with loans that had evidence of deteriorated credit quality. The same aggregation criteria, however, were used to determine those loan pools. Each loan pool is accounted for as a single asset with a single composite interest rate and an aggregate expectation of cash flows.

On a quarterly basis, we estimate the total principal and interest expected to be collected over the remaining life of each loan pool. These estimates include assumptions regarding default rates, forbearances and other factors that reflect then-current market conditions. If a decrease in the expected cash flows of a loan pool is probable and would cause the expected cash flows to be less than the expected cash flows at the date of the Consolidation or the end of the previous fiscal quarter, whichever is later, we would record the impairment as:

- a provision for PEAKS Trust student loan losses in our Consolidated Statement of Income; and
- an increase in the allowance for loan losses on our Consolidated Balance Sheet.

The provision for PEAKS Trust student loan losses represents the increase in the allowance for loan losses that occurred during the period. The allowance for loan losses is the difference between the carrying value and the total present value of the expected principal and interest collections of each loan pool, discounted by the loan pool's effective interest rate at the date of the Consolidation or the end of the previous fiscal quarter, whichever is later. If a significant increase in the expected cash flows of a loan pool is probable and would cause the expected cash flows to be greater than the expected cash flows at the date of the Consolidation or the end of the previous fiscal quarter, whichever is later, we would:

- first reverse any allowance for loan losses with respect to that loan pool that was previously recorded on our Consolidated Balance Sheet, up to the amount of that allowance; and

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

- record any remaining increase prospectively as a yield adjustment over the remaining estimated lives of the loans in the loan pool.

The impact of prepayments, changes in variable interest rates and any other changes in the timing of the expected cash flows of a loan pool are recognized prospectively as adjustments to interest income.

The impact of modifications made to loans in a loan pool is incorporated into our quarterly assessment of whether a significant change in the expected cash flows of the loan pool is probable or has occurred. We consider the historical loss experience associated with the PEAKS Trust Student Loans in estimating the future probabilities of default for all of the outstanding PEAKS Trust Student Loans.

The excess of any cash flows expected to be collected with respect to a loan pool of the PEAKS Trust Student Loans over the carrying value of the loan pool is referred to as the accretable yield. The accretable yield is not reported on our Consolidated Balance Sheets, but it is accreted and included as interest income at a level rate of return over the remaining estimated life of the loan pool. If we determine that the timing and/or amounts of expected cash flows with respect to a loan pool are not reasonably estimable, no interest income would be accreted and the loans in that loan pool would be reported as nonaccrual loans. We recognize the accretable yield of the PEAKS Trust Student Loans as interest income, because the timing and the amounts of the expected cash flows are reasonably estimable.

If a PEAKS Trust Student Loan is paid in full or charged-off, that loan is removed from the loan pool. If the amount of the proceeds received for that loan, if any, is less than the unpaid principal balance of the loan, the difference is first applied against the loan pool's nonaccretable difference for principal losses (i.e., the lifetime credit loss estimate established at the date of the Consolidation). If the nonaccretable difference for principal losses with respect to a loan pool has been fully depleted, any unpaid loan principal balance in excess of the proceeds received for the loan is charged-off against the loan pool's allowance for loan losses. We do not recognize charge-offs of individual PEAKS Trust Student Loans when those loans reach certain stages of delinquency, because those loans are accounted for at a loan pool level.

If any portion of a PEAKS Trust Student Loan that had previously been charged-off is recovered, the amount collected increases the applicable loan pool's nonaccretable difference. If the nonaccretable difference with respect to the applicable loan pool has been fully depleted, the amount collected increases that loan pool's allowance for loan losses.

**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.

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.

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**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, government investigations, 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.

We determine the amount of our contingent liabilities related to our guarantee obligations by estimating the expected payments to be made under the guarantee and the amount that we expect to be repaid to us. We also consider the payment options available to us. To the extent that we project that we will have sufficient funds available to discharge our guarantee obligations for the outstanding balance of those private education loans that have been charged off at the time that they default, we incorporate that assumption into our estimate of the contingent liability. If we do not believe that we will have sufficient funds available, we assume that we will make monthly payments to satisfy our guarantee obligations as allowed under the applicable agreements. We discount the amount of those expected future monthly payments at a risk-free rate of interest. Making payments for the full amount of the charged-off loans at the time that they default results in us paying a lesser amount than we otherwise would have been required to pay under our guarantee obligations in future periods and, therefore, results in an estimated contingent liability that is less than if we had assumed we would make monthly payments in the future.

We discount the amounts that we expect will be repaid to us to reflect a risk-free rate of interest. The difference between the amount of the guarantee payments that we expect to make and the discounted amount that we expect will be repaid to us is included in our estimate of the amount of our contingent liability related to our guarantee obligations.

**Debt.** The PEAKS Trust issued senior debt in the initial aggregate principal amount of \$300,000 (the "PEAKS Senior Debt"). In accordance with ASC 810, we included the PEAKS Senior Debt on our consolidated balance sheet at its fair value as of February 28, 2013, the date of the Consolidation. The difference between the fair value of the PEAKS Senior Debt and its outstanding aggregate principal balance at the date of the Consolidation was recorded as an accrued discount on our consolidated balance sheet at the date of the Consolidation. The accrued discount will be recognized in interest expense at a level rate of return over the life of the PEAKS Senior Debt.

**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 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.

**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.

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We do not charge a separate fee for textbooks that students use in their education programs. 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 length of the education program. 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 an education program at an institution. We reassess the collectability of tuition revenue on a student-by-student basis throughout our revenue recognition period. We reassess the collectability of tuition revenue that we may earn based on new information and changes in the facts and circumstances relevant to a student's ability to pay, which primarily include when a student withdraws from a program of study.

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.

We provide institutional scholarships and awards to our institutions' students, which those students use to help reduce their educational expenses. Institutional scholarships and awards reduce the students' tuition charges and are recorded as offsets to revenue in the period in which the tuition is earned.

Interest income on the PEAKS Trust Student Loans, which is the accretion of the accretable yield on the PEAKS Trust Student Loans, is included in revenue and recognized based on the effective interest method as described in Note 11 – PEAKS Trust Student Loans.

**Advertising Costs.** We expense all advertising costs as incurred. Advertising expense, which is included in Student services and administrative expenses in our Consolidated Statements of Income, was \$177,791 in the year ended December 31, 2013, \$174,009 in the year ended December 31, 2012 and \$192,080 in the year ended December 2011.

**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 due to death or disability, 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, 2013, approximately 13.7 million shares of our common stock were held in treasury. Our Board of Directors has authorized us to repurchase outstanding shares of our common stock, but we do not expect to repurchase any outstanding shares of our common stock in 2014. See Note 8 – Stock Repurchases, 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

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Other assets or Other liabilities, on our Consolidated Balance Sheets. We recognize a liability for the costs to terminate the lease of a leased facility when we cease using that leased facility.

**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" ("ASC 740"), 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. Revision of 2011 and 2012 Financial Statements**

We identified corrections to our 2011 and 2012 financial statements related to the recognition of revenue with respect to students who withdrew from a program of study. We also corrected the calculation of the contingent loss for the 2009 RSA in our 2012 financial statements.

We evaluated the cumulative impact of those items on prior periods under the guidance in ASC 250, "Accounting Changes and Error Corrections" ("ASC 250"), relating to SEC Staff Accounting Bulletin ("SAB") No. 99, "Materiality." We also evaluated the impact of correcting those items through an adjustment to our financial statements for the fiscal year ended December 31, 2013. We concluded, based on the guidance in ASC 250 relating to SAB No. 108, "Considering the Effects of Prior Year Misstatement when Quantifying Misstatements in Current Year Financial Statements," that the correction of those items in our 2011 and 2012 fiscal year would not be material, but would be material if corrected out-of-period in our 2013 fiscal year. As a result, we have revised our audited consolidated financial statements as of and for the fiscal years ended December 31, 2012 and December 31, 2011 to reflect the correction of those items that should have been recognized in those periods. The amounts of the corrections as of December 31, 2012 and December 31, 2011 are shown in the Revisions column in the tables below.

Our revised Consolidated Balance Sheet as of December 31, 2012 and Consolidated Statements of Shareholders' Equity as of December 31, 2012, 2011 and 2010 also reflect the correction of the classification of funds held for students from Title IV Programs that result in a credit balance on a student's account as restricted and amounts related to the vesting of RSUs from retained earnings to capital surplus. The amounts of these corrections related to our Consolidated Balance Sheets were not material and are shown in the Revisions column in the tables below. The December 31, 2012 Consolidated Balance Sheet reflects an adjustment to increase retained earnings by \$5,366 and decrease capital surplus by \$5,366 for the cumulative effect of the classification of the vesting of RSUs as of December 31, 2011. We also increased retained earnings as of December 31, 2011 by \$306 for the cumulative effect of the adjustment for the recognition of revenue with respect to students who withdrew from a program of study in prior years.

The December 31, 2010 amounts presented on our Consolidated Statement of Shareholders' Equity reflect an adjustment to increase retained earnings by \$2,969 and decrease capital surplus by \$2,969 for the cumulative effect of the classification of the vesting of RSUs. We also decreased retained earnings as of December 31, 2010 in our Consolidated Statement of Shareholders' Equity by \$1,028 for the cumulative effect of the adjustments for the recognition of revenue with respect to students who withdrew from a program of study in prior periods.

We reclassified the following items in our Consolidated Statement of Income for the year ended December 31, 2012 to conform with the current year presentation:

- settlement cost was reclassified to loss related to loan program guarantees;
- loss related to private student loan programs was reclassified to loss related to loan program guarantees; and
- an asset impairment was reclassified from loss related to private student loan programs to a separate line item.

We also corrected the classification of losses related to loan program guarantees, which were previously recorded as reductions to revenue in our Consolidated Statements of Income for the years ended December 31, 2012 and December 31, 2011, to report those amounts on a separate line. The amount of those corrections is shown in the Revisions column in the tables below.

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The following table sets forth the effect of the revisions on the affected line items on our Consolidated Balance Sheet as of the date indicated.

	<b>As of December 31, 2012</b>		
	<b>As Previously Reported</b>	<b>Revisions</b>	<b>As Revised</b>
<b>Balance Sheet Data:</b>			
Cash and cash equivalents	\$ 246,342	\$ (2,877)	\$ 243,465
Restricted cash	601	2,877	3,478
Accounts receivable, net	77,313	1,615	78,928
Deferred income taxes (current)	44,547	0	44,547
Total current assets	384,965	1,615	386,580
Deferred income taxes	56,112	1,359	57,471
Total assets	672,230	2,974	675,204
Other current liabilities	86,722	20,074	106,796
Total current liabilities	306,949	20,074	327,023
Other liabilities	98,327	(15,911)	82,416
Total liabilities	545,276	4,163	549,439
Capital surplus	206,703	(9,590)	197,113
Retained earnings	959,072	8,401	967,473
Total shareholders' equity	126,954	(1,189)	125,765
Total liabilities and shareholders' equity	672,230	2,974	675,204

The following table sets forth the effect of the revisions and reclassifications on the affected line items in our Consolidated Statement of Income for the year ended December 31, 2012.

	<b>Year Ended December 31, 2012</b>			
	<b>As Previously Reported</b>	<b>Revisions</b>	<b>Reclassifications</b>	<b>As Revised</b>
<b>Statement of Income Data:</b>				
Revenue	\$ 1,287,209	\$ (576)	\$ 0	\$ 1,286,633
Cost of educational services	539,223	0	(873)	538,350
Student services and administrative expenses	422,345	(21,489)	0	400,856
Settlement cost	21,750	0	(21,750)	0
Asset impairment	0	0	15,166	15,166
Legal and other investigation costs	0	0	873	873
Loss related to private student loan programs	71,102	0	(71,102)	0
Loss related to loan program guarantees	0	23,339	77,686	101,025
Total costs and expenses	1,054,420	1,850	0	1,056,270
Operating income	232,789	(2,426)	0	230,363
Income before provision for income taxes	230,414	(2,426)	0	227,988
Provision for income taxes	89,949	(931)	0	89,018
Net income	140,465	(1,495)	0	138,970
Earnings per share:				
Basic	\$ 5.88			\$ 5.82
Diluted	\$ 5.85			\$ 5.79

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The following table sets forth the effect of the revisions on the affected line items in our Consolidated Statement of Income for the year ended December 31, 2011.

	<b>Year Ended December 31, 2011</b>		
	<b>As Previously Reported</b>	<b>Revisions</b>	<b>As Revised</b>
<b>Statement of Income Data:</b>			
Revenue	\$ 1,499,949	\$ (28)	\$ 1,499,977
Cost of educational services	553,065	0	553,065
Student services and administrative expenses	439,808	(25,652)	414,156
Loss related to loan program guarantees	0	23,500	23,500
Total costs and expenses	992,873	(2,152)	990,721
Operating income	507,076	2,180	509,256
Income before provision for income taxes	508,153	2,180	510,333
Provision for income taxes	200,401	846	201,247
Net income	307,752	1,334	309,086
Earnings per share:			
Basic	\$ 11.22		\$ 11.27
Diluted	\$ 11.13		\$ 11.18

The following table sets forth the effect of the revisions on the affected line items in our Consolidated Statement of Comprehensive Income for the year ended December 31, 2012.

	<b>Year Ended December 31, 2012</b>		
	<b>As Previously Reported</b>	<b>Revisions</b>	<b>As Revised</b>
<b>Statement of Comprehensive Income Data:</b>			
Net income	\$ 140,465	\$ (1,495)	\$ 138,970
Comprehensive income	142,014	(1,495)	140,519

The following table sets forth the effect of the revisions on the affected line items in our Consolidated Statement of Comprehensive Income for the year ended December 31, 2011.

	<b>Year Ended December 31, 2011</b>		
	<b>As Previously Reported</b>	<b>Revisions</b>	<b>As Revised</b>
<b>Statement of Comprehensive Income Data:</b>			
Net income	\$ 307,752	\$ 1,334	\$ 309,086
Comprehensive income	302,782	1,334	304,116

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The following table sets forth the effect of the revisions on the affected line items in our Consolidated Statement of Cash Flows for the year ended December 31, 2012.

	<b>Year Ended December 31, 2012</b>		
	<b>As Previously Reported</b>	<b>Revisions</b>	<b>As Revised</b>
<b>Statement of Cash Flows Data:</b>			
Net income	\$ 140,465	\$ (1,495)	\$ 138,970
Provision for doubtful accounts	78,307	(21,489)	56,818
Deferred income taxes	(58,640)	(1,359)	(59,999)
Restricted cash	1,527	2,267	3,794
Accounts receivable	(107,514)	20,376	(87,138)
Other operating assets and liabilities	68,890	3,967	72,857
Net cash flows from operating activities	105,354	2,267	107,621

The following table sets forth the effect of the revisions on the affected line items in our Consolidated Statement of Cash Flows for the year ended December 31, 2011.

	<b>Year Ended December 31, 2011</b>		
	<b>As Previously Reported</b>	<b>Revisions</b>	<b>As Revised</b>
<b>Statement of Cash Flows Data:</b>			
Net income	\$ 307,752	\$ 1,334	\$ 309,086
Provision for doubtful accounts	61,308	(25,653)	35,655
Deferred income taxes	(8,991)	0	(8,991)
Restricted cash	(1,873)	931	(942)
Accounts receivable		23,473	
	(40,477)		(17,004)
Other operating assets and liabilities	35,118	846	35,964
Net cash flows from operating activities	387,832	931	388,763

The revisions had an effect on capital surplus, retained earnings and total shareholders' equity as of December 31, 2012, December 31, 2011 and December 31, 2010, as reported in our Consolidated Statements of Shareholders' Equity. The effect on capital surplus, retained earnings and total shareholders' equity as of December 31, 2012 is shown in the Balance Sheet Data table above. The revisions resulted in the following changes to capital surplus, retained earnings and total shareholders' equity as of December 31, 2011:

- a decrease in capital surplus of \$5,366;
- an increase in retained earnings of \$5,672; and
- an increase in total shareholders' equity of \$306.

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The revisions resulted in the following changes to capital surplus, retained earnings and total shareholders' equity as of December 31, 2010:

- a decrease in capital surplus of \$2,969;
- an increase in retained earnings of \$1,941; and
- a decrease in total shareholders' equity of \$1,028.

The revisions had an effect on net income for the years ended December 31, 2012 and December 31, 2011, as reported in our Consolidated Statements of Shareholders' Equity. The effect of the revisions on net income for the years ended December 31, 2012 and December 31, 2011, as reported in our Consolidated Statements of Shareholders' Equity, is shown in the Statement of Income Data tables above.

### **3. New Accounting Guidance**

In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, which is included in the Codification under ASC 606, "Revenue Recognition" ("ASC 606"). This guidance requires the recognition of revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration expected in exchange for those goods or services. This guidance will become effective for our interim and annual reporting periods beginning January 1, 2017. We have not completed our evaluation of the impact that this guidance may have on our consolidated financial statements.

In April 2014, the FASB issued ASU No. 2014-08, which is included in the Codification under ASC 205, "Presentation of Financial Statements" ("ASC 205"). This update changes the requirements for reporting discontinued operations and clarifies when disposals of groups of assets qualify for a discontinued operations presentation under ASC 205. This guidance will become effective for our interim and annual reporting periods beginning January 1, 2015, and will be applied to any transactions that meet those requirements beginning January 1, 2015.

In July 2013, the FASB issued ASU No. 2013-11, which is included in the Codification under ASC 740. This update provides guidance on the presentation of unrecognized tax benefits when net operating loss carryforwards, similar tax losses or tax credit carryforwards exist. This guidance became effective for our interim and annual reporting periods beginning January 1, 2014. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In February 2013, the FASB issued ASU No. 2013-02, which is included in the Codification under ASC 220, "Other Comprehensive Income" ("ASC 220"). This update requires an entity to report the effect, by component, of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income. This guidance was effective for our interim and annual reporting periods beginning January 1, 2013. The adoption of this guidance requires us to provide additional disclosures regarding the amounts reclassified out of accumulated other comprehensive income during a reporting period. We have included these disclosures in the footnotes to our consolidated financial statements. The adoption of this guidance did not have a material impact on our consolidated financial statements.

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

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

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**4. Acquisitions**

On August 1, 2013, we acquired all of the membership interests of Cable Holdings for \$7,150 in cash, net of cash acquired. Cable Holdings is an education company that operates under the name of Benchmark Learning and offers short-term information technology and business learning solutions for career advancers and other professionals. The acquisition of Cable Holdings allowed us to immediately begin operating in the short-term learning solutions market, which we hope to expand upon by leveraging our current employer relationships, alumni and facilities, and integrating Cable Holdings' operations into the Center for Professional Development @ ITT Technical Institute (the "CPD").

Our consolidated financial statements include the results of Cable Holdings from the acquisition date. The revenue and expenses of Cable Holdings included in our Consolidated Statements of Income for the year ended December 31, 2013 were not material. Our revenue, net income and earnings per share would not have been materially affected, if the revenue and expenses of Cable Holdings were presented for the years ended December 31, 2013, 2012 and 2011 as if the transaction had occurred at the beginning of the earliest period presented. The costs incurred to acquire Cable Holdings were expensed and were not material.

We accounted for the acquisition of Cable Holdings in accordance with ASC 805, "Business Combinations" ("ASC 805"), which requires the use of the acquisition method of accounting for all business combinations. We considered the report of a third-party valuation firm in allocating the purchase price to identifiable net assets. The excess of the consideration paid over the estimated fair values of the identifiable net assets acquired was recognized as goodwill and is expected to be deductible for income tax purposes. The identifiable intangible assets acquired consist of customer relationships, non-compete agreements and training materials, which are being amortized over a weighted-average life of approximately five years. The estimated aggregate amortization expense in each of the next five succeeding fiscal years is not material.

The following table sets forth the estimated fair values to be allocated to the major classes of assets acquired and liabilities assumed in the Cable Holdings acquisition as of the acquisition date:

	<u>Assets Acquired</u>	<u>Liabilities Assumed</u>
Accounts receivable and other current assets	\$ 1,110	
Furniture and equipment	480	
Identifiable intangible assets	2,390	
Goodwill	3,958	
Accounts payable and other liabilities		\$ 788

On January 31, 2014, we acquired certain assets and assumed certain liabilities of CompetenC Solutions, Inc. and Great Equalizer, Inc. for approximately \$5,186. CompetenC Solutions, Inc. and Great Equalizer, Inc. were education companies that operated primarily under the name of Ascolta and offered short-term information technology and business learning solutions for career advancers and other professionals. We acquired the Ascolta business to expand the CPD offerings in the short-term learning solutions market.

We will account for the acquisition of the Ascolta business in accordance with ASC 805. The purchase price has been preliminarily allocated to identifiable net assets. The excess of the consideration paid over the estimated fair values of the identifiable net assets acquired will be recognized as goodwill and is expected to be deductible for income tax purposes. The fair value of the identifiable intangible assets acquired is preliminary, pending receipt of the final valuation. The identifiable intangible assets acquired consist of customer relationships and non-compete agreements, which are expected to be amortized over an estimated weighted-average life of approximately five years.

The following table sets forth the estimated fair values allocated to the major classes of assets acquired and liabilities assumed in the Ascolta business acquisition as of the acquisition date:

	<u>Assets Acquired</u>	<u>Liabilities Assumed</u>
Accounts receivable and other current assets	\$ 849	
Furniture and equipment	370	
Identifiable intangible assets	1,670	
Goodwill	3,332	
Other current liabilities		\$ 1,035

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The estimated fair values of the assets acquired and liabilities assumed in the Ascolta acquisition are preliminary and based on information that was available to us as of the acquisition date and as of the date of issuance of these financial statements. We may revise the allocation of the purchase price when we complete the final review of the information. We expect to finalize the purchase price allocation by October 31, 2014.

Our revenue, net income and earnings per share would not have been materially affected, if the revenue and expenses of the Ascolta business were presented for the years ended December 31, 2013, 2012 and 2011 as if the transaction had occurred at the beginning of the earliest period presented. The costs incurred to acquire the Ascolta business were expensed and were not material.

**5. Fair Value and Credit Risk of Financial Instruments**

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

The following table sets forth information regarding the recurring fair value measurement of our financial assets as reflected on our Consolidated Balance Sheet as of December 31, 2013:

<u>Description</u>	<u>As of December 31, 2013</u>	<u>Fair Value Measurements at Reporting Date Using</u>		
		<u>(Level 1) Quoted Prices in Active Markets for Identical Assets</u>	<u>(Level 2) Significant Other Observable Inputs</u>	<u>(Level 3) Significant Unobservable Inputs</u>
Cash equivalents:				
Money market fund	\$ 214,985	\$ 214,985	\$ 0	\$ 0
Restricted cash:				
Money market fund	2,433	2,433	0	0
Other assets:				
Money market fund	8,626	8,626	0	0
	<u>\$ 226,044</u>	<u>\$ 226,044</u>	<u>\$ 0</u>	<u>\$ 0</u>

The following table sets forth information regarding the recurring fair value measurement of our financial assets as reflected on our Consolidated Balance Sheet as of December 31, 2012:

<u>Description</u>	<u>As of December 31, 2012</u>	<u>Fair Value Measurements at Reporting Date Using</u>		
		<u>(Level 1) Quoted Prices in Active Markets for Identical Assets</u>	<u>(Level 2) Significant Other Observable Inputs</u>	<u>(Level 3) Significant Unobservable Inputs</u>
Cash equivalents:				
Money market fund	\$ 151,784	\$ 151,784	\$ 0	\$ 0
Restricted cash:				
Money market fund	2,877	2,877	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>

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.

The carrying amounts for cash and cash equivalents, restricted cash, accounts receivable, accounts payable, and other current liabilities approximate fair value because of the immediate or short-term maturity of these financial instruments. We did not have any financial assets or liabilities recorded at estimated fair value on a non-recurring basis in our Consolidated Balance Sheets as of December 31, 2013 or 2012.

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As of December 31, 2013, the carrying value of the PEAKS Trust Student Loans was approximately \$84,209. The estimated fair value of the PEAKS Trust Student Loans was approximately \$99,100 as of December 31, 2013. The fair value of the PEAKS Trust Student Loans was estimated using the income approach with estimated discounted expected cash flows. We utilized inputs that were unobservable in determining the estimated fair value of the PEAKS Trust Student Loans. The significant inputs used in determining the estimated fair value included the default rate, repayment rate and discount rate. 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 the notes receivable and other receivables included in Prepaid expenses and other current assets or Other assets on our Consolidated Balance Sheet was approximately \$2,500 as of December 31, 2013 and approximately \$9,600 as of December 31, 2012. We estimated the fair value of the notes receivable and other receivables by discounting the future cash flows using current rates for similar arrangements. The assumptions used in this estimate are considered unobservable inputs. Fair value measurements that utilize significant unobservable inputs are categorized as Level 3 measurements under the accounting guidance.

Each of the carrying value and the estimated fair value of our debt under our credit agreement was approximately \$50,000 as of December 31, 2013 and \$140,000 as of December 31, 2012. The fair value of our debt under our credit agreement 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 debt under our credit agreement. Fair value measurements that utilize significant other observable inputs are categorized as Level 2 measurements under the accounting guidance.

As of December 31, 2013, the carrying value of the PEAKS Senior Debt was approximately \$229,224. The estimated fair value of the PEAKS Senior Debt was approximately \$239,400 as of December 31, 2013. The fair value of the PEAKS Senior Debt was estimated using the income approach with estimated discounted cash flows. We utilized inputs that were unobservable in determining the estimated fair value of the PEAKS Senior Debt. The significant input used in determining the estimated fair value was the discount rate utilized for both credit and liquidity purposes. Fair value measurements that utilize significant unobservable inputs are categorized as Level 3 measurements under the accounting guidance.

Financial instruments that potentially subject us to credit risk consist primarily of accounts receivable, interest-bearing investments, notes receivable and the PEAKS Trust Student Loans. 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 and cash equivalents 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. The PEAKS Trust Student Loans consist of a large number of individual loans owed by borrowers, whose credit profiles vary and who are located throughout the United States.

#### **6. Financial Aid Programs**

We participate in various Title IV Programs of the HEA. In 2013, in the aggregate, our institutions derived approximately 82% of their applicable revenue from funds distributed under those Title IV Programs, as determined on a cash accounting basis under the calculation of the provision of the HEA commonly referred to as the "90/10 Rule."

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. 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 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.

#### **7. Equity Compensation Plans**

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

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

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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 two shares. As of December 31, 2013, 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. All awards outstanding as of December 31, 2013 under the 1999 Directors Stock Plan and the 1997 Stock Plan will expire in 2014.

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

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Stock-based compensation expense	\$ 11,638	\$ 16,658	\$ 17,074
Income tax (benefit)	(\$ 4,481)	(\$ 6,414)	(\$ 6,574)

We did not capitalize any stock-based compensation cost in the years ended December 31, 2013, 2012 and 2011.

As of December 31, 2013, we estimated that pre-tax compensation expense for unvested stock-based compensation grants in the amount of approximately \$13,900, net of estimated forfeitures, will be recognized in future periods. This expense will be recognized over the remaining service period applicable to the grantees which, on a weighted-average basis, is approximately 2.0 years.

**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 Amended 2006 Plan and Original 2006 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. All stock options awarded under the Amended 2006 Plan and Original 2006 Plan typically vest and become exercisable in three equal installments commencing with the first anniversary of the date of grant.

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:

	<b>Year Ended December 31, 2013</b>				
	<b># of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Aggregate Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value <sup>(1)</sup></b>
Outstanding at beginning of period	1,574,604	\$ 84.90	\$ 133,691		
Granted	156,500	\$ 19.55	3,059		
Forfeited	(16,668)	\$ 75.11	(1,252)		
Exercised	0	\$ 0.00	0		
Expired	(381,988)	\$ 69.48	(26,543)		
Outstanding at end of period	1,332,448	\$ 81.77	\$ 108,955	2.4 years	\$ 2,198
Exercisable at end of period	1,040,443	\$ 92.28	\$ 96,016	2.1 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, 2013 and multiplying the difference between the closing market price of our common stock and the exercise price of each of those stock options by the number of shares subject to those stock options that were outstanding or exercisable, as applicable.

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

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Shares subject to stock options granted	156,500	156,500	159,500
Weighted average grant date fair value	\$ 9.27	\$ 31.36	\$ 28.90
Shares subject to stock options exercised	0	202,820	118,410
Intrinsic value of stock options exercised	\$ 0	\$ 4,802	\$ 3,095
Proceeds received from stock options exercised	\$ 0	\$ 8,345	\$ 5,599
Tax benefits realized from stock options exercised	\$ 0	\$ 1,602	\$ 1,190

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:

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Risk-free interest rates	0.7%	0.7%	1.8%
Expected lives (in years)	4.6	4.5	4.7
Volatility	60%	51%	48%
Dividend yield	None	None	None

**Restricted Stock Units.** Under the Amended 2006 Plan and Original 2006 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 Amended 2006 Plan and Original 2006 Plan that were not vested as of December 31, 2013 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, 2013</u>	
	<u># of RSUs</u>	<u>Weighted Average Grant Date Fair Value</u>
Unvested at beginning of period	413,645	\$ 75.35
Granted	522,014	\$ 19.98
Forfeited	(129,327)	\$ 46.72
Vested	<u>(68,488)</u>	\$ 88.60
Unvested at end of period	<u>737,844</u>	<u>\$ 39.96</u>

The total fair market value of the RSUs that vested and were settled in shares of our common stock was \$1,241 in the year ended December 31, 2013, \$4,568 in the year ended December 31, 2012 and \$2,454 in the year ended December 31, 2011. Also, in the year ended December 31, 2012, 48,935 RSUs vested and were settled in cash for \$3,073.

**8. Stock Repurchases**

As of December 31, 2013, approximately 7.8 million shares remained available for repurchase under the share repurchase program (the "Repurchase Program") authorized by our Board of Directors. The terms of the Repurchase Program provide that we may repurchase shares of our common stock, from time to time depending on market conditions and other considerations, in the open market or through privately negotiated transactions in accordance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Unless earlier terminated by our Board of Directors, the Repurchase Program will expire when we repurchase all shares authorized for repurchase thereunder.

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

	<u>Year Ended December 31,</u>	
	<u>2013</u>	<u>2012</u>
Number of shares	0	3,025,700
Total cost	\$ 0	\$ 207,918
Average cost per share	\$ 0	\$ 68.72

**9. Earnings (Loss) Per Common Share**

Earnings (loss) 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 (loss) 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>2013</u>	<u>2012</u>	<u>2011</u>
	(In thousands)		
Shares:			
Weighted average number of shares of common stock outstanding	23,412	23,880	27,429
Shares assumed issued (less shares assumed purchased for treasury) for stock-based compensation	<u>Not Applicable</u>	<u>119</u>	<u>226</u>
Outstanding shares for diluted earnings (loss) per share calculation	<u>23,412</u>	<u>23,999</u>	<u>27,655</u>

A total of approximately 1.4 million shares for fiscal year 2013, approximately 1.7 million shares for fiscal year 2012 and approximately 1.1 million shares for fiscal year 2011 were excluded from the calculation of our diluted earnings per common share, because the effect was anti-dilutive.

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**10. Variable Interest Entities**

Under ASC 810, an entity that holds a variable interest in a VIE and meets certain requirements would be considered to be the primary beneficiary of the VIE and required to consolidate the VIE in its consolidated financial statements. In order to be considered the primary beneficiary of a VIE, an entity must hold a variable interest in the VIE and have both:

- the power to direct the activities that most significantly impact the economic performance of the VIE; and
- the right to receive benefits from, or the obligation to absorb losses of, the VIE that could be potentially significant to the VIE.

The PEAKS Trust and the 2009 Entity (defined below) are VIEs as defined under ASC 810. We hold variable interests in the PEAKS Trust as a result of:

- a subordinated note issued to us by the PEAKS Trust in exchange for the portion of each private education loan disbursed to us under the PEAKS Program that we transferred to the PEAKS Trust (“Subordinated Note”); and
- our guarantee of the payment of the principal and interest owed on the PEAKS Senior Debt, the administrative fees and expenses of the PEAKS Trust and a minimum required ratio of assets of the PEAKS Trust to outstanding PEAKS Senior Debt (“PEAKS Guarantee”).

We hold variable interests in an unaffiliated entity (the “2009 Entity”) as a result of:

- a risk sharing agreement that we entered into with the 2009 Entity (the “2009 RSA”) on February 20, 2009 in connection with other agreements to create a program that made private education loans available to our students to help pay the students’ cost of education that financial aid from federal, state and other sources did not cover (the “2009 Loan Program”); and
- a revolving note owed to us by the 2009 Entity (the “Revolving Note”).

To determine whether we are the primary beneficiary of the PEAKS Trust or the 2009 Entity, we:

- assessed the risks that the VIE was designed to create and pass through to its variable interest holders;
- identified the variable interests in the VIE;
- identified the other variable interest holders and their involvement in the activities of the VIE;
- identified the activities that most significantly impact the VIE’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 VIE that could potentially be significant to the VIE.

We determined that the activities of the PEAKS Trust and the 2009 Entity that most significantly impact the economic performance of the PEAKS Trust and the 2009 Entity involve the servicing (which includes the collection) of the PEAKS Trust Student Loans and loans owned by the 2009 Entity. To make that determination, we analyzed various possible scenarios of student loan portfolio performance to evaluate the potential economic impact on the PEAKS Trust and the 2009 Entity. 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 became the primary beneficiary of the PEAKS Trust on February 28, 2013. This was the first date that we had the power to direct the activities of the PEAKS Trust that most significantly impact the economic performance of the PEAKS Trust, because we could have exercised our right to terminate the PEAKS Servicing Agreement (as defined below), due to the failure of the entity that performs those servicing activities for the PEAKS Trust Student Loans on behalf of the PEAKS Trust to meet certain performance criteria specified in the PEAKS Servicing Agreement. We have not, however, exercised our right to terminate the PEAKS Servicing Agreement. As a result of our primary beneficiary conclusion, we consolidated the PEAKS Trust in our consolidated financial statements beginning on February 28, 2013. Prior to February 28, 2013, the PEAKS Trust was not required to be consolidated in our consolidated financial statements, because we concluded that we were not the primary beneficiary of the PEAKS Trust prior to that time. The PEAKS Trust is discussed in more detail below. The PEAKS Servicing Agreement is the agreement between the servicer and the PEAKS Trust (among other parties) that specifies the servicing activities to be provided by the servicer related to the PEAKS Trust Student Loans (the “PEAKS Servicing Agreement”).

Our consolidated financial statements for periods after February 28, 2013 include the PEAKS Trust, because we were considered to have control over the PEAKS Trust under ASC 810 as a result of our substantive unilateral right to terminate the PEAKS Servicing

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Agreement. We do not, however, actively manage the operations of the PEAKS Trust, and the assets of the consolidated PEAKS Trust can only be used to satisfy the obligations of the PEAKS Trust. Our obligations under the PEAKS Guarantee remain in effect, until the PEAKS Senior Debt and the PEAKS Trust's fees and expenses are paid in full. See Note 16—Commitments and Contingencies.

Based on our analysis, we also concluded that we were not the primary beneficiary of the 2009 Entity as of December 31, 2013, because we did not have the power to direct the servicing activities on the private education loans owned by the 2009 Entity. As a result, we are not required under ASC 810 to consolidate the 2009 Entity in our consolidated financial statements as of and for the fiscal year ended December 31, 2013. Our conclusion that we were 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 arising from our conclusion that we were not the primary beneficiary of the 2009 Entity. The 2009 Entity is discussed in more detail below.

We may become the primary beneficiary of the 2009 Entity, if the entity that performs the servicing activities for the 2009 Entity (the "2009 Loan Program Servicer") fails to meet certain performance criteria specified in the servicing agreement that governs the servicing activities of the private education loans made under the 2009 Loan Program (the "2009 Servicing Agreement"). If the 2009 Loan Program Servicer fails to meet those performance criteria, we have the right to terminate the 2009 Servicing Agreement and, therefore, would be considered to have the power to direct the activities of the 2009 Entity that most significantly impact the economic performance of the 2009 Entity. If that occurs, we would be required to consolidate the 2009 Entity in our consolidated financial statements. As of December 31, 2013, we believe that the performance criteria specified in the 2009 Servicing Agreement were met and, therefore, we did not have the right to terminate the 2009 Servicing Agreement. Based on preliminary loan performance data as of September 30, 2014 that we have received regarding the private education loans made under the 2009 Loan Program, however, we believe that, as of September 30, 2014, the 2009 Loan Program Servicer may not have met the performance criteria specified in the 2009 Servicing Agreement. As a result, it appears likely that the 2009 Loan Program Servicer either has failed, or within the foreseeable future will fail, to meet the performance criteria in the 2009 Servicing Agreement. Once that occurs, following a cure period and that assuming that no cure occurs, we will have the right to terminate the 2009 Servicing Agreement. As a result of that right, we will be required to consolidate the 2009 Entity into our consolidated financial statements. We believe that this right to terminate the 2009 Servicing Agreement will become operative in late 2014 or early 2015.

**PEAKS Trust.** On January 20, 2010, we entered into agreements with unrelated third parties to establish the PEAKS Program, which was a private education loan program for our students. Under the PEAKS Program, an unrelated lender originated private education loans to our eligible students and, subsequently, sold those loans to the PEAKS Trust. The PEAKS Trust issued the PEAKS Senior Debt to investors. The 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 the 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 does not bear interest and was recorded net of an unamortized discount based on an imputed interest rate of 9.0% in Other assets on our Consolidated Balance Sheet as of December 31, 2012. Prior to October 1, 2012, the discount was amortized and recognized in Interest income in our Consolidated Statements of Income over the term of the Subordinated Note. The maturity date of the Subordinated Note is in March 2026. The amount owed to us under the Subordinated Note was approximately \$73,000 as of December 31, 2012. The carrying value of the Subordinated Note was eliminated from our Consolidated Balance Sheet when we consolidated the PEAKS Trust in our consolidated financial statements beginning on February 28, 2013.

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 PEAKS Trust Student Loans) serve as collateral for, and are intended to be the principal source of, the repayment of the PEAKS Senior Debt and the Subordinated Note.

In the three months ended December 31, 2012, we determined it was probable that we would not collect the carrying value of the Subordinated Note and, therefore, concluded that the Subordinated Note was impaired. We recorded an impairment charge in the amount of approximately \$10,300, which equaled the total carrying value of the Subordinated Note prior to recording the impairment charge. The carrying value of the Subordinated Note was approximately \$0 as of December 31, 2012, and was included on our Consolidated Balance Sheet in Other assets. The carrying value of the Subordinated Note was eliminated from our Consolidated Balance Sheet when we consolidated the PEAKS Trust in our consolidated financial statements. We did not recognize any interest income related to the Subordinated Note in our Consolidated Statements of Income after September 30, 2012.

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Under the PEAKS Guarantee we guarantee payment of the principal and interest owed on the PEAKS Senior Debt, the administrative fees and expenses of the PEAKS Trust and a minimum required ratio of assets of the PEAKS Trust to outstanding PEAKS Senior Debt. Our guarantee 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 amounts that we paid under the PEAKS Guarantee (which do not include Payments on Behalf of Borrowers, as defined below), to the extent of available funds remaining in the PEAKS Trust. As of December 31, 2012, we had made payments totaling \$12,342 under the PEAKS Guarantee (excluding Payments on Behalf of Borrowers), which we expected to be repaid to us (the "PEAKS Guarantee Receivable"). The PEAKS Guarantee Receivable was eliminated from our Consolidated Balance Sheet when we consolidated the PEAKS Trust in our consolidated financial statements. See Note 16 – Commitments and Contingencies, for a further discussion of the PEAKS Guarantee.

We did not consolidate the PEAKS Trust in our consolidated financial statements as of December 31, 2012, because we concluded that we were not the primary beneficiary of the PEAKS Trust prior to February 28, 2013. We did, however, include the PEAKS Guarantee Receivable, net of accrued discount, and the contingent liability related to the PEAKS Guarantee in our consolidated financial statements as of December 31, 2012. We did not record a PEAKS Guarantee Receivable or a contingent liability related to the PEAKS Guarantee in our consolidated financial statements as of December 31, 2013. See Note 16 – Commitments and Contingencies, for a further discussion of those amounts.

We concluded that we became the primary beneficiary of the PEAKS Trust on February 28, 2013 and, therefore, were required to consolidate the PEAKS Trust in our consolidated financial statements. In accordance with ASC 810, the consolidation of the PEAKS Trust was treated as an acquisition of assets and liabilities and, therefore, the assets and liabilities of the PEAKS Trust were included in our consolidated financial statements at their fair value as of February 28, 2013. The following table sets forth the fair value of the assets and liabilities of the PEAKS Trust as of February 28, 2013 that were included on our Consolidated Balance Sheet on that date:

	<b>As of February 28, 2013</b>	
	<b>Assets</b>	<b>Liabilities</b>
Restricted cash	\$ 1,703	
PEAKS Trust student loans, less allowance for loan losses of \$0	7,282	
PEAKS Trust student loans, excluding current portion, less allowance for loan losses of \$0	104,834	
Current portion of PEAKS Trust senior debt		\$ 103,356
Other current liabilities		471
PEAKS Trust senior debt, excluding current portion		122,740
Total	<u>\$ 113,819</u>	<u>\$ 226,567</u>

The following table sets forth the carrying value of the assets and liabilities related to the PEAKS Program as of February 28, 2013 that we eliminated from our consolidated balance sheet when we consolidated the PEAKS Trust in our consolidated financial statements, and the line items within which those assets and liabilities were included:

	<b>As of February 28, 2013</b>	
	<b>Assets</b>	<b>Liabilities</b>
Other assets	\$ 6,614	
Other current liabilities		\$ 3,060
Other liabilities		43,054
Total	<u>\$ 6,614</u>	<u>\$ 46,114</u>

The fair value of the PEAKS Trust's liabilities exceeded the fair value of the PEAKS Trust's assets as of February 28, 2013 by \$112,748. The amount of this excess was reduced by \$39,500, which represented the net amount of the carrying value of the assets and liabilities related to the PEAKS Program that had been recorded in our consolidated financial statements as of February 28, 2013 and were eliminated upon the Consolidation. As a result, we recognized a total loss of \$73,248 in our Consolidated Statement of Income for the year ended December 31, 2013 related to the Consolidation.

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The following table sets forth the carrying values of assets and liabilities of the PEAKS Trust that were included on our Consolidated Balance Sheet as of December 31, 2013:

	<u>As of December 31, 2013</u>	
	<u>Assets</u>	<u>Liabilities</u>
Restricted cash	\$ 2,593	
PEAKS Trust student loans, less allowance for loan losses of \$0	7,730	
PEAKS Trust student loans, excluding current portion, less allowance for loan losses of \$29,349	76,479	
Current portion of PEAKS Trust senior debt		\$ 157,883
Other current liabilities		697
PEAKS Trust senior debt, excluding current portion		<u>71,341</u>
Total	<u>\$ 86,802</u>	<u>\$ 229,921</u>

The assets of the PEAKS Trust can only be used to satisfy the obligations of the PEAKS Trust. Payment of the administrative fees and expenses of the PEAKS Trust and the principal and interest owed on the PEAKS Senior Debt are guaranteed by us under the PEAKS Guarantee.

The following table sets forth the revenue and expenses of the PEAKS Trust, excluding the loss on consolidation of the PEAKS Trust, that were included in our Consolidated Statement of Income in the year ended December 31, 2013:

	<u>Year Ended December 31, 2013</u>
Revenue	\$ 12,996
Student services and administrative expenses	5,288
Provision for PEAKS Trust student loan losses	29,349
Interest expense	<u>21,288</u>
Income (loss) before provision for income taxes	<u>\$ (42,929)</u>

The revenue of the PEAKS Trust consists of interest income on the PEAKS Trust Student Loans, which is the accretion of the accretable yield on the PEAKS Trust Student Loans. The servicing, administrative and other fees incurred by the PEAKS Trust are included in Student services and administrative expenses in our Consolidated Statements of Income. The provision for PEAKS Trust student loan losses represents the increase in the allowance for loan losses that occurred during the period. The allowance for loan losses represents the difference between the carrying value and the total present value of the expected principal and interest collections of each loan pool of the PEAKS Trust Student Loans, discounted by the loan pool's effective interest rate as of December 31, 2013. Interest expense of the PEAKS Trust represents interest expense on the PEAKS Senior Debt, which includes the contractual interest obligation and the accretion of the discount on the PEAKS Senior Debt.

Beginning in the fourth quarter of 2012 and continuing through January 2014, we made payments on behalf of certain student borrowers under the PEAKS Program to the PEAKS Trust to avoid defaults by those borrowers on their PEAKS Trust Student Loans ("Payments on Behalf of Borrowers"), which defaults would have triggered much larger contractually required payments by us under the PEAKS Guarantee. At the time we made Payments on Behalf of Borrowers, we believed that those payments were contractually permitted and a form of payment to the PEAKS Trust that would satisfy obligations that were contractually required. Since that time, however, we have determined that Payments on Behalf of Borrowers are not permitted or required to support the PEAKS Trust. If we had not made Payments on Behalf of Borrowers, we would have had to make contractually required payments under the PEAKS Guarantee in greater amounts. We made Payments on Behalf of Borrowers after assessing:

- the likelihood of us being contractually required to make payments under the PEAKS Guarantee in the near future;
- the effect on our liquidity that would result from making payments under the PEAKS Guarantee compared to making Payments on Behalf of Borrowers;
- the effect that Payments on Behalf of Borrowers may have on the funds available to the PEAKS Trust to repay the Subordinated Note to us following full payment of the PEAKS Trust's other obligations; and
- the fact that we will not be able to recover Payments on Behalf of Borrowers from the PEAKS Trust or the student borrowers on whose behalf we made those payments.

Payments on Behalf of Borrowers assisted in:

- maintaining the ratio of assets of the PEAKS Trust to outstanding PEAKS Senior Debt at the required level (the "Asset/Liability Ratio"); and

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- satisfying the following month's required payment of interest on the PEAKS Senior Debt and administrative fees and expenses of the PEAKS Trust.

Prior to the Consolidation, Payments on Behalf of Borrowers were reflected on our financial statements as a reduction to our contingent liability accrual. Following the Consolidation, Payments on Behalf of Borrowers were not reflected on our financial statements, since those payments were intercompany transactions, which were eliminated from our financial statements as a result of the Consolidation.

The following table sets forth the guarantee payments and Payments on Behalf of Borrowers that were made related to the PEAKS Program in the periods indicated:

<u>Type of Payment</u>	<u>January 1, 2013 Through February 28, 2013 <sup>(1)</sup></u>	<u>March 1, 2013 Through December 31, 2013 <sup>(1)</sup></u>	<u>Total Year Ended December 31, 2013</u>	<u>Year Ended December 31, 2012</u>
PEAKS Guarantee	\$ 854	\$ 1,559	\$ 2,413	\$ 12,342
Payments on Behalf of Borrowers	532	10,967	11,499	2,762
Total	<u>\$ 1,386</u>	<u>\$ 12,526</u>	<u>\$ 13,912</u>	<u>\$ 15,104</u>

- (1) We have provided separate columns showing the payment amounts prior to and after the Consolidation, because all transactions with the PEAKS Trust were eliminated from our consolidated financial statements after the Consolidation. Cash payments were, however, made by us throughout the periods indicated, including the periods after the Consolidation

In January 2014, we made Payments on Behalf of Borrowers of \$1,832. In March 2014, we entered into a letter agreement, dated as of March 17, 2014, with the trustee under the PEAKS Program and the holders of the PEAKS Senior Debt (the "Letter Agreement"), in order to resolve differing interpretations of the permissibility of the Payments on Behalf of Borrowers under the PEAKS Program documents. Pursuant to the Letter Agreement, the trustee agreed to waive, and the holders of the PEAKS Senior Debt consented to the waiver of, any:

- breach of the PEAKS Program documents caused by us making Payments on Behalf of Borrowers, including any failure to make payments under the PEAKS Guarantee as a result thereof; and
- event of default under the PEAKS Program documents that may have arisen or resulted by us making Payments on Behalf of Borrowers.

In the Letter Agreement, we agreed, after the date of the Letter Agreement, not to make any further payments of any kind on behalf of any borrower in respect of a private education loan made under the PEAKS Program. In accordance with the terms of the Letter Agreement, we paid \$40,000 on March 20, 2014, which is considered to be a payment under the PEAKS Guarantee and was applied primarily to make a mandatory prepayment of the PEAKS Senior Debt.

**2009 Entity.** On February 20, 2009, we entered into agreements with the 2009 Entity to create the 2009 Loan Program. Under the 2009 Loan Program, an unrelated lender originated private education loans to our eligible students and, subsequently, sold those loans to the 2009 Entity. The 2009 Entity purchased the private education loans from the lender utilizing funds received from its owners in exchange for participation interests in the private education loans acquired by the 2009 Entity. The lender disbursed the proceeds of the private education loans to us for application to the students' account balances with us that represented their unpaid education costs. No new private education loans were or will be originated under the 2009 Loan Program after December 31, 2011, but immaterial amounts related to loans originated prior to that date were disbursed by the lender through June 2012.

In connection with the 2009 Loan Program, we entered into 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. Under the 2009 RSA, we have an obligation to make the monthly payments due and unpaid on those private education loans that have been charged off above a certain percentage ("Regular Payments"). Instead of making Regular Payments, however, we may elect to:

- pay the then outstanding balance (plus accrued and unpaid interest) of those private education loans that have been charged off above a certain percentage and, with respect to which, an amount equal to at least ten monthly payments has been paid; or
- pay the then outstanding balance (plus accrued and unpaid interest) of those private education loans that have been charged off above a certain percentage and, with respect to which, an amount equal to at least ten monthly payments has not been paid, plus any interest that would otherwise have been payable until ten monthly payments had been made, discounted at the rate of 10% per annum

(collectively, "Discharge Payments"). We determined that the ability to make Discharge Payments as of December 31, 2013 did not give us the power to direct the activities that most significantly impacted the economic performance of the 2009 Entity and, therefore, did not change our conclusion that we were not the primary beneficiary of the 2009 Entity.

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We are entitled to all amounts that the 2009 Entity recovers from loans in a particular loan pool made under the 2009 Loan Program that have been charged off, until all payments that we made under the 2009 RSA with respect to that loan pool have been repaid to us by the 2009 Entity. The following table sets forth the payments that we made to the 2009 Entity related to our guarantee obligations under the 2009 RSA and the amount of recoveries from charged-off loans paid to us by the 2009 Entity in the periods indicated:

	<b>Year Ended December</b>	
	<b>31,</b>	
	<b>2013</b>	<b>2012</b>
Regular Payments	\$ 1,791	\$ 1,990
Discharge Payments	912	0
Recoveries from Charged-Off Loans	(103)	(234)
	\$ 2,600	\$ 1,756

In the fiscal year ended December 31, 2013, we also offset \$9,091 owed by us under the 2009 RSA against amounts owed to us by the 2009 Entity under the Revolving Note, instead of making additional payments in that amount. See Note 16 – Commitments and Contingencies for a further discussion of the offset. Approximately \$6,786 of the amount that we claimed as an offset against the Revolving Note represented Discharge Payments. We recorded all of the amounts claimed as offsets in Other current liabilities on our Consolidated Balance Sheet as of December 31, 2013. In the year ended December 31, 2013, the 2009 Entity did not remit to us \$574 of recoveries from charged-off loans that were owed to us. We recorded all of the amounts owed to us from the 2009 Entity for recoveries from charged-off loans in Prepaid expenses and other current assets on our Consolidated Balance Sheet as of December 31, 2013. See Note 16 – Commitments and Contingencies, for a further discussion of the 2009 RSA. We determined that claiming an offset against the Revolving Note for Regular Payments or Discharge Payments did not give us the power to direct the activities that most significantly impacted the economic performance of the 2009 Entity as of and for the year ended December 31, 2013 and, therefore, did not change our conclusion that we were not the primary beneficiary of the 2009 Entity.

In addition, we have made advances to the 2009 Entity under the Revolving Note. We did not make any advances in the fiscal years ended December 31, 2013 or 2012 to the 2009 Entity under the Revolving Note that we were not contractually required to make. Certain of the assets of the 2009 Entity serve as collateral for the Revolving Note. The Revolving Note bears interest, is subject to customary terms and conditions and is currently due and payable in full. The 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. The period of time during which we could have made additional advances under the Revolving Note ended on January 1, 2014.

The amount owed to us under the Revolving Note, excluding the offsets described above, was approximately \$8,200 as of December 31, 2013 and \$8,300 as of December 31, 2012. In the three months ended December 31, 2012, we determined that circumstances indicated it was probable that we would not collect the full carrying value of the Revolving Note and, therefore, concluded that the Revolving Note was impaired. We recorded an impairment charge in the amount of \$4,900, which equaled the amount that the carrying value of the Revolving Note exceeded the present value of the expected future cash flows from that note. The carrying value of the Revolving Note prior to recording the impairment charge was approximately \$7,800. The carrying value of the Revolving Note was approximately \$2,500 as of December 31, 2013 and \$2,900 as of December 31, 2012, and was included on our Consolidated Balance Sheets in Prepaid expenses and other current assets as of December 31, 2013 and in Other assets as of December 31, 2012. We have not recognized any interest income related to the Revolving Note in our Consolidated Statements of Income during the time that the Revolving Note has been impaired.

**11. PEAKS Trust Student Loans**

We concluded that we were required to consolidate the PEAKS Trust in our consolidated financial statements beginning on February 28, 2013. See Note 10 – Variable Interest Entities, for a further discussion of the Consolidation. As a result, the assets and liabilities of the PEAKS Trust were included on our Consolidated Balance Sheet as of December 31, 2013. The PEAKS Trust Student Loans are included in the line items related to the PEAKS Trust Student Loans on our Consolidated Balance Sheet.

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A significant number of the PEAKS Trust Student Loans were determined to be credit impaired upon consolidation. Loans determined to be credit impaired upon consolidation or acquisition (“Purchased Credit Impaired Loans” or “PCI Loans”), are initially measured at fair value in accordance with ASC 310-30, “Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality” (“ASC 310-30”). A loan is considered a PCI Loan, if it has evidence of deteriorated credit quality following the loan’s origination date. As a result, at the date of consolidation or acquisition, it is probable that all contractually required payments under a PCI Loan will not be collected.

The PEAKS Trust Student Loans that did not individually have evidence of deteriorated credit quality at the time of consolidation were also initially measured at fair value and are accounted for in accordance with ASC 310-30. We believe that following the guidance of ASC 310-30 by analogy with respect to those loans provides the most reasonable presentation of the value of those loans, primarily due to:

- the evidence of deteriorated credit quality of a significant number of the PEAKS Trust Student Loans; and
- the probability that all contractually required payments with respect to those loans will not be collected.

All of the PEAKS Trust Student Loans are, therefore, considered to be, and reported as, PCI Loans.

This accounting treatment is consistent with the Confirmation Letter, in which the AICPA summarized the SEC staff’s view regarding the accounting in subsequent periods for discount accretion associated with loan receivables acquired in a business combination or asset purchase. In this letter, the AICPA states that it understands that the SEC staff will not object to an accounting policy based on contractual or expected cash flow. We believe that following ASC 310-30 by analogy with respect to the PEAKS Trust Student Loans that did not individually have evidence of deteriorated credit quality at the time of consolidation is an appropriate application of the accounting guidance to determine the initial measurement of the value of those loans.

PCI Loans recognized upon consolidation or acquisition in the same fiscal quarter may be aggregated into one or more pools, provided that the PCI Loans in each pool have common risk characteristics. The PEAKS Trust Student Loans were considered to be PCI Loans upon consolidation and were aggregated into 24 separate pools of loans, based on common risk characteristics of the loans, which included:

- the fiscal quarter in which the PEAKS Trust Student Loan was originated; and
- the consumer credit score of the borrower.

PCI Loans that do not have evidence of deteriorated credit quality are not aggregated in the same pools with PCI Loans that have evidence of deteriorated credit quality. The same aggregation criteria, however, were used to determine those loan pools. Each loan pool is accounted for as a single asset with a single composite interest rate and an aggregate expectation of cash flows.

Upon the Consolidation on February 28, 2013, the PEAKS Trust Student Loans were recorded at their estimated fair value. The estimated fair value of the PEAKS Trust Student Loans as of February 28, 2013 was determined using an expected cash flow methodology. Projected default rates and forbearances were considered in applying the estimated cash flow methodology. Prepayments of loans were not considered when estimating the expected cash flows, because, historically, few PEAKS Trust Student Loans have been prepaid. No allowance for loan loss was established as of February 28, 2013, because all of the PEAKS Trust Student Loans were recorded at fair value and future credit losses are considered in the estimate of fair value.

The following table sets forth the estimated fair value, accretable yield and expected cash flows for the PEAKS Trust Student Loans, in total and for those loans pursuant to which ASC 310-30 was applied by analogy, as of the date indicated:

	<b>As of February 28, 2013</b>	
	<b>Total</b>	<b>ASC 310-30 Applied By Analogy</b>
Estimated fair value	\$ 112,116	\$ 60,177
Accretable yield	\$ 100,953	\$ 58,843
Expected cash flows	\$ 213,069	\$ 119,020

The excess of any cash flows expected to be collected with respect to a loan pool of the PEAKS Trust Student Loans over the carrying value of the loan pool is referred to as the accretable yield. The accretable yield is not reported on our Consolidated Balance Sheets, but it is accreted and included as interest income using the effective interest method, which is at a level rate of return over the remaining estimated life of the loan pool.

The contractually required future principal and interest payments for all PEAKS Trust Student Loans outstanding at February 28, 2013 totaled approximately \$487,800. The contractually required future principal and interest payments for the PEAKS Trust Student

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Loans outstanding at February 28, 2013 pursuant to which ASC 310-30 was applied by analogy totaled approximately \$213,600. The excess of the contractually required payments of the PEAKS Trust Student Loans over the expected cash flows is referred to as the nonaccretable difference. As of February 28, 2013, the nonaccretable difference was approximately \$274,700 for all outstanding PEAKS Trust Student Loans and approximately \$94,600 for those outstanding PEAKS Trust Student Loans pursuant to which ASC 310-30 was applied by analogy.

On a quarterly basis subsequent to February 28, 2013, we estimate the principal and interest expected to be collected over the remaining life of each loan pool. These estimates include assumptions regarding default rates, forbearances and other factors that reflect then-current market conditions. Prepayments of loans were not considered when estimating the expected cash flows, because, historically, few PEAKS Trust Student Loans have been prepaid.

If a decrease in the expected cash flows of a loan pool is probable and would cause the expected cash flows to be less than the expected cash flows at the date of the Consolidation or the end of the previous fiscal quarter, whichever is later, we would record the impairment as:

- a provision for PEAKS Trust student loan losses in our Consolidated Statement of Income; and
- an increase in the allowance for loan losses on our Consolidated Balance Sheet.

The provision for PEAKS Trust student loan losses represents the increase in the allowance for loan losses that occurred during the period. The allowance for loan losses is the difference between the carrying value and the total present value of the expected principal and interest collections of each loan pool, discounted by the loan pool's effective interest rate at the date of the Consolidation or the end of the previous fiscal quarter, whichever is later. If a significant increase in the expected cash flows of a loan pool is probable and would cause the expected cash flows to be greater than the expected cash flows at the date of Consolidation or the end of the previous fiscal quarter, whichever is later, we would:

- first reverse any allowance for loan losses with respect to that loan pool that was previously recorded on our Consolidated Balance Sheet, up to the amount of that allowance; and
- record any remaining increase prospectively as a yield adjustment over the remaining estimated lives of the loans in the loan pool.

The following table sets forth information regarding changes in the allowance for loan losses of the loan pools of the PEAKS Trust Student Loans in the aggregate in the period indicated:

	<b>Year Ended December 31, 2013</b>
Balance as of February 28, 2013	\$ 0
Loans charged off	0
Recoveries from charged off loans	0
Provision for loan losses	29,349
Balance as of December 31, 2013	\$ 29,349

Adjustments to the interest income of a loan pool are recognized prospectively, if those adjustments are due to:

- changes in variable interest rates; or
- any other changes in the timing of the expected cash flows of the loan pools.

Modifications were made to PCI Loans in each of the fiscal quarters in 2013 and were primarily due to forbearances granted with respect to the payment of those loans. We consider the impact of any modifications made to PCI Loans as part of our quarterly assessment of whether:

- a probable and significant change in the expected cash flows of the PCI Loans has occurred; and
- the loans should continue to be accounted for and reported as PCI loans.

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In evaluating the impact of modifications made to PCI Loans on the expected cash flows of those loans, we consider the effect of any foregone interest and the potential for future default. These default estimates are used to calculate expected credit losses with respect to each loan pool. In developing these probabilities of default estimates, we considered the relationship between the credit quality characteristics of the loans in the loan pool and certain assumptions based on the performance history of the PEAKS Trust Student Loans and industry data related to the severity and recovery lag of defaults applicable to private education loans. Loans for which Payments on Behalf of Borrowers were made were assumed to be defaulted loans in our default estimates. Forbearances have been granted with respect to the payment of approximately 25% of the PEAKS Trust Student Loans.

The charge off of a PCI Loan results in the removal of that loan from the underlying PCI Loan pool and reduces the loan pool discount. If the discount for principal losses for a particular PCI Loan pool has been fully depleted, the charge off of a PCI Loan will reduce the PCI Loan pool's allowance for loan losses. Removal of a PCI Loan from the underlying PCI Loan Pool does not change the effective yield of the PCI Loan Pool.

As of December 31, 2013, the outstanding balance of the PEAKS Trust Student Loans, including accrued interest, was approximately \$279,400. The carrying amount of the PEAKS Trust Student Loans included under the line items related to the PEAKS Trust Student Loans on our Consolidated Balance Sheet was \$84,209 as of December 31, 2013. The PEAKS Trust Student Loans were not included on our Consolidated Balance Sheets prior to February 28, 2013.

The following table sets forth information regarding aggregate changes in accretable yield of the loan pools of the PEAKS Trust Student Loans, in total and for those loans pursuant to which ASC 310-30 was applied by analogy, for the period indicated:

	<u>Year Ended December 31, 2013</u>	
	<u>Total</u>	<u>ASC 310-30 Applied By Analogy</u>
Balance as of January 1	\$ 0	\$ 0
Additions resulting from the Consolidation	100,953	58,843
Accretion	(12,996)	(7,243)
Reclassification from nonaccretable difference and changes in expected cash flows	<u>(17,377)</u>	<u>(9,326)</u>
Balance as of December 31	<u>\$ 70,580</u>	<u>\$ 42,274</u>

**12. Property and Equipment**

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

	<u>As of December 31,</u>	
	<u>2013</u>	<u>2012</u>
Furniture and equipment	\$ 162,128	\$ 171,534
Buildings and building improvements	134,993	134,303
Land and land improvements	39,609	39,609
Leasehold improvements	20,953	21,447
Software	8,620	8,620
Construction in progress	<u>156</u>	<u>1,177</u>
	\$ 366,459	\$ 376,690
Less: Accumulated depreciation and amortization	<u>(197,950)</u>	<u>(186,800)</u>
Property and equipment, net	<u>\$ 168,509</u>	<u>\$ 189,890</u>

Software includes purchased and internally developed software.

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

	Year Ended December 31,		
	2013	2012	2011
Depreciation and amortization expense	\$ 27,007	\$ 29,320	\$ 27,856

**13. Debt**

On March 21, 2012, we entered into a credit agreement (the “Credit Agreement”) that provided for a \$325,000 senior revolving credit facility. We entered into amendments to the Credit Agreement on March 31, 2014, May 29, 2014, June 30, 2014 (the “Third Amendment”), July 30, 2014 (the “Fourth Amendment”) and September 15, 2014 (the “Fifth Amendment”), and we entered into a Consent to Credit Agreement, which is effective upon the delivery by us to the lenders of our audited consolidated financial statements included in this filing (the “Consent”). The Credit Agreement, as so amended and including the Consent, is referred to herein as the “Amended Credit Agreement.” The Amended Credit Agreement has a maturity date of March 21, 2015.

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

Under the Amended Credit Agreement, the aggregate commitment of the lenders, effective June 30, 2014, is reduced to \$135,000, and the portion of the commitments available for letters of credit is increased from \$25,000 to \$85,000. Certain letters of credit in an aggregate amount of approximately \$2,352 previously issued by JPMorgan Chase Bank, N.A. are deemed to be letters of credit issued pursuant to the Amended Credit Agreement. If we have not caused the issuance of a letter of credit payable to the ED (“ED Letter of Credit”) by November 15, 2014, the aggregate commitments of the lenders will be reduced to \$100,000. In addition, the commitments of the lenders under the Amended Credit Agreement will be reduced to the extent that borrowings are repaid by us using proceeds from certain types of transactions specified in the Fourth Amendment and the Fifth Amendment, as described further below.

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

- 3.60% per annum in the year ended December 31, 2013;
- 2.40% per annum in the year ended December 31, 2012; and
- 1.20% per annum in the year ended December 31, 2011.

The commitment fee under the Amended Credit Agreement was 0.40% as of December 31, 2013.

We recognized interest expense and fees (including the facility fee and commitment fee) on our borrowings under the Amended Credit Agreement or the prior credit agreement, as applicable, of \$3,424 in the year ended December 31, 2013, \$3,303 in the year ended December 31, 2012 and \$1,825 in the year ended December 31, 2011.

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In addition to the participation fee required to be paid by us pursuant to the original terms of the Credit Agreement related to letters of credit, which accrues at the same rate used to determine the interest rate applicable to Eurodollar Revolving Loans (as defined in the Amended Credit Agreement), the Fifth Amendment provides that an additional participation fee is required to be paid by us related to the ED Letter of Credit, which will accrue at a ticking fee rate on the average daily amount of the lenders' letter of credit exposure with respect to the ED Letter of Credit. The ticking fee rate is defined as:

- 0.00% per annum for the period from September 15, 2014 through and including March 21, 2015;
- 1.00% per annum for the period from March 22, 2015 through and including March 21, 2016;
- 2.00% per annum for the period from March 22, 2016 through and including March 21, 2017;
- 3.00% per annum for the period from March 22, 2017 through and including March 21, 2018;
- 4.00% per annum for the period from March 22, 2018 through and including March 21, 2019; and
- 5.00% per annum for the period from March 22, 2019 through November 15, 2019.

The Amended Credit Agreement contains, among other things, covenants, representations and warranties and events of default customary for credit facilities. We are required to maintain compliance with a maximum Leverage Ratio, a minimum fixed charge coverage ratio, a minimum liquidity amount, and several covenants related to the ED's regulations. We were in compliance with those covenants as of December 31, 2013, after giving effect to the Third Amendment and the Fourth Amendment. The Third Amendment provides that noncompliance with the Leverage Ratio as of the end of the fiscal quarters ending March 31, 2013, June 30, 2013 and September 30, 2013, and noncompliance with the fixed charge coverage ratio as of the end of the fiscal quarters ending March 31, 2013, June 30, 2013, September 30, 2013, and December 31, 2013 (in each case, before giving effect to the Third Amendment) have been waived by the lenders. In addition, among other things, the Third Amendment, the Fourth Amendment, the Fifth Amendment and the Consent, taken together:

- provided that our consolidated financial statements (and related certificates) as of and for the fiscal year ended December 31, 2013, did not have to be furnished by us to the lenders until October 15, 2014;
- provide that our condensed consolidated financial statements (and related certificates) as of and for the fiscal quarter ended March 31, 2014, do not have to be furnished by us to the lenders until November 15, 2014;
- provide that our condensed consolidated financial statements (and related certificates) as of and for the fiscal quarter ended June 30, 2014, do not have to be furnished by us to the lenders until November 15, 2014;
- provide that our condensed consolidated financial statements (and related certificates) as of and for the fiscal quarter ended September 30, 2014, do not have to be furnished by us to the lenders until December 15, 2014;
- amend certain covenants to allow for the Consolidation beginning on February 28, 2013, and for other factors; and
- waive certain defaults related to our financial reporting.

The Amended Credit Agreement:

- is secured by a pledge of the equity interests of our subsidiaries;
- is guaranteed by one of our subsidiaries;
- is secured by security interests in substantially all of our personal property and the personal property of the subsidiary guarantor; and
- is secured by mortgages on 30 separate parcels of land owned by us, including all of the improvements thereto and fixtures thereon (the "Mortgaged Property").

The Fourth Amendment provides that an event of default under the Amended Credit Agreement will occur, if, among other things, the ED imposes a delay of more than five days in our receipt of Title IV Program funds. The Fifth Amendment provides that an event of default under the Amended Credit Agreement will occur if, among other things, we do not engage a financial advisor acceptable to the administrative agent before November 15, 2014 (or another date not later than December 15, 2014, if acceptable to the administrative agent). Based on our discussions with the administrative agent, we understand that the financial advisor would be retained to assist us in our ongoing efforts to identify and secure alternative financing.

The Fifth Amendment provides that the ED Letter of Credit will not be issued unless we have previously delivered certain real estate due diligence items related to the Mortgaged Property. In addition, the Fifth Amendment allows for the ED Letter of Credit, if issued, to have a term ending not later than November 15, 2019.

Under the Amended Credit Agreement, we are required to provide cash collateral (in an amount equal to 109% of the face amount of the ED Letter of Credit and 103% of the face amount of all other letters of credit) for any letter of credit issued under the Amended Credit Agreement:

- after July 30, 2014, immediately upon issuance, except for the ED Letter of Credit, for which cash collateral is not required, until the earlier of December 31, 2014 or when net cash proceeds are received from certain transactions described in the next paragraph; and
- before July 30, 2014, by the earlier of December 31, 2014 or when net cash proceeds are received from certain transactions described in the next paragraph.

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All amounts posted as cash collateral for letters of credit will be treated as cash for purposes of determining our compliance with the minimum liquidity covenant of the Amended Credit Agreement.

Under the Fourth Amendment and the Fifth Amendment, in the event that any net cash proceeds are received by us or a material subsidiary of ours in connection with any sale, transfer, lease or other disposition of the Mortgaged Property, including in connection with any sale and leaseback transaction, any mortgage financing or similar transaction with respect to the Mortgaged Property or the incurrence by us of indebtedness that is not permitted under the Amended Credit Agreement, those net cash proceeds will:

- first, be delivered to the administrative agent in order to cash collateralize all then outstanding letters of credit under the Amended Credit Agreement, until such time as the administrative agent holds cash collateral equal to 109% of the face amount of the ED Letter of Credit and 103% of the face amount of all other letters of credit, or if the ED Letter of Credit has not yet been issued when the net cash proceeds are received, to be held by the administrative agent until the issuance of the ED Letter of Credit and application of the proceeds to cash collateral; and
- second, be used to repay outstanding borrowings under the Amended Credit Agreement, which repayments will be accompanied by a corresponding pro rata reduction of the commitment of each lender under the Amended Credit Agreement.

The Fourth Amendment also implements additional restrictions on us, including, without limitation:

- the exception to the limitation on asset dispositions not otherwise permitted under the Amended Credit Agreement is reduced from \$75,000 in the aggregate during the term of the Amended Credit Agreement to \$5,000 in the aggregate during the period from July 30, 2014 through the remaining term of the Amended Credit Agreement, and all of those asset dispositions must be for fair market value and an adequate cash purchase consideration, as reasonably determined by the administrative agent, provided that those limitations do not apply to an asset disposition of the Mortgaged Property, if that asset disposition generates net cash proceeds of at least 75% of the appraised value of that Mortgaged Property;
- in addition to the existing limitation on sale and leaseback transactions that the net cash proceeds received therefrom may not exceed \$125,000 in the aggregate during the term of the Amended Credit Agreement, any sale and leaseback transaction must be for fair market value and an adequate cash purchase consideration, as reasonably determined by the administrative agent, provided that any sale and leaseback transaction of the Mortgaged Property will be deemed to be for fair market value and an adequate cash purchase consideration, if it generates net cash proceeds of at least 75% of the appraised value of that Mortgaged Property;
- the permitted indebtedness consisting of secured indebtedness at any time outstanding (and not otherwise permitted by the Amended Credit Agreement) is reduced from \$25,000 to \$5,000 in aggregate principal amount; and
- permitted liens to secure indebtedness, obligations and/or liabilities at any one time outstanding (which liens are not otherwise permitted by the Amended Credit Agreement) may not secure debt in excess of \$5,000 in aggregate principal amount, reduced from the original \$25,000.

If any collateral is sold in a transaction permitted under the Amended Credit Agreement or is financed by indebtedness permitted under the Amended Credit Agreement, the administrative agent will release the mortgage or other security interest in that collateral.

As of December 31, 2013, the outstanding borrowings under the Amended Credit Agreement totaled \$50,000 and were classified as a current liability, because we believed it was probable that we would not be in compliance with certain covenants under the Amended Credit Agreement during the 12 months following December 31, 2013.

If we are not in compliance with one or more covenants and are unable to obtain a waiver of our noncompliance or an amendment to the Amended Credit Agreement that would allow us to be in compliance with those covenants or otherwise not be in default under the Amended Credit Agreement, the lenders would have various remedies, including:

- the lending commitments under the Amended Credit Agreement may be terminated;
- our ability to request the issuance of letters of credit and to obtain amendments, extensions or renewals of letters of credit already issued under the Amended Credit Agreement may be terminated;
- all then outstanding borrowings and other amounts owed under the Amended Credit Agreement may be declared immediately due and payable; and
- we could be required to provide cash collateral (in an amount equal to 109% of the face amount of the ED Letter of Credit and 103% of the face amount of all other letters of credit) for our obligations with respect to any outstanding letters of credit, if that cash collateral has not already been posted.

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In the event that we or our subsidiary guarantor do not pay in full, upon demand, all of our outstanding borrowings and other amounts owed under the Amended Credit Agreement or we, or our subsidiary guarantor, do not provide, upon demand, the cash collateral for our letter of credit obligations, the lenders would be entitled to recourse against the collateral security, including the Mortgaged Property, that we and our subsidiary guarantor have provided, in order to obtain payment of amounts we owe or are required to provide as cash collateral.

For the period February 28, 2013 through December 31, 2013, our consolidated financial statements consolidate the PEAKS Trust. See Note 10 – Variable Interest Entities, for a further discussion of the Consolidation. In January 2010, the PEAKS Trust issued PEAKS Senior Debt in the aggregate principal amount of \$300,000 to investors. The PEAKS Senior Debt matures in January 2020 and bears interest at a variable rate based on the LIBOR, plus a 550 basis point margin. The minimum LIBOR rate applied to the PEAKS Senior Debt cannot be less than 2.00%. There are no scheduled principal repayment requirements for the PEAKS Senior Debt prior to the January 2020 maturity date. Under the terms of the PEAKS Program documents, however, amounts received on a monthly basis by the PEAKS Trust that exceed the fees and expenses of the PEAKS Trust then due and the interest then due on the PEAKS Senior Debt are to be paid to reduce the outstanding principal balance of the PEAKS Senior Debt. We estimate that the amount received in 2014 by the PEAKS Trust from PEAKS Trust Student Loan borrowers that could be used to reduce the outstanding principal balance of the PEAKS Senior Debt, will not be material. The assets of the PEAKS Trust (which include, among other assets, the PEAKS Trust Student Loans) serve as collateral for, and are intended to be the principal source of, the repayment of the PEAKS Senior Debt. Payment of the PEAKS Senior Debt may be accelerated by the indenture trustee of the PEAKS Trust or by the holders of the PEAKS Senior Debt in response to certain events of default under the indenture under the PEAKS Program (the “PEAKS Indenture”), including, among other things:

- a payment default by the PEAKS Trust;
- a default in the performance or observation of the PEAKS Trust’s covenants, agreements or conditions under the PEAKS Indenture;
- a breach of our obligations under the PEAKS Guarantee; and
- certain bankruptcy events with respect to the PEAKS Trust or us.

An acceleration of the payment of the PEAKS Senior Debt would result in an acceleration of our obligation to pay the full amount of the PEAKS Senior Debt pursuant to the terms of the PEAKS Guarantee, if the PEAKS Trust was not able to make that payment (and we believe that it is unlikely that the PEAKS Trust would be able to make that payment). The acceleration of our obligation to pay the full amount of the PEAKS Senior Debt, and/or our inability to make that payment, could result in cross-defaults under the Amended Credit Agreement.

The PEAKS Trust must maintain a minimum required Asset/Liability Ratio. The minimum required Asset/Liability Ratio is 1.05/1.00. The applicable required Asset/Liability Ratio as of each monthly measurement date, however, is based on our compliance, as of the prior quarterly measurement date, with certain metrics specified in the PEAKS Program documents, including maximum leverage ratios and minimum liquidity amounts. If we are not in compliance with those metrics as of the end of a fiscal quarter, the required Asset/Liability Ratio increases to 1.40/1.00, until the monthly measurement date following the end of a succeeding quarter at which we are in compliance with those metrics. As a result of the Consolidation and other factors, we were not in compliance with those metrics as of December 31, 2013. We do not expect to be in compliance with those metrics prior to December 31, 2014.

If the amount of the assets of the PEAKS Trust does not equal or exceed the outstanding PEAKS Senior Debt by the applicable required Asset/Liability Ratio on a monthly measurement date, we are required to make a payment under the PEAKS Guarantee in an amount that would reduce the outstanding principal balance of the PEAKS Senior Debt to the extent necessary to cause the ratio of the assets of the PEAKS Trust to the resulting outstanding PEAKS Senior Debt to equal or exceed the applicable required Asset/Liability Ratio. See Note 16 – Commitments and Contingencies, for a further discussion of the PEAKS Guarantee.

As a consequence of the restatement of our unaudited condensed consolidated financial statements in our Quarterly Reports on Form 10-Q for the fiscal quarters ended March 31, 2013, June 30, 2013 and September 30, 2013, certain quarterly reports that we were required to deliver to the indenture trustee of the PEAKS Trust under the PEAKS Guarantee were inaccurate. We delivered corrected quarterly reports to the indenture trustee on October 9, 2014. If we had delivered accurate quarterly reports or, with respect to periods in 2014 through June 30, 2014, delivered quarterly reports, to the indenture trustee of the PEAKS Trust, we believe the indenture trustee would have made payment demands beginning in April 2013, requiring us to make additional payments under the PEAKS Guarantee totaling \$60,340, in the aggregate, in order to maintain an Asset/Liability Ratio of 1.40/1.00. On October 9, 2014, we made a guarantee payment of \$50,000, which payment, along with other payments that we have made to the PEAKS Trust in recent months, included amounts that would have become due between April 2013 and September 2014, had we delivered accurate quarterly reports.

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The delivery of inaccurate quarterly reports constituted a breach of the PEAKS Guarantee and an event of default under the PEAKS Indenture. In the event of a default under the PEAKS Indenture, the payment of the entire amount of the PEAKS Senior Debt could be accelerated, which would trigger our obligation to pay the full amount of the PEAKS Senior Debt pursuant to our obligations under the PEAKS Guarantee, additional remedies could be sought against us and there could be a cross-default under the Amended Credit Agreement, any of which would have a material adverse effect on our results of operations, financial condition and cash flows. We believe that the delivery of the corrected quarterly reports and making the additional guarantee payments satisfied our obligations under the PEAKS Guarantee with respect to these matters and cured the event of default under the PEAKS Indenture. We cannot predict, however, whether the holders of the PEAKS Senior Debt will assert other breaches of the PEAKS Guarantee by us or assert that any breach of the PEAKS Guarantee or event of default under the PEAKS Indenture was not properly cured.

We estimate that we have and will make payments under the PEAKS Guarantee totaling approximately \$159,500 in the year ending December 31, 2014 to cause the PEAKS Trust to maintain the applicable required Asset/Liability Ratio. That estimated amount includes the:

- \$40,000 that we paid in March 2014 pursuant to the Letter Agreement, which was applied primarily to make a mandatory prepayment of the PEAKS Senior Debt (see Note 10 – Variable Interest Entities, for a further discussion of the Letter Agreement);
- payments totaling approximately \$51,700 that we made from July 2014 through September 2014 to satisfy our obligations under the PEAKS Guarantee with respect to the increased minimum required Asset/Liability Ratio in prior periods; and
- \$50,000 that we paid in October 2014, as described in the immediately preceding paragraph.

As of December 31, 2013, the outstanding principal balance of the PEAKS Senior Debt was approximately \$255,600 and the carrying value was \$229,224. We recorded \$157,883 as a current liability as of December 31, 2013, which represented our estimate of the amount of the carrying value that would have been due in the 12 months following December 31, 2013 after giving consideration to the effects of the restatement, as described above. The PEAKS Senior Debt was recorded on our consolidated balance sheet as of February 28, 2013 at its estimated fair value on that date, which was approximately \$226,096. The outstanding principal balance of the PEAKS Senior Debt as of February 28, 2013 was \$257,533. The \$31,437 difference between the estimated fair value and the outstanding principal balance of the PEAKS Senior Debt as of February 28, 2013 was recorded as an accrued discount on our consolidated balance sheet and will be recognized as Interest expense in our Consolidated Statements of Income using an effective interest rate method over the term of the PEAKS Senior Debt. The effective interest rate on the PEAKS Senior Debt was approximately 9.90% per annum in the year ended December 31, 2013. We recognized interest expense on the PEAKS Senior Debt of \$21,288 in the year ended December 31, 2013, which included \$4,926 of discount accretion.

The following table sets forth the estimated principal payments on the PEAKS Senior Debt in the periods indicated:

<u>Fiscal Year</u>	<u>Amount</u>
2014	\$ 161,219
2015	\$ 16,699
2016	\$ 7,618
2017	\$ 8,194
2018	\$ 8,909
2019 - 2020	\$ 51,393

**14. Income Taxes**

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

	<u>Year Ended December 31,</u>		
	<u>2013</u>	<u>2012</u>	<u>2011</u>
Current income tax expense:			
U.S. federal	\$ 39,279	\$ 126,585	\$ 174,264
State and local	4,611	22,004	35,128
Total	<u>\$ 43,890</u>	<u>\$ 148,589</u>	<u>\$ 209,392</u>
Deferred income tax (benefit):			
U.S. federal	(\$ 46,345)	(\$ 51,145)	(\$ 6,718)
State and local	(7,757)	(8,426)	(1,427)
Total	<u>(\$ 54,102)</u>	<u>(\$ 59,571)</u>	<u>(\$ 8,145)</u>
Total provision (benefit) for income taxes	<u>(\$ 10,212)</u>	<u>\$ 89,018</u>	<u>\$ 201,247</u>

We recognized approximately \$298 of state income tax benefit in the year ended December 31, 2013, as a result of state operating losses.

We do not include the PEAKS Trust in our consolidated income tax returns because the PEAKS Trust is a tax-exempt entity. Therefore, we did not recognize income tax expense or benefit for the PEAKS Trust in the provision for income taxes included in our

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Consolidated Statement of Income for the year ended December 31, 2013. The effect of the exclusion of the PEAKS Trust from our income tax provision is shown in the reconciliation of our effective income tax rate as a percentage of income shown below.

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

	<b>As of December 31,</b>	
	<b>2013</b>	<b>2012</b>
Deferral of book costs	(\$ 1,748)	(\$ 1,810)
Property and equipment	(1,807)	(6,416)
Pension	(10,566)	(2,712)
Other	(1,189)	(2,308)
Gross deferred tax (liabilities)	(\$ 15,310)	(\$ 13,246)
Deferred revenue	\$ 10,902	\$ 14,687
Accounts receivable	3,551	6,073
Legal accrual	3,455	2,018
Compensation and benefits	3,316	1,643
Stock-based compensation	20,794	22,680
Operating leases	2,386	735
Legal settlement accrual	0	17,834
Other assets	8,356	18,772
Other contingent liabilities	108,423	30,822
Gross deferred tax assets	\$ 161,183	\$ 115,264
Net deferred income tax asset	\$ 145,873	\$ 102,018

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:

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
U.S. federal statutory income tax rate	(35.0%)	35.0%	35.0%
PEAKS Trust rate differential	11.9%	0%	0%
State income taxes, net of federal benefit	(5.6%)	3.4%	3.9%
Permanent book/tax differences	2.8%	0.9%	0.4%
Other	(1.5%)	(0.3%)	0.1%
Effective income tax rate	(27.4%)	39.0%	39.4%

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

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Balance as of January 1	\$ 20,690	\$ 22,050	\$ 22,888
Increases (decreases) from:			
Tax positions taken during a prior period	1,675	195	1,042
Tax positions taken during the current period	870	759	2,434
Settlements with taxing authorities	186	(1,027)	(2,487)
Lapse of statute of limitations	(1,130)	(1,287)	(1,827)
Balance as of December 31	\$ 22,291	\$ 20,690	\$ 22,050

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The amount of unrecognized tax benefits that, if recognized, would have affected our effective tax rate as of December 31, 2013 was \$10,575. 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 \$6,371 as of December 31, 2013 and \$5,699 as of December 31, 2012. In each of the years ended December 31, 2013, 2012 and 2011, 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, 2013, we were no longer subject to federal, state or local income tax examinations for tax years prior to 2010, except in eleven states where we are still subject to income tax examinations for tax year 2009 and one state where we are still subject to income tax examination for the tax years 2005 through 2008.

**15. 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.

The information presented below is based on an actuarial valuation date as of December 31 for 2013 and 2012.

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

	<b>Year Ended December 31,</b>	
	<b>2013</b>	<b>2012</b>
Projected benefit obligation at beginning of year	\$ 57,246	\$ 54,485
Service cost	0	0
Actuarial (gain) loss	(5,345)	3,180
Interest cost	1,756	2,062
Benefits paid	(4,245)	(2,481)
Plan amendments	0	0
Projected benefit obligation at end of year	<u>\$ 49,412</u>	<u>\$ 57,246</u>
Fair value of plan assets at end of year	<u>76,710</u>	<u>64,390</u>
Funded status at end of year	<u>\$ 27,298</u>	<u>\$ 7,144</u>

Our accumulated benefit obligation was \$49,412 at December 31, 2013 and \$57,246 at December 31, 2012.

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:

	<b>As of December 31,</b>	
	<b>2013</b>	<b>2012</b>
Non-current assets	\$27,584	\$7,459
Non-current (liabilities)	(286)	(315)
Total	<u>\$27,298</u>	<u>\$7,144</u>

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The weighted-average assumptions used to determine benefit obligations as of December 31, 2013 and 2012 are as follows:

	<b>2013</b>	<b>2012</b>
Discount rate	4.25%	3.25%
Rate of compensation increase	N/A	N/A

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

	<b>Year Ended December 31,</b>	
	<b>2013</b>	<b>2012</b>
Fair value of plan assets at beginning of year	\$ 64,390	\$ 58,839
Actual return on plan assets	16,565	8,032
Employer contributions	0	0
Benefits paid	(4,245)	(2,481)
Fair value of plan assets at end of year	\$ 76,710	\$ 64,390

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

**Fair Value Measurements as of December 31, 2013**

<b>Asset Category</b>	<b>Total</b>	<b>(Level 1)</b>	<b>(Level 2)</b>	<b>(Level 3)</b>
		<b>Quoted Prices in Active Markets for Identical Assets</b>	<b>Significant Other Observable Inputs</b>	<b>Significant Unobservable Inputs</b>
Cash and cash equivalents	\$ 934	\$ 934	\$ 0	\$ 0
Fixed income securities <sup>(a)</sup>	12,596	12,596	0	0
Equity securities:				
Domestic large cap	40,669	40,669	0	0
Mid cap value/growth <sup>(a)</sup>	12,610	12,610	0	0
Small cap value/growth <sup>(a)</sup>	7,163	7,163	0	0
Foreign equities	2,738	2,738	0	0
Total	\$ 76,710	\$ 76,710	\$ 0	\$ 0

(a) Mutual funds.

**Fair Value Measurements as of December 31, 2012**

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

(a) Mutual funds.

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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.

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 pension benefit cost as of the dates indicated:

	<b>As of December 31,</b>	
	<b>2013</b>	<b>2012</b>
Net actuarial (loss)	(\$ 546)	(\$ 20,191)
Prior service credit	5,578	7,133
Total accumulated other comprehensive income (loss)	\$ 5,032	(\$ 13,058)
Income tax benefit (expense)	(1,886)	5,128
Total accumulated other comprehensive income (loss), net of tax	\$ 3,146	(\$ 7,930)

The following table sets forth the changes in the components of Accumulated other comprehensive loss on our Consolidated Balance Sheet in the fiscal year ended December 31, 2013:

	<b>Defined Benefit Pension Items</b>		
	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Income Tax Benefit (Expense)</b>	<b>Accumulated Other Comprehensive Income (Loss) Net of Income Tax</b>
Balance at January 1, 2013	(\$ 13,058)	\$ 5,128	(\$ 7,930)
Net actuarial gain	17,566	(6,811)	10,755
Settlement gain	42	(17)	25
Amortization of:			
Actuarial (gains)/losses	2,037	(790)	1,247
Prior service costs/(credits)	(1,555)	604	(951)
Balance at December 31, 2013	\$ 5,032	(\$ 1,886)	\$ 3,146

The reclassification of prior service costs or credits, actuarial gains or losses and settlement gain from Accumulated other comprehensive loss are included in the computation of net periodic pension benefit cost (income). Net periodic pension benefit cost (income) was included in compensation expense in Cost of educational services and Student services and administrative expenses in our Consolidated Statements of Income in the fiscal year ended December 31, 2013.

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

	<b>Year Ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Interest cost	\$ 1,756	\$ 2,062	\$ 2,405
Expected return on assets	(4,344)	(4,231)	(4,756)
Recognized net actuarial loss	2,037	2,718	1,803
Amortization of prior service (credit) cost	(1,555)	(1,555)	(1,555)
Settlement loss	42	792	1,204
Total net periodic pension benefit (income)	(\$ 2,064)	(\$ 214)	(\$ 899)

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

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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:

	<u>Year Ended December 31,</u>		
	<u>2013</u>	<u>2012</u>	<u>2011</u>
Net actuarial (gain) loss	(\$ 17,566)	(\$ 621)	\$ 9,504
Amortization of net actuarial loss	(2,037)	(2,718)	(1,803)
Prior service cost (credit)	0	0	0
Amortization of prior service cost (credit)	1,555	1,555	1,555
Settlement	(42)	(792)	(1,204)
Other comprehensive (income) loss	<u>(\$ 18,090)</u>	<u>(\$ 2,576)</u>	<u>\$ 8,052</u>
Total recognized in net periodic pension benefit (income) and other comprehensive (income) loss	<u>(\$ 20,154)</u>	<u>(\$ 2,790)</u>	<u>\$ 7,153</u>

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 income and recognized in net periodic pension benefit cost for the year ended December 31, 2014 is \$0 and the estimated prior service credit that is expected to be amortized from accumulated other comprehensive income and recognized in net periodic pension benefit cost for the year ended December 31, 2014 is \$1,555.

The weighted-average assumptions used to determine net periodic pension benefit cost in the years ended December 31, 2013, 2012 and 2011 are as follows:

	<u>2013</u>	<u>2012</u>	<u>2011</u>
Discount rate	3.25%	4.00%	5.00%
Expected long-term return on plan assets	7.00%	7.50%	8.00%
Rate of compensation increase	N/A	N/A	N/A

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 2014	\$ 3,576
Fiscal 2015	\$ 3,464
Fiscal 2016	\$ 4,315
Fiscal 2017	\$ 4,896
Fiscal 2018	\$ 3,538
Fiscal 2019 – 2023	\$ 16,838

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. Actual asset allocations may vary from the targeted allocations for various reasons, including market conditions and the timing of transactions. 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.

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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 2013 and 2012, 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 2014.

**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.

On July 1, 2013, we changed the rate at which we made contributions to the ESI 401(k) Plan on behalf of our employees. Prior to July 1, 2013, we contributed 100% of the first 1% and 50% of the next 4% of an employee's salary that the employee contributed to his or her ESI 401(k) Plan account. Beginning July 1, 2013, we contribute 50% of the first 6% of an employee's salary that the employee contributes to his or her ESI 401(k) Plan account.

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:

- \$3,454 in the year ended December 31, 2013;
- \$4,597 in the year ended December 31, 2012; and
- \$5,308 in the year ended December 31, 2011.

**16. 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, 2013, the total face amount of those surety bonds was approximately \$19,300. As of December 31, 2013, we also had issued approximately \$2,246 of letters of credit to our workers' compensation insurers.

We are also subject to various claims and contingencies, including those related to litigation, government investigations, 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.

The following table sets forth the components of our recorded liability related to our claims and contingencies and where the amounts were included on our Consolidated Balance Sheets as of the dates indicated:

	<u>As of December 31,</u>	
	<u>2013</u>	<u>2012</u>
PEAKS Guarantee <sup>(1)</sup>	\$ 0	\$ 47,500
2009 RSA	116,923	28,232
2007 RSA <sup>(2)</sup>	0	46,000
Other	8,957	5,246
Total	<u>\$ 125,880</u>	<u>\$ 126,978</u>
Other current liabilities	\$ 25,893	\$ 85,655
Other liabilities	99,987	41,323
Total	<u>\$ 125,880</u>	<u>\$ 126,978</u>

(1) We consolidated the PEAKS Trust in our consolidated financial statements as of February 28, 2013. See Note 10 – Variable Interest Entities, for a further discussion of the Consolidation.

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(2) As defined below

Other current liabilities primarily represented our estimate of the loss that we believed we would realize during the 12- month period following the dates indicated. As of December 31, 2013, Other current liabilities included \$9,091 that we claimed as an offset against amounts owed to us under the Revolving Note. See “ – Guarantees,” for a further discussion of the amounts we claimed as offsets under the Revolving Note. The amounts included in Other liabilities primarily related to our estimated contingent liabilities for the 2009 RSA as of December 31, 2013 and the PEAKS Guarantee and 2009 RSA as of December 31, 2012, and represented our estimate of the loss that we believed we would realize after the 12-month period following the dates indicated and over a period that could exceed 10 years.

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

	<b>Year Ended December 31,</b>	
	<b>2013</b>	<b>2012</b>
Balance as of January 1	\$ 126,978	\$ 36,028
Increases (decreases) from:		
Additional accruals:		
PEAKS Guarantee <sup>(1)</sup>	0	55,935
2009 RSA <sup>(2)</sup>	90,964	23,340
2007 RSA	0	21,750
Other	4,038	117
Payments, net of recoveries of \$103 and \$234 <sup>(3)</sup>	(2,600)	(1,756)
Payments under PEAKS Guarantee, net of estimated recoveries of \$1,408 and \$6,668	(1,005)	(5,674)
Payments on Behalf of Borrowers	(11,499)	(2,762)
Settlement payment – 2007 RSA	(46,000)	0
Elimination of intercompany transactions <sup>(4)</sup>	11,118	0
Elimination of PEAKS Guarantee accrual <sup>(5)</sup>	(46,114)	0
Balance as of December 31	<u>\$ 125,880</u>	<u>\$ 126,978</u>

- (1) Our guarantee 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 by the PEAKS Trust of the amount of payments we made under the PEAKS Guarantee (which do not include Payments on Behalf of Borrowers) to the extent that funds remain in the PEAKS Trust after the PEAKS Senior Debt and all fees and expenses of the PEAKS Trust have been paid in full. The PEAKS Senior Debt matures in January 2020 and, therefore, we do not expect to begin receiving any repayment of amounts that we previously paid under the PEAKS Guarantee until February 2020. The accrual related to the PEAKS Guarantee as of December 31, 2012 was recorded net of estimated recoveries, taking into consideration the present value of the estimated recoveries.
- (2) This amount represents a change in our accounting estimate for the amount of our guarantee obligations under the 2009 RSA. We revised our estimate for the 2009 RSA based on an enhanced default rate methodology and more recent performance data that we obtained in the three months ended December 31, 2013. The primary enhancements and performance data included: (i) an adjustment to the default estimates for student borrowers, as a result of recently obtained actual default data for similarly-situated student borrowers; (ii) an adjustment to the default rate expectations, due to declines in repayment performance; (iii) our ability to make Discharge Payments; and (iv) a lower expectation for collections on defaulted loans as a result of the performance to date of collections.
- (3) Includes payments, net of recoveries, under the 2009 RSA.
- (4) We consolidated the PEAKS Trust in our consolidated financial statements as of February 28, 2013 and, as a result, we have eliminated from our consolidated financial statements the amount of payments under the PEAKS Guarantee and Payments on Behalf of Borrowers that we made following the Consolidation. See Note 10 – Variable Interest Entities, for a further discussion of the Consolidation.
- (5) As a result of the Consolidation, we have eliminated from our consolidated financial statements the contingent liability related to the PEAKS Guarantee that we had previously recorded.

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

In order to determine the amount of the contingent liability to record related to our guarantee obligations under the 2009 RSA and, prior to the Consolidation, the PEAKS Guarantee, we utilize estimates of, among other things, the projected repayment performance of the private education loans made under each of the 2009 Loan Program and the PEAKS Program, which projections involve numerous

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assumptions. Based on those projections and other factors, we estimate the amount of payments that we expect to make and the amounts that we expect to be repaid to us under those programs.

Under the 2009 RSA, we are entitled to all amounts that the 2009 Entity recovers from loans in a particular loan pool made under the 2009 Loan Program that have been charged off, until all payments that we made under the 2009 RSA with respect to that loan pool have been repaid to us by the 2009 Entity. Pursuant to the terms of the PEAKS Program documents, we will be entitled to repayment by the PEAKS Trust of the amount of payments we made under the PEAKS Guarantee (which do not include Payments on Behalf of Borrowers) to the extent that funds remain in the PEAKS Trust after the PEAKS Senior Debt and all fees and expenses of the PEAKS Trust have been paid in full. The PEAKS Senior Debt matures in January 2020 and, therefore, we do not expect to begin receiving any repayment of amounts that we previously paid under the PEAKS Guarantee until February 2020.

We discount the amounts that we expect will be repaid to us under each of the 2009 RSA and the PEAKS Program documents to reflect an imputed interest cost for the period of time between when payments are expected to be made by us and when amounts are expected to be repaid to us. The difference between the amount of the guarantee payments that we expect to make and the discounted amount that we expect will be repaid to us under each of the 2009 RSA and the PEAKS Program documents is included in our estimate of the amount of our contingent liability related to our guarantee obligations under the 2009 RSA and PEAKS Guarantee.

In connection with the change in accounting estimate of the contingent liability related to our guarantee obligations under the 2009 RSA, we also consider the payment options available to us under the 2009 Loan Program, including our ability to make Discharge Payments under the 2009 RSA. To the extent that we project that we will have sufficient funds available to make Discharge Payments under the 2009 RSA, we incorporate an assumption that we will make Discharge Payments into our estimate of the amount of payments that we expect to make when determining the contingent liability. Making Discharge Payments results in us paying a lesser amount than we otherwise would have been required to pay under our guarantee obligations in future periods under the 2009 RSA and, therefore, results in an estimated contingent liability amount that is less than if we had assumed that we would make Regular Payments in future periods.

In connection with estimating our recorded liability for claims and contingencies as of December 31, 2013 and 2012, we 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 PEAKS Guarantee (for the year ended December 31, 2012 only) and 2009 RSA (collectively, the "RSAs"), we made certain assumptions with respect to the performance of the private education loans made under the 2009 Loan Program and PEAKS Program over the life of those loans. The life of a private education loan made under the 2009 Loan Program or PEAKS Program 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 repayment performance of the private education loans made under each of the 2009 Loan Program and PEAKS Program;
- the timing and rate at which those private education loans will be paid;
- the changes in the variable interest rates applicable to the private education loans and PEAKS Senior Debt;
- the amounts and timing of collections in the future on those private education loans that have defaulted;
- the fees and expenses associated with servicing those private education loans; and
- our ability to utilize the available options for payment of our obligations under the 2009 RSA.

We consulted with third-party consumer credit consulting firms in arriving at our assumptions and estimates. The assumptions have changed, and may continue to change, significantly over time as actual results become known, which would affect our estimated range of possible losses related to the 2009 RSA. With respect to our guarantee obligations under the 2009 RSA, we believe that it is reasonably possible that we may incur losses in an estimated range of \$11,000 less than to \$28,000 greater than the liability recorded as of December 31, 2013 for those contingencies. As with any estimate, as facts and circumstances change, the recorded liability and estimated range of reasonably possible losses could change significantly. With respect to legal proceedings, we determined that we cannot provide an estimate of the possible losses, or the range of possible losses, in excess of the amount, if any, accrued, for various reasons, including but not limited to some or all of the following:

- there are significant factual issues to be resolved;
- there are novel or unsettled legal issues presented;
- the proceedings are in the early stages;

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- there is uncertainty as to the likelihood of a class being certified or decertified or the ultimate size and scope of the class;
- there is uncertainty as to the outcome of pending appeals or motions; and
- in many cases, the plaintiffs have not specified damages in their complaint or in court filings.

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

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

- treble the amount of unspecified funds paid to us for federal student grants;
- treble the amount of unspecified default payments, special allowance payments and interest received by lenders with respect to federal student loans received by our students;
- all civil penalties allowed by law; and
- attorney’s fees and costs.

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

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

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

On March 11, 2013, a complaint in a securities class action lawsuit was filed against us and two of our current executive officers in the United States District Court for the Southern District of New York under the caption: *William Koetsch, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* (the “Koetsch Litigation”). On April 17, 2013, a second 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 caption: *Massachusetts Laborers’ Annuity Fund, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* (the “MLAF Litigation”). On July 25, 2013, the court consolidated the Koetsch Litigation and the MLAF Litigation under the caption: *In re ITT Educational Services, Inc. Securities Litigation* (the “Securities Litigation”) and named the Plumbers and Pipefitters National Pension Fund and Metropolitan Water Reclamation District Retirement Fund as the lead plaintiffs. On October 7, 2013, an amended complaint was filed in the Securities Litigation, and on January 15, 2014, a second amended complaint was filed in the Securities Litigation.

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The second amended complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by:

- our failure to properly account for the 2007 RSA, 2009 RSA and PEAKS Program;
- employing devices, schemes and artifices to defraud;
- making untrue statements of material facts, or omitting material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading;
- making the above statements intentionally or with reckless disregard for the truth;
- engaging in acts, practices, and a course of business that operated as a fraud or deceit upon lead plaintiffs and others similarly situated in connection with their purchases of our common stock;
- deceiving the investing public, including lead plaintiffs and the purported class, regarding, among other things, our artificially inflated statements of financial strength and understated liabilities; and
- causing our common stock to trade at artificially inflated prices and causing the plaintiff and other putative class members to purchase our common stock at inflated prices.

The putative class period in this action is from April 24, 2008 through February 25, 2013. The plaintiffs seek, among other things, the designation of this action as a class action, an award of unspecified compensatory damages, interest, costs and expenses, including counsel fees and expert fees, and such equitable/injunctive and other relief as the court deems appropriate. On July 22, 2014, the district court denied most of our motion to dismiss all of the plaintiffs' claims for failure to state a claim for which relief can be granted. On August 5, 2014, we filed our answer to the second amended complaint denying all of the plaintiffs' claims. All of the defendants have defended, and intend to continue to defend, themselves vigorously against the allegations made in the second amended complaint.

On September 30, 2014, 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 Indiana under the caption: *David Banes, Individually and on Behalf of All Others Similarly Situated v. Kevin M. Modany, et al.* (the "Banes Litigation"). The complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by:

- misleading investors regarding the integrity of our financial reporting, including the reporting of the PEAKS Trust;
- knowingly or recklessly making materially false and/or misleading statements and/or failing to disclose material adverse facts about our business operations and prospects, including that:
  - our financial statements contained errors related to the accounting of the PEAKS Trust and the PEAKS Program; and
  - we lacked adequate internal controls over financial reporting;
- knowingly or recklessly engaging in acts, transactions, practices, and courses of business that operated as a fraud or deceit upon the plaintiff and the purported class;
- employing devices, schemes and artifices to defraud in connection with the purchase and sale of our common stock;
- deceiving the investing public, including the plaintiff and the purported class; and
- artificially inflating and maintaining the market price of our common stock and causing the plaintiff and other putative class members to purchase our common stock at artificially inflated prices.

The putative class period in this action is from April 26, 2013 through September 19, 2014. The plaintiffs seek, among other things, the designation of this action as a class action, an award of unspecified damages, interest, costs and expenses, including counsel fees and expert fees, and such other relief as the court deems proper. All of the defendants intend to defend themselves vigorously against the allegations made in the complaint.

On October 3, 2014, 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 Indiana under the caption: *Babulal Tarapara, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* (the "Tarapara Litigation"). The complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by knowingly or recklessly making false and/or misleading statements and failing to disclose material adverse facts about our business, operations, prospects and financial results. In particular, the complaint alleges that:

- we failed to consolidate the PEAKS Trust in our consolidated financial statements;
- our consolidated financial statements contained errors related to the accounting of the PEAKS Trust and PEAKS Program;
- we improperly accounted for our guarantee obligations under the PEAKS Guarantee;
- our financial results were overstated;

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- we lacked adequate internal and financial controls;
- our consolidated financial statements were materially false and misleading at all relevant times;
- we artificially inflated and maintained the market price of our common stock, causing the plaintiff and other putative class members to purchase our common stock at artificially inflated prices;
- we deceived the investing public, including the plaintiff and the purported class; and
- we employed devices, schemes and artifices to defraud in connection with the purchase and sale of our common stock.

The putative class period in this action is from February 26, 2013 through September 18, 2014. The plaintiffs seek, among other things:

- the designation of this action as a class action;
- an award of unspecified compensatory damages, including interest;
- an award of reasonable costs and expenses, including counsel fees and expert fees; and
- such other relief as the court deems proper.

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

On October 9, 2014, 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 Indiana under the caption: *Kumud Jindal, Individually and on Behalf of All Others Similarly Situated v. Kevin M. Modany, et al.* (the “Jindal Litigation”). The complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder by knowingly or recklessly making false and/or misleading statements and failing to disclose material adverse facts about our business, operations, prospects and financial results. In particular, the complaint alleges that:

- our financial statements contained errors related to the accounting of the PEAKS Trust and PEAKS Program;
- we lacked adequate internal controls over financial reporting;
- our financial statements were materially false and misleading at all relevant times;
- we engaged in acts, transactions, practices and courses of business which operated as a fraud and deceit upon plaintiff and the purported class;
- we employed devices, schemes and artifices to defraud in connection with the purchase and sale of our common stock; and
- we artificially inflated and maintained the market price of our common stock, causing the plaintiff and other putative class members to purchase our common stock at artificially inflated prices.

The putative class period in this action is from April 26, 2013 through September 19, 2014. The plaintiffs seek, among other things, the designation of this action as a class action, an award of unspecified damages, interest, attorneys’ fees, expert fees and other costs, and such other relief as the court deems proper. All of the defendants intend to defend themselves vigorously against the allegations made in the complaint.

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

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

The complaint seeks:

- unspecified damages;

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

On August 6, 2013, the parties agreed to stay the Wilfred Litigation, until the Securities Litigation was dismissed with prejudice or the defendants filed an answer in the Securities Litigation. On September 8, 2014, the district court approved the parties' agreement for an additional stay of the Wilfred Litigation, until the earlier of:

- a final disposition of the Securities Litigation; or
- 30 days after written notice terminating the stay has been provided by any of the parties in the Wilfred Litigation to all other parties.

On May 27, 2014, a complaint in a shareholder derivative lawsuit was filed against two of our current executive officers, all of our current Directors and one former Director in the United States District Court for the District of Delaware under the following caption: *Janice Nottenkamper, Derivatively on Behalf of Nominal Defendant ITT Educational Services, Inc. v. Kevin M. Modany, et al.* (the "Nottenkamper Litigation"). The complaint alleges, among other things, that from 2008 to May 27, 2014, the defendants engaged in illicit conduct, made false and misleading statements, concealed the truth and failed to disclose material information concerning:

- our exposure under guarantees entered into with third-party lenders to obtain financing for our students;
- increases in our bad debt expense caused by increases in student loan defaults;
- our reserves associated with our obligations under third-party private education loan programs and internal student financing;
- the unwillingness of third-party lenders to provide private education loans to our students; and
- our pushing students into high-cost private loans that were likely to default.

As a result of this conduct, the complaint alleges that the defendants breached their fiduciary duties to us, were unjustly enriched, abused their control of us and grossly mismanaged us by:

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

The complaint seeks:

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

Although the Wilfred Litigation and Nottenkamper Litigation are each brought nominally on behalf of us, we expect to incur defense costs and other expenses in connection with those actions.

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On May 18, 2012, we received a Civil Investigative Demand (the “Original CID”) from the U.S. Consumer Financial Protection Bureau (the “CFPB”). In September 2013, the CFPB withdrew the Original CID and we received a new Civil Investigative Demand (the “New CID”) from the CFPB. Both the Original CID and the New CID provided that the purpose of the CFPB’s investigation was, in part, “to determine whether for-profit post-secondary companies, student loan origination and servicing providers, or other unnamed persons have engaged or are engaging in unlawful acts or practices relating to the advertising, marketing, or origination of private student loans.” Both the Original CID and the New CID contained broad requests for oral testimony, production of documents and written reports related to private education loans made to our students, internal financing provided to our students and certain other aspects of our business. We provided documentation and other information to the CFPB, while preserving our rights to object to its inquiry.

On February 26, 2014, the CFPB filed a complaint against us in the United States District Court for the Southern District of Indiana under the following caption: *Consumer Financial Protection Bureau v. ITT Educational Services, Inc.* (the “CFPB Litigation”). The complaint alleges, among other things, that we violated:

- Section 1036(a)(1) of the Consumer Financial Protection Act of 2010 (the “CFPA”), 12 U.S.C. §5536(a)(1), which prohibits unfair, deceptive and abusive acts and practices, from July 21, 2011 through December 2011, by:
  - subjecting consumers to undue influence or coercing them into taking out private education loans through a variety of unfair acts and practices designed to interfere with the consumers’ ability to make informed, uncoerced choices;
  - taking unreasonable advantage of consumers’ inability to protect their interest in selecting or using the private education loans; and
  - taking unreasonable advantage of consumers’ reasonable reliance on us to act in the consumers’ interests; and
  - the Truth in Lending Act, 15 U.S.C. §§ 1601 *et seq.*, and Regulation Z thereunder, 12 C.F.R. Part 1026, which require certain disclosures to be made in writing to consumers in connection with the extension of consumer credit, since March 2009 by failing to disclose a discount that constituted a finance charge.

On April 28, 2014, we filed a motion to dismiss the CFPB Litigation for, among other reasons, lack of jurisdiction and failure to state a claim upon which relief can be granted. We have defended, and intend to continue to defend, ourselves vigorously against the allegations made in the complaint.

On February 27, 2014, the New Mexico Attorney General filed a complaint against us in the District Court of New Mexico under the following caption: *State of New Mexico, ex rel. Gary K King, Attorney General v. ITT Educational Services, Inc., et al.* (the “New Mexico Litigation”). On April 4, 2014, we removed the New Mexico Litigation to the U.S. District Court for the District of New Mexico. The complaint alleges, among other things, that we engaged in a pattern and practice of exploiting New Mexico consumers by using deceptive, unfair, unconscionable and unlawful business practices in the marketing, sale, provision and financing of education goods and services in violation of New Mexico’s Unfair Practices Act. In particular, the complaint contains allegations that:

- we misrepresented matters related to our nursing education program, including, without limitation, its programmatic accreditation status, the transferability of credits earned in the program and the curriculum of the program;
- we misrepresented the terms of the financial aid available to students and the cost of our programs;
- we engaged in unfair or deceptive trade practices;
- we failed to issue refunds; and
- our form enrollment agreement contained unenforceable and unconscionable provisions.

The complaint seeks:

- an order declaring portions of our enrollment agreement illusory, unconscionable and unenforceable;
- preliminary and permanent injunctive relief;
- disgorgement of unjust enrichment amounts;
- unspecified civil penalty amounts;
- restitution; and
- reasonable costs, including investigative costs.

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

On December 17, 2013, a complaint was filed against us in a purported class action in the Superior Court of the State of California for the County of Los Angeles under the following caption: *La Sondra Gallien, an individual, James Rayonez, an individual, Giovanni Chilin, an individual, on behalf of themselves and on behalf of all persons similarly situated v. ITT Educational Services, Inc., et al.* (the “Gallien Litigation”).

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The plaintiffs filed an amended complaint on February 13, 2014. The amended complaint alleges, among other things, that under California law, we:

- failed to pay wages owed;
- failed to pay overtime compensation;
- failed to provide meal and rest periods;
- failed to provide itemized employee wage statements;
- engaged in unlawful business practices; and
- are liable for civil penalties under the California Private Attorney General Act.

The purported class includes recruiting representatives employed by us during the period of December 17, 2009 through December 17, 2013. The amended complaint seeks:

- compensatory damages, including lost wages and other losses;
- general damages;
- pay for missed meal and rest periods;
- restitution;
- liquidated damages;
- statutory penalties;
- interest;
- attorneys' fees, cost and expenses;
- civil and statutory penalties;
- injunctive relief; and
- such other and further relief as the court may deem equitable and appropriate.

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

There can be no assurance that the ultimate outcome of the Leveski Litigation, Securities Litigation, Baner Litigation, Tarapara Litigation, Jindal Litigation, Wilfred Litigation, Nottenkamper Litigation, CFPB Litigation, New Mexico Litigation, Gallien Litigation or other actions (including other actions under federal or state securities laws) will not have a material adverse effect on our financial condition, results of operations or cash flows.

The current officers named in the Securities Litigation, Baner Litigation, Tarapara Litigation, Jindal Litigation, Wilfred Litigation and Nottenkamper Litigation include Daniel M. Fitzpatrick and Kevin M. Modany.

Certain of our current and former officers and Directors are or may become a party in the actions described above and/or are or may become subject to government investigations. Our By-laws and Restated Certificate of Incorporation obligate us to indemnify our officers and Directors to the fullest extent permitted by Delaware law, provided that their conduct complied with certain requirements. We are obligated to advance defense costs to our officers and Directors, subject to the individual's obligation to repay such amount if it is ultimately determined that the individual was not entitled to indemnification. In addition, our indemnity obligation can, under certain circumstances, include indemnifiable judgments, penalties, fines and amounts paid in settlement in connection with those actions and investigations.

**Government Investigations.** We are subject to investigations and claims of non-compliance with regulatory standards and other actions brought by regulatory agencies. Some of the more significant pending investigations, claims and actions are described below. If the results of any investigations, claims and/or actions are unfavorable to us, we may be required to pay money damages or be subject to fines, penalties, injunctions, operational limitations, loss of eligibility to participate in federal or state financial aid programs, debarments, additional oversight and reporting, or other civil and criminal sanctions. Those sanctions could have a material adverse effect on our financial condition, results of operations and cash flows.

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

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We believe that our acts and practices relating to our students in Massachusetts are lawful. There can be no assurance, however, that the ultimate outcome of the MAG investigation will not have a material adverse effect on our financial condition, results of operations and/or cash flows.

In January, February, April and May 2014, we received subpoenas and/or CIDs from the Attorneys General of Arkansas, Arizona, Colorado, Connecticut, Hawaii, Idaho, Iowa, Kentucky, Missouri, Nebraska, North Carolina, Oregon, Pennsylvania, Tennessee and Washington under the authority of each state's consumer protection statutes. The Attorney General of the Commonwealth of Kentucky has informed us that it will serve as the point of contact for the multistate group to respond to questions relating to the subpoenas and CIDs. The subpoenas and CIDs contain broad requests for information and the production of documents related to our students and practices, including marketing and advertising, recruitment, financial aid, academic advising, career services, admissions, programs, licensure exam pass rates, accreditation, student retention, graduation rates and job placement rates, as well as many other aspects of our business. We believe that several other companies in the proprietary postsecondary education sector have received similar subpoenas and CIDs. We are cooperating with the Attorneys General of the states involved. There can be no assurance, however, that the ultimate outcome of the state Attorneys General investigation will not have a material adverse effect on our financial condition, results of operations and/or cash flows.

On February 8, 2013, we received the first of many subpoenas from the SEC. In a letter accompanying each of the subpoenas, the SEC states that it is conducting an investigation of us. The SEC's subpoenas requested the production of documents and communications that, among other things, relate to our actions and accounting associated with:

- agreements that we entered into with the 2009 Entity to create the 2009 Loan Program, including, without limitation, the 2009 RSA;
- agreements that we entered into to create the PEAKS Program;
- certain accounting-related documents associated with the 2009 Loan Program, the PEAKS Program and internal student financing; and
- our board of directors-related materials associated with the 2009 Loan Program, the PEAKS Program and internal student financing.

We have provided the information requested, including testimony of senior employees. On August 7, 2014, we received a "Wells Notice" from the Staff of the SEC notifying us that the Staff had made a preliminary determination to recommend that the SEC file an enforcement action against us. According to the Staff, the enforcement action would allege violations of Sections 10(b), 13(a) and 13(b)(2) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13 and 13a-15 under the Exchange Act. The proposed action relates primarily to certain disclosures and accounting surrounding the two loan programs noted above. The SEC's notice said that the Staff's recommendation may:

- involve a civil injunctive action, public administrative proceeding and/or cease-and-desist proceeding against us; and
- seek remedies that include an injunction, a cease-and-desist order and monetary relief, including civil monetary penalties.

A Wells Notice is neither a formal allegation nor a finding of wrongdoing. Instead, it is a preliminary determination by the Staff to recommend that the SEC file a civil enforcement action or administrative proceeding against the recipient. Under the SEC's procedures, a recipient of a Wells Notice has an opportunity to respond in the form of a Wells submission that seeks to persuade the SEC that such an action should not be brought. Accordingly, we made a submission to the Staff in response to the Wells Notice setting forth why the factual record does not support the enforcement action recommended by the Staff and that any perceived shortcomings were made in good faith. Although we intend to defend ourselves vigorously should the SEC authorize any legal action that does not comport with our view of the facts, we cannot predict the outcome of any legal action or whether the matters will result in any settlement. We cannot assure you that the ultimate outcome of the SEC investigation, any legal action by the SEC or any settlement will not have a material adverse effect on our financial condition, results of operations and/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 10 years and we expect that:

- most of 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:

- \$53,212 in the year ended December 31, 2013;

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

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, 2013 are as follows:

2014	\$ 44,714
2015	38,582
2016	27,939
2017	19,084
2018	13,282
2019 and thereafter	<u>12,446</u>
	<u>\$156,047</u>

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

**Guarantees.** We entered into the PEAKS Guarantee in connection with the PEAKS Program and the 2009 RSA in connection with the 2009 Loan Program. Under the PEAKS Guarantee, we guarantee payment of the principal and interest owed on the PEAKS Senior Debt, the administrative fees and expenses of the PEAKS Trust and a minimum required Asset/Liability Ratio. The PEAKS Guarantee contains, among other things, representations and warranties and events of default that we believe are customary for guarantees of this type. 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, if the law is changed to reduce the maximum allowable percentage of our annual revenue derived from Title IV Program funds from 90% to 75% or less. At this time, we believe that the likelihood of such a change in the law 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 we made under the PEAKS Guarantee (which do not include Payments on Behalf of Borrowers) to the extent that funds are remaining in the PEAKS Trust. As of December 31, 2012, the amount of payments that we had previously made under the PEAKS Guarantee and that we expected to recover was \$12,342. We recorded this amount, net of an accrued discount of \$5,674, in Other assets on our Consolidated Balance Sheet as of December 31, 2012.

We concluded that we were required to consolidate the PEAKS Trust in our consolidated financial statements beginning on February 28, 2013. See Note 10 – Variable Interest Entities, for a further discussion of the Consolidation. As a result, the assets and liabilities of the PEAKS Trust have been included on, and all intercompany transactions have been eliminated from, our Consolidated Balance Sheet as of December 31, 2013. While we no longer record a contingent liability for the PEAKS Guarantee on our Consolidated Balance Sheet beginning on February 28, 2013, our obligations under the PEAKS Guarantee remain in effect.

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.

Under the 2009 RSA, we have the right to elect to make Discharge Payments with respect to private education loans made under the 2009 Loan Program that have been charged off. The effect of a making a Discharge Payment related to a private education loan is to reduce the aggregate amount that we may have to pay under our guarantee obligations with respect to that loan. We have claimed as an offset against the Revolving Note amounts that would have the effect of discharging our obligations with respect to certain charged off loans under the 2009 RSA. In addition, in the three months ended December 31, 2013, we made Discharge Payments to the 2009 Entity. We may continue to make Discharge Payments in future periods, if we believe that doing so would be economically beneficial to us. Making Discharge Payments may result in us paying amounts to the 2009 Entity in advance of when a guarantee payment would be due, which would negatively impact our liquidity in a particular period, but may result in us paying a lesser amount than we otherwise would have been required to pay under our guarantee obligation in future periods under the 2009 RSA. See Note 10 – Variable Interest Entities, for a further discussion of Discharge Payments.

We are not able to estimate the undiscounted maximum potential amount of future payments that we could be required to make under the 2009 RSA, because those payments will be affected by:

- the timing of future defaults;

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- the use, timing and length of forbearances granted to borrowers;
- of the use, timing and length of deferral periods;
- changes in the interest rate on the loans made under the 2009 Loan Program, since those loans are based on the prime rate plus a margin; and
- the fact that those loans will consist of a large number of loans of individually immaterial amounts.

We believe that it is probable that we will make additional payments under the 2009 RSA. The following table sets forth the estimated amount of Regular Payments and Discharge Payments that we expect to pay and the estimated amount of recoveries from charged-off loans that we expect to be paid to us by the 2009 Entity in the periods indicated:

<u>Year</u>	<u>Estimated Regular Payments</u>	<u>Estimated Discharge Payments</u>	<u>Estimated Total Payments</u>	<u>Estimated Recoveries</u>
2014	\$ 9,009	\$ 0	\$ 9,009	\$ (1,011)
2015	14,251	0	14,251	(1,200)
2016	16,060	0	16,060	(1,200)
2017	16,333	0	16,333	(1,200)
2018 and later	0	75,194	75,194	(300)
	<u>\$ 55,653</u>	<u>\$ 75,194</u>	<u>\$ 130,847</u>	<u>\$ (4,911)</u>

We believe that the vast majority of the \$75,194 of estimated payments projected to be paid after 2017 will be made by us in 2018. The estimated future payment amounts and timing related to the 2009 RSA assume, among other factors, that we do not make any Discharge Payments until 2018 and do make Discharge Payments to the fullest extent possible in 2018 and later years. If we do not make the Discharge Payments as assumed in 2018 and later years, we estimate that we would make approximately \$97,400 of Regular Payments in 2018 through 2027. Of this amount, approximately \$15,100 to \$16,400 would be paid annually in each of 2018 through 2022, and approximately \$16,600, in the aggregate, would be paid in 2023 through 2027.

The amounts of the estimated Regular Payments and the estimated recoveries were discounted at a risk-free rate of interest in determining our contingent liability for the 2009 RSA. The total amount of the discount as of December 31, 2013 was approximately \$9,015.

The estimated future payment amounts, the estimated timing of those payments and the estimated amount of recoveries with respect to the RSAs discussed above and elsewhere in this Annual Report on Form 10-K are only estimates, are based on numerous assumptions and are subject to change. As with any estimate, as facts and circumstances change, the estimated amounts and timing could change. We made a number of assumptions in preparing the estimates, which assumptions may not be correct. The assumptions included, among other things, the following:

- the repayment performance of the private education loans made under the 2009 Loan Program or PEAKS Program, as applicable;
- the timing and rate at which those private education loans will be paid;
- the changes in the variable interest rates applicable to those private education loans and, with respect to the PEAKS Program, the PEAKS Senior Debt;
- the amounts and timing of collections in the future on those private education loans that have been charged off;
- the fees and expenses associated with servicing those private education loans; and
- our ability to utilize the available options for payment of our obligations under the 2009 RSA.

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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, 2013 and December 31, 2012, the total collateral maintained in a restricted bank account was approximately \$8,600. This amount was included in Other assets on our Consolidated Balance Sheets as of each of those dates. The 2009 RSA also requires that we comply with certain covenants, including that we maintain certain financial ratios which are measured on a quarterly basis and deliver compliance certificates on a quarterly basis setting forth the status of our compliance with those financial ratios. If we are not in compliance with those covenants at the end of each fiscal quarter, we are required to increase the amount of collateral maintained in the restricted bank account to a predetermined amount, until the end of a succeeding quarter at which we are in compliance with those covenants. The predetermined amount is based on the percentage of the aggregate principal balance of the private education loans made under the 2009 Loan Program that exceeds a certain percentage as of the end of each fiscal quarter. We were not in compliance with those covenants as of December 31, 2013.

As a consequence of the restatement of our unaudited condensed consolidated financial statements in our Quarterly Reports on Form 10-Q for the fiscal quarters ended March 31, 2013, June 30, 2013 and September 30, 2013, certain quarterly compliance certificates that we were required to deliver to the 2009 Entity under the 2009 RSA were inaccurate. Those inaccuracies did not affect our compliance with the financial ratio covenants in the 2009 RSA as of March 31, 2013. We were not, however, in compliance with the financial ratio covenants in the 2009 RSA as of June 30, 2013 and subsequent measurement dates. Further, due to our failure to timely file our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 and our Quarterly Reports on Form 10-Q for the fiscal quarters ended March 31, 2014 and June 30, 2014, we did not timely deliver the required compliance certificates under the 2009 RSA with respect to those periods. As a result of our noncompliance with the financial ratio covenants as of June 30, 2013 and subsequent measurement dates, the amount of collateral required to be maintained in the restricted bank account has been increased by approximately \$2,600. We intend to make in October 2014 a deposit in that amount to the restricted bank account to be held as additional collateral under the 2009 RSA.

The following table sets forth the approximate aggregate amount of guarantee payments, Discharge Payments and Payments on Behalf of Borrowers that were made related to the PEAKS Program and 2009 RSA and the amount of recoveries from charged-off loans paid to us by the 2009 Entity, in the periods indicated:

<b>Type of Payment (Receipt)</b>	<b>January 1, 2013 Through February 28, 2013<sup>(1)(2)</sup></b>	<b>March 1, 2013 Through December 31 2013<sup>(1)(2)</sup></b>	<b>Total Year Ended December 31, 2013</b>	<b>Year Ended December 31, 2012</b>
Guarantee:				
PEAKS Program	\$ 854	\$ 1,55	\$ 2,413	\$ 12,342
2009 RSA Regular Payments	0		1,791	1,990
2009 RSA Discharge Payments	0		912	0
Payments on Behalf of Borrowers	532	10,9€	11,499	2,762
2009 RSA-Recoveries from Charged-Off Loans	0		(103)	(234)
<b>Total</b>	<b>\$ 1,386</b>	<b>\$ 12,52</b>	<b>\$ 16,512</b>	<b>\$ 16,860</b>

- (1) We have provided separate columns showing the payment amounts prior to and after the Consolidation, because all transactions with the PEAKS Trust were eliminated from our consolidated financial statements after the Consolidation. Cash payments were, however, made by us throughout the periods indicated, including the periods after the Consolidation.
- (2) The 2009 RSA payments are made to, and recoveries are received from, the 2009 Entity. The 2009 Entity was not consolidated in our consolidated financial statements and, therefore, separate disclosure of amounts paid or received before and after the February 28, 2013 date of Consolidation is not applicable.

In the fiscal year ended December 31, 2013, we also offset \$9,091 owed by us under the 2009 RSA against amounts owed to us by the 2009 Entity under the Revolving Note, instead of making additional payments in that amount. Approximately \$6,786 of the amount that we claimed as an offset against the Revolving Note in the fiscal year ended December 31, 2013 represented Discharge Payments. We recorded all of the amounts claimed as offsets in Other current liabilities on our Consolidated Balance Sheet as of December 31, 2013. In the year ended December 31, 2013, the 2009 Entity did not remit to us \$574 of recoveries from charged-off loans that were owed to us. We recorded all of the amounts owed to us from the 2009 Entity for recoveries from charged-off loans in Prepaid expenses and other current assets on our Consolidated Balance Sheet as of December 31, 2013.

In the first quarter of 2013, we notified the 2009 Entity that:

- we had determined that the 2009 Entity was in default of its obligations to us under the loan and security agreement pursuant to which the Revolving Note was issued (the "2009 Loan Agreement");

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- as a result of that default, all amounts under the Revolving Note were immediately due and payable; and
- we would not make payments under the 2009 RSA until we received credit for the full amount due us under the Revolving Note, based on the provisions of the 2009 Loan Agreement and the 2009 RSA that allow us to set off amounts owed by us under the 2009 RSA against amounts owed to us by the 2009 Entity under the Revolving Note.

At that time, the outstanding amount of the Revolving Note due to us was approximately \$8,200, representing principal and accrued interest. In response to our notification, the 2009 Entity:

- denied that it had defaulted under the 2009 Loan Agreement and, therefore, our ability to accelerate the payment of the Revolving Note; and
- refused our demand to immediately pay the Revolving Note in full.

As a consequence, over the period from February 2013 through August 2013, we offset our then current payment obligations under the 2009 RSA and the amount of Discharge Payments we elected to make during that period against all of the 2009 Entity's obligations owed to us under the Revolving Note (the "Offset").

We understand that the 2009 Entity's position is that the Offset was improper, because:

- it has not defaulted under the 2009 Loan Agreement; and
- even if it had defaulted under the 2009 Loan Agreement, the assets of the 2009 Entity against which we could offset or exercise our other remedies, were limited.

We further understand the 2009 Entity's position to be that, because the Offset was improper, we are in default under the 2009 RSA. In April 2013, the 2009 Entity notified us that it had taken control of the restricted account containing the cash collateral that we deposited to secure our obligations under the 2009 RSA (the "Collateral"). At that time, the amount of funds in that account was approximately \$8,600. To our knowledge, the 2009 Entity has taken no further action related to the Collateral. We believe that our good faith exercise of our right of offset provided for in the 2009 Loan Agreement and the 2009 RSA does not constitute an event of default under the 2009 RSA, and that the 2009 Entity's seizure of control of the restricted account containing the Collateral constitutes an additional default by the 2009 Entity.

We cannot assure you, however, that the Offset will ultimately be determined to have been proper. In the event of a default by us under the 2009 RSA related to the Offset, we may be required to pay to the 2009 Entity approximately \$8,600, representing the amount of the Offset, net of approximately \$500 of recoveries from charged-off loans that are owed, but have not been paid, to us. If the 2009 Entity instead were to withdraw Collateral in that amount from the restricted bank account, we would be required to deposit that amount of cash in the account to maintain the required level of Collateral. Any such payment or deposit would reduce the amount of our contingent liability related to the 2009 RSA.

At the end of each reporting period, we assess whether we should recognize a contingent liability related to our guarantee obligations under the 2009 RSA (and, prior to February 28, 2013, the PEAKS Guarantee) and, if so, in what amount. As with any assessment, as facts and circumstances change, the recorded liability could change, and has changed, significantly. In order to make this assessment, we made certain assumptions with respect to the performance of the private education loans made under the 2009 Loan Program (and, prior to February 28, 2013, the PEAKS Program) over the life of those loans. The life of a private education loan made under the 2009 Loan Program or PEAKS Program may be in excess of ten years from the date of disbursement. Therefore, our assessment was based on assumptions for periods in excess of ten years, and those assumptions included, among other things, the following:

- the repayment performance of the private education loans made under the 2009 Loan Program (and, prior to February 28, 2013, the PEAKS Program);
- the timing and rate at which those private education loans will be paid;
- the changes in the variable interest rates applicable to those private education loans (and, prior to February 28, 2013, the PEAKS Senior Debt);
- the amounts and timing of collections in the future on those private education loans that have defaulted;
- prior to February 28, 2013, the fees and expenses associated with servicing the PEAKS Trust Student Loans; and
- our ability to utilize the available options for payment of our obligations under the 2009 RSA.

We consulted with third-party consumer credit consulting firms in arriving at our assumptions. The assumptions have changed, and may continue to change, significantly over time as actual results become known. Our recorded liability for our guarantee obligations under the 2009 RSA (and, prior to February 28, 2013, the PEAKS Guarantee) was included in Other current liabilities and Other liabilities on our Consolidated Balance Sheets.

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**17. Risks and Uncertainties**

Many of the amounts of assets, liabilities, revenues and expenses reported in our consolidated financial statements are based on estimates and assumptions that affect the amounts reported. We are subject to risks and uncertainties that could affect amounts reported in our consolidated financial statements in future periods. Our future performance, results of operations, financial condition, cash flows, liquidity, capital resources, ability to meet our obligations and ability to comply with covenants, metrics and regulatory requirements are subject to significant risks and uncertainties that could cause actual results to be materially different from our estimated results, including, but not limited to, the following:

- The Consolidation of the PEAKS Trust and other factors, among other things:
  - have resulted in violations by us of covenants under the Amended Credit Agreement. We have obtained waivers and amendments relating to those violations;
  - have negatively impacted our compliance with:
    - the ED's financial responsibility measurements, primarily our institutions' composite score; and
    - our compliance with the financial requirements of certain state education and professional licensing authorities ("SAs"); and
  - have negatively impacted the financial metrics to which we are subject under the PEAKS Program and 2009 RSA.

See Note 13 – Debt and Note 16 – Commitments and Contingencies for additional information.

- We believe that we will be required to consolidate the 2009 Entity into our consolidated financial statements in the foreseeable future, which could impact our compliance with:
  - covenants under the Amended Credit Agreement;
  - the ED's financial responsibility measurements, primarily our institutions' composite score;
  - the financial requirements of certain SAs; and
  - the financial metrics to which we are subject under the PEAKS Program and 2009 RSA.

See Note 10 – Variable Interest Entities for additional information.

- Our institutions' failure to submit their audited consolidated financial statements and Compliance Audits to the ED by the due date resulted in sanctions imposed by the ED on our institutions that include, among other things, our institutions having to post a letter of credit, being placed on heightened cash monitoring ("HCM") and being provisionally certified. We have arranged for the letter of credit and have implemented procedures to address HCM, which requirements are not expected to significantly impact the timing of receipt of student financial aid funds. See Note 13 – Debt for additional information.
- We are required to submit the ED Letter of Credit on or before November 4, 2014. The term of the letter of credit is for a period that ends on November 4, 2019. With respect to any letter of credit issued under the Amended Credit Agreement, we are required to provide cash collateral in an amount equal to 109% of the face amount of the ED Letter of Credit and 103% of the face amount of all other letters of credit. Based on the required amount of the ED Letter of Credit and other letters of credit outstanding as of the date of this filing, the amount of the cash collateral that we will have to provide is approximately \$89,300. Such collateral may be provided from available funds. See Note 13 – Debt for additional information.
- We are subject to various claims and contingencies, including those related to litigation, government investigations, business transactions, guarantee arrangements and employee-related matters, among others. With regard to these matters, we cannot provide an estimate of the possible losses, or range of possible losses, in excess of the amounts, if any, accrued. See the subsections entitled "Litigation" and "Government Investigations" in Note 16 - Commitments and Contingencies, for a further discussion of certain litigation and government investigations to which we are subject.
- The significant guarantee obligations that we have under the PEAKS Guarantee and 2009 RSA. Based on various assumptions, including the historical and projected performance and collection of the PEAKS Trust Student Loans, we believe that we will make payments under the PEAKS Guarantee of approximately \$163,966 in 2014 and approximately \$9,165 in 2015. In addition, based upon various assumptions, including the historical and projected performance and collections of the private education loans under the 2009 Loan Program, we believe that we will make payments under the 2009 RSA of approximately \$9,009 in 2014 and \$14,251 in 2015. See Note 13 – Debt and Note 16 – Commitments and Contingencies for a further discussion of the RSAs, estimated payment amounts and contingent liabilities.

**ITT EDUCATIONAL SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in thousands, except per share data and unless otherwise stated)**

- As of December 31, 2013, the outstanding borrowings under the Amended Credit Agreement totaled \$50,000 and were classified as a current liability, because we believe it is probable that we will not be in compliance with certain covenants under the Amended Credit Agreement during the 12 months following December 31, 2013. If we are not in compliance with one or more covenants and are unable to obtain a waiver of our noncompliance or an amendment to the Amended Credit Agreement that would allow us to be in compliance with those covenants or otherwise not be in default under the Amended Credit Agreement, the lenders would have various remedies, including:
  - the lending commitments under the Amended Credit Agreement may be terminated;
  - our ability to request the issuance of letters of credit and to obtain amendments, extensions or renewals of letters of credit already issued under the Amended Credit Agreement may be terminated; and
  - all then outstanding borrowings and other amounts owed under the Amended Credit Agreement may be declared immediately due and payable.

In the event that we or our subsidiary guarantor do not pay in full, upon demand, all of our outstanding borrowings and other amounts owed under the Amended Credit Agreement or we, or our subsidiary guarantor, do not provide, upon demand, the cash collateral for our letter of credit obligations, the lenders would be entitled to recourse against the collateral security, including the Mortgaged Property, that we and our subsidiary guarantor have provided, in order to obtain payment of amounts we owe or are required to provide as cash collateral.

- We incurred a net loss in the year December 31, 2013 and we had negative working capital as of December 31, 2013, primarily due to the impact of the Consolidation and the loss that we recorded related to our guarantee obligations under the 2009 RSA.

Based on our current projections, we believe that cash generated from operations will be sufficient for us to satisfy our RSA payments, letters of credit cash collateralization, working capital, loan repayment and capital expenditure requirements over the 12-month period following the date that this Annual Report on Form 10-K was filed with the SEC. We also believe that any reduction in cash and cash equivalents that may result from their use to make payments under the RSAs, provide cash collateral for letters of credit, construct facilities or repay loans will not have a material adverse effect on our expansion plans, planned capital expenditures, ability to meet any applicable regulatory financial responsibility standards or ability to conduct normal operations over the 12-month period following the date that this Annual Report on Form 10-K was filed with the SEC. Accordingly, our consolidated financial statements contained in this Annual Report on Form 10-K were prepared on the basis that we will continue to operate as a going concern. However, there can be no assurance that the ultimate outcome of these events individually or in the aggregate will not have a material adverse effect on our financial condition, results of operations or cash flows.

## **18. Subsequent Event**

On October 23, 2014, the company's Chief Executive Officer and Chief Financial Officer received similar Wells Notices as those described in Note 16. Accordingly, they intend to submit a response to the staff of the Division of Enforcement ("Staff") setting forth why the law and the factual record do not support the Staff's Wells Notice. The recipients intend to defend themselves vigorously should the SEC authorize any legal action. We cannot predict the outcome of any legal action or whether the matters will result in any settlement. The ultimate outcome of the SEC investigation, any legal action by the SEC or any settlement could have a material adverse effect on our financial condition, results of operations and/or cash flows.

## Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over our financial reporting ("ICFR"), as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). 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.

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 principal executive officer and principal financial officer, our management assessed the effectiveness of our ICFR as of December 31, 2013. In making this assessment, our management used the criteria described in the 1992 *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment using these criteria, management concluded that we did not maintain effective ICFR as of December 31, 2013 because of the material weaknesses described below.

A material weakness is a deficiency, or a combination of deficiencies, in ICFR, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis.

Our management has concluded that there were four material weaknesses in our ICFR as of December 31, 2013. Specifically, we did not maintain effective internal controls related to:

- the assessment of events that could affect the determination of whether we are the primary beneficiary of variable interest entities in which we hold a variable interest;
- the assessment of the completeness and accuracy of the data maintained by the servicer of the private education loans that are owned by a variable interest entity that we were required to consolidate;
- the review of assumptions and methodologies developed by third-party consultants to project guarantee obligations under the 2009 RSA; and
- the timely identification and communication of information relevant to the private education loan programs to those members of our management who are responsible for our financial reporting processes.

Our management determined that these material weaknesses resulted in adjustments to multiple line items on our financial statements during the preparation of our 2013 annual consolidated financial statements and restatement of our interim consolidated financial statements as of and for the quarterly periods ended March 31, 2013, June 30, 2013 and September 30, 2013 or could result in a material misstatement of our annual or interim consolidated financial statements that would not be prevented or detected on a timely basis. As a result, our management determined that each of these deficiencies constituted a material weakness in our ICFR as of December 31, 2013, and our ICFR was not effective as of that date.

The control deficiency related to our assessment of events that could affect the determination of whether we are the primary beneficiary of a variable interest entity affected multiple line items in our financial statements. See Note 10 – Variable Interest Entities of the Notes to Consolidated Financial Statements for a discussion of the effect that consolidating a variable interest entity beginning February 28, 2013 had on our consolidated financial statements. The control deficiency related to our failure to maintain effective internal controls over the data maintained by the servicer of the private education loans could have resulted in misstatements of the fair value of the private education loans upon consolidation of the variable interest entity and the amount of the allowance for loan losses. The control deficiency related to our review of assumptions and methodologies developed by consultants to project guarantee obligations under the 2009 RSA resulted in adjustments to our loss related to loan program guarantees, other liabilities and related financial disclosures during the preparation of our 2013 consolidated financial statements. The control deficiency related to the identification and communication of information is considered to have contributed to the other identified material weaknesses, as relevant information related to the private loan programs was not provided timely to those individuals responsible for our financial reporting processes or our independent registered accountants.

Our management excluded the PEAKS Trust from our assessment of ICFR as of December 31, 2013, because beginning February 28, 2013, we became the primary beneficiary of the PEAKS Trust. The PEAKS Trust is a controlled variable interest entity whose assets and total revenues represented 11% and 1%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2013.

The effectiveness of our ICFR as of December 31, 2013 has been audited by PricewaterhouseCoopers LLP, our independent registered public accounting firm, as stated in their accompanying report.

**Schedule of Expenditures of State of Florida Financial Assistance  
For the Year Ended December 31, 2013**

State Agency/ State Project	Catalog of State of Florida Financial Assistance Number	Grant Code	State of Florida Expenditures
<b>Department of Education and Commissioner of Education</b>			
Florida Student Assistance Grant	48.054	99970	\$ 908,094
Florida Bright Futures Scholarship Program*	48.059	97040	\$ 12,728
Total Expenditures of State of Florida Financial Aid			\$ 920,822

\*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 2013.

**Note to Schedule of Expenditures of State of Florida Financial Assistance  
For the Year Ended December 31, 2013**

**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, 2013 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 2013 include the Tampa, Miami, Deerfield Beach, Fort Lauderdale, Jacksonville, St. Petersburg, Fort Myers, Tallahassee, Lake Mary, Orlando, Pensacola, 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 and Management of  
ITT Educational Services, Inc.:

We have audited, in accordance with auditing 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, the consolidated financial statements of ITT Educational Services, Inc. (the "Company"), which comprise the consolidated balance sheets as of December 31, 2013, the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for the year then ended, the related notes to the financial statements and the effectiveness of the Company's internal control over financial reporting, and have issued our report thereon dated October 15, 2014 (except for Note 18 to the consolidated financial statements, as to which the date is October 27, 2014).

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*.

The purpose of this report is solely to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

PricewaterhouseCoopers LLP

October 15, 2014,  
except for Note 18 to the consolidated financial statements,  
as to which the date is October 27, 2014



**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 and Management 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 could have a direct and material effect on each of the Company's major State of Florida programs for the year ended December 31, 2013. The Company's major State of Florida programs 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 13-2 through 13-5 related to the determination and application of the awards to eligible students. 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, 2013.

### ***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, 2013.

### ***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 Cost as audit finding number 13-1 for the Florida Student Assistance Grant. Our opinion on this major State of Florida program is not modified with respect to this matter.

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 for the Florida Bright Futures Scholarship Program (Catalog #48.059), as described in the accompanying Schedule of Findings and Questioned Costs as items 13-2 through 13-5, to be material weaknesses.



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 response to the internal control over compliance 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.

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 consolidated financial statements of the Company as of and for the year ended December 31, 2013, and have issued our report thereon dated October 15, 2014 (except for Note 18 to the consolidated financial statement, as to which the date is October 27, 2014), which contained an unmodified opinion on those consolidated financial statements. Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying Schedule of Expenditures of State of Florida Financial Assistance as presented on page 61, 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 consolidated 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 consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statement and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated 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 State of Florida Financial Assistance is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

PricewaterhouseCoopers LLP

October 27, 2014

**ITT Educational Services, Inc.  
 Schedule of Findings and Questioned Costs  
 December 31, 2013**

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**Summary of Results**

**Section I - Financial Statements:**

Type of auditor's report issued	Unqualified
Internal control over financial reporting:	
Material weakness(es) identified?	Yes
Significant deficiencies identified not considered to be material weaknesses?	Yes
Noncompliance material to financial statements noted?	No

**Section II - Major State of Florida Programs:**

Internal control over Major State of Florida Programs:	
Material weakness(es) identified?	Yes
Significant deficiencies identified not considered to be material weaknesses?	None reported
Type of auditor's reports issued on compliance for Major State of Florida Programs?	
Florida Student Assistance Grant	Unmodified
Florida Bright Futures Scholarship Program	Qualified
Any audit findings disclosed that are required to be reported in accordance with <i>Chapter 10.650, Rules of the State of Florida Auditor General</i> ?	Yes

**Section III - The Company's major State of Florida projects under audit are:**

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

A threshold of \$100,000 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 #2 above.

# ITT Educational Services, Inc.

## Schedule of Findings and Questioned Costs

### December 31, 2013

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#### Section I – Financial Statement Findings

##### Material Weaknesses

##### **Finding 2013-1 (Application of Consolidation Accounting to Variable Interest Entities):**

*Criteria:* The Company is expected to maintain sufficient controls for purposes of mitigating material misstatements within the Company's financial statements based on the criteria established in the Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

*Condition:* The Company did not maintain effective internal controls to identify reconsideration events (as described in ASC 810-10-35) that may impact the primary beneficiary determination for its variable interest entities, specifically reconsideration events that did not involve written changes to underlying agreements. As such, the Company failed to identify a change in operational status of its right to terminate the loan service agreement for a variable interest entity which ultimately changed the Company's primary beneficiary determination during the year. It was determined that controls were not sufficient to identify all reconsideration events and that there is a material weakness in internal control over financial reporting.

*Cause:* The Company did not design detailed controls to sufficiently identify reconsideration events that did not involve written changes to agreements.

*Effect:* Interim financial statements filed during 2013 required restatement as a result of the company's failure to identify and evaluate a reconsideration event requiring consolidation of a variable interest entity as of February 2013.

*Recommendation:* We recommend that the Company develop more detailed control procedures to appropriately identify potential reconsideration events that arise from operational and other changes in addition to written changes to agreements.

##### *Management's Views and Corrective Action Plan:*

The Company's Board of Directors and management are committed to remediating the control deficiency that constitutes this material weakness by implementing changes to our internal control over financial reporting ("ICFR"), as well as the continued improvement of our overall system of ICFR. The Company is in the process of implementing measures to remediate the underlying causes of the control deficiency that gave rise to this material weakness, primarily through additional review procedures and engaging supplemental resources. The Company believes these measures will remediate the control deficiency, however, all of the corrective processes, procedures and related evaluation or remediation that the Company believes are necessary have not been completed. As the Company continues to evaluate and work to remediate the control deficiency that gave rise to this material weakness, it may determine that additional measures are required to address the control deficiency.

##### **Finding 2013-2 (Completeness and Accuracy of Student Loan Data Underlying PEAKS Trust Student Loan Receivables):**

*Criteria:* The Company is expected to maintain sufficient controls for purposes of mitigating material misstatements within the Company's financial statements based on the criteria established in the Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

*Condition:* The Company did not maintain effective internal controls to ensure that management was able to identify errors in the completeness and accuracy of the loan data reported by the loan servicer used in management's cash flow projections. Based on the nature and potential magnitude of the errors observed in the accuracy of the loan data, it was determined that controls were not sufficient and that there is a material weakness in internal control over financial reporting.

# ITT Educational Services, Inc.

## Schedule of Findings and Questioned Costs

### December 31, 2013

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*Cause:* Management did not properly consider the scope limitations of the servicer's SSAE 16 report covering the underlying loan data used by management for cash flow projections. As a result, management failed to design effective controls to monitor completeness and accuracy of the underlying loan data. This control deficiency prevented management from identifying errors in the servicer's underlying data which were discovered through the detail testing performed by the Company's independent auditor.

*Effect:* Multiple errors were observed in the accuracy of certain underlying loan data which included incorrect loan status for several loans, inconsistencies in applying the Company's loan default policy, and multiple days of missed accrued interest, which could have a material impact on the financial statements.

*Recommendation:* We recommend that the Company enhance its control activities over the student loan portfolio managed by the servicer to ensure a precise enough level of review to prevent material misstatement of the financial statements. Management should consider scope limitations of servicer reports that may require additional consideration and implementation of end user controls.

*Management's Views and Corrective Action Plan:*

The Company's Board of Directors and management are committed to remediating the control deficiency that constitutes this material weakness by implementing changes to our internal control over financial reporting ("ICFR"), as well as the continued improvement of our overall system of ICFR. The Company is in the process of implementing measures to remediate the underlying causes of the control deficiency that gave rise to this material weakness, primarily through additional review procedures and engaging supplemental resources. The Company believes these measures will remediate the control deficiency, however, all of the corrective processes, procedures and related evaluation or remediation that the Company believes are necessary have not been completed. As the Company continues to evaluate and work to remediate the control deficiency that gave rise to this material weakness, it may determine that additional measures are required to address the control deficiency.

#### **Finding 2013-3 (Estimation and Review of Contingent Loss Estimates):**

*Criteria:* The Company is expected to maintain sufficient controls for purposes of mitigating material misstatements within the Company's financial statements based on the criteria established in the Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

*Condition:* The Company did not maintain effective internal controls over management's detailed review of the assumptions and methodology used by a third party expert to project the performance of student loans. As a result of errors noted in the projections, an audit adjustment was necessary to increase recorded loss accruals in 2013. Based on the nature and magnitude of the audit adjustment, it was determined that controls were not sufficient and that there is a material weakness in internal control over financial reporting.

*Cause:* The Company did not design detailed controls to sufficiently review the assumptions and methodology utilized by the third party expert.

*Effect:* Management's review of the assumptions and methodology used by the expert was not performed at a sufficient level of detail to identify potential flaws in assumptions and methodology which resulted in a material audit adjustment to the financial statements.

*Recommendation:* We recommend that ITT's management design and implement a formal, detailed review process to assess the outside expert's loan performance forecasts to identify potential flaws in assumptions and methodology that could result in a material misstatement. Management should consider including additional members of the management team in the quarterly assessment of the forecast models, and design detailed review procedures for the assumptions and methodology used in the models.

# ITT Educational Services, Inc.

## Schedule of Findings and Questioned Costs

### December 31, 2013

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#### *Management Views and Corrective Action Plan:*

The Company's Board of Directors and management are committed to remediating the control deficiency that constitutes this material weakness by implementing changes to our internal control over financial reporting ("ICFR"), as well as the continued improvement of our overall system of ICFR. The Company is in the process of implementing measures to remediate the underlying causes of the control deficiency that gave rise to this material weakness, primarily through additional review procedures and engaging supplemental resources. The Company believes these measures will remediate the control deficiency, however, all of the corrective processes, procedures and related evaluation or remediation that the Company believes are necessary have not been completed. As the Company continues to evaluate and work to remediate the control deficiency that gave rise to this material weakness, it may determine that additional measures are required to address the control deficiency.

#### **Finding 2013-4 (Timely Identification and Communication to Members of Management):**

*Criteria:* The Company is expected to maintain sufficient controls for purposes of mitigating material misstatements within the Company's financial statements based on the criteria established in the Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

*Condition:* The Company did not completely identify and timely communicate information relevant to the private loan programs to the appropriate individuals within management with the responsibilities and relevant expertise to consider the information in the Company's financial reporting processes. Additionally, individuals with access to relevant private loan information and the responsibility to monitor the accounting for the private loan programs were not properly assigned and trained. Based on the nature of these deficiencies, it was determined that there is a material weakness in internal control over financial reporting.

*Cause:* The Company failed to provide information relevant to the private loan programs to those members of management charged with the responsibility of considering the information for the Company's financial reporting processes in a timely manner.

*Effect:* The consideration of other elements of internal controls resulted in the identification of deficiencies in the other elements of internal controls relating to private loan matters which contributed in part to the two material weaknesses described in Findings 2013-1 and 2013-2 above.

*Recommendation:* We recommend that the Company evaluate their disclosure controls, procedures, practices and policies to ensure that all relevant data, communications with external parties, information regarding changes to existing agreements, and other pertinent information relating to private loan matters is provided in a timely manner to those in an accounting function with the responsibilities and relevant expertise to consider the information in the Company's financial reporting processes. Such evaluation should include assessment of the sufficiency of resources, adequate training, and assignment of roles and responsibilities within the financial reporting organization.

#### *Management's Views and Corrective Action Plan:*

The Company's Board of Directors and management are committed to remediating the control deficiency that constitutes this material weakness by implementing changes to our internal control over financial reporting ("ICFR"), as well as the continued improvement of our overall system of ICFR. The Company is in the process of implementing measures to remediate the underlying causes of the control deficiency that gave rise to this material weakness, primarily through additional review procedures and engaging supplemental resources. The Company believes these measures will remediate the control deficiency, however, all of the corrective processes, procedures and related evaluation or remediation that the Company believes are necessary have not been completed. As the Company continues to evaluate and work to remediate the control deficiency that gave rise to this material weakness, it may determine that additional measures are required to address the control deficiency.

# ITT Educational Services, Inc.

## Schedule of Findings and Questioned Costs

### December 31, 2013

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#### Significant deficiency

##### **Finding 2013-5 (Revenue Recognition):**

*Criteria:* The Company is expected to maintain sufficient controls for purposes of mitigating material misstatements within the Company's financial statements based on the criteria established in the Internal Control – Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

*Condition:* The Company did not maintain effective internal controls to ensure that incremental revenue earned per state refund policies on students that withdrew from the institution was deemed collectible prior to recognition

*Cause:* The Company did not design detailed controls to sufficiently consider the collectibility of the incremental revenue recognized on student withdrawals.

*Effect:* The Company improperly recognized revenue prior to collectibility being reasonably assured which resulted in an audit adjustment to decrease revenue and partially offsetting amounts of bad debt expense in the current and prior periods.

*Recommendation:* We recommend that the Company design and implement a formal process to assess whether incremental revenue recognized within the student billing system at the time a student withdraws from the institution is reasonably assured of collection. As part of this process management should subsequently identify cash received related to the services provided for which no revenue was recognized (due to lack of collectibility), and record the related revenue at the time the cash is received.

##### *Management's Views and Corrective Action Plan:*

We have developed a standard process to identify incremental revenue computed within the student billing system at the time a student withdraws from the institution in order to assess whether collection of that revenue is reasonably assured. A standard process has also been developed to determine the amount of cash collected that relates to services provided for which revenue had not been recognized.

**2012** – There are no financial statement findings from prior years which require an update in this report.

**ITT Educational Services, Inc.**  
**Schedule of Findings and Questioned Costs**  
**For the Year Ended December 31, 2013**

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**Section II – State Project Findings and Questioned Costs**

**Introduction**

Our examination was performed for the calendar year 2013 and included award recipients as follows:

	<b>Description of Category</b>	<b>Number of Students</b>	<b>Percent of Population</b>	<b>Amount of Awards</b>	<b>Percent of Population</b>
FSAG (1)	Population	793	100.0%	\$ 908,094	100.0%
	Sample Tested	50	6.3%	\$ 51,931	5.7%
	Test Results (4)	4	0.5%	\$ -	0.0%
FMSA (2)	Population	8	100.0%	\$ 9,628	100.0%
	Sample Tested	8	100.0%	\$ 9,628	100.0%
	Test Results (5)	6	75.0%	\$ 405	5.0%
FGSVSA (3)	Population	3	100.0%	\$ 3,100	100.0%
	Sample Tested	3	100.0%	\$ 3,100	100.0%
	Test Results (6)	0	0.0%	\$ -	0.0%

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- (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 one finding type at one institution. See Part III for additional information regarding Finding #13-1 including the written finding, recommendation, and management's response.
  - (5) Our testing identified ten instances among four finding types at three institutions. See Part III, for additional information regarding Findings #13-2 through #13-5, including the written findings, recommendations, and management's responses.
  - (6) Our testing did not identify any findings relating to FGSVSA.

Note: There were no Florida Academic Scholars Awards disbursed during 2013.

# ITT Educational Services, Inc.

## Schedule of Findings and Questioned Costs

### For the Year Ended December 31, 2013

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The following audit findings were reportable for the year ended December 31, 2013. 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 #13-1 (FSAG, Catalog #48.054: Total population - 793 students, \$908,094)**

Our audit identified one institution which failed to notify four students of the grants they were to receive for the school year. The students were appropriately awarded the correct amount, but 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 findings were caused by human error by the financial aid personnel which resulted in errors with the completion of the cost summary and payment addendum for the students. The institution uses the cost summary and payment addendum as the award letter. In response to the finding, management issued an award letter to the students to provide notification of the awards.

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

#### **Management's View**

The importance of proper award notification on the Cost Summary and Payment Addendum prior to disbursement has been communicated by management. Directors of Finance are instructed to review all students eligible for disbursement to ensure that a valid and signed cost summary exists in the file displaying the award. Management has emphasized consistent and accurate review such that all eligible students receive proper notification prior to disbursement.

#### **Finding #13-2 (FMSA, Catalog #48.059: Total population - 8 students, \$9,628)**

Our audit identified three instances at two institutions in which the financial personnel at the respective institution reported the incorrect number of credit hours enrolled by award eligible students, resulting in the incorrect award amounts disbursed by the State in the name of those students. These students met all Bright Futures eligibility requirements and should have received the fixed amount as prescribed by the Department of Education and Florida State Code 1009.538 based on the number of credit hours enrolled during the term. The findings were the result of clerical errors in the institutions' reporting of the number of credit hours enrolled in by each student to the State. The number of credit hours reported by the institutions to the State did not match the number of hours enrolled per each student's transcript. As a result, the State over-awarded two students by \$42 and \$100, respectively, and under-awarded one student by \$50.

#### **Recommendation**

To avoid such clerical issues in the future, management should seek to refine the review process in place to ensure the accuracy of the number of credit hours reported to the State for each student each term. Further, the institution should consider performing the reconciliation of funds received from the State to funds disbursed to students on a monthly basis versus annually in order to identify these issues earlier. Lastly, as it relates to the under-awards, the institution should disburse the remaining amounts to the affected student.

# ITT Educational Services, Inc.

## Schedule of Findings and Questioned Costs

### For the Year Ended December 31, 2013

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#### Management's View

The applicable students have been made whole. Directors of Finance will retrain staff on accurate award amounts based on credit hours enrolled and award rate per credit hour as stressed by management. An improved reconciliation process has been implemented that will allow us to reconcile funds that we have received from the State on a quarterly basis allowing us to identify issues earlier. This retraining and consistent review and oversight by the Directors of Finance will improve accuracy of the calculation prior to State submission.

#### **Finding #13-3 (FMSA, Catalog #48.059: Total population - 8 students, \$9,628)**

Our audit identified one instance in which the institution failed to allocate the appropriate amount of funds received to the eligible student, resulting in \$9 in questioned costs. This student met all Bright Futures eligibility requirements and should have received the fixed amount as prescribed by the Department of Education and Florida State Code 1009.538. The finding was caused by a clerical error in which the disbursement per the student's ledger card was \$9 greater than the amount allocated to the student per the State's reconciliation report.

#### Recommendation

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 that are added to the student's account. Further, the institution should consider performing the reconciliation of funds received from the State to funds disbursed to students on a monthly basis versus annually in order to identify these issues earlier.

#### Management's View

The applicable students have been made whole. Directors of Finance will retrain staff on accurate award amounts based on credit hours enrolled and award rate per credit hour as stressed by management. An improved reconciliation process has been implemented that will allow us to reconcile funds that we have received from the State on a quarterly basis allowing us to identify issues earlier. This retraining and consistent review and oversight by the Directors of Finance will improve accuracy of the calculation prior to State submission.

#### **Finding #13-4 (FMSA, Catalog #48.059: Total population - 8 students, \$9,628)**

Our audit identified four instances at two institutions in which the school failed to disburse the funds on a timely basis. These students met all Bright Futures eligibility requirements and should have received the fixed amount as prescribed by the Department of Education and Florida State Code 1009.538 during the terms in which the awards were disbursed. However, in each case, the student's account was not credited with the grant amount until months after the completion of the terms. As stated in Florida State Code 1009.535(b), "An institution that receives funds from the program shall certify to the department the amount of funds disbursed to each student and shall remit to the department any undisbursed advances within 60 days after the end of regular registration." Per review of the student ledger cards, the institutions are not disbursing the funds to the students within 60 days after the end of the regular registration period. Therefore, the funds must either be returned to the State or disbursed in the term for which they are awarded. The findings were the result of clerical errors by the finance personnel at each institution. However, due to the fact that all funds were eventually disbursed to the eligible students, there are no questioned costs.

#### Recommendation

To avoid such clerical issues in the future, management should seek to refine the review process in place to ensure that eligible students are disbursed funding in the terms for which they are awarded. Further, the institution should consider performing the reconciliation of funds received from the State to funds disbursed to students on a monthly basis versus annually in order to identify these issues earlier. The annual reconciliation identified the failed disbursements in three of the four instances of this finding. Therefore, a more timely reconciliation would help ensure timely disbursements.

# ITT Educational Services, Inc.

## Schedule of Findings and Questioned Costs

### For the Year Ended December 31, 2013

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#### Management's View

The Directors of Finance have retrained their staff to ensure that accurate and timely awards are made to students. Headquarters has provided additional oversight to ensure timely disbursements of funding. An improved reconciliation process has been implemented that will allow us to reconcile funds that we have received from the State on a quarterly basis allowing us to identify issues earlier.

#### **Finding #13-5 (FMSA, Catalog #48.059: Total population - 8 students, \$9,628)**

Our audit identified two instances at two institutions in which the school failed to return funds to the State for student drops/withdrawals during the term in a timely basis. As stated in Florida State Code 1009.535(a), "An institution must make a refund to the department within 30 days after the end of the semester of any funds received for courses dropped by a student or courses from which a student has withdrawn after the end of the drop and add period." In both instances, the institutions failed to return for funds within 30 days. One student withdrew prior to ever enrolling in courses at the institution, yet the student had been deemed Bright Future eligible upon acceptance to the institution. Therefore, \$650 was disbursed from the State to the institution in the student's name in June 2013. Those funds were returned to the State in January 2014, as a result of the annual reconciliation process. The other student received funding for 16 credit hours during the September 2013 term. However, the student dropped a course during the term and the institution failed to return the excess funding to the State, resulting in \$204 in questioned costs. Both findings were the result of clerical errors by the finance personnel at the institutions.

#### Recommendation

To avoid such clerical issues in the future, management should seek to refine the review process in place to ensure that eligible students were disbursed the correct funding for the hours completed during the term. Further, the institution should consider performing the reconciliation of funds received from the State to funds disbursed to students on a monthly basis versus annually in order to identify these issues earlier. The first instance was settled, albeit not timely, as a result of the annual reconciliation. However, since the second instance occurred during the 2013-2014 academic year, it would not have been noted until the 2013-2014 annual reconciliation is completed.

#### Management's View

Directors of Finance have retrained their staff on accurate award amounts based on credit hours enrolled and award rate per credit hour as stressed by management. An improved reconciliation process has been implemented that will allow us to reconcile funds that we have received from the State on a quarterly basis allowing us to identify issues earlier. Headquarters has provided additional oversight to ensure timely refunds to the State.

# ITT Educational Services, Inc.

## Status of Prior Year Findings and Questioned Costs

### For the Year Ended December 31, 2013

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#### **Status of Prior Year Findings:**

##### **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.

#### **Status**

Management continues to discuss the importance of ensuring the student receives a cost summary prior to the award being granted. The process has been changed so that the Director of Finance checks 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.

#### **Status**

Management understands the importance of having the State grant funds reconciled. We are reconciling the State grant program on a more frequent basis. This should resolve the issue. ITT understands the importance of proper reporting to the State. In addition, headquarters has provided additional resources to assist with the reconciliation process.

##### **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.

#### **Status**

We are performing reconciliations on a more frequent basis. During the reconciliation process we 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.**  
**Status of Prior Year Findings and Questioned Costs**  
**For the Year Ended December 31, 2013**

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**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.

**Status**

Management has ensured that the applicable students were made whole. The Directors of Finance re-trained their staff to ensure that accurate awards are made to the students. This will ensure the accuracy of the student awards before they are 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.

**Status**

Management understands the importance of properly disbursing the State grant award and disbursing the same amount to the student. We are reconciling the State grant program on a more frequent basis. This is helping to resolve the issue and ensure what is awarded to the student is also reported to the State.

**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.

**Status**

Management has ensured that the applicable student was made whole. The Directors of Finance re-trained their staff to ensure that accuracy of the calculation and disbursement of the awards. This is helping to ensure the accuracy of the student awards before they are certified and sent to the State. Additional headquarter oversight has been provided to assist the campuses with this process.