ITT EDUCATIONAL SERVICES INC
Form 10-Q
April 26, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended **March 31, 2007**

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ________ to ________

Commission file number **1-13144**

ITT EDUCATIONAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes **x** No **o**

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

Large accelerated filer	**x**	Accelerated filer	**o**	Non-accelerated filer	**o**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes **o** No **x**

40,724,204
Number of shares of Common Stock, $.01 par value, outstanding at March 31, 2007

ITT EDUCATIONAL SERVICES, INC.

Carmel, Indiana

Quarterly Report to Securities and Exchange Commission

March 31, 2007

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	March 31, 2007 (unaudited)	As of December 31, 2006	March 31, 2006 (unaudited)
Assets			
Current assets:			
Cash and cash equivalents	$8,012	$161,905	$6,672
Short-term investments	341,460	195,007	270,879
Accounts receivable, net	9,858	9,367	9,775
Deferred income taxes	7,486	4,771	4,015
Prepaid expenses and other current assets	13,397	9,902	30,264
Total current assets	380,213	380,952	321,605
Property and equipment, net	149,207	148,411	131,070
Direct marketing costs, net	21,560	21,628	18,392
Investments	--	--	9,521
Other assets	9,354	9,329	1,078
Total assets	$560,334	$560,320	$481,666
Liabilities and Shareholders' Equity			
Current liabilities:			
Accounts payable	$56,358	$47,948	$42,185
Accrued compensation and benefits	11,273	13,899	9,010
Accrued income taxes	8,015	11,003	7,122
Other accrued taxes	3,574	3,242	2,901
Other accrued liabilities	8,013	6,251	5,818
Deferred revenue	205,770	202,162	179,326
Total current liabilities	293,003	284,505	246,362
Long-term debt	150,000	150,000	--
Deferred income taxes	12,822	13,713	14,432
Minimum pension liability	--	--	9,899
Other liabilities	12,869	8,157	7,737
Total liabilities	468,694	456,375	278,430
Shareholders' equity			
Preferred stock, $.01 par value, 5,000,000 shares authorized, none issued	--	--	--
Common stock, $.01 par value, 300,000,000 shares authorized, 54,068,904 issued	541	541	541
Capital surplus	32,921	46,982	65,472
Retained earnings	537,961	508,195	410,153
Accumulated other comprehensive (loss)	(6,448)	(6,533)	(6,016)
Treasury stock, 13,344,700, 13,029,471 and 10,322,431 shares, at cost	(473,335)	(445,240)	(266,914)
Total shareholders' equity	91,640	103,945	203,236
Total liabilities and shareholders' equity	$560,334	$560,320	$481,666

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

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

	Three Months Ended March 31,	
	2007	**2006**
Revenue	$204,170	$176,315
Costs and expenses:		
Cost of educational services	90,770	90,404
Student services and administrative expenses	69,293	56,112
Special legal and other investigation costs	--	(430)
Total costs and expenses	160,063	146,086
Operating income	44,107	30,229
Interest income, net	844	2,507
Income before provision for income taxes	44,951	32,736
Provision for income taxes	17,354	12,262
Net income	$27,597	$20,474
Earnings per share:		
Basic	$0.67	$0.46
Diluted	$0.66	$0.45
Weighted average shares outstanding:		
Basic	40,915	44,823
Diluted	41,590	45,798

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

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

	Three Months Ended March 31,	
	2007	**2006**
Cash flows from operating activities:		
Net income	$27,597	$20,474
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	6,641	4,898
Provision for doubtful accounts	4,641	2,549
Deferred income taxes	(3,606)	(764)
Excess tax benefit from stock option exercises	(11,050)	(3,164)
Stock-based compensation expense	1,975	1,921
Changes in operating assets and liabilities:		
Accounts receivable	(5,132)	1,665
Prepaid expenses and other assets	(3,520)	(16,191)
Direct marketing costs, net	68	(902)
Accounts payable and accrued liabilities	12,403	(14,432)
Income and other accrued taxes	10,746	12,036
Deferred revenue	3,608	3,872
Net cash flows from operating activities	44,371	11,962
Cash flows from investing activities:		
Facility expenditures and land purchases	(4,918)	(4,949)
Capital expenditures, net	(2,519)	(3,613)
Proceeds from sales and maturities of investments	590,817	372,535
Purchase of investments	(737,270)	(255,245)
Net cash flows from investing activities	(153,890)	108,728
Cash flows from financing activities:		
Excess tax benefit from stock option exercises	11,050	3,164
Proceeds from exercise of stock options	9,625	9,218
Repurchase of common stock	(65,049)	(140,135)
Net cash flows from financing activities	(44,374)	(127,753)
Net change in cash and cash equivalents	(153,893)	(7,063)
Cash and cash equivalents at beginning of period	161,905	13,735
Cash and cash equivalents at end of period	$8,012	$6,672

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

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

	Common Stock		Capital	Retained	Accumulated Other Comprehensive	Common Stock in Treasury		
	Shares	Amount	Surplus	Earnings	Income/(Loss)	Shares	Amount	Total
Balance as of December 31, 2005	54,069	$541	$68,714	$389,679	($6,016)	(8,378)	($144,324)	$308,594
For the three months ended March 31, 2006 (unaudited):								
Net income				20,474				20,474
Exercise of stock options			(8,327)			282	17,545	9,218
Tax benefit from exercise of stock options			3,164					3,164
Stock-based compensation			1,921					1,921
Common shares repurchased						(2,226)	(140,135)	(140,135)
Balance as of March 31, 2006	54,069	541	65,472	410,153	(6,016)	(10,322)	(266,914)	203,236
For the nine months ended December 31, 2006 (unaudited):								
Net income				98,042				98,042
Other comprehensive income:								
Minimum pension liability, net of tax					6,016			6,016
Comprehensive income								104,058
Adoption of SFAS No. 158, net of tax					(6,533)			(6,533)
Exercise of stock options			(28,707)			641	42,449	13,742
Tax benefit from exercise of stock options			11,125					11,125
Common shares repurchased						(3,381)	(222,838)	(222,838)
Stock-based compensation			1,146					1,146
Issuance of shares for Directors' Deferred Compensation Plan			(153)			4	272	119
Restricted stock awards and shares tendered for taxes			(1,901)			29	1,791	(110)
Balance as of December 31, 2006	54,069	541	46,982	508,195	(6,533)	(13,029)	(445,240)	103,945
Effect of adoption of FIN No. 48				2,169				2,169
Balance as of January 1, 2007 (unaudited)	54,069	541	46,982	510,364	(6,533)	(13,029)	(445,240)	106,114
For the three months ended March 31, 2007 (unaudited):								
Net income				27,597				27,597
Other comprehensive income:								
SFAS No. 158 amortization of pension loss, net of tax					85			85
Comprehensive income								27,682
Exercise of stock options			(27,269)			494	36,894	9,625
Tax benefit from exercise of stock options			11,233					11,233
Common shares repurchased						(810)	(65,049)	(65,049)
Stock-based compensation			1,975					1,975
Issuance of shares for Directors' Deferred Compensation Plan						1	60	60
Balance as of March 31, 2007	54,069	$541	$32,921	$537,961	($6,448)	(13,344)	($473,335)	$91,640

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

ITT EDUCATIONAL SERVICES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2007

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

1. The Company and Basis of Presentation

We are a leading provider of technology-oriented postsecondary education in the United States based on revenue and student enrollment. As of March 31, 2007, we were offering diploma and associate, bachelor and master degree programs to more than 49,000 students. As of March 31, 2007, we had 90 institutes and nine learning sites located in 33 states. All of our institutes 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. Our corporate headquarters are located in Carmel, Indiana.

The accompanying unaudited condensed consolidated financial statements include our wholly-owned subsidiaries' accounts and have been prepared in accordance with generally accepted accounting principles in the United States of America for interim periods and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Certain information and footnote disclosures, including significant accounting policies, normally included in a complete presentation of financial statements prepared in accordance with those principles, rules and regulations have been omitted. The Condensed Consolidated Balance Sheet as of December 31, 2006 was derived from audited financial statements but, as presented in this report, may not include all disclosures required by accounting principles generally accepted in the United States. In the opinion of our management, the financial statements contain all adjustments necessary to fairly state our financial condition and results of operations. The interim financial information should be read in conjunction with the audited consolidated financial statements and notes thereto contained in our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2006.

2. Summary of Certain Accounting Policies

Income Taxes. Effective January 1, 2007, we adopted Financial Accounting Standards Board (FASB) Interpretation Number 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, (FIN No. 48), 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. Upon adoption of FIN No. 48, we recognized a decrease of approximately $3,391 in the liability for unrecognized tax benefits, which was accounted for as an increase to retained earnings of $2,169 as of January 1, 2007 and a reduction of federal tax benefits of $1,222.

As of January 1, 2007, after the implementation of FIN No. 48, our unrecognized tax benefits were $6,820. The amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is $5,494. We expect our unrecognized tax benefits to increase by less than $1,500 over the next 12 months for state tax positions related to the current and prior years.

We record interest and penalties related to unrecognized tax benefits in income tax expense. As of January 1, 2007, we had approximately $523 accrued for the payment of interest and penalties related to unrecognized tax benefits in our Condensed Consolidated Balance Sheet.

We file income tax returns in the United States (federal) and in various state and local jurisdictions. In most instances, we are no longer subject to federal, state and local income tax examinations by tax authorities for years prior to 2003.

3. New Accounting Pronouncements

In February 2007, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, (SFAS No. 159), which permits companies to choose to measure certain financial instruments and other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We will adopt SFAS No. 159 no later than January 1, 2008. We have not determined the effect that the adoption of SFAS No. 159 will have on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, (SFAS No. 157), which provides guidance on the use of fair value to measure assets and liabilities and expands the disclosure required in a company s financial statements for fair value measurements. SFAS No. 157 will apply whenever other accounting pronouncements require or permit fair value measurements for assets and liabilities and is effective for fiscal years beginning after November 15, 2007. We will adopt SFAS No. 157 no later than January 1, 2008 and have not determined the effect that the adoption will have on our consolidated financial statements.

Also in September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R), (SFAS No. 158), which requires a company to measure the funded status of a defined benefit postretirement plan as of the date of the company s year-end balance sheet. This provision of SFAS No. 158 is effective for fiscal years ending after December 15, 2008 and will be adopted by us no later than December 31, 2008. We have not determined the effect that the adoption of this provision of SFAS No. 158 will have on our consolidated financial statements.

4. **Equity Compensation**

We recognized $1,975 of stock-based compensation and a related income tax benefit of $760 in our net income for the three months ended March 31, 2007. We recognized $1,921 of stock-based compensation and a related income tax benefit of $740 in our net income for the three months ended March 31, 2006. We did not capitalize any stock-based compensation cost in the three months ended March 31, 2007 or 2006.

As of March 31, 2007, we estimated that pre-tax compensation expense for unvested stock-based compensation grants in the amount of approximately $6,765, 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 2.6 years.

The stock options granted, forfeited, exercised and expired during the period indicated are as follows:

	Three Months Ended March 31, 2007				
	# of Shares	**Weighted Average Exercise Price**	**Aggregate Exercise Price**	**Weighted Average Remaining Contractual Term**	**Aggregate Intrinsic Value [(1)]**
Outstanding at beginning of period	2,570,809	$33.88	$87,103		
Granted	157,080	77.60	12,190		
Forfeited	(2,968)	51.47	(153)		
Exercised	(493,767)	19.49	(9,625)		
Expired	--	--	--		
Outstanding at end of period	2,231,154	$40.12	$89,515	5.5 years	$96,168
Exercisable at end of period	1,974,899	$36.39	$71,875	5.6 years	$88,941

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(1) The aggregate intrinsic value of the stock options was calculated by subtracting the weighted average exercise price from the closing market price of our common stock on March 30, 2007, and multiplying the result by the number of shares subject to the options outstanding or exercisable, as applicable.

On April 2, 2007, we granted stock options representing 69,282 shares of our common stock with an exercise price of $82.20, which become exercisable in three equal annual installments commencing with the first anniversary of the grant date.

Information regarding the stock options granted and exercised during the three months ended March 31, 2007 and 2006 is as follows:

	Three Months Ended March 31,	
	2007	**2006**
Shares subject to stock options granted	157,080	56,500
Weighted average grant date fair value	$28.50	$21.67
Shares subject to stock options exercised	493,767	281,049
Intrinsic value of stock options exercised	$29,223	$8,237

Proceeds received from stock options exercised	$9,625	$9,218
Tax benefits realized from stock options exercised	$11,233	$3,164

The fair value of our stock options was determined at the grant date using a binomial option pricing model for stock options granted on and after January 1, 2005. We recognize the fair value of stock options as compensation expense over the service period applicable to the grantee using the straight-line method.

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

	Three Months Ended March 31,	
	2007	**2006**
Risk-free interest rates	4.8%	4.3%
Expected lives (in years)	4.7	4.3
Volatility	35%	42%
Dividend yield	None	None

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

	Three Months Ended March 31, 2007			
	# of Shares of Restricted Stock	**Weighted Average Grant Date Fair Value**	**# of RSUs**	**Weighted Average Grant Date Fair Value**
Unvested at beginning of period	24,532	$60.90	88	$68.25
Granted	--	--	24,818	77.85
Forfeited	(105)	58.30	(82)	77.60
Vested	--	--	--	--
Unvested at end of period	24,427	$60.91	24,824	$77.82

On April 2, 2007, we granted the following RSUs having a grant date fair value of $82.20: 9,125 with a time-based period of restriction that ends on the third anniversary of the date of grant; and 18,249 with a time-based period of restriction that ends on the fifth anniversary of the date of grant.

5. <u>Stock Repurchases</u>

Our Board of Directors has authorized us to repurchase the following number of shares of our common stock pursuant to our share repurchase program (the "Repurchase Program"):

Number of Shares	**Board Authorization Date**
2,000,000	April 1999
2,000,000	April 2000
5,000,000	October 2002
5,000,000	April 2006
5,000,000	April 2007

The shares that remained available for repurchase under the Repurchase Program were 1,871,200 as of March 31, 2007 and 6,871,200 as of April 24, 2007. 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.

In the three months ended March 31, 2007, we repurchased 809,900 shares of our common stock for $65,049, or at an average price of $80.32 per share. In the three months ended March 31, 2006, we repurchased 2,225,700 shares of our common stock for $140,135, or at an average price of $62.96 per share.

6. <u>Debt</u>

On December 22, 2006, we entered into a credit agreement with a single lender to borrow up to $150,000 under a revolving credit facility. We can borrow under the credit facility on either a secured or unsecured basis. The credit agreement matures on October 1, 2009 and the amount of credit available thereunder decreases by $21,429 each calendar quarter beginning April 1, 2008.

Borrowings under the credit agreement bear interest at variable rates based on fixed increments over the London Interbank Offered Rate (LIBOR). As of March 31, 2007, we had $150,000 of secured borrowings under the credit agreement at an interest rate of 5.47% per annum. Approximately $157,950 of our investments served as collateral for the secured borrowings as of March 31, 2007.

During the three months ended March 31, 2007, we recognized $2,106 of interest expense on our borrowings under the credit agreement.

7. Investments

The following table sets forth how our investments were classified on our Condensed Consolidated Balance Sheets as of the dates indicated:

	As of:								
	March 31, 2007			**December 31, 2006**			**March 31, 2006**		
	Available-for-Sale	**Held-to-Maturity**	**Total**	**Available-for-Sale**	**Held-to-Maturity**	**Total**	**Available-for-Sale**	**Held-to-Maturity**	**Total**
Short-term investments	$332,005	$9,455	$341,460	$185,535	$9,472	$195,007	$266,850	$4,029	$270,8
Non-current investments	--	--	--	--	--	--	- -	9,521	9,521
	$332,005	$9,455	$341,460	$185,535	$9,472	$195,007	$266,850	$13,550	$280,4

The following table sets forth the aggregate fair market value of our available-for-sale investments and aggregate amortized cost of our held-to-maturity investments as of the dates indicated:

	As of: March 31, 2007	December 31, 2006	March 31, 2006
Available-for-Sale Investments:			
Auction rate equity securities	$ --	$ 21,300	$ 45,400
Auction rate debt securities and variable rate demand notes	332,005	164,235	221,450
	$ 332,005	$ 185,535	$ 266,850
Held-to-Maturity Investments:			
Marketable debt securities	$ 9,455	$ 9,472	$ 13,550

We had no material gross unrealized holding or realized gains (losses) from our investments in auction rate securities and variable rate demand notes in the three months ended March 31, 2007 and 2006. All income generated from those investments was recorded as interest income. We recognized interest income of $2,949 in the three months ended March 31, 2007 and $2,463 in the three months ended March 31, 2006.

The following table sets forth the contractual maturities of our debt securities classified as available-for-sale and held-to-maturity as of March 31, 2007:

Contractual Maturity	Available-for-Sale	Held-to-Maturity
Due within five years	$ 1,000	$ 9,455
Due after five years through ten years	27,385	--
Due after ten years	303,620	--
	$ 332,005	$ 9,455

8. Earnings Per Common Share

Earnings per common share for all periods have been calculated in conformity with SFAS No. 128, Earnings Per Share. This data is based on the weighted average number of shares of our common stock outstanding during each period as set forth in the following table:

	Three Months Ended March 31, 2007	2006
	(In thousands)	
Shares:		
Weighted average number of shares of common stock outstanding	40,915	44,823
Shares assumed issued (less shares assumed purchased for treasury) for stock-based compensation	675	975
Outstanding shares for diluted earnings per share calculation	41,590	45,798

A total of 171,000 shares for the three months ended March 31, 2007 and 5,000 shares for the three months ended March 31, 2006 have been excluded from the calculation of our diluted earnings per common share because the effect was anti-dilutive.

9. Employee Pension Benefits

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

	Three Months Ended March 31,	
	2007	**2006**
Service cost	$ --	$1,669
Interest cost	769	782
Expected return on assets	(1,202)	(892)
Recognized net actuarial loss	138	339
Amortization of prior service cost	--	(443)
Net periodic pension cost/(benefit)	($295)	$1,455

We contributed $15,000 to the ESI Pension Plan during the three months ended March 31, 2006 and $0 in the three months ended March 31, 2007. We do not expect to make any contributions to the ESI Pension Plan in 2007.

Effective March 31, 2006, the benefit accruals under the ESI Pension Plan and the ESI Excess Pension Plan were frozen for all participants in those plans. As a result of the freeze, we recognized a pre-tax curtailment gain of $421 in the three months ended March 31, 2006, due to the acceleration of the amortization of prior service cost and decrease in projected benefit obligation.

We adopted the recognition provisions of SFAS No. 158 effective December 31, 2006. SFAS No. 158 requires that the funded status of a defined benefit postretirement plan be recognized on a company s balance sheet, and that any changes in the funded status of that type of plan be recognized through comprehensive income. We recorded $8,277 in other assets for our qualified pension plan, a liability of $1,656 in other liabilities for our nonqualified pension plan and $6,533, net of tax, in accumulated other comprehensive loss on our December 31, 2006 Condensed Consolidated Balance Sheet upon our adoption of SFAS No. 158. Our March 31, 2007 Condensed Consolidated Balance Sheet reflects an asset of $8,734 in other assets for our qualified pension plan, a liability of $1,680 in other liabilities for our nonqualified pension plan and $6,448, net of tax, in accumulated other comprehensive loss.

Retrospective application of SFAS No. 158 is not permitted and, therefore, prior period balances and activity related to the pension plans have not been changed. Prepaid pension costs of $18,084 are included in prepaid expenses and other current assets on the Condensed Consolidated Balance Sheet as of March 31, 2006.

10. 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 March 31, 2007, the total face amount of those surety bonds was approximately $14,159. In addition, as of March 31, 2007, we provided irrevocable standby letters of credit in the amount of approximately $1,200 to secure the payment of construction costs associated with a facility that we built in 2006 and the payment of our workers compensation claims.

On March 4, 2005, we were served with a qui tam action that was filed on April 8, 2004 in the United States District Court for the Southern District of Indiana by a former employee (relator) on behalf of himself and the federal government under the following caption: *United States of America ex rel. Robert Olson v. ITT Educational Services, Inc. d/b/a ITT Technical Institute* (the Olson Action). We were served with the Olson Action after the U.S. Department of Justice ("DOJ") declined to intervene in the litigation. On June 24, 2005, the relator filed an amended complaint in the Olson Action. On January 9, 2006, the court dismissed the Olson Action without prejudice and gave the relator an opportunity to replead his complaint. On March 20, 2006, the relator filed a second amended complaint under seal. On April 18, 2006, the DOJ again declined to intervene in the litigation and the court unsealed the second amended complaint. In the second amended complaint, the relator alleged that we violated the False Claims Act, 31 U.S.C. § 3729, *et seq*., by knowingly making and using false records and statements relating to, among other things, student recruitment, admission, enrollment, attendance, grading, testing, graduate placement, programs of study and course materials in order to fraudulently obtain student loans and tuition from the federal government. The complaint sought an unspecified judgment and attorney s fees and costs. On February 26, 2007, the court dismissed the Olson Action with prejudice for failure to prosecute.

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.

We are also subject to various claims and contingencies in the ordinary course of our business, including those related to litigation, business transactions, employee-related matters and taxes, among others. We cannot assure you of the ultimate outcome of any litigation involving us. Any litigation alleging violations of education or consumer protection laws and/or regulations, misrepresentation, fraud or deceptive practices may also subject our affected institutes to additional regulatory scrutiny.

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

Forward-Looking Statements

All statements, trend analyses and other information contained in this report that are not historical facts are forward-looking statements within the meaning of the safe harbor provision of the Private Securities Litigation Reform Act of 1995 and as defined in Section 27A of the Securities Act of 1933 (the Securities Act) and Section 21E of the Exchange Act. Forward-looking statements are made based on our management s current expectations and beliefs concerning future developments and their potential effects on us. You can identify those statements by the use of words such as could, should, would, may, will, project, believe, anticipate, expect, plan, estimate, forecast, potential, intend, continue and contemplate, as well as similar words and expressions. Forward-looking statements involve risks and uncertainties and do not guarantee future performance. We cannot assure you that future developments affecting us will be those anticipated by our *management. Among the factors that could cause actual results to differ materially from those expressed in our forward-looking statements are the following:*

- *business conditions and growth in the postsecondary education industry and in the general economy;*
- *changes in federal and state governmental regulations with respect to education and accreditation standards, or the interpretation or enforcement of those regulations, including, but not limited to, the level of government funding for, and our eligibility to participate in, student financial aid programs utilized by our students;*
- *our failure to comply with the extensive education laws and regulations and accreditation standards that we are subject to;*