Attachment 11 - ITT Educational Services, Inc.
Consolidated Financial Statements

ITT Educational Services, Inc.

Consolidated Financial Statements
For the Years Ended December 31, 2006 and 2005

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Exhibit I
Management's Report on Internal Control Over Financial Reporting

PRICEWATERHOUSECOOPERS

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Report of Independent Registered Public Accounting Firm

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

We have completed integrated audits of ITT Educational Services, Inc.'s consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the index appearing under Item 15.1 present fairly, in all material respects, the financial position of ITT Educational Services, Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15.2 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes 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. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 1 to the consolidated financial statements, the Company changed the manner in which it accounts for employee pension benefits and share based compensation in 2006.

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Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing on page F-1, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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.

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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.

PricewaterhouseCoopers LLP

Indianapolis, Indiana
February 23, 2007

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

	As of December 31, 2006	2005
Assets		
Current assets:		
Cash and cash equivalents	$161,905	$13,735
Short-term investments	195,007	388,152
Accounts receivable, less allowance for doubtful accounts of $2,181 and $1,118	9,367	13,989
Deferred income taxes	4,771	4,190
Prepaid expenses and other current assets	9,902	16,942
Total current assets	380,952	437,008
Property and equipment, net	148,411	127,406
Direct marketing costs, net	21,628	17,490
Investments	--	9,538
Prepaid pension obligation	8,277	--
Restricted cash	527	500
Other assets	525	549
Total assets	$560,320	$592,491
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$47,948	$56,101
Accrued compensation and benefits	13,899	10,344
Accrued income taxes	11,003	--
Other accrued taxes	3,242	3,998
Other accrued liabilities	6,251	5,242
Deferred revenue	202,162	175,454
Total current liabilities	284,505	251,139
Long-term debt	150,000	--
Deferred income taxes	13,713	15,364
Minimum pension liability	--	9,899
Other liabilities	8,157	7,495
Total liabilities	456,375	283,897
Commitments and contingent liabilities (Note 11)		
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
Capital surplus	46,982	68,714
Retained earnings	508,195	389,679
Accumulated other comprehensive (loss)	(6,533)	(6,016)
Treasury stock, 13,029,471 and 8,377,780 shares, at cost	(445,240)	(144,324)
Total shareholders' equity	103,945	308,594
Total liabilities and shareholders' equity	$560,320	$592,491

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,		
	2006	**2005**	**2004**
Revenue	$757,764	$688,003	$617,834
Costs and expenses:			
Cost of educational services	356,851	328,343	298,747
Student services and administrative expenses	219,820	193,003	174,396
Special legal and other investigation costs	(430)	1,219	25,143
Total costs and expenses	576,241	522,565	498,286
Operating income:	181,523	165,438	119,548
Interest income, net	8,104	8,853	3,834
Income before provision for income taxes	189,627	174,291	123,382
Provision for income taxes	71,111	64,579	48,119
Net income	$118,516	$109,712	$75,263
Earnings per share:			
Basic	$2.77	$2.38	$1.64
Diluted	$2.72	$2.33	$1.61
Weighted average shares outstanding:			
Basic	42,722	46,138	45,791
Diluted	43,629	47,112	46,808

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,		
	2006	2005	2004
Cash flows from operating activities:			
Net income	$118,516	$109,712	$75,263
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	21,641	17,819	18,249
Provision for doubtful accounts	10,862	10,679	11,996
Deferred income taxes	(1,906)	5,232	5,290
Excess tax benefit from stock option exercises	(14,289)	8,704	6,355
Stock-based compensation expense	3,067	--	--
Changes in operating assets and liabilities:			
Restricted cash	(27)	7,694	302
Short-term investments	--	--	13,347
Accounts receivable	(6,240)	(14,238)	(13,028)
Prepaid expenses and other assets	(4,053)	(8,254)	(1,952)
Direct marketing costs, net	(4,138)	(2,777)	(3,869)
Accounts payable and accrued liabilities	(13,667)	13,526	3,246
Income and other accrued taxes	27,383	(12,580)	1,255
Deferred revenue	26,708	18,662	26,428
Net cash flows from operating activities	163,857	154,179	142,882
Cash flows from investing activities:			
Facility expenditures and land purchases	(18,929)	(25,145)	(16,376)
Capital expenditures, net	(23,717)	(21,334)	(19,116)
Proceeds from sales and maturities of investments	1,637,322	690,025	1,128,172
Purchase of investments	(1,434,639)	(748,782)	(1,277,816)
Net cash flows from investing activities	160,037	(105,236)	(185,136)
Cash flows from financing activities:			
Proceeds from revolving borrowings	150,000	--	--
Excess tax benefit from stock option exercises	14,289	--	--
Proceeds from exercise of stock options	22,960	11,008	8,601
Repurchase of common stock	(362,973)	(55,605)	--
Net cash flows from financing activities	(175,724)	(44,597)	8,601
Net change in cash and cash equivalents	148,170	4,346	(33,653)
Cash and cash equivalents at beginning of period	13,735	9,389	43,042
Cash and cash equivalents at end of period	$161,905	$13,735	$9,389
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Income taxes (net of refunds)	$43,898	$63,734	$34,965
Non-cash financing activities:			
Issuance of treasury stock for:			
Directors Deferred Compensation Plan	$119	$185	$ --

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)

	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, 2003	54,069	$541	$52,687	$221,400	$(4,263)	(8,638)	$(124,241)	$146,124
Net income				75,263				75,263
Other comprehensive (loss):								
Minimum pension liability, net of tax					(1,269)			(1,269)
Comprehensive income								73,994
Exercise of stock options			614	(2,753)		563	10,740	8,601
Tax benefit from exercise of stock options			6,355					6,355
Balance as of December 31, 2004	54,069	541	59,656	293,910	(5,532)	(8,075)	(113,501)	235,074
Net income				109,712				109,712
Other comprehensive (loss):								
Minimum pension liability, net of tax					(484)			(484)
Comprehensive income								109,228
Exercise of stock options			318	(13,943)		619	24,633	11,008
Tax benefit from exercise of stock options			8,704					8,704
Common shares repurchased						(929)	(55,605)	(55,605)
Issuance of shares for Directors' Deferred Compensation Plan			36			7	149	185
Balance as of December 31, 2005	54,069	541	68,714	389,679	(6,016)	(8,378)	(144,324)	308,594
Net income				118,516				118,516
Other comprehensive income:								
Minimum pension liability, net of tax					6,016			6,016
Comprehensive income								124,532
Adoption of SFAS No. 158, net of tax					(6,533)			(6,533)
Exercise of stock options			(37,034)			923	59,994	22,960
Tax benefit from exercise of stock options			14,289					14,289
Common shares repurchased						(5,607)	(362,973)	(362,973)
Stock-based compensation			3,067					3,067
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

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. We are a leading for-profit provider of postsecondary education in the United States based on revenue and student enrollment. As of December 31, 2006, we were offering diploma and associate, bachelor and master degree programs at 87 institutes and nine learning sites located in 33 states. All of our institutes are authorized by the applicable educational authorities of the states in which they operate and are accredited by an accrediting commission recognized by the United States Department of Education ("ED"). We have provided career-oriented programs since 1969 under the "ITT Technical Institute" name. Our corporate headquarters are located in Carmel, Indiana.

Basis of Presentation. The consolidated financial statements include our wholly-owned subsidiaries' accounts and have been prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP"). All significant intercompany balances and transactions are eliminated upon consolidation. Certain reclassifications have been made in the consolidated financial statements of prior years to conform to the current year presentation.

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.

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

Restricted Cash. Title IV Program funds and certain other monies transferred to us by electronic funds transfer are subject to holding restrictions, generally from three to seven days, before they can be drawn into our cash account. The funds subject to these holding periods are classified as restricted cash within our current assets until they are applied to the students' accounts. In addition, a Maryland education regulation requires us to maintain an escrow account as a condition to operating our institute in Owings Mills, MD. The funds in this escrow account are classified as restricted cash within our non-current assets.

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 are classified as either current or non-current based on the maturity date of each security. Auction rate debt securities and variable rate demand notes classified as available-for-sale, however, are included in current assets despite the long-term contractual maturity if we have the ability to liquidate these investments within one year.

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

Accounts Receivable. We extend unsecured credit to our students for tuition and fees and we record a receivable for the tuition and fees earned in excess of the payment received from or on behalf of a student. The individual student balances of these receivables are insignificant. We record an allowance for doubtful accounts with respect to accounts receivable on an institute-by-institute basis, using the institute's historical collection experience. We review the historical collection experience for each institute, consider other facts and circumstances related to an institute and adjust the calculation to record an allowance for doubtful accounts as appropriate. If our current collection trends were to differ significantly from our historic collection experience, however, we would make a corresponding adjustment to our allowance. We write-off the accounts receivable due from former students when we conclude that collection is not probable.

Property and Equipment. Property and equipment is recorded in 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 the American Institute of Certified Public Accountants Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Facility construction costs are capitalized as incurred, with depreciation commencing when the facility is placed in service. We have historically paid for all real estate projects without any external financing and, therefore, no interest costs have been capitalized.

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:

Type of Property and Equipment	Estimated Useful Life
Furniture and equipment	2 to 10 years
Leasehold and building improvements	3 to 14 years
Buildings	20 to 40 years
Software	3 to 8 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.

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," we regularly review our long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. 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 using a discounted cash flows model. If the amount of discounted cash flows 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.

Direct Marketing Costs. Direct costs incurred relating to the enrollment of new students are capitalized using the successful efforts method. Direct marketing costs subject to capitalization include salaries and employee benefits of recruiting representatives and other direct costs. Successful efforts is the ratio of students enrolled to prospective students interviewed. The higher the rate of interviewed students who enroll, the greater the percentage of our direct marketing costs that are capitalized. We amortize our direct marketing costs on a cost-pool-by-cost-pool basis over the period that we expect to receive revenue streams associated with those assets. The direct costs subject to capitalization are readily quantifiable and are not subject to estimation. We define a cost pool as the group of students that begin each academic quarter ("Class"). The direct marketing costs that are capitalized with respect to a particular Class are amortized using a method that corresponds to the amount of tuition revenue that will be recognized in each academic quarter for that Class. Since we recognize tuition revenue for a Class on a straight-line basis over the program length, we also recognize the amortization of the capitalized direct marketing costs with respect to that Class on a straight-line basis over the same period. If a student withdraws, however, any remaining amount of the capitalized direct marketing costs related to that student is expensed immediately, because the realizability of the remaining capitalized direct marketing costs related to that student is impaired.

We review the carrying amount of the capitalized direct marketing costs on a regular basis in order to compare the recorded amounts with the estimated remaining future revenue streams associated with those assets. If we determine that the value of the capitalized direct marketing costs recorded exceeds the remaining future revenue estimated to be generated from those assets, the excess amount is written off and recorded as an expense for the related period. The amortization method and period are based on historical trends of student enrollment and retention activity and are not subject to significant assumptions. We regularly evaluate the factors used to determine the amounts to be deferred and amortized and the future recoverability of those deferred costs.

Direct marketing costs on the balance sheet totaled $46,706 at December 31, 2006 and $39,705 at December 31, 2005, less accumulated amortization of $25,078 at December 31, 2006 and $22,215 at December 31, 2005.

Insurance Liabilities. We record insurance liabilities and related expenses for health, workers compensation and other insurance reserves 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 unreported claims incurred but not reported. We consider our historical experience in determining the appropriate insurance reserves to record. If our current insurance claim trends were to differ significantly from our historic claim experience, however, we would make a corresponding adjustment to our insurance reserves.

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

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

Fair Value and Credit Risk of Financial Instruments. The carrying amounts for cash and cash equivalents, restricted cash, accounts receivable, accounts payable, other accrued liabilities and deferred revenue approximate fair value because of the immediate or short-term maturity of these financial instruments. Investments classified as available-for-sale are recorded at their market value.

The fair market value of our long-term debt is estimated based on current market conditions and rates for debt that have the same characteristics and remaining maturities. As of December 31, 2006, the carrying value and estimated fair market value of our long-term debt was $150,000.

Financial instruments that potentially subject us to credit risk consist primarily of accounts receivable and interest-bearing investments. The credit risk of our accounts receivable is minimal, due to the small individual amounts owed by a large number of students which make up this balance. Our interest-bearing investments generally consist of high-quality securities issued by various entities and major financial institutions.

Recognition of Revenue. Tuition revenue is recorded on a straight-line basis over the length of the applicable course. If a student withdraws from an institute, the standards of most state education authorities that regulate our institutes, the accrediting commission that accredits our institutes and our own internal policy limit a student's obligation for tuition and fees to the institute depending on when a student withdraws during an academic quarter ("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 quarter that has elapsed at the time the student withdraws. The greater the portion of the academic quarter that has elapsed at the time the student withdraws, the greater the student's obligation is to the institute for the tuition and fees related to that academic quarter. 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.

Tuition revenue includes textbooks students use in their programs of study. We amortize the costs of textbooks on a straight-line basis over the applicable course length and record the deferral of textbook costs in prepaids and other current assets. Laptop computer sales and the related cost of the laptop computers are recognized when the student receives the laptop computer. Tool kit sales and the related cost of the tool kits are recognized when the kits are distributed to the students. Academic fees (which are charged only one time to students on their first day of class attendance) are recognized as revenue on a straight-line basis over the average program length. Deferred revenue is recorded for fees collected in excess of revenue recognized. If a student withdraws from an institute, all unrecognized revenue relating to his or her fees, net of any refunds that result from any applicable Refund Policy, is recognized upon the student's departure.

An administrative fee is charged to a student and recognized as revenue when the student withdraws or graduates from a program of study at an institute.

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

Advertising Costs. We expense all advertising costs as incurred.

Equity-Based Compensation. Effective January 1, 2006, we adopted SFAS No. 123R, "Share-Based Payment," ("SFAS No. 123R") which prescribes the accounting for equity instruments exchanged for employee and director services. We followed the SEC's guidance in Staff Accounting Bulletin ("SAB") No. 107, "Share-Based Payment," when we adopted SFAS No. 123R. Under SFAS No. 123R, stock-based compensation cost is measured at the date of grant, based on the calculated fair value of the grant, and is recognized as an expense 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, or when he or she is eligible to retire. As a result, under 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 adopted SFAS No. 123R using the modified prospective transition method. Under this transition method, the financial statement amounts for the periods before 2006 have not been restated to reflect the fair value method of expensing the stock-based compensation. The compensation expense recognized on or after January 1, 2006 includes the compensation cost based on the fair value on the date of grant estimated in accordance with: (a) SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure," ("SFAS No. 123") for all stock-based compensation that was granted prior to, but vested on or after, January 1, 2006; and (b) SFAS No. 123R for all stock-based compensation that was granted on or after January 1, 2006.

We use an option pricing model to determine the fair value of stock options and we use the market price of our common stock to determine the fair value of restricted stock and restricted stock units. The fair value of the stock options granted prior to January 1, 2005 was determined using the Black-Scholes model. For all stock options granted on or after January 1, 2005, we used a binomial option pricing model which, similar to the Black-Scholes 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.

The assumptions supporting these variables were consistent under both option pricing models.

Prior to January 1, 2006, we accounted for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," ("APB Opinion No. 25") and related interpretations. Under the intrinsic value method, minimal compensation expense was recognized in our financial statements, because the vast majority of the stock-based compensation that we granted was in the form of nonqualified stock options and all of the stock options granted had exercise prices equivalent to the fair market value of our common stock on the grant date.

If the stock-based compensation expense in the year ended December 31, 2006 had been determined in accordance with APB No. 25, instead of SFAS No. 123R, our:

- pretax operating income would have increased $3,067 in the year ended December 31, 2006;
- income tax benefit would have decreased approximately $1,181 in the year ended December 31, 2006;
- net income would have increased $1,886 in the year ended December 31, 2006;
- basic earnings per share would have increased $0.04 in the year ended December 31, 2006; and
- diluted earnings per share would have increased $0.04 in the year ended December 31, 2006.

Prior to adopting SFAS No. 123R, we provided proforma disclosures under SFAS No. 123. Those disclosures included proforma compensation expense related to the stock-based compensation granted to employees and directors calculated on a straight-line basis over the full vesting period of the grants and reflected forfeitures as they occurred. If we had reflected the stock-based compensation for retirement-eligible grantees over the applicable service period consistent with SFAS No. 123R, the prior period SFAS No. 123 pro forma net income disclosed in the annual report on Form 10-K for that period would have been approximately $95,300 in the year ended December 31, 2005, instead of the $92,005 disclosed, and approximately $70,900 in the year ended December 31, 2004, instead of the $67,806 disclosed. The total stock-based compensation expense ultimately realized under SFAS No. 123 and SFAS No. 123R would be the same but the timing of when the expense would be reflected differs.

Under SFAS No. 123R, the tax benefit of tax deductions in excess of the compensation expense resulting from the exercise of stock options is presented under cash flows from financing activities in our Consolidated Statements of Cash Flows. Prior to adopting SFAS No. 123R, we presented the tax benefit resulting from the exercise of stock options under cash flows from operating activities in our Consolidated Statements of Cash Flows.

We generally issue shares of our common stock from treasury shares upon the exercise of stock options. As of December 31, 2006, 13,029,471 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 are unable to determine at this point how many shares we will repurchase over the next 12 months. See Note 3 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 in accordance with SFAS No. 13, "Accounting for Leases." The difference between the amount of rent expense recorded and the amount of rent actually paid is recorded as accrued rent on our Consolidated Balance Sheets.

Income Taxes. In accordance with SFAS No. 109, "Accounting for 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.

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 historical net income and the average number of shares of our common stock outstanding during each period as set forth in the following table:

	Year Ended December 31,		
	2006	2005	2004
		(In thousands)	
Shares:			
Weighted average number of shares of common stock outstanding	42,722	46,138	45,791
Shares assumed issued (less shares assumed purchased for treasury) for stock-based compensation	907	974	1,017
Outstanding shares for diluted earnings per share calculation	43,629	47,112	46,808

A total of 30,000 shares for fiscal year 2006, 1,000 shares for fiscal year 2005 and 613,000 shares for fiscal year 2004 have been excluded from the calculation of our diluted earnings per common share because the effect was anti-dilutive.

New Accounting Pronouncements. In July 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 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 a tax return. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. We estimate that the adoption of FIN No. 48 will increase retained earnings as of January 1, 2007 by up to $2,000 for income tax benefits not previously recognized.

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 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. Those provisions of SFAS No. 158 are effective for fiscal years ending after December 15, 2006. We recorded an asset of $8,277 for our qualified pension plan, a liability of $1,656 for our nonqualified pension plan and $6,533, net of tax, in accumulated other comprehensive income on our December 31, 2006 Consolidated Balance Sheet. Retrospective application of SFAS No. 158 is not permitted and, therefore, prior year balances and activity related to the pension plans have not been changed. See Note 10 for additional disclosure regarding our pension plans.

SFAS No. 158 also 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.

In February 2007, the FASB issued 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.

2. **Equity Compensation Plans**

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

- *2006 ITT Educational Services, Inc. Equity Compensation Plan* - Awards may be granted to our employees and directors under the 2006 ITT Educational Services, Inc. Equity Compensation Plan ("2006 Equity Compensation Plan") in the form of stock options (incentive and nonqualified), stock appreciation rights ("SARs"), restricted stock, restricted stock units ("RSUs"), performance shares, performance units and other stock-based awards as defined in the plan. The maximum number of shares of our common stock that may be issued pursuant to awards under this plan is 4,000,000. Each share underlying stock options and SARs granted and not forfeited or terminated, reduces the number of shares available for future awards by one share. The delivery of a share in connection with a "full-value award" (i.e., an award of restricted stock, RSUs, performance shares, performance units or any other stock-based award with value denominated in shares) reduces the number of shares remaining for other awards by three shares. As of December 31, 2006, 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.

- *ITT Educational Services, Inc. 1994 Stock Option Plan* - A maximum of 810,000 shares of our common stock were available to be issued upon the exercise of nonqualified stock options granted under the ITT Educational Services, Inc. 1994 Stock Option Plan ("1994 Stock Plan").

No additional awards have been or will be granted after May 9, 2006 under the 1999 Directors Stock Plan or the 1997 Stock Plan. No awards have been granted under the 1994 Stock Plan since the plan expired on December 29, 2004.

We recognized $3,067 of stock-based compensation and a related income tax benefit of $1,181 in our net income for the year ended December 31, 2006. We did not capitalize any stock-based compensation cost in the year ended December 31, 2006.

As of December 31, 2006, we estimated that pre-tax compensation expense for unvested stock-based compensation grants in the amount of approximately $1,828, 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 2.2 years.

In the years ended December 31, 2005 and 2004, we did not recognize any stock-based compensation expense in our Consolidated Statements of Income in accordance with APB Opinion No. 25. If the compensation expense related to the stock-based compensation for the years ended December 31, 2005 and 2004 had been determined based on the fair value of the stock-based compensation at grant date consistent with SFAS No. 123, our compensation expense would have increased and our net income and earnings per share would have been reduced to the pro forma amounts indicated below:

	Year Ended December 31,	
	2005	**2004**
Net income as reported	$109,712	$75,263
Deduct: Total stock-based compensation expense determined under the fair value based method, net of tax	(17,707)	(7,457)
Pro forma net income	$92,005	$67,806
Earnings per share:		
Basic as reported	$2.38	$1.64
Impact of stock-based compensation	(0.39)	(0.16)
Basic pro forma	$1.99	$1.48
Diluted as reported	$2.33	$1.61
Impact of stock options	(0.38)	(0.16)
Diluted pro forma	$1.95	$1.45

On October 24, 2005, the Compensation Committee of our Board of Directors accelerated the vesting of all unvested, nonqualified stock options granted to our employees and directors that had exercise prices greater than the closing price of our common stock on that date. In addition, certain of our executives were awarded nonqualified stock options during 2005 that were fully vested and immediately exercisable. The purpose for accelerating the vesting and award of those stock options was to reduce our compensation costs associated with those stock options upon our adoption of SFAS No. 123R in 2006.

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

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

Under the 1997 Stock Plan, the stock options granted typically vest and become 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 2 days from the date of grant.

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

	Year Ended December 31, 2006				
	Number of Shares	Weighted Average Exercise Price	Aggregate Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value [(1)]
Outstanding at beginning of period	3,422,352	$30.86	$105,641	6.2 years	
Granted	80,500	60.49	4,869		
Forfeited	(10,000)	44.70	(447)		
Exercised	(922,043)	(24.90)	(22,960)		
Expired	None	None	None		
Outstanding at end of period	2,570,809	$33.88	$87,103	5.6 years	$83,341
Exercisable at end of period	2,451,632	$32.84	$80,500	5.6 years	$82,043

(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 December 29, 2006, and multiplying the result by the number of options outstanding or exercisable, as applicable.

Information regarding the stock options granted and exercised during the years ended December 31, 2006, 2005 and 2004 is as follows:

	Year Ended December 31,		
	2006	2005	2004
Stock options granted	80,500	894,985	777,500
Weighted average fair value	$22.31	$19.06	$25.96
Stock options exercised	922,043	618,733	563,616
Intrinsic value of stock options exercised	$37,273	$22,556	$16,902
Proceeds received from stock options exercised	$22,960	$11,008	$8,601
Tax benefits realized from stock options exercised	$14,289	$8,704	$6,355

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 our stock options was determined at the grant date using the Black-Scholes option pricing model for stock options granted prior to January 1, 2005 and 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:

	Year Ended December 31,		
	2006	2005	2004
Risk-free interest rates	4.3%	4.0%	3.3%
Expected lives (in years)	4	4	5
Volatility	42%	44%	58%
Dividend yield	None	None	None

Restricted Stock and RSUs. Under the 1997 Stock Plan, restricted shares awarded were subject to a restriction period set by the Compensation Committee of our Board of Directors, during which time the shares may not be sold, transferred, assigned or pledged. For restricted stock awards issued under the 1997 Stock Plan during the year ended December 31, 2006, the restriction period ends on the third anniversary of the date of grant. Under the 2006 Equity Compensation Plan, restricted shares and RSUs awarded are subject to a restriction period of at least: (a) three years in the case of a time-based period of restriction; and (b) one year in the case of a performance-based period of restriction. All restricted shares and RSUs awarded under the 2006 Equity Compensation Plan as of December 31, 2006 have a time-based restriction period that ends on the third anniversary of the date of grant. We determine the fair value of the restricted stock and RSUs granted based on the closing market price of our common stock on the date of grant. We recognize the fair value of the restricted stock and RSUs as compensation expense over the service period applicable to the grantee using the straight-line method.

The following table sets forth the restricted stock and RSUs that were granted, forfeited and vested during the period indicated:

	Year Ended December 31, 2006			
	Number of Shares of Restricted Stock	**Weighted Average Grant Price**	**Number of RSUs**	**Weighted Average Grant Price**
Unvested at beginning of period	—	$ N/A	—	$ N/A
Granted	32,487	60.26	88	68.25
Forfeited	(1,980)	(58.30)	—	N/A
Vested	(5,975)	(58.30)	0	N/A
Unvested at end of period	24,532	$60.90	88	$68.25

The total fair market value of the shares vested during the year ended December 31, 2006 was $348.

3. Stock Repurchases

In October 2002, our Board of Directors authorized us to repurchase 5,000,000 shares of our common stock and, in April 2006, our Board of Directors authorized us to repurchase an additional 5,000,000 shares of our common stock (the "Repurchase Program"). As of December 31, 2006, 2,681,100 shares were available for repurchase under the Repurchase Program. 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 year ended December 31, 2006, we repurchased 5,606,600 shares of our common stock for $362,973, or at an average price of $64.74 per share. In the year ended December 31, 2005, we repurchased 928,600 shares of our common stock for $55,605, or at an average price of $59.88 per share.

4. Debt

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. The credit facility will be used to allow us to continue repurchasing shares of our common stock while maintaining compliance with certain ratios required by various education authorities that regulate us. 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. We have the option to borrow under the credit agreement on either a secured or unsecured basis which, subject to certain conditions, can be changed by us at any time upon ten days prior written notice to the lender. Certain investments held in a pledged account serve as the collateral for any secured borrowings under the credit agreement.

The availability of borrowings under the credit agreement is subject to our ability at the time of borrowing to satisfy certain specified conditions. These conditions include an absence of default by us, as defined in the credit agreement, and that certain representations and warranties contained in the credit agreement continue to be true and accurate. We are also required to maintain a certain maximum leverage ratio and a minimum ratio of cash and investments to outstanding indebtedness at the end of each of our fiscal quarters. We were in compliance with those ratio requirements as of December 31, 2006.

Borrowings under the credit agreement bear interest at variable rates based on fixed increments over the London Interbank Offered Rate. We pay a commitment fee of 0.15% per annum of the unused amount of the credit facility. As of December 31, 2006, the borrowings under the credit agreement were $150,000, all of which were unsecured, and bore interest at a rate of 5.73% per annum. No interest was paid on the borrowings during the year ended December 31, 2006.

On January 8, 2007, we converted the $150,000 of unsecured borrowings to secured borrowings under the credit agreement at an interest rate of 5.47% per annum, at which time approximately $157,950 of our investments served as collateral for the secured borrowings under the credit agreement.

5. Special Legal and Other Investigation Costs

Consistent with our accounting policy for contingent liabilities, we periodically reassess the probable and estimable legal costs associated with a claim or a potential claim. As of December 31, 2006, we had an accrual of $148 for estimated costs associated with the U.S. Department of Justice ("DOJ") investigation of us, the inquiry initiated by the SEC into the allegations investigated by the DOJ, and the securities class action, shareholder derivative and books and records inspection lawsuits filed against us and certain of our current and former officers and directors (collectively, the "Actions"). In the year ended December 31, 2006, we were billed $279 for legal costs associated with the Actions. We recorded a net charge of $1,219 in the year ended December 31, 2005 for estimated legal costs associated with the Actions, and we were billed $5,117 for those legal costs during 2005. In accordance with the financial accounting standards for loss contingencies, we have accrued what we believe to be a reasonable estimate of costs that are probable we will incur.

6. Financial Aid Programs

We participate in various federal student financial aid programs under Title IV ("Title IV Programs") of the Higher Education Act of 1965, as amended ("HEA"). Approximately 57% of our 2006 revenue, determined on a cash accounting basis as defined by the ED regulations, was indirectly derived from funds distributed under these programs.

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

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

	As of December 31,					
	2006			2005		
	Available-For-Sale	Held-to-Maturity	Total	Available-For-Sale	Held-to-Maturity	Total
Short-term investments	$185,535	$9,472	$195,007	$382,915	$5,237	$388,152
Non-current investments	--	--	--	--	9,538	9,538
	$185,535	$9,472	$195,007	$382,915	$14,775	$397,690

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 December 31,	
	2006	2005
Available-for-Sale Investments:		
Auction rate equity securities	$ 21,300	$ 43,300
Auction rate debt securities and variable rate demand notes	$ 164,235	$ 339,615
	$ 185,535	$ 382,915
Held-to-Maturity Investments:		
Marketable debt securities	$ 9,472	$ 14,775

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 years ended December 31, 2006, 2005 and 2004. All income generated from those investments was recorded as interest income.

The components of investment income included in interest income, net in the Consolidated Statements of Income for the periods indicated were as follows:

	Year Ended December 31,		
	2006	2005	2004
Net realized gains on the sale of investments	$ 63	$ 109	$ 19
Interest income	8,288	8,826	4,356
Change in net unrealized holding (loss)	--	--	(29)
	$8,351	$8,935	$4,346

The following table sets forth the contractual maturities of our debt securities classified as available-for-sale and held-to-maturity as of December 31, 2006:

Contractual Maturity	Available-for-Sale	Held-to-Maturity
Due within five years	$ 3,500	$ 9,472
Due after five years through ten years	13,235	--
Due after ten years	147,500	--
	$ 164,235	$ 9,472

8. Property and Equipment

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

	As of December 31,	
	2006	2005
Furniture and equipment	$116,447	$122,884
Buildings and building improvements	78,281	55,603
Leasehold improvements	8,086	6,731
Software	15,544	15,506
Construction in progress	832	8,532
Land and land improvements	28,719	24,943
	247,909	234,199
Less: Accumulated depreciation	(99,498)	(106,793)
Property and equipment, net	$148,411	$127,406

Software includes purchased and internally developed software. Accumulated depreciation includes accumulated amortization of capitalized software of $7,830 at December 31, 2006 and $7,088 at December 31, 2005. We recorded software amortization expense of $3,808 in the year ended December 31, 2006, $2,147 in the year ended December 31, 2005, and $2,380 in the year ended December 31, 2004. We recorded depreciation and amortization expense for furniture and equipment, leasehold improvements and buildings and building improvements in the amount of $17,833 in the year ended December 31, 2006, $15,672 in the year ended December 31, 2005 and $15,869 in the year ended December 31, 2004.

9. Income Taxes

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

	Year Ended December 31,		
	2006	2005	2004
Current income tax expense:			
U.S. federal	$62,464	$51,108	$36,471
State and local	10,606	8,239	6,358
Total	73,070	59,347	42,829
Deferred income tax expense (benefit):			
U.S. federal	(1,546)	4,365	4,413
State and local	(413)	867	877
Total	(1,959)	5,232	5,290
Total provision for income taxes	$71,111	$64,579	$48,119

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

	As of December 31,	
	2006	2005
Direct marketing costs	$(8,441)	$(6,860)
Capitalized software	(3,018)	(3,302)
Deferral of book costs	(1,601)	(1,551)
Property and equipment	(3,150)	(4,383)
Pension	(2,564)	(6,950)
Other	(474)	--
Gross deferred tax liabilities	(19,248)	(23,046)
Deferred revenue	1,941	1,708
Minimum pension liability	--	3,883
Legal accrual	980	971
Compensation and benefits	2,945	2,194
Stock-based compensation	883	--
Operating leases	1,997	1,584
Other	1,560	1,533
Gross deferred tax assets	10,306	11,873
Net deferred income tax (liability)	$(8,942)	$(11,173)

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

	Year Ended December 31,		
	2006	2005	2004
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	3.6%	3.4%	3.9%
Other	(1.1%)	(1.3%)	0.1%
Effective income tax rate	37.5%	37.1%	39.0%

In 2006 and 2005, our tax exempt investment income was greater than in prior years, which had a favorable effect on our effective income tax rate in 2006 and 2005 compared to 2004. We also implemented certain state tax planning strategies during 2005 which resulted in a decrease in our state income tax rate.

10. 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. This plan provides for payment of those benefits at retirement that cannot be paid from the ESI Pension Plan due to federal statutory limits on the amount of benefits that can be paid and compensation that can be recognized under a tax-qualified retirement plan. 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 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.

All information below is based on an actuarial valuation date as of September 30.

Our accumulated benefit obligation was $54,743 at December 31, 2006 and $51,801 at December 31, 2005.

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

	Year Ended December 31,	
	2006	2005
Projected benefit obligation at beginning of year	$ 59,169	$ 48,379
Service cost	1,670	6,935
Actuarial loss	689	3,169
Interest cost	3,005	2,848
Benefits paid	(2,372)	(2,162)
Plan amendments	(7,418)	--
Projected benefit obligation at end of year	54,743	59,169
Fair value of plan assets at end of year	61,364	44,789
Funded status at end of year	$ 6,621	$ (14,380)

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

	Year Ended December 31,	
	2006	2005
Fair value of plan assets at beginning of year	$ 44,789	$ 32,340
Actual return on plan assets	3,947	2,816
Employer contributions	15,000	11,795
Benefits paid	(2,372)	(2,162)
Fair value of plan assets at end of year	$ 61,364	$ 44,789

The following table sets forth the fair value of total plan assets by major asset category as of the measurement date used for the periods indicated:

	Year Ended December 31,			
	2006		2005	
	Amount	Percent	Amount	Percent
Cash and cash equivalents	$ 420	1%	$ 375	1%
Mutual funds	37,426	61%	28,498	64%
Common stocks	22,382	36%	14,841	33%
Foreign equities	1,136	2%	1,075	2%
Total	$61,364	100%	$44,789	100%

The following table sets forth the amounts recognized in our Consolidated Balance Sheets as of the dates indicated:

	As of December 31,	
	2006	2005
Current assets	$ --	$ 4,484
Non-current assets	8,277	--
Current liabilities	--	--
Non-current (liabilities)	(1,656)	(11,665)
Total	$ 6,621	$ (7,181)

The following table sets forth the amounts recognized in accumulated other comprehensive income, pre-tax, in our Consolidated Balance Sheets as of the dates indicated:

	As of December 31,	
	2006	2005
Net loss	$ 10,748	$ --
Prior service cost	--	--
Additional minimum liability	--	9,899
Total	$ 10,748	$ 9,899

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

	Year Ended December 31,		
	2006	2005	2004
Service cost	$ 1,670	$ 6,935	$ 6,539
Interest cost	3,005	2,848	2,261
Expected return on assets	(4,443)	(3,247)	(2,238)
Recognized net actuarial loss	823	1,425	1,150
Amortization of prior service cost	(22)	(88)	(88)
Net periodic benefit cost	$ 1,033	$ 7,873	$ 7,624
FAS 88 curtailment gain	(684)	--	--
Total benefit cost	$ 349	$ 7,873	$ 7,624

The amount of net loss and prior service cost in accumulated other comprehensive income expected to be recognized as components of net periodic benefit cost during fiscal year 2007 are $552 and $0, respectively.

The incremental effect of applying SFAS No. 158 on individual line items in the Consolidated Balance Sheet as of December 31, 2006 is as follows:

	Before Application of SFAS No. 158 (without AML Adjustment)	Adjustment for Additional Minimum Liability ("AML")	Before Application of SFAS No. 158 (with AML Adjustment)	SFAS No. 158 Adoption Adjustment	After Applicatio n of SFAS No. 158
Prepaid/(Accrued)	$ 7,470	$ 9,873	$ 17,343	$ (10,722)	$ 6,621
Intangible asset	--	--	--	--	--
Deferred tax asset	3,883	(3,883)	--	4,215	4,215
AOCI (1) (net of tax)	(6,016)	6,016	--	(6,533)	(6,533)
AOCI (1) (pre-tax)	(9,899)	9,873	(26)	(10,722)	(10,748)

(1) Accumulated other comprehensive income (loss).

The weighted-average assumptions used to determine benefit obligations as of September 30, 2006 and 2005 are as follows:

	2006	2005
Discount rate	5.75%	5.50%
Rate of compensation increase	4.50%	4.50%

The weighted-average assumptions used to determine net periodic pension cost in the years ended September 30, 2006, 2005 and 2004 are as follows:

	2006	2005	2004
Discount rate	5.50%	5.75%	6.00%
Expected long-term return on plan assets	8.00%	8.00%	8.00%
Rate of compensation increase	4.50%	4.50%	4.50%

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, as permitted under Paragraph 26 of SFAS No. 87, "Employers' Accounting for Pensions."

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

Year	Amount
Fiscal 2007	$3,100
Fiscal 2008	$3,200
Fiscal 2009	$4,000
Fiscal 2010	$3,300
Fiscal 2011	$4,100
Fiscal 2012 - 2016	$21,100

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

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

We determine our discount rate by using the Moody's Aa corporate bond rate as of our actuarial valuation date. The average lives of the bonds used to determine this benchmark rate approximate the periods represented in our pension plan actuarial valuation.

In January 2006, we contributed $15,000 to the ESI Pension Plan and do not expect to make any contribution to the ESI Pension Plan in 2007.

During 2006, prior to the adoption of SFAS No. 158, we decreased our minimum pension liability by $9,899 as a result of:

- funding the ESI Pension Plan with a $15,000 contribution; and
- refinements made to our future expected benefit payment assumptions due to freezing the Pension Plans.

We also recorded a corresponding $6,016 increase in shareholders' equity, which was net of a $3,883 deferred tax asset. During 2005, we increased our minimum pension liability by $798 as a result of:

- obtaining an investment return on plan assets that was less than our original estimates;
- a decrease in our discount rate; and
- refinements made to our future expected benefit payment assumptions.

We also recorded a corresponding $484 reduction in shareholders' equity, which was net of a $314 deferred tax asset.

Retirement Savings Plan. Our ESI 401(k) Plan, a defined contribution plan, covers substantially all of our employees. Prior to March 19, 2004, our contributions under the ESI 401(k) Plan were made in cash to a fund that invested in our common stock, which a plan participant could not redirect to other plan investment options until the participant reached age 55. All of our contributions under the ESI 401(k) Plan that we have made on and after March 19, 2004 have been in the form of cash to plan investment options directed by the participant.

Our ESI Excess Savings Plan, a nonqualified, unfunded deferred compensation plan, covers a select group of our management. The plan provides for salary deferral of contributions that the participants are unable to make under the ESI 401(k) Plan and our contributions that cannot be paid under the ESI 401(k) Plan due to federal statutory limits on the amount that an employee can contribute under a defined contribution plan. The practical effect of the ESI Excess Savings Plan is to provide a savings plan to all of our employees on a uniform basis.

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 $3,836 in the year ended December 31, 2006, $3,761 in the year ended December 31, 2005, and $3,246 in the year ended December 31, 2004.

11. 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, 2006, the total face amount of those surety bonds was approximately $17,500. In addition, as of December 31, 2006, we provided irrevocable standby letters of credit in the amount of $1,477 to secure the payment of construction costs associated with a facility that we built in 2006 and the payment of our workers' compensation claims.

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:

- 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 $27,866 in the year ended December 31, 2006, $30,038 in the year ended December 31, 2005, and $26,546 in the year ended December 31, 2004. 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, 2006 are as follows:

2007	$ 26,926
2008	26,017
2009	19,633
2010	11,217
2011	7,120
2012 and thereafter	11,145
	$102,058

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

Contingent Liabilities. 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 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 alleges 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 seeks an unspecified judgment and attorney's fees and costs. We intend to defend ourselves vigorously against the allegations in the complaint.

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 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.

Exhibit I

Management's Report on Internal Control Over Financial Reporting

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

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

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

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

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we assessed the effectiveness of our ICFR as of December 31, 2006. Our assessment included extensive documenting, evaluating and testing of the design and operating effectiveness of our ICFR. In making this assessment, our management used the criteria for *Internal Control-Integrated Framework* set forth by The Committee of Sponsoring Organizations of the Treadway Commission. These criteria are in the areas of control environment, risk assessment, control activities, information and communication, and monitoring. Based on our assessment using these criteria, our management concluded that we maintained effective ICFR as of December 31, 2006.

Our management's assessment of the effectiveness of our ICFR as of December 31, 2006 has been audited by PricewaterhouseCoopers LLP, our independent registered public accounting firm, as stated in its accompanying report.

ITT Educational Services, Inc.
Carmel, Indiana
February 23, 2007