ITT Educational Services, Inc.

Consolidated Financial Statements
For the Years Ended December 31, 2008 and 2007

ITT Educational Services, Inc.
Table of Contents
December 31, 2008 and 2007

Page(s)

Report of Independent Registered Public Accounting Firm

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

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, shareholders' equity and cash flows present fairly, in all material respects, the financial position of ITT Educational Services, Inc. and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control Over Financial Reporting appearing in Appendix I. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As described in Notes 9 and 1 to the consolidated financial statements, the Company changed the manner in which it accounts for employee pension benefits in 2008 and 2006 and uncertain tax positions in 2007.

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

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

PricewaterhouseCoopers LLP

Indianapolis, Indiana
February 18, 2009

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

	As of December 31,	
	2008	**2007**
Assets		
Current assets:		
Cash and cash equivalents	$226,255	$7,228
Short-term investments	138,709	303,360
Restricted cash	10,405	6,061
Accounts receivable, less allowance for doubtful accounts of $16,064 and $5,378	29,779	15,132
Deferred income taxes	12,104	7,418
Prepaid expenses and other current assets	13,793	10,624
Total current assets	431,045	349,823
Property and equipment, net	166,671	153,265
Direct marketing costs, net	22,973	20,567
Other assets	3,170	17,298
Total assets	$623,859	$540,953
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$54,815	$45,120
Accrued compensation and benefits	21,133	16,137
Accrued income taxes	14,976	6,028
Other current liabilities	11,423	11,512
Deferred revenue	162,206	213,127
Total current liabilities	264,553	291,924
Long-term debt	150,000	150,000
Deferred income taxes	1,504	11,754
Other liabilities	19,951	16,717
Total liabilities	436,008	470,395
Commitments and contingent liabilities (Note 10)	--	--
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	135,655	127,017
Retained earnings	732,107	531,363
Accumulated other comprehensive (loss)	(13,384)	(3,417)
Treasury stock, 15,352,376 and 14,375,582 shares, at cost	(667,068)	(584,946)
Total shareholders' equity	187,851	70,558
Total liabilities and shareholders' equity	$623,859	$540,953

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,		
	2008	**2007**	**2006**
Revenue	$1,015,333	$869,508	$757,764
Costs and expenses:			
Cost of educational services	383,769	358,601	356,851
Student services and administrative expenses	303,693	268,876	219,390
Total costs and expenses	687,462	627,477	576,241
Operating income	327,871	242,031	181,523
Interest income	6,505	10,747	8,444
Interest (expense)	(4,611)	(8,292)	(340)
Income before provision for income taxes	329,765	244,486	189,627
Provision for income taxes	126,793	92,894	71,111
Net income	$202,972	$151,592	$118,516
Earnings per share:			
Basic	$5.22	$3.77	$2.77
Diluted	$5.17	$3.71	$2.72
Weighted average shares outstanding:			
Basic	38,881	40,268	42,722
Diluted	39,243	40,883	43,629

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,		
	2008	**2007**	**2006**
Cash flows from operating activities:			
Net income	$202,972	$151,592	$118,516
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	22,230	23,249	21,641
Provision for doubtful accounts	43,286	18,599	10,862
Deferred income taxes	(8,450)	(6,737)	(1,906)
Excess tax benefit from stock option exercises	(1,158)	(37,480)	(14,289)
Stock-based compensation expense	7,235	5,100	3,067
Pension settlement and amortization of prior service costs	1,554	--	--
Changes in operating assets and liabilities:			
Restricted cash	(4,350)	(6,087)	(27)
Accounts receivable	(57,933)	(24,364)	(6,240)
Direct marketing costs, net	(2,406)	1,061	(4,138)
Accounts payable	9,695	(2,828)	(8,153)
Accrued income taxes	10,163	37,969	27,206
Other operating assets and liabilities	1,042	7,252	(9,390)
Deferred revenue	(50,921)	10,965	26,708
Net cash flows from operating activities	172,959	178,291	163,857
Cash flows from investing activities:			
Facility expenditures and land purchases	(18,093)	(12,589)	(18,929)
Capital expenditures, net	(17,543)	(15,514)	(23,717)
Proceeds from sales and maturities of investments	1,085,559	1,963,447	1,637,322
Purchase of investments	(920,480)	(2,071,800)	(1,434,639)
Net cash flows from investing activities	129,443	(136,456)	160,037
Cash flows from financing activities:			
Proceeds from revolving borrowings	--	--	150,000
Excess tax benefit from stock option exercises	1,158	37,480	14,289
Proceeds from exercise of stock options	3,241	31,002	22,960
Repurchase of common stock	(87,774)	(264,994)	(362,973)
Net cash flows from financing activities	(83,375)	(196,512)	(175,724)
Net change in cash and cash equivalents	219,027	(154,677)	148,170
Cash and cash equivalents at beginning of period	7,228	161,905	13,735
Cash and cash equivalents at end of period	$226,255	$7,228	$161,905
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Income taxes (net of refunds)	$123,223	$59,624	$43,898
Interest	$5,036	$7,854	$ --
Non-cash financing activities:			
Issuance of treasury stock for Directors compensation	$60	$60	$119

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, 2005	54,069	$541	$65,973	$392,420	($6,016)	(8,378)	($144,324)	$308,594
Net income				118,516				118,516
Other comprehensive income:								
Minimum pension liability, net of $3,883 of income tax					6,016			6,016
Comprehensive income								124,532
Adoption of SFAS No. 158, net of $4,215 of income 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
Stock-based compensation			3,067					3,067
Common shares repurchased						(5,607)	(362,973)	(362,973)
Issuance of shares for Directors' compensation				(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	83,329	471,848	(6,533)	(13,029)	(445,240)	103,945
Effect of adoption of FIN 48				2,169				2,169
Balance as of January 1, 2007	54,069	541	83,329	474,017	(6,533)	(13,029)	(445,240)	106,114
Net income				151,592				151,592
Other comprehensive income:								
Amortization of pension loss, net of $227 of income tax					351			351
Net actuarial pension gain, net of $1,784 of income tax					2,765			2,765
Comprehensive income								154,708
Exercise of stock options			(77)	(94,246)		1,314	125,325	31,002
Tax benefit from exercise of stock options			38,588					38,588
Stock-based compensation			5,100					5,100
Common shares repurchased						(2,659)	(264,994)	(264,994)
Issuance of shares for Directors' compensation						1	60	60
Restricted stock cancellations and shares tendered for taxes			77			(2)	(97)	(20)
Balance as of December 31, 2007	54,069	541	127,017	531,363	(3,417)	(14,375)	(584,946)	70,558
Net income				202,972				202,972
Other comprehensive income:								
Amortization of prior service cost, net of $10 of income tax					17			17
Net actuarial pension loss, net of $7,237 of income tax					(11,212)			(11,212)
Pension settlement loss, net of $599 of income tax					928			928
Unrealized gain					428			428
Comprehensive income								193,133
Prior service costs, net of $83 of income tax					(128)			(128)
Adoption of SFAS No. 158 change in pension measurement date, net of $210 of income tax				325				325
Exercise of stock options				(2,528)		75	5,769	3,241
Tax benefit from exercise of stock options			1,201					1,201
Stock-based compensation			7,235					7,235
Common shares repurchased						(1,050)	(87,774)	(87,774)
Issuance of shares for Directors' compensation				(25)		1	85	60
Restricted stock cancellations			202			(3)	(202)	--
Balance as of December 31, 2008	54,069	$541	$135,655	$732,107	($13,384)	(15,352)	($667,068)	$187,851

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, 2008, we were offering master, bachelor and associate degree programs to approximately 62,000 students and had 105 institutes and nine learning sites located in 37 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. These reclassifications have no impact on previously reported net income, total shareholders' equity or cash flows.

Use of Estimates. The preparation of these consolidated financial statements, in accordance with GAAP, includes estimates and assumptions that are determined by our management. Actual results could differ materially from the estimates. Significant accounting estimates and assumptions are used for, but not limited to: the allowance for doubtful accounts; useful lives of tangible and intangible assets; self insurance; pension liabilities; stock-based compensation; unrecognized tax benefits and litigation exposures.

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

Restricted Cash. 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 identified as restricted cash 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 considered restricted cash and classified as other assets. The balance of this escrow account was $559 as of December 31, 2008 and $553 as of December 31, 2007.

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

In the second quarter of 2008, we began extending larger amounts of unsecured credit to our students due to a decrease in private education loans made to our students by third-party lenders. We categorized these receivables based on the students' credit profiles and recorded an allowance for doubtful accounts based on historical collection experience related to amounts owed by our students with similar credit profiles.

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

Property and Equipment. Property and equipment is recorded 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 capitalize interest on our real estate construction projects in accordance with Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 34, "Capitalization of Interest Cost."

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	3 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 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. The direct costs subject to capitalization are readily quantifiable and are not subject to estimation. 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. 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. The amortization method and period are based on historical trends of student enrollment and retention activity and are not subject to significant assumptions.

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. 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 our Consolidated Balance Sheets totaled $50,798 at December 31, 2008 and $48,058 at December 31, 2007, less accumulated amortization of $27,825 at December 31, 2008 and $27,491 at December 31, 2007.

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

Contingent Liabilities. We are subject to various claims and contingencies in the ordinary course of our business, including those related to litigation, business transactions, 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.

Guarantees. In accordance with FASB Interpretation No. ("FIN") 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FASB Interpretation No. 34" ("FIN 45"), we recognize a liability for the fair value of a guarantee obligation upon its issuance. The fair market value of our guarantee of the payment of certain private loans previously made to our students by an unaffiliated lender was estimated based on historical charge off experience with respect to private loans made to our students and the present value of the expected cash flows that may result from the settlement of the guarantee obligation in the future.

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.

In accordance with Accounting Principles Board Opinion No. 6, "Status of Accounting Research Bulletins," we record "losses" from the sale of treasury stock that exceed previous net "gains" from the sale of treasury stock as a charge to retained earnings.

Fair Value and Credit Risk of Financial Instruments. 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 became effective for us on January 1, 2008. This pronouncement did not have any effect on our consolidated financial statements, because we did not elect the fair value methodology under SFAS No. 159 for any of our financial instruments or other items that are not currently required to be measured at fair value.

Effective January 1, 2008, we adopted SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"), for financial assets and financial liabilities measured on a recurring basis. This statement defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures regarding fair value measurements. SFAS No. 157 applies whenever other accounting pronouncements require or permit fair value measurements for assets and liabilities.

SFAS No. 157 defines fair value for financial reporting as the price that would be received upon the sale of an asset or paid upon the transfer of a liability in an orderly transaction between market participants at the measurement date. The fair value measurement of our financial assets utilized assumptions categorized as observable inputs under SFAS No. 157. Observable inputs are assumptions based on independent market data sources.

The following table sets forth information regarding the fair value measurement of our financial assets as of December 31, 2008:

Description	As of 12/31/2008	Fair Value Measurements at Reporting Date Using (Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Cash Equivalents	$225,894	$222,394	$3,500	$--
Restricted Cash	10,385	10,385	--	--
Short-Term Investments	138,709	53,056	85,653	--
	$374,988	$285,835	$89,153	$--

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

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

As of January 31, 2009, we had liquidated $31,000 of the assets that were categorized as Level 2 as of December 31, 2008 for amounts that were equivalent to the reported fair values of those assets.

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 value of our long-term debt is estimated by discounting the future cash flows using current rates for similar loans with similar characteristics and remaining maturities. As of December 31, 2008, the carrying value of our long-term debt was $150,000 and the estimated fair value was approximately $149,000.

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 relatively minor due to the large number of individual student balances that make up this amount. 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. Generally, 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 record the cost of these textbooks in prepaid expenses and other current assets and amortize the cost of textbooks on a straight-line basis over the applicable course length. Laptop computer and tool kit sales, and the related cost of each, are recognized when the student receives the laptop computer or tool kit. Academic fees (which are charged only one time to students on their first day of class attendance) are recognized as revenue on a straight-line basis over the average program length. If a student withdraws from an 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. 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 on a straight-line basis over the period of time that the grantee must provide services to us before the stock-based compensation is fully vested. The vesting period is generally the period set forth in the agreement granting the stock-based compensation. Under the terms of our stock-based compensation plans, some grants immediately vest in full when the grantee's employment or service terminates, or when he or she is eligible to retire. As a result, in certain circumstances, the period of time that the grantee must provide services to us in order for that stock-based compensation to fully vest may be less than the vesting period set forth in the agreement granting the stock-based compensation. In these instances, compensation expense will be recognized over this shorter period.

We use 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 ("RSUs"). 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.

We generally issue shares of our common stock from treasury shares upon the exercise of stock options. As of December 31, 2008, 15,352,376 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, which is included in other liabilities, 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.

Effective January 1, 2007, we adopted FIN 48, “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109” (“FIN 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. This interpretation requires the evaluation of whether it is more likely than not, based on the technical merits of a tax position, that the benefits resulting from the position will be realized by the company. Upon adoption of FIN 48, we recognized a decrease of approximately $3,391 in the liability for unrecognized tax benefits, which was accounted for as an increase in retained earnings of $2,169 as of January 1, 2007 and a reduction of federal tax benefits of $1,222.

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

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 weighted average number of shares of our common stock outstanding during each period as set forth in the following table:

	Year Ended December 31,		
	2008	**2007**	**2006**
		(In thousands)	
Shares:			
Weighted average number of shares of common stock outstanding	38,881	40,268	42,722
Shares assumed issued (less shares assumed purchased for treasury) for stock-based compensation	362	615	907
Outstanding shares for diluted earnings per share calculation	39,243	40,883	43,629

A total of 396,226 shares for fiscal year 2008, 14,146 shares for fiscal year 2007 and 30,000 shares for fiscal year 2006 have been excluded from the calculation of our diluted earnings per common share because the effect was anti-dilutive.

New Accounting Pronouncements.

Effective November 15, 2008, we adopted SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles” (“SFAS No. 162”), which identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States. The adoption of this pronouncement did not have a material impact on our consolidated financial statements.

In December 2008, the FASB issued FASB Staff Position (“FSP”) No. FAS 140-4 and FIN 46(R)-8, “Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities” (“FSP No. 140-4 and FIN 46(R)-8”), which requires additional disclosures about transfers of financial assets and involvement with variable interest entities. FSP No. 140-4 and FIN 46(R)-8 became effective for our fiscal year ended December 31, 2008. We did not have any transactions which required disclosure under this guidance.

Also in December 2008, the FASB issued FSP No. FAS 132(R)-1 “Employers’ Disclosures about Postretirement Benefit Plan Assets” (“FSP No. 132(R)-1”), which requires enhanced disclosures about plan assets in an employer’s defined benefit pension or other postretirement plan. These disclosures are intended to provide users of financial statements with a greater understanding of how investment allocation decisions are made, the major categories of plan assets, the inputs and valuation techniques used to measure the fair value of plan assets and significant concentrations of risk within plan assets. FSP No. 132(R)-1 will apply to our plan asset disclosures beginning with our fiscal year ending December 31, 2009.

In September 2008, the FASB issued FSP No. FAS 133-1 and FIN 45-4 “Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB No. 161” (“FSP No. 133-1 and FIN 45-4”), which requires additional disclosures for credit derivatives and certain guarantees. The disclosures required by this guidance that relate to credit derivatives and certain guarantees became effective for our fiscal year ended December 31, 2008. We did not have any transactions which required disclosure under this guidance.

In May 2008, the FASB issued SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts – an interpretation of FASB Statement No. 60" ("SFAS No. 163"), which clarifies how FASB Statement No. 60 applies to financial guarantee insurance contracts, including the recognition and measurement of premium revenue and claim liabilities. SFAS No. 163 is effective commencing with our first fiscal quarter of 2009. We do not believe that the adoption of this pronouncement will have a material impact on our consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133" ("SFAS No. 161"), which expands the disclosure requirements for derivative instruments and hedging activities. SFAS No. 161 is effective commencing with our first fiscal quarter of 2009. We do not believe that the adoption of this pronouncement will have a material impact on our consolidated financial statements.

In February 2008, the FASB issued FSP No. 157-2, "Effective Date of FASB Statement No. 157" ("FSP No. 157-2"), which delays the effective date of SFAS No. 157 for nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. FSP No. 157-2 is effective commencing with our first fiscal quarter of 2009. We do not believe that the adoption of this guidance will have a material impact on our consolidated financial statements, because we do not have any nonfinancial assets or nonfinancial liabilities recognized or disclosed at fair value.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51" ("SFAS No. 160"), which establishes accounting and reporting standards for the noncontrolling interest of a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 is effective commencing with our first fiscal quarter of 2009. We do not believe that the adoption of this pronouncement will have a material impact on our consolidated financial statements.

In December 2007, the FASB revised and replaced SFAS No. 141, "Business Combinations," with SFAS No. 141(R), "Business Combinations" ("SFAS No. 141(R)"), which establishes principles and requirements for how a company recognizes and measures assets, liabilities and noncontrolling interests acquired or assumed in a business combination. SFAS No. 141(R) applies to any of our business combinations or acquisitions that occur after December 31, 2008.

In November 2007, FASB's Emerging Issues Task Force issued 07-01, "Accounting for Collaborative Arrangements" ("EITF 07-01"), which defines collaborative arrangements and establishes reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties. EITF 07-01 is effective commencing with our first fiscal quarter of 2009 and applies to arrangements in existence as of the effective date. We do not believe that the adoption of this guidance will have a material impact 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, 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, 2008, restricted stock, RSUs and nonqualified stock options have been awarded under this plan.
- *1999 Outside Directors Stock Option Plan* – A maximum of 500,000 shares of our common stock were available to be issued upon the exercise of nonqualified stock options granted to non-employee directors under the 1999 Outside Directors Stock Option Plan ("1999 Directors Stock Plan").
- *1997 ITT Educational Services, Inc. Incentive Stock Plan* – A maximum of 8,100,000 shares of our common stock were available to be issued upon the exercise of stock options and pursuant to other forms of awards under the 1997 ITT Educational Services, Inc. Incentive Stock Plan ("1997 Stock Plan"), but no more than 20% of the total number of shares on a cumulative basis could have been used for restricted stock or performance share awards. A maximum of 1.5% of our outstanding shares of common stock could have been issued annually, with any unissued shares available to be issued in later years.

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

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

	Year Ended December 31,		
	2008	2007	2006
Stock-based compensation expense	$7,235	$5,100	$3,067
Income tax (benefit)	($2,785)	($1,963)	($1,181)

We did not capitalize any stock-based compensation cost in the years ended December 31, 2008, 2007 and 2006.

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.

As of December 31, 2008, we estimated that pre-tax compensation expense for unvested stock-based compensation grants in the amount of approximately $9,835, 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 two years.

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

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

Under the 1997 Stock Plan, the stock options granted typically 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 two days from the date of grant.

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

	Year Ended December 31, 2008				
	# of Shares	Weighted Average Exercise Price	Aggregate Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (1)
Outstanding at beginning of period	1,468,993	$50.25	$73,816		
Granted	177,543	86.83	15,416		
Forfeited	(3,584)	60.27	(216)		
Exercised	(75,435)	42.96	(3,241)		
Expired	(6,000)	10.83	(65)		
Outstanding at end of period	1,561,517	$54.89	$85,710	4.7 years	$62,603
Exercisable at end of period	1,227,314	$46.86	$57,516	4.2 years	$59,055

(1) The aggregate intrinsic value of the stock options was calculated by multiplying the number of shares subject to the options outstanding or exercisable, as applicable, by the closing market price of our common stock on December 31, 2008, and subtracting the applicable aggregate exercise price.

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

	Year Ended December 31,		
	2008	2007	2006
Shares subject to stock options granted	177,543	245,362	80,500
Weighted average grant date fair value	$36.83	$30.05	$22.31
Shares subject to stock options exercised	75,435	1,313,746	922,043
Intrinsic value of stock options exercised	$3,165	$100,544	$37,273
Proceeds received from stock options exercised	$3,241	$31,002	$22,960
Tax benefits realized from stock options exercised	$1,201	$38,588	$14,289

The intrinsic value of a stock option is the difference between the fair market value of the stock and the option exercise price. The fair value of each stock option grant was estimated on the date of grant using the following assumptions:

	Year Ended December 31,		
	2008	2007	2006
Risk-free interest rates	2.7%	4.5% - 4.8%	4.3%
Expected lives (in years)	4.0	4.7	4.0
Volatility	53%	35%	42%
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, 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, 2008 have a time-based restriction period that ends on the third anniversary of the date of grant, except for one grant of 18,249 RSUs made in 2007 which has a time-based restriction period that ends on the fifth anniversary of the date of grant.

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

	Year Ended December 31, 2008			
	# of Shares of Restricted Stock	Weighted Average Grant Date Fair Value	# of RSUs	Weighted Average Grant Date Fair Value
Unvested at beginning of period	22,672	$61.02	58,097	$84.40
Granted	--	--	43,778	81.32
Forfeited	(3,232)	60.83	(6,796)	84.93
Vested	--	--	--	--
Unvested at end of period	19,440	$61.05	95,079	$82.95

No shares of restricted stock or RSUs vested during the year ended December 31, 2008.

3. Stock Repurchases

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

As of December 31, 2008, 3,972,100 shares remained 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.

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

	Year Ended December 31,	
	2008	2007
Number of shares	1,049,700	2,659,300
Total cost	$87,774	$264,994
Average price per share	$83.62	$99.65

From January 30, 2009 through February 13, 2009, we repurchased 263,300 outstanding shares of our common stock pursuant to our existing repurchase authorization at a total cost of $33,414 or at an average cost per share of $126.90.

4. Debt

On December 17, 2007, we entered into an Amended and Restated Credit Agreement (the "Credit Agreement") with a single lender (the "Lender") to borrow up to $160,000 under two revolving credit facilities: one in the maximum principal amount of $50,000; and the other in the maximum principal amount of $110,000. Borrowings under the Credit Agreement are used to allow us to continue repurchasing shares of our common stock while maintaining compliance with certain financial ratios required by various education authorities that regulate us.

Both revolving credit facilities under the Credit Agreement mature on July 1, 2010. The borrowings under each credit facility may be secured or unsecured at our election, provided that we have not defaulted under the Credit Agreement, in which case, any borrowings made on a secured basis must remain secured. Cash equivalents and investments held in a pledged account serve as the collateral for any secured borrowings under the Credit Agreement.

The Credit Agreement contains, among other things, covenants, representations and warranties and events of default customary for credit facilities. 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, 2008.

Borrowings under the Credit Agreement bear interest at the London Interbank Offered Rate (the "LIBOR"), plus an applicable margin based on our indebtedness to net worth ratio, adjusted quarterly. We pay a commitment fee of 0.15% per annum of the average daily unused amount of the credit facilities. As of December 31, 2008, the borrowings under the Credit Agreement were $150,000, all of which were secured and bore interest at a rate of 0.59% per annum. Approximately $157,950 of our investments and cash equivalents served as collateral for the secured borrowings as of December 31, 2008.

We recognized interest expense on our borrowings of $4,559 in the year ended December 31, 2008, $8,208 in the year ended December 31, 2007 and $214 in the year ended December 31, 2006.

5. 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 72% of our 2008 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.

6. 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,					
	2008			2007		
	Available-For-Sale	Held-to-Maturity	Total	Available-For-Sale	Held-to-Maturity	Total
Current investments	$138,709	--	$138,709	$303,360	$--	$303,360
Non-current investments	--	--	--	--	--	--
	$138,709	--	$138,709	$303,360	$--	$303,360

The following table sets forth the aggregate fair market value of our available-for-sale investments as of the dates indicated:

	As of December 31,	
	2008	2007
Available-for-Sale Investments:		
Auction rate securities	$--	$130,575
Variable rate demand notes	30,500	172,785
Government obligations	53,056	--
Government agency obligations	29,641	--
Corporate obligations	25,512	--
	$138,709	$303,360

The following table sets forth the net unrealized gains in accumulated other comprehensive income (loss) on our Consolidated Balance Sheets related to our available-for-sale investments:

	As of December 31,	
	2008	2007
Government obligations	$146	$--
Government agency obligations	165	--
Corporate obligations	117	--
	$428	$--

The following table sets forth the unrealized gains and losses on available-for-sale investments that were included in accumulated other comprehensive income (loss) on our Consolidated Balance Sheets in the periods indicated:

	Year Ended December 31,		
	2008	2007	2006
Unrealized gains	$428	$--	$--
Unrealized losses	--	--	--

No unrealized gains or losses were reclassified out of our accumulated other comprehensive income (loss) during our fiscal years ended December 31, 2008, 2007 and 2006.

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

	Year Ended December 31,		
	2008	2007	2006
Net realized gains on the sale of investments	$--	$--	$63
Interest income	6,498	10,566	8,288
	$6,498	$10,566	$8,351

The following table sets forth the contractual maturities of our debt securities classified as available-for-sale as of December 31, 2008:

Contractual Maturity	Available-for-Sale
Due within five years	$108,209
Due after five years through ten years	7,000
Due after ten years	23,500
	$138,709

7. Property and Equipment

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

	As of December 31,	
	2008	2007
Furniture and equipment	$118,840	$122,314
Buildings and building improvements	102,584	87,924
Leasehold improvements	10,467	9,830
Software	8,459	9,653
Construction in progress	2,570	2,335
Land and land improvements	34,809	31,477
	277,729	263,533
Less: Accumulated depreciation	(104,437)	(104,319)
Accumulated amortization - Software	(6,621)	(5,949)
Property and equipment, net	$166,671	$153,265

Software includes purchased and internally developed software.

The following table sets forth the amortization expense for software and the depreciation and amortization expense for furniture and equipment, buildings and building improvements and leasehold improvements in the periods indicated:

	Year Ended December 31,		
	2008	2007	2006
Amortization expense - software	$1,854	$3,682	$3,808
Depreciation and amortization expense	$20,376	$19,567	$17,833

8. Income Taxes

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

	Year Ended December 31,		
	2008	2007	2006
Current income tax expense:			
U.S. federal	$116,016	$85,282	$62,464
State and local	19,227	14,349	10,606
Total	135,243	99,631	73,070
Deferred income tax expense (benefit):			
U.S. federal	(7,108)	(5,669)	(1,546)
State and local	(1,342)	(1,068)	(413)
Total	(8,450)	(6,737)	(1,959)
Total provision for income taxes	$126,793	$92,894	$71,111

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

	As of December 31,	
	2008	2007
Direct marketing costs	($8,966)	($8,027)
Capitalized software	(717)	(1,446)
Deferral of book costs	(1,744)	(1,521)
Property and equipment	(663)	(2,485)
Pension	--	(5,233)
Other	(1,455)	(423)
Gross deferred tax liabilities	($13,545)	($19,135)
Deferred revenue	2,592	2,200
Accounts receivable	6,270	2,099
Legal accrual	1,118	1,132
Compensation and benefits	4,030	2,978
Stock-based compensation	5,531	2,721
Operating leases	1,725	1,897
Pension	760	--
Other	2,119	1,772
Gross deferred tax assets	$24,145	$14,799
Net deferred income tax asset (liability)	$10,600	($4,336)

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

	Year Ended December 31,		
	2008	2007	2006
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	3.6%	3.5%	3.6%
Other	(0.2%)	(0.5%)	(1.1%)
Effective income tax rate	38.4%	38.0%	37.5%

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

	Year Ended December 31,	
	2008	2007
Balance as of January 1	$8,564	$6,820
Increases (decreases) from:		
Tax positions taken during a prior period	--	--
Tax positions taken during the current period	2,851	3,050
Settlements with taxing authorities	--	(1,084)
Lapse of statute of limitations	(526)	(222)
Balance as of December 31	$10,889	$8,564

The amount of unrecognized tax benefits that, if recognized, would have affected our effective tax rate as of December 31, 2008 was $8,668. We do not expect the amount of our unrecognized tax benefits to significantly increase or decrease during the next 12 months. The amount of interest and penalties related to unrecognized tax benefits accrued on our Consolidated Balance Sheets was $821 as of December 31, 2008 and $666 as of December 31, 2007. In each of the years ended December 31, 2008 and 2007, the amount of interest expense and penalties related to our unrecognized tax benefits that we recognized in our Consolidated Statement of Income was not material.

We file income tax returns in the United States (federal) and in various state and local jurisdictions. As of December 31, 2008, we were no longer subject to federal, state or local income tax examinations for tax years prior to 2005, except in ten states where we are still subject to income tax examinations for tax years 2001 through 2004.

9. Employee Benefit Plans

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

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

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

Effective January 1, 2008, we changed the term of the required vesting service under the ESI Pension Plan from five years to three years. This change resulted in the recognition of $128, net of tax, of prior service costs in accumulated other comprehensive income on our Consolidated Balance Sheet as of December 31, 2008.

Effective December 31, 2008, we adopted the measurement date provisions of SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)" ("SFAS No. 158"). SFAS No. 158 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. We utilized the pension measurements as of September 30, 2007 to determine the amount of the net periodic benefit cost allocated to the three month period ended December 31, 2007 for the transition to a calendar year-end measurement date. We recognized a benefit of $325, net of income tax, in our retained earnings as of December 31, 2008, as a result of our adoption of the measurement date provisions of SFAS No. 158.

The information presented below is based on an actuarial valuation date as of December 31 for 2008 and September 30 for 2007.

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

	Year Ended December 31,	
	2008	**2007**
Projected benefit obligation at beginning of year	$54,276	$54,743
Service cost	--	--
Actuarial (gain)	(2,133)	(815)
Interest cost	3,859	3,080
Benefits paid	(4,905)	(2,732)
Plan amendments	211	--
Projected benefit obligation at end of year	$51,308	$54,276
Fair value of plan assets at end of year	49,458	67,159
Funded (unfunded) status at end of year	($1,850)	$12,883

Our accumulated benefit obligation was $51,308 at December 31, 2008 and $54,276 at December 31, 2007.

The weighted-average assumptions used to determine benefit obligations as of December 31, 2008 and September 30, 2007 are as follows:

	2008	**2007**
Discount rate	6.25%	6.00%
Rate of compensation increase	N/A	N/A

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

	Year Ended December 31,	
	2008	2007
Fair value of plan assets at beginning of year	$67,159	$61,364
Actual return on plan assets	(14,047)	8,527
Employer contributions	1,251	--
Benefits paid	(4,905)	(2,732)
Fair value of plan assets at end of year	$49,458	$67,159

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,			
	2008		2007	
	Amount	Percent	Amount	Percent
Cash and cash equivalents	$337	1%	$530	1%
Bond mutual funds	23,483	48%	25,500	38%
Equity mutual funds	7,487	15%	12,480	18%
Common stocks	17,448	35%	28,001	42%
Foreign equities	703	1%	648	1%
Total	$49,458	100%	$67,159	100%

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. Retrospective application of SFAS No. 158 was not permitted and, therefore, prior period balances and activity related to the ESI Pension Plan and ESI Excess Pension Plan have not been changed.

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

	As of December 31,	
	2008	2007
Current assets	$--	$--
Non-current assets	--	14,756
Current (liabilities)	(257)	(1,508)
Non-current (liabilities)	(1,593)	(365)
Total	($1,850)	$12,883

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

	As of December 31,	
	2008	2007
Net actuarial (loss)	($22,543)	($5,621)
Prior service cost	(184)	--
Income tax benefit	8,915	2,204
Total accumulated other comprehensive (loss)	($13,812)	($3,417)

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

	Year Ended December 31,		
	2008	2007	2006
Service cost	$--	$--	$1,670
Interest cost	3,088	3,080	3,005
Expected return on assets	(5,228)	(4,793)	(4,443)
Recognized net actuarial loss	--	578	823
Amortization of prior service cost	27	--	(22)
Net periodic benefit cost	($2,113)	($1,135)	$1,033
FAS 88 curtailment (gain)	--	--	(684)
FAS 88 settlement loss	1,527	--	--
Total net periodic pension cost (benefit)	($586)	($1,135)	$349

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 estimated net actuarial loss and prior service cost that is expected to be amortized from accumulated other comprehensive income and recognized in net periodic pension cost for the year ended December 31, 2009 is $0.

The weighted-average assumptions used to determine net periodic pension cost in the years ended December 31, 2008 and September 30, 2007 and 2006 are as follows:

	2008	2007	2006
Discount rate	6.00%	5.75%	5.50%
Expected long-term return on plan assets	8.00%	8.00%	8.00%
Rate of compensation increase	N/A	N/A	4.50%

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

Year	Amount
Fiscal 2009	$3,549
Fiscal 2010	$3,171
Fiscal 2011	$4,376
Fiscal 2012	$4,996
Fiscal 2013	$3,454
Fiscal 2014 – 2018	$17,262

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

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

We determine our discount rate by performing a yield curve analysis which reflects estimated pension cash flows as of our actuarial valuation date. High-quality fixed income investments with lives that approximate the periods represented in our pension plan actuarial valuation were used to estimate this rate.

In 2008, we made no contribution to the ESI Pension Plan and contributed $1,251 to the ESI Excess Pension Plan. We do not expect to make any contribution to the ESI Pension Plan or ESI Excess Pension Plan in 2009.

During 2006, prior to adopting 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
- making refinements to our future expected benefit payment assumptions due to freezing the ESI Pension Plan and ESI Excess Pension Plan.

We also recorded a corresponding $6,016 increase in shareholders' equity, which was net of a $3,883 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 provided for salary deferral of contributions that the participants were 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. Effective for plan years beginning on and after January 1, 2008, we froze the ESI Excess Savings Plan, such that employees may no longer make salary deferrals and we will no longer make contributions under the ESI Excess Savings Plan. Amounts previously credited to an employee under the ESI Excess Savings Plan will, however, continue to accrue interest in accordance with the terms of the ESI Excess Savings Plan until those amounts are distributed pursuant to the plan's terms.

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

- $3,043 in the year ended December 31, 2008;
- $3,583 in the year ended December 31, 2007; and
- $3,836 in the year ended December 31, 2006.

10. 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, 2008, the total face amount of those surety bonds was approximately $19,700.

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.

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 15 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:

- $32,574 in the year ended December 31, 2008;
- $29,114 in the year ended December 31, 2007; and
- $27,866 in the year ended December 31, 2006.

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, 2008 are as follows:

2009	$36,456
2010	31,104
2011	27,595
2012	24,144
2013	17,898
2014 and thereafter	25,508
	$162,705

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

11. Guarantees

In October 2007, we entered into a risk sharing agreement ("RSA") with an unaffiliated lender for private education loans to be provided to our students by or through that lender to help pay the students' cost of education that student financial aid from federal, state and other sources did not cover. Under the RSA, if more than a certain percentage of those private education loans, based on dollar volume, are charged off by the lender, we guarantee the repayment of any private education loans that the lender charges off above that percentage. Based on the terms of the RSA, our obligations thereunder will remain in effect until all private education loans made under the RSA are paid in full or charged off by the lender. We will have the right to pursue repayment from the borrowers for those charged off private education loans under the RSA that we pay to the lender pursuant to our guarantee obligation. The RSA was terminated effective February 22, 2008, such that no private education loans will be made under the RSA after that date.

The RSA requires that we comply with certain covenants, including that we maintain certain financial ratios which are measured as of December 31 in each year. If we are not in compliance with those ratios at any measurement date, we are obligated to provide the lender with a letter of credit in an amount based on a percentage of the outstanding private education loans under the RSA that have not been paid in full or charged off from time to time. We were in compliance with the covenants as of December 31, 2008.

The maximum potential future payments that we could be required to make pursuant to our guarantee obligation under the RSA are affected by:

- the amount of the private education loans made under the RSA;
- the fact that those loans will consist of a large number of loans of individually immaterial amounts;
- the interest and fees associated with those loans;
- the repayment performance of those loans; and
- when during the life of those loans they are charged off.

As a result, we are not able to estimate the undiscounted maximum potential future payments that we could be required to make under the RSA. Our recorded liability related to the RSA as of December 31, 2008 was not material.

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, 2008. 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, 2008.

The effectiveness of our ICFR as of December 31, 2008 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 18, 2009