This 3DAdvisors Report Covers:

✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues
✓ **Fundamentals:** Analysis of fundamentals
✓ **Deception:** Deception detection analysis

Direct Student Loans Far More Risky Than Admitted
ITT Educational Services Inc. (NYSE:ESI)

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Business Description

ITT Educational Services Inc. provides postsecondary degree programs in the United States. The Company offers diploma, associate, bachelor, and master degree programs in various fields of study, including information technology, electronics technology, drafting and design, business, criminal justice, and health sciences. As of March 31, 2008, it had 100 institutes and 9 learning sites located in 34 states that offered degree programs to approximately 54,000 students. The Company was founded in 1946 and is headquartered in Carmel, Indiana.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Services	**$74.85**	**$2.90B**	**1,294,270**
Industry:	52 Wk Range:	Trailing P/E:	Shrs Out:
Education & Training Services	**$42.24-$117.08**	**15.70**	**38.69M**
F/T Employees:	FYE:	Forward P/E:	Short % of Float:
3,700	**31-Dec**	**13.15**	**12.60%**

Summary of 3DAdvisors Findings for ESI

- **Fundamentals:** Credit crisis leads Company into risky business of making loans
- **Accounting:** Balance sheet impact of student loans could be very significant
- **Accounting:** Student loan impact on cash flows also significant
- **Insider Trading:** Analysis of Form 144s turns up hidden selling way off highs
- **Deception:** Verbal deceptive indicators reveal doubts about loans, economy
- **Accounting:** Miscellaneous noteworthy items

Discussion of 3DAdvisors Findings for ESI

The bifurcation of opinion concerning the publicly traded for-profit education companies represents a curious conundrum in the current market environment. The bull case suggests that the economic meltdown will bring more student enrollments as workers seek to enhance their credentials in an ever more competitive job market. On the other hand, the bear case argues that new students seeking to enroll will have an increasingly difficult time getting student loans as corporate tuition reimbursement plans get cut back (most students are employed full-time and go to school part-time, with employers often footing most of the bill) at the same time private loan sources have become much more restrictive or dried up altogether along with other sources of consumer credit, especially for riskier borrowers.

Though recent increases in the federal government's Stafford Loan program have no doubt eased the pressure somewhat, many students are still left to fill any funding gap with private loans that were once plentiful but have all but disappeared in the midst of the credit crisis. In response, some of the for-profit education companies have begun to use their own balance sheets to provide loans to students directly, with ITT Educational Services Inc. (NYSE:ESI) being the most notable example. With students often considered sub-prime borrowers in the best of economic times, we feel this shift in the ESI business model represents a dramatic change in the Company's risk profile, especially in the current environment. Yet the recent share price suggests the bulls have held sway, and investors don't understand or fully appreciate the risks. Our thesis is based on both ESI and peer group fundamentals, but also on some subtle and not so subtle shifts in executive behavior.

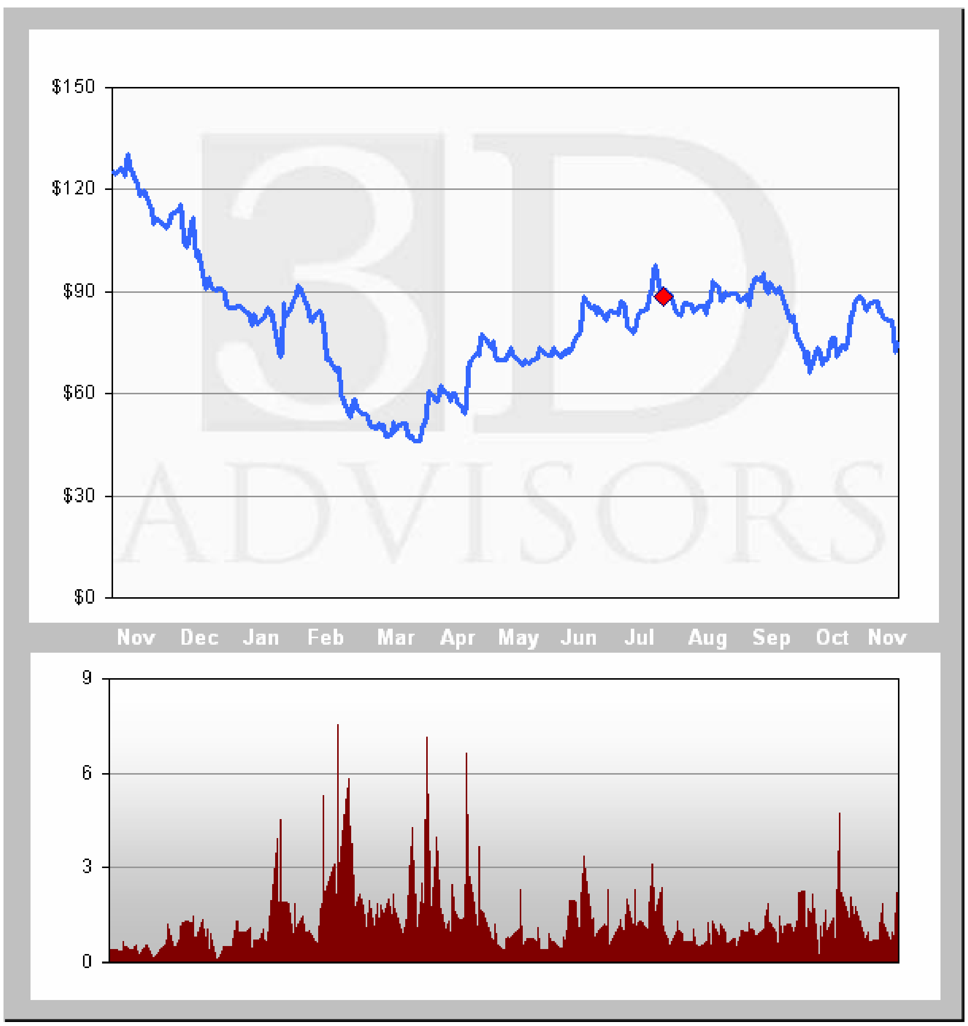
The recent ESI insider trading profile is understated and all but off the radar of most analysts. However, we have detected sales of restricted stock by lower level executives that are not Section 16 filing insiders (and thus are not required to file evidence of their trades on a Form 4) but who nonetheless appear to be senior executives in key operating roles. Though the trades are comparatively modest in size, we have good reason to believe they represent substantial percentages of each individual's actionable holdings, and at prices well off the recent highs. Given that we have been actively monitoring several of the companies in the industry for some time (see recent coverage of Apollo Group Inc. on 03/04/08 and 10/15/08) the discovery of the faint but unmistakable trading signals at ESI provided more than ample motivation to dig further.

What we have found is that the credit quality of student borrowers and the related receivables are lower at ESI than its peers, even before the recent economic turmoil. Making matters more interesting, the Company's growing emphasis on providing internally funded loans has caused a significant decline in its deferred revenue accounts and interest income while substantially increasing both accounts receivable and bad debt expense. Management was peppered on the 3Q08 conference call with questions from analysts trying to understand the risks inherent in providing direct student loans and how fast that risk was growing. Not surprisingly, executives danced around the related questions, directly answering few if any of the more pointed inquiries.

To better understand the extent of management obfuscation during the last conference call, we have for the first time engaged an outside consultant that is an expert in systematically detecting and analyzing deception in press releases, conference call transcripts and other corporate communications to confirm our sense that management was being deliberately misleading and vague in its responses to questions concerning student financing and its impact on the business. Not only did our consultant identify high levels of verbal deceptive indicators in responses to questions about student loan financing, but it is also clear management is uncertain and concerned about the impact of a weakening economy on the overall business.

In his prepared remarks at the start of the Q308 conference call, CEO **Kevin Modany** made a litany of detour and qualified protest statements intended to convince investors of the strength and positive impact of their third quarter operating results and future expansion efforts and his use of enhanced qualifiers to describe the quarter's results such as, "fantastic", "excellent", "wonderful", "exceptional" and "amazing" could be an attempt to oversell their current optimism to shareholders as the economy slips further into recession. Though Mr. Modany wants investors to believe "that the challenging economic environment creates excellent opportunities for our business", his own words belie a lack of confidence, and other executive behaviors and certain fundamentals leave us as doubters, too.

Figure 1. ESI Daily Closing Price (Top) and Trading Volume (Bottom, millions of shares) 11/01/07 through 11/21/08. Red diamond is where two executives sold restricted shares on the same day. Source: Reuters and ESI SEC Filings.



Fundamentals: Credit crisis leads Company into risky business of making loans

Clearly, the key issue for ESI is the need to fill the void left by private lenders who have scaled back or exited altogether the student loan market with internally funded loans, thus forcing the Company into unfamiliar territory and exposing its balance sheet to potentially serious risks.

After Sallie Mae withdrew from making consolidation loans and loans to students at certain institutions in February 2008, and with the credit crunch causing other third-party lenders to do the same, the pressure is increasing for most of the for-profit education companies to make up the difference. When Sallie Mae exited, ESI maintained that it still had “arrangements” with three separate unaffiliated lenders to provide private loans to students. The likelihood of those three lenders still being in the game, however, seems slim as large players such as Wachovia, Citicorp and Chase have since either suspended or significantly curtailed their loan programs this year. This list is expanding, as state higher education loan programs in New Hampshire, Missouri, Pennsylvania, Michigan and Massachusetts are among those that have suspended programs this year.

What is not so clear is the actual gap ESI is experiencing between tuition and funds received from Title IV programs (such as Stafford Loans) and what it must cover with its own loan programs for students. The extent to which the Company will need to make loans and assume an unknown amount of risk is a key question, and thus far the Company has been unwilling to provide clear answers. At the end of fiscal 2006 ESI received approximately 61% of its revenues from Title IV programs. The balance was received from unaffiliated sources and private student loan programs (34%), state student financial aid (2%) and “other” (3%). In 2007 these percentages moved slightly. Title IV funding moved up to 63% with unaffiliated, private student loan programs falling to 29%, state aid stayed the same at 3%, and the “other” category increasing to 6%.

Source of Funds	Percent 2007	Percent 2006
Title IV Programs	63%	61%
Unaffiliated, private student loan programs	29%	34%
State student financial aid programs	2%	2%
Other	6%	3%
Total	100%	100%

Although these are only slight shifts, they indicate that non-government related financial institutions were already beginning to withdraw private funding opportunities and ESI, interpreted as the “other” category, was filling in the gap, well before the credit crisis came to a head during 3Q of this year. Title IV program information is not disclosed on a quarterly basis, and as a result, we will have to wait until the 2008 SEC Form 10-K is released to see how these numbers have shifted. But it is disclosed in the 2Q08 and 3Q08 SEC Form 10-Qs that, “beginning in the second quarter of 2008, we have extended larger amounts of unsecured credit to our students due to a decrease in private education loans made to our students by third-party lenders…" . It is our expectation the "other" category will increase significantly, reflecting the fact that ESI has been forced to fill in a much larger gap with internally funded loans to its students.

One factor that is expected to take at least some pressure off ESI and other for-profit education companies that are confronted with having to make direct loans is that with the passage of the Continued Access Act on April 17, 2008 certain Title IV program loans were increased, allowing students to borrow more under the programs. And even though the Company said that as a result it "anticipates a decline in the percentage of our revenue that we indirectly derive from private education loans made to our students, including internally funded student financing", it does admit that the effect of the legislation is still not fully known and they still expect that funding from private education loans, including internally funded student financing in 2008 could be in the range of 12% to 13%, which is a still a pretty dramatic change from the 29% in 2007. ESI cites the additional $2,000 available to students under Title IV Stafford Loans as the main contributor to their estimate of this gap shrinkage.

But the impact on current financials of the increase in Stafford Loans is anything but clear as this analyst found out during the Q308 conference call when he asked about the impact of the increased funding on the current quarter:

> **Analyst:** Thanks, as we think about the moving parts from the financing side, how much of that benefit have you seen from the higher Stafford Loan limits coming through on the quarter, I guess how much of the $2,000 have they started to be able to access? And then just, what's just a timing of the re-packaging as some of your continuing students start to access those funds.
>
> **Dan Fitzpatrick, CFO:** Well basically the way that works is that $2,000 is available per academic year. For each academic quarter they'd be entitled to $667, so for those students we'd be able to get back and re-package for the March quarter, potentially you could receive the entire $2,000 you would have March, June and September's impact there.
>
> In terms of how it's going to play out as far as the student's population, it would depend on when they've started and what they're scheduled to be re-packaged. Students are re-packaged on a nine-month basis. Three quarters, so folks who started in June, they would have got their initial disbursement. But they'd get their next log if you will, as we re-package them; let's see that would be in March of next year.
>
> **Analyst:** How much of that population do you think has been impacted --
>
> **Dan Fitzpatrick, CFO:** In our system, if you're asking about how much of an impact it has on the total student population, we would guesstimate that the mid 90% of our students are going to be able to utilize the $2,000.
>
> **Kevin Modany, CEO:** I think that goes back to you are our original estimate where we were originally looking at 25% gap and that got cut in half to basically 12%, 12.5% and that's how we factored in that number. If you're asking how much of that is showing in the current quarter, all the new students we're re-packaging them with

the additional dollars or the new, we've got some portion of the continuing so we're able to go back and get some funding for some of those people, but you won't see 100% of it impacted for a couple of quarters.

Analyst: Right. I guess that's my question. How much of that re-packaging of the continuing students came through this quarter? How much can we expect as we go through the next few quarters then?

Kevin Modany, CEO: Yeah, I mean, for the new, you've got all of them. For the continuing, I mean, you're going to see probably a third of the dollars coming through for maybe 50% of them. Somewhere in that range, that would give you a rough estimate.

Mondany initially avoids answering the question and responds in an overly courteous and specific manner. He is attempting to carve out the portion of the question he can answer as it applies to “total student population” but actively avoids trying to provide additional information about “continuing students” until he is further pressed by the analyst. His response is overly vague and non-specific and would indicate that they are not confident that they are going to get the dollars for their continuing student population they hope for, and that, they may have concerns it could be actually lower than the 50% he states.

Another wildcard is the impact of dwindling corporate tuition reimbursement programs. It is not disclosed by the Company what portion of revenue comes directly or indirectly from different types of tuition benefits plans, but it is clear those benefits are shrinking as the credit crisis continues and the economy slips further into recession. The U.S. automakers have suspended such programs for their white collar executives, for instance. Intel has ceased benefits that covered tuition at for-profit institutions. It’s a fair bet that many others are in the process of following suit as tuition benefits can be expensive and are considered low hanging fruit when revenue growth slows and management starts looking to cut expenses.

And as the economic news continues to get worse and the employment picture bleaker, many current students will likely lose their jobs and hence their means to finance their continuing education through tuition reimbursement plans, that is if they hadn’t already been cut. The Company tries to argue that in past periods of economic weakness they have done quite well as workers seek to improve their credentials to better compete in a lean job market. But this downturn is unlike any in recent memory as the sharp contraction is punctuated by the turmoil in the credit markets and the drying up of private sources of student loans.

<u>Accounting: Balance sheet impact of student loans could be very significant</u>

In the opening comments CEO Modany reiterates that the estimated funding gap of students going forward is 12% to 13%. “Some portion of that amount will be funded by third-party private education lenders to our students and the remainder will be funded through our internal financing. Our internally funded financing has and will continue to result in day sales outstanding and bad debt expense that are higher than our historical ranges…The criteria that we used to determine a student’s eligibility for our internal financing is similar to the criteria used by the lender that made private education loans to our students before 2008."

Bad debt expense rose to 5% of revenues in the 3Q08 from 3.9% in the 2Q08 and 1.8% in the 3Q07 while days sales outstanding (DSO) rose to 12.1 days from 10.8 days in the 2Q08 and 6.9 days in the 3Q07. This is a 75% increase in DSO in a single year with the caveat that "the possibility exists that our DSO could increase in future periods compared to the same prior year periods."

The likelihood that these measures will increase is greatly increased by the fact management is really entering into an area that they know little about. In fact, management admits that they don't know what the underwriting standards are. From the 3Q08 conference call:

> **Analyst:** And the relationship there is seems to suggest that those numbers at least at this juncture are pretty low. If you just look at the change in AR, either sequentially or year-over-year its relationship to revenues, generally, is it actually coming in less that what you guys thought earlier on, and is the gap filled by private lenders?
>
> **Kevin Modany, CEO:** Well, again we're not given a lot of guidance, but let me try to give you a little bit of color. We've really kind of went at this looking at these underwriting standards that we really don't have a lot of detail about. We don't know what the underwriting standards are, so we really have to process transactions through those underwriting standards to get a general sense of where things are coming out… We have just want to make sure we get a couple of quarters of new students through the underwriting standards, get all of the continuing students through the re-packaging efforts through there, because as we understand it, the underwriting standards actually incorporate where you are in your academic period, so if you're further along, you may actually get higher approval rates than not, so I want to make sure we get a full class through there, and then we'll kind of digest where we're at.

The problem is that ESI is not in the business of lending. ESI does not have the capability to diversify its loan portfolio and therefore potentially have the ability to charge lower rates on certain types of loans. The private lenders are getting out of the business presumably because the risk profile has changed to such a degree that it does not make sense from a business perspective. ESI is now filling that gap and taking on so much more relative risk without the ability to diversify.

The table below shows that gross student receivables increased in 2005 by 25%, followed by a 22.7% decrease in 2006 and a 76.7% increase in 2007. The increase in 2007 was prior to the passage of the Continued Access Act in April of 2008 (which expanded the funds available to students each year under different Title IV programs). Unfortunately, ESI does not disclose information about allowances or write-offs on a quarterly basis and we are only provided a net receivables number. However, given that net receivables saw a 120.5% increase in the first nine months of 2008, one can presume that gross receivables have followed a similar expansion. The key will be the allowances made against these receivables. Given that bad debt expenses have been increasing and totaled $29.4 million for the first nine months of 2008, a 58% increase over fiscal year end 2007, one can only imagine that the figures will be quite high.

Interestingly, write-offs saw a slow decline in absolute terms from 2004 to 2006 falling from $12.1 million in 2004 to $9.8 million in 2006. However, in 2007 write-offs nearly doubled, jumping to $15.4 million. In fact, write-offs have equaled or been slightly greater than net receivables in every year except for 2005. Again, due to the lack of quarterly disclosure, we will have to wait until fiscal year end 2008 to see the real drama.

Accounts Receivable	2004	2005	2006	2007	1Q08	2Q08	3Q08
Gross Student Receivables ($m)	11.9	15.0	11.6	20.5	NA	NA	NA
Net Receivables ($m)	10.4	13.9	9.4	15.1	15.1	29.2	33.3
Bad Debt Expense ($m)	12.0	10.7	10.8	18.6	6.9	9.7	12.8
Write-offs ($m)*	12.1	11.1	9.8	15.4	NA	NA	NA
Write-offs as % of Bad Debt (%)	101.0	103.7	90.7	82.8	NA	NA	NA
Write-offs as % of Gross Tuition Receivables (%)	101.4	74.0	84.5	75.0	NA	NA	NA

* Note: write-offs are not disclosed on a quarterly basis. In addition, ESI also does not provide disclosure on allowances on a quarterly basis.

Accounting: Student loan impact on cash flows also significant

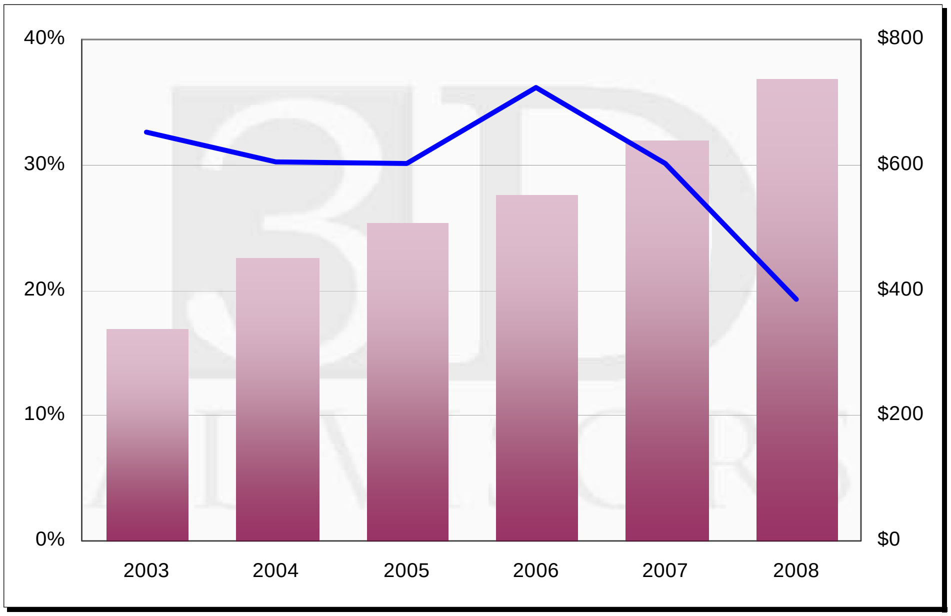
Cash flow from operations has been more volatile over the course of 2008 versus 2007. The increase in accounts receivable and corresponding consumption of cash has certainly been one factor. The other factor has been the decline in the deferred revenue account. As the funds from Sallie Mae have been worked down (Sallie Mae terminated its agreement with the Company in February of 2008) and private third-party loans have slowed, there has been a corresponding drop in deferred revenue. It is a fact that the shift from private to federal loans will negatively impact cash flow because with private loans cash is received up front and with federal it is dispersed by academic quarter.

One must wonder, however, the real effect on cash flow levied by the exit of private loan providers and the reality of ESI having to make up the slack by providing its own financing (read: no cash until student pays). The Company has already seen a sharp drop in deferred revenue this year, not only in absolute terms but, more dramatically, when comparing it to total revenues (see Figure 2 below). But the real indicator of the Company's new direction may just be the jump in accounts receivable for the same period. One can only guess this is a direct by-product of ESI increasing balance sheet cannibalization in order to internally fund student loans (Figure 3).

From an investing perspective, ESI continues to spend on facility and land purchases as it pursues its goal of opening six to eight new colleges in 2008. In addition, they continue to be very active in the purchase and sales of investments. However, the proceeds from the sale of investments have certainly declined over the past year. In the first nine months of 2007, ESI received $1.63 billion in proceeds from the sale and maturity of investments. That figure fell to $964.6 million in the first nine months of 2008. On the financing side, there has been no new debt issued but $87.8

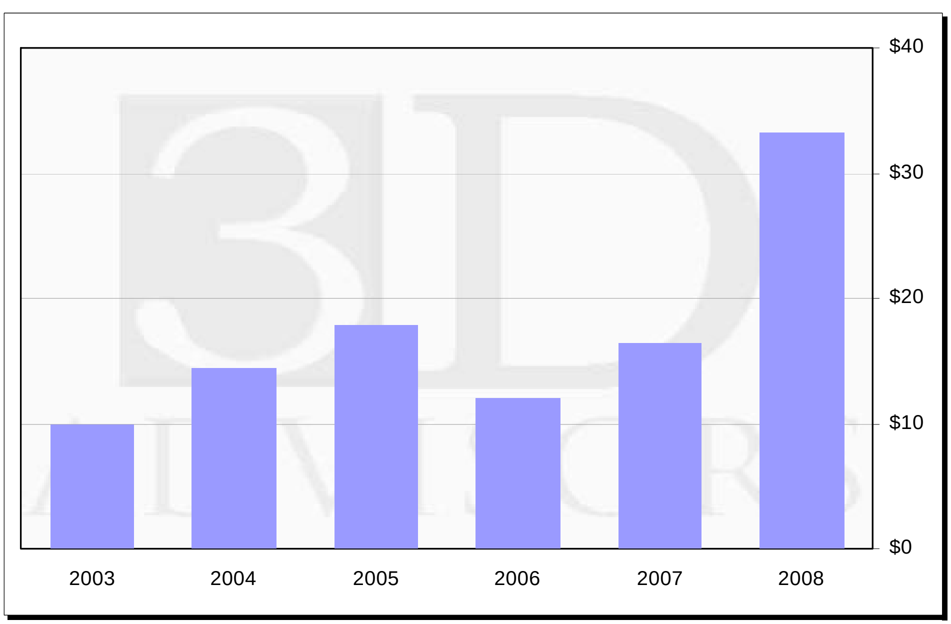
million worth of its common stock has been repurchased over the course of the 1Q08 and the 3Q08.

Figure 2. Total Revenue (Red Bars and Right Scale) and Percentage of Deferred Revenue is of Total Revenue (Blue Line and Left Scale), (9 Months Ended, 2003-2008). Source: ESI SEC Filings.



The $150 million long-term debt that the Company carries was taken on in 2006 (restated in 2007) and was entered into in order to “allow us to continue repurchasing shares of our common stock”. It is noteworthy to us that “Approximately $158 million of our investments and cash equivalents served as collateral for the secured borrowings as of 09/30/08”. This high level of pledged assets does not give one the feeling that the lender has overwhelming confidence in the Company’s creditworthiness.

Figure 3. Accounts Receivable (At Sept. 30, Millions) Source: ESI SEC Filings.



Insider Trading: Analysis of Form 144s turns up hidden selling way off highs

At first glance, the ESI trading profile would reveal no Section 16 insider selling since late 2007 when the shares were trading in the $125 range since no Form 4s were filed. But after taking our search down a level to look at Form 144 filings, a more interesting pattern emerged. For those who are not familiar with Rule 144, it requires insiders who are selling restricted shares, which are unregistered, to file a Form 144 which exempts them from the SEC's registration requirements so that the shares can be sold on the open market just as registered shares are. Restricted securities are securities acquired in unregistered, private sales from the issuer or from an affiliate of the issuer. Investors typically receive restricted securities through private placement offerings, Regulation D offerings or employee stock benefit plans. We sometimes pick up interesting behavioral clues by looking at the Form 144 filings even when we see no activity in the more typical Form 4 analysis.

Upon review of recent Form 144 activity we found evidence of three insiders selling at the Company in recent months, data that has managed to stay off the radar of most analysts due to the fact that the sellers were not required to file a Form 4 under Section 16 rules. It is fairly clear, however, by virtue of their job descriptions and upon comparing the sizes of their security sales to the holdings of "named" Section 16 insiders, that those individuals involved are indeed relatively senior managers and their sales constituted a significant portion of their holdings.

Two July sellers are the most interesting to us as they dropped what appears to be the majority of their positions just after the 3Q08 earnings report. Both sold on the same day as well which is interesting in that it cannot be ruled out that there may have been a development prompting both to act at the same time:

- **Gary R. Carlson (60)** – V.P. Academic Affairs. Carlson has been with the Company since 1997 and in his current position since 2002. On July 29th, he dropped 10,820 shares which he acquired through option exercises on the same day. His 144 filing indicates that he had initiated a 10b5-1 plan on 09/04/07. Since this plan's origination, he has sold on two separate occasions (3,000 shares each time) at about $108 and $127. His recent sale, at roughly $88, was significantly larger than his earlier two trades and looks to be the majority of his holdings based on the holdings of officers above him in the pay scale.

- **John W. Hawthorne** – V.P. Student Services. Although the ESI website indicates that Hawthorne is a senior officer, no biography is offered. What we do know is that he set up his 10b5-1 plan in March of 2008 and began selling in September, dropping 2,097 shares a month in September, October, and November. As was the case with Carlson, he broke from his pattern on July 29th, the same day as Carlson's move, selling 7,184 shares. Just like Carlson, Hawthorne exercised options on the sale date, selling the entire lot. Like Carlson, we are quite interested to see Hawthorne selling more shares in the $88 range than he had sold in the $108 to $127 range. His recent sale also appears to be a majority of his holdings.

- **Barry S. Simich** – Vice President, Operations. Simich has served as Vice President, Operations since 2005. Between 2001 and 2005 he served as one of the Company's District Managers. Between 1991 and 2001 he served as Director of an ITT Technical Institute. Simich entered into a 10b5-1 plan on 02/11/08 and began exercising options for 750 shares per month, selling all of them, in May of 2008. He has reacted the same way through November. Clearly, Simich was around for the stock highs of late 2007, but apparently chose not to act. His current sales, now totaling 4,500, are likely to be approaching significant percentage reductions.

Aside from the above data, additional disclosure concerning actual holdings of these individuals is unavailable. Based on holdings data of other members of management for whom we *do* have holdings data, we are comfortable with the assumption that these individuals have sold significant portions of their holdings with these transactions.

It is clear that there has been a significant erosion of holdings over the past year as the stock held by management and directors has dropped (measuring from Proxy to Proxy) from 3.6% to 1.7% of the total shares outstanding prior to the above sales, with most of the distribution occurring during the late 2007 highs when ESI shares traded up around $110 to $120. One of the big reductions from that period was by General Counsel **Clark Elwood** (a registered Section 16 filer, so he did file Form 4s) who in 2007 had **reduced his exposure to ESI shares and/or options by 85%** with sales of over 166,000 shares. His sales, at the highs, gain more significance when one realizes that the only new options he will have vest through January of 2010 not only total just 24,500 shares but are underwater at this time as well. During the same time period as Elwood's sales a similar reduction had occurred by Director and former Sr. V.P. of ITT Industries, **James Fowler** who **cleared out of 80%** (just fewer than 34,000 shares) of his position, also at the highs in late 2007. He will see just 4,000 new shares vest in January 2010.

<u>Deception: Verbal deceptive indicators reveal doubts about loans, economy</u>

As we mentioned in the introduction, we engaged a consultant that is expert in identifying verbal deceptive indicators to go over the 3Q08 conference call transcript. We did this because we felt that management was less than forthcoming in responding to multiple analyst questions concerning the Company's efforts to provide students with direct loans, the impact such efforts were having on its financial condition, and the effect economic conditions were having on growth rates and several other areas. We were interested in getting both confirmation on our read of the attempts at obfuscation during the call, but also to see if the analysis would reveal any other areas where we should focus additional research and investigation.

Interestingly, the prepared remarks at the beginning of the call contained as much if not more verbal indicators of potential deception than the analyst question and answer session. Throughout the opening statements, the CEO and CFO made a multiple detour and qualified protest statements intended to convince investors of the strength and positive impact of their third quarter operating results and future growth expansion efforts. Their use of enhanced qualifiers to describe third quarter results such as, "fantastic", "excellent", "wonderful", "exceptional" and "amazing" could be an attempt to oversell their current optimism to shareholders as a slow and recessionary economy looms.

Protest statements such as how "challenging economic environments create excellent opportunities" and "our high degree of confidence in our ability to achieve our 2008 goals" may reflect their attempt to try and minimize obvious investor concerns in these areas. Numerous times, they relied on detour statements (i.e., “based on our earlier comments”, “to reiterate our previous issued comments”, ”as we previously communicated to you”, “as you already read in the morning’s press release”) to perhaps distract investors away from the more current issues that they may anticipate as becoming problematic for them in the financial services sector. These would include the impact of the disruption in the private student loan market, bad debt expenses and increasing internal financing demands, expansion program efforts, student recruitment and graduate employment outlook. Overall, management is consistently reluctant to provide any information outside of their current and historical data as economic conditions change. These behaviors would strongly suggest that they are showing signs of having some major concerns over students and operations and their ability to sustain a positive impact as they enter into the fourth quarter and beyond.

Overall, our consultant concluded that behavioral analysis of the conference call produced a medium to high level of concern. Management displayed medium to high levels of verbal deceptive indicators on most questions. Collectively, behavioral analysis consistently indicates that management has underlying concerns surrounding potentially significant issues as outlined below:

- Management has significant concerns about the overall outlook of the financial market and its impact on private student loans. During the call, management offers numerous protest statements intended to convince investors that they plan to “closely monitor” the situation on both students and operations. Even though they exhibit behaviors that are designed to instill confidence to their investors, such as, “we have no plans to change what we do or who we serve”, they are reluctant to discuss issues that could potentially impact the internal financing program and single lender third-party loans. This could indicate that the issues that need to be resolved will be significantly more challenging than they insist.

- Management may not be comfortable in its ability to create a sustainable student enrollment and recruitment stream if challenging economic conditions persist. Throughout the Q&A, they consistently use detour statements to revert back to historical data and prior year periods. These behaviors coupled with the lack of future guidance suggest that management may not be comfortable with its ability to sustain current revenue and earnings.

- Management is also evasive on questions relating to pricing plans, selling loans, bad debt and deferred revenue. In the questions that address these issues, management may be withholding or omitting information they do not currently wish to disclose relevant to current financial events.

One specific example from the analysis that we thought was very interesting involved the very brief closing statement made by the CEO, which as it turns out touched on the biggest issue facing the Company, namely, its move to begin providing loans directly to its students:

> **Operator:** Thank you. Mr. Modany we are out of time for today. I'd like to send the floor back over to management for any additional or closing comment.
>
> **Kevin Modany, CEO:** I appreciate everyone’s participating in the call. And we look forward to talking with you again in January, again at that time we hope to provide

you a little bit of additional color on the financing. We understand that's the key issue here and we're getting very close to the point where we're comfortable enough to start talking about that in some detail. So again, thanks for participating in the call and we look forward to talking to you all in January of 2009. Thank you.

Our consultant highlighted the middle of the quote from the CEO and then made the following comment:

CEO's final remarks are a vague protest statement that is an attempt to minimize concerns over financing. His need to state this at the end of the call may be an indication that they may lack confidence in their ability in meeting their internal financial and operating goals and may have some uncertainty about the challenges they could face in these areas.

Accounting: Miscellaneous noteworthy items

- The Company's capitalized direct marketing cost number remains flat, even though enrollment is rising. Given Company commentary on enrollment increases quarter by quarter, we would think that these capitalized expenses should have gone up by more than they did. It could be that they are adjusting the capitalization and amortization to level quarterly earnings.

- The decrease in funds received by private education loans made to students by third-party lenders was significant enough for them to cite it as a negative in the liquidity section. The point is made in so many areas of the SEC Form 10-Q regarding the increase in internally funded student financing, such as the negative cash effect, higher net receivables with greater DSO and more bad debt expense that it is clear this is a significant change in the business and the need for more working capital and added debt or liquidation of investments seem sure to be coming. Also, stock repurchases will no doubt have to be scaled back, which to some extent has already taken place.

- There is very little information on the available for sale securities and so far there is no disclosure (in the 3Q08 SEC Form 10-Q) of the $130 million of auction rate securities that were on the books at 12/31/07. They are gone and it is clear from prior SEC Form 10-Qs that this occurred in Q1 but, again, no detail. The Company, however, says that it had no material gross unrealized holding or realized gains or (losses) from its investments in auction rate securities. It is difficult to see how they got out of the auction rates with no material losses. At year-end they may have to come to grips with fair value on the $150 million of short term investments carried as available for sale securities, including the ARS holdings.