ITT EDUCATIONAL SERVICES INC
Form 10-Q
April 27, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2004

OR

o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number 1-13144

ITT EDUCATIONAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No **o**

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ý No **o**

45,715,429

Number of shares of Common Stock, $.01 par value, outstanding at March 31, 2004.

ITT EDUCATIONAL SERVICES, INC.

Indianapolis, Indiana

Quarterly Report to Securities and Exchange Commission

March 31, 2004

PART I

FINANCIAL INFORMATION

EXPLANATORY NOTE

FAILURE TO OBTAIN A REVIEW OF THE INTERIM FINANCIAL STATEMENTS

As we previously disclosed in our 2004 Annual Meeting Notice and Proxy Statement, our Board of Directors has appointed a Special Committee to conduct an investigation, which investigation is separate and independent from the investigation being conducted by us and our management, into the facts and circumstances alleged to be the subject matter underlying, and in any way related to, the current investigations by the United States Department of Justice (DOJ), the Office of the Attorney General for the State of California (CAG) and the class action lawsuits that have been filed against us and other defendants named therein. The Special Committee has hired outside counsel to assist it in its investigation. We have been advised by our independent auditor, PricewaterhouseCoopers LLP, that it will be unable to complete its review of our quarterly results prior to the completion of the Special Committee s investigation and its review of the results of that investigation. Accordingly, our independent auditor has not reviewed the accompanying unaudited consolidated financial statements as of March 31, 2004 and for the three-month period then ended in accordance with Rule 10-01(d) of Regulation S-X promulgated by the Securities and Exchange Commission (SEC). We cannot predict the outcome of the Special Committee s investigation.

Since the unaudited consolidated financial statements contained in this report have not been reviewed by our independent auditor, we may be deemed not to be current in our filings required under the Securities Exchange Act of 1934, as amended. Upon the completion of the review by our independent auditor, we intend to file an amendment to this report, which will include a discussion of any material changes from the unreviewed financial statements contained in this filing. We understand that completion of a review of the unaudited consolidated financial statements and the filing of the amendment will make this report current, although it will not be deemed timely for purposes of the rules governing eligibility to use registration statements on Forms S-2 and S-3.

Item 1. FINANCIAL STATEMENTS.

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ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

(unaudited)

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Revenues	$ 141,730	$ 119,000
Costs and Expenses		
Cost of educational services	76,493	68,333
Student services and administrative expenses	41,449	36,998
Special legal costs	9,700	
Total costs and expenses	127,642	105,331
Operating income	14,088	13,669
Interest income, net	709	448
Income before income taxes	14,797	14,117
Income taxes	5,771	5,435
Net income	$ 9,026	$ 8,682
Earnings per common share (basic):	$ 0.20	$ 0.19
Earnings per common share (diluted):	$ 0.19	$ 0.19

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	March 31, 2004 (unaudited)	December 31, 2003	March 31, 2003 (unaudited)
Assets			
Current assets			
Cash and cash equivalents	$ 186,428	$ 168,273	$ 106,451
Restricted cash		8,496	
Short-term investments	58,855	63,938	28,264
Accounts receivable, net	8,519	9,398	9,162
Deferred and prepaid income tax	6,846	2,906	2,609
Prepaids and other current assets	6,972	3,635	8,232
Total current assets	267,620	256,646	154,718
Property and equipment, net	79,660	81,503	66,566
Direct marketing costs	11,979	10,844	10,555
Investments	20,674	13,467	
Other assets	961	810	1,707
Total assets	$ 380,894	$ 363,270	$ 233,546
Liabilities and Shareholders Equity			
Current liabilities			
Accounts payable	$ 36,627	$ 36,543	$ 24,695
Accrued compensation and benefits	12,335	16,986	4,900
Other accrued liabilities	25,878	18,444	9,306
Deferred revenue	127,685	130,364	98,323
Total current liabilities	202,525	202,337	137,224
Deferred income tax	4,709	4,691	5,318
Minimum pension liability	7,012	7,012	8,041
Other liabilities	3,004	3,106	2,038
Total liabilities	217,250	217,146	152,621
Shareholders equity			
Preferred stock, $.01 par value, 5,000,000 shares authorized, none issued or outstanding			
Common stock, $.01 par value, 150,000,000 shares authorized, 54,068,904 issued	540	540	540
Capital surplus	57,097	52,688	45,014
Retained earnings	228,397	221,400	181,999
Accumulated comprehensive income	(4,263)	(4,263)	(4,888)
Treasury stock, 8,353,475, 8,638,535, and 9,293,599 shares, at cost	(118,127)	(124,241)	(141,740)
Total shareholders equity	163,644	146,124	80,925
Total liabilities and shareholders equity	$ 380,894	$ 363,270	$ 233,546

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Three Months Ended March 31, 2004	2003
Cash flows provided by (used for) operating activities:		
Net income	$ 9,026	$ 8,682
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,867	5,416
Provision for doubtful accounts	2,501	2,002
Deferred taxes	(3,922)	(1,507)
Increase/decrease in operating assets and liabilities:		
Short-term investments	(2,074)	(2,593)
Accounts receivable	(1,622)	(2,191)
Direct marketing costs	(1,135)	54
Accounts payable and accrued liabilities	2,765	(493)
Prepaids and other assets	(3,488)	(3,094)
Deferred revenue	(2,679)	(4,674)
Net cash provided by (used for) operating activities	4,239	1,602
Cash flows provided by (used for) investing activities:		
Facility purchases		(7,641)
Capital expenditures, net	(3,024)	(1,757)
Proceeds from maturities of held-to-maturity investments	23,156	
Purchase of held-to-maturity investments	(23,206)	
Net cash provided by (used for) investing activities	(3,074)	(9,398)
Cash flows provided by (used for) financing activities:		
Purchase of treasury stock		(27,958)
Exercise of stock options	8,494	11,168
Net cash provided by (used for) financing activities	8,494	(16,790)
Net increase (decrease) in cash, cash equivalents and restricted cash	9,659	(24,586)
Cash, cash equivalents and restricted cash at beginning of period	176,769	131,037
Cash, cash equivalents and restricted cash at end of period	$ 186,428	$ 106,451

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

ITT EDUCATIONAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands)

	Common Stock		Capital	Retained	Compre-hensive	Accumulated Other Compre-hensive	Treasury Stock		
	Shares	Amount	Surplus	Earnings	Income	Income/(Loss)	Shares	Amount	Total
Balance as of December 31, 2002	54,069	$ 540	$ 40,393	$ 184,409		$ (4,888)	(8,986)	$ (131,430)	$ 89,024
Exercise of stock options				(21,867)			1,425	35,906	14,039
Tax benefit from exercise of stock options			12,295						12,295
Purchase of treasury stock							(1,078)	(28,726)	(28,726)
Issue treasury stock for board of directors plan							1	9	9
Comprehensive income:									
Net income for 2003				58,858	$ 58,858				58,858
Other comprehensive income, net of tax:									
Minimum pension liability adjustment					625	625			625
Other comprehensive income					625				
Comprehensive income					$ 59,483				
Balance as of December 31, 2003	54,069	540	52,688	221,400		(4,263)	(8,638)	(124,241)	146,124
For the three months ended March 31, 2004 (unaudited):									
Exercise of stock options			150	(2,029)			285	6,114	4,235
Tax benefit from exercise of stock options			4,259						4,259
Net income				9,026					9,026
Balance as of March 31, 2004	54,069	$ 540	$ 57,097	$ 228,397		$ (4,263)	(8,353)	$ (118,127)	$ 163,644

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

ITT EDUCATIONAL SERVICES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2004

(Dollar amounts in thousands, unless otherwise stated)

1. **Basis of Presentation**

As we previously disclosed in our 2004 Annual Meeting Notice and Proxy Statement, our Board of Directors has appointed a Special Committee to conduct an investigation, which investigation is separate and independent from the investigation being conducted by us and our management, into the facts and circumstances alleged to be the subject matter underlying, and in any way related to, the current investigations of us by the DOJ and CAG and the class action lawsuits that have been filed against us and other defendants named therein. The Special Committee has hired outside counsel to assist it in its investigation. We have been advised by our independent auditor, PricewaterhouseCoopers LLP, that it will be unable to complete its review of our quarterly results prior to the completion of the Special Committee s investigation and its review of the results of that investigation. Accordingly, our independent auditor has not reviewed the accompanying unaudited consolidated financial statements as of March 31, 2004 and for the three-month period then ended in accordance with Rule 10-01(d) of Regulation S-X promulgated by the SEC. We cannot predict the outcome of the Special Committee s investigation.

We prepared the accompanying unaudited consolidated financial statements in accordance with generally accepted accounting principles for interim periods. In the opinion of our management, the financial statements contain all adjustments necessary to present fairly our financial condition and results of operations. Certain information and footnote disclosures, including significant accounting policies, normally included in a complete presentation of financial statements prepared in accordance with generally accepted accounting principles, have been omitted. The interim financial statements should be read in conjunction with the audited financial statements and notes thereto contained in our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2003.

2. **Summary of Certain Accounting Principles and Policies**

Stock Options. We adopted and our stockholders approved the ITT Educational Services, Inc. 1994 Stock Option Plan and the 1997 ITT Educational Services, Inc. Incentive Stock Plan, and we also established the 1999 Outside Directors Stock Option Plan (collectively, the Plans). We have adopted the disclosure only provisions of SFAS No. 123, Accounting for Stock-Based Compensation. Accordingly, no compensation cost has been recognized in the financial statements for the Plans. We have elected, as permitted by the standard, to continue following the intrinsic value based method of accounting for stock options consistent with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. Under the intrinsic method, compensation cost for stock options is measured as the excess, if any, of the quoted market price of our common stock at the measurement date over the exercise price.

If compensation costs for the Plans had been determined based on the fair value of the stock options at grant date consistent with SFAS No. 123, our compensation costs would have increased and our net income and earnings per share would have been reduced to the proforma amounts indicated below:

	Three Months Ended March 31, 2004		Three Months Ended March 31, 2003	
Net income as reported	$	9,026	$	8,682
Deduct: Total stock-based employee compensation expense determined under the fair value based method for stock options, net of tax		(1,922)		(1,161)
Proforma net income	$	7,104	$	7,521
Earnings per share:				
Basic as reported	$	0.20	$	0.19
Basic proforma	$	0.16	$	0.17
Diluted as reported	$	0.19	$	0.19
Diluted proforma	$	0.15	$	0.16

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Risk free interest rates	3.2%	2.7%
Expected lives (in years)	5	5
Volatility	57%	57%
Dividend yield	None	None

Contingent Liabilities. We are subject to litigation in the ordinary course of our business. 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 estimatable 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.

3. **New Accounting Pronouncements**

In December 2003, the Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Standards (SFAS) No. 132 revised (SFAS No. 132R), Employers Disclosures about Pensions and Other Postretirement Benefits. The provisions of SFAS No. 132R do not change the measurement and recognition provisions of SFAS No. 87, Employers Accounting for Pensions, SFAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, and SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions. SFAS No. 132R adds interim period and annual financial statement disclosures. See Note 7, which presents the additional interim disclosures required by SFAS No. 132R.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements to certain entities in which the equity investors do not have either a controlling financial interest or sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for variable interest entities in which we hold a variable interest. We do not hold variable interests in variable interest entities and, therefore, FIN 46 will not have an impact on our financial condition or results of operations.

4. **Special Legal Costs**

Consistent with our accounting policy for contingent liabilities (pursuant to which we accrue probable legal costs associated with a claim or a potential claim), we recorded a charge of $9,700 in the three months ended March 31, 2004 for estimated legal costs associated with the investigation of us being conducted by the DOJ, the inquiry initiated by the SEC into the allegations being investigated by the DOJ, and the securities class action and shareholder derivative lawsuits filed against us, certain of our current and former executive officers and each of our Directors (collectively, the Actions), as described below in Note 9. During the three months ended March 31, 2004, we paid $159 of those legal costs, and the remaining $9,541 are included in Other accrued liabilities as of March 31, 2004. We believe that it is probable that we will incur at least $9,700 in legal costs related to these matters. Due to the uncertainty regarding the outcomes of these matters, however, we cannot estimate the maximum amount of costs that we could potentially incur with respect to these matters. In accordance with the financial accounting standards for loss contingencies, we have accrued what we believe to be the minimum amount of costs that is probable we will incur, since we are unable to estimate with any greater certainty any other amount. If our estimate proves to be inadequate, however, it is possible that we could subsequently be required to record a charge to earnings which could have a material adverse effect on our results of operations.

5. **Investments**

Investments with original maturity dates of less than 90 days are included in cash and cash equivalents and are recorded at cost, which approximates market value. Investments classified as trading securities that have maturity dates in excess of 90 days at the time of purchase are recorded at their market value and are included in short-term investments. Investments classified as held-to-maturity include investments that are recorded at their amortized cost. Short-term investments have maturity dates within one year following the balance sheet date. Non-current investments have maturity dates between one and three years following the balance sheet date.

The cost of securities sold is based on the first-in, first-out method. All of our investments are in marketable debt securities.

	As of Mar 31, 2004			As of Dec 31, 2003			As of Mar 31, 2003		
	Trading securities	**Held-to-maturity**	**Total**	**Trading securities**	**Held-to-maturity**	**Total**	**Trading securities**	**Held-to-maturity**	**Total**
Cash and cash equivalents	$ 186,428	$	$ 186,428	$ 168,273	$	$ 168,273	$ 106,451	$	$ 106,451
Short-term investments	15,165	43,690	58,855	13,347	50,591	63,938	28,264		28,264
Non-current investments		20,674	20,674		13,467	13,467			
	$ 201,593	$ 64,364	$ 265,957	$ 181,620	$ 64,058	$ 245,678	$ 134,715	$	$ 134,715

6. **Earnings Per Share**

Earnings per common share for all periods have been calculated in conformity with SFAS No. 128, Earnings Per Share. This data is based on historical net income and the average number of shares of our common stock outstanding during each period.

	Average Shares Outstanding (in thousands) Three Months Ended March 31,	
	2004	2003
Basic	45,608	45,014
Diluted	46,763	46,042

The difference in the number of shares used to calculate basic and diluted earnings per share represents the average number of shares assumed issued under our stock option plans less shares assumed to be purchased with proceeds from the exercise of those stock options.

7. **Employee Pension Benefits**

The net periodic benefit costs for the ESI Pension Plan (Pension Plan) and the ESI Excess Pension Plan (Excess Plan) are as follows:

	For the Three Months Ended March 31,	
	2004	**2003**
Service cost	$ 1,765	$ 1,470
Interest cost	570	445
Expected return on assets	(550)	(392)
Recognized net actuarial loss		