

ITT EDUCATIONAL SERVICES INC
Form 11-K
May 09, 2003

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 11-K

ANNUAL REPORT

**PURSUANT TO SECTION 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2002

OR

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

For the transition period from to

Commission file number 1-13144

A. Full title of the plan and the address of the plan, if different from that of the issuer named below:

ESI 401(k) PLAN

B. Name of issuer of the securities held pursuant to the plan and the address of its principal executive office:

ITT EDUCATIONAL SERVICES, INC.

5975 Castle Creek Parkway N. Drive

P.O. Box 50466

Indianapolis, Indiana 46250-0466

(317) 594-9499

ESI 401(k) PLAN

Annual Report to the Securities and Exchange Commission

December 31, 2002

Item 4. The ESI 401(k) Plan (the Plan) is subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA) and the Plan s financial statements and schedules have been prepared in accordance with the financial reporting requirements of ERISA. Such financial statements and schedules are included in this Report in lieu of the information required by Items 1 - 3 of Form 11-K.

FINANCIAL STATEMENTS AND EXHIBIT.

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Report of Independent Accountants

Financial Statements:

Statements of Net Assets Available for Benefits at December 31, 2002 and 2001

Statements of Changes in Net Assets Available for Benefits for the years ended December 31, 2002 and 2001

Notes to Financial Statements

Supplemental Schedules*:

Schedule H line 4i:

Schedule of Assets (Held at End of Year)

Schedule H line 4j:

Schedule of Reportable (5%) Transactions for the year ended December 31, 2002

Signature

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* Other schedules required by section 2520.103-10 of the Department of Labor s Rules and Regulations for Reporting and Disclosure under ERISA have been omitted as they are not applicable.

Report of Independent Accountants

To the Participants and Administrator of
the ESI 401(k) Plan

In our opinion, the accompanying statements of net assets available for benefits and the related statements of changes in net assets available for benefits present fairly, in all material respects, the net assets available for benefits of the ESI 401(k) Plan (the Plan) at December 31, 2002 and 2001, and the changes in net assets available for benefits for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Plan's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of assets (held at end of year) and of reportable (5%) transactions for the year ended December 31, 2002 are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ PricewaterhouseCoopers LLP
PRICEWATERHOUSECOOPERS LLP
Indianapolis, IN
March 26, 2003

ESI 401(k) Plan**Statement of Net Assets Available for Benefits***December 31, 2002 and 2001*

| | As of December 31, | |
|--|----------------------|----------------------|
| | 2002 | 2001 |
| Assets: | | |
| Investments, at fair value: | | |
| Registered investment companies | \$ 29,600,348 | \$ 29,916,507 |
| Common/collective fund | 9,822,057 | 7,317,491 |
| Employer securities | 35,269,884 | 27,165,147 |
| Cash and cash equivalents | 15,887 | 7,594 |
| Participant loans | 2,524,762 | 2,134,241 |
| Total investments | 77,232,938 | 66,540,980 |
| Contributions receivable: | | |
| Employer | 115,425 | 237,371 |
| Participant | 287,658 | 461,102 |
| Total assets | 77,636,021 | 67,239,453 |
| Liabilities: | | |
| Accrued excess contributions | 26,254 | 17,486 |
| Net assets available for benefits | \$ 77,609,767 | \$ 67,221,967 |

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

ESI 401(k) Plan**Statements of Changes in Net Assets Available for Benefits***for the years ended December 31, 2002 and 2001*

| | For the Years Ended December 31, | |
|---|-------------------------------------|---------------|
| | 2002 | 2001 |
| Additions to net assets: | | |
| Contributions: | | |
| Employer | \$ 2,785,423 | \$ 2,340,702 |
| Participant | 7,169,805 | 5,439,870 |
| Rollover | 2,807,905 | 65,730 |
| Investment income: | | |
| Net appreciation in fair value of investments | 2,461,135 | 9,164,863 |
| Interest and dividends | 1,099,124 | 997,061 |
| Total additions | 16,323,392 | 18,008,226 |
| Deductions from net assets: | | |
| Disbursements to participants | (5,803,317) | (7,095,635) |
| Administrative expenses | (132,275) | (93,690) |
| Total deductions | (5,935,592) | (7,189,325) |
| Net increase | 10,387,800 | 10,818,901 |
| Net assets available for benefits, at beginning of year | 67,221,967 | 56,403,066 |
| Net assets available for benefits, at end of year | \$ 77,609,767 | \$ 67,221,967 |

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

ESI 401(k) Plan

Notes to Financial Statements

December 31, 2002 and 2001

1. Summary of Plan Provisions

The following description of the ESI 401(k) Plan (the Plan) provides only general information. Participants should refer to the Summary Plan Description and the Plan document for more complete descriptions of the Plan 's provisions.

General

The Plan is a defined contribution plan covering all eligible salaried employees of ITT Educational Services, Inc. (ITT/ESI or Employer) (or an affiliate of ITT/ESI that adopts the Plan) who have completed three months of continuous service. It is subject to Section 401(a) of the Internal Revenue Code (IRC) and the provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). The ITT/ESI Employee Benefit Plan Administration and Investment Committee (the Committee) is the plan administrator of the Plan for purposes of ERISA. J.P. Morgan/American Century Retirement Plan Services provides administrative services under a written agreement with the Committee. UMB Bank, N.A. is the trustee of the Plan.

Contributions

Several amendments to the Plan affecting participant and ITT/ESI contributions became effective on January 1, 2002:

A participant can contribute any designated percentage of his or her pretax annual base compensation, as defined in the Plan, up to IRC limits.

ITT/ESI 's matching contribution is 100% of the first 1% of base compensation and 50% of the next 4% of base compensation that a participant contributes to the Plan during each payroll processing period.

ITT/ESI 's retirement contribution of 1% of a participant 's base compensation for each payroll processing period was eliminated.

Prior to January 1, 2002:

A participant could contribute up to 16% of his or her pretax annual base compensation each year, as defined in the Plan.

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ITT/ESI made a matching contribution equal to 50% of the first 5% of base compensation that a participant contributed to the Plan during each payroll processing period.

ITT/ESI made a retirement contribution of 1% of a participant's base compensation for each payroll processing period.

ITT/ESI contributions are made or invested in ITT/ESI common stock. Participant contributions are invested among a number of available investment funds as directed by each participant. At age 55, participants may choose to re-allocate existing ITT/ESI contribution accounts and allocate all future ITT/ESI contributions among all available investment funds. Contributions are subject to certain IRC limitations.

Participant Accounts

Each participant's account is credited with the participant's contributions, the ITT/ESI matching contributions and, for Plan years beginning before 2002, ITT/ESI retirement contributions, and an allocation of Plan earnings derived from the participant's investment options, and is charged with an allocation of administrative expenses. Earnings and administrative expenses are allocated among the funds based on account balances. The benefit to which a participant is entitled is the benefit that can be provided from the vested portion of the participant's Plan account. Forfeitures from terminated participants' non-vested accounts are used to reduce future ITT/ESI contributions. Total forfeitures for participants' non-vested accounts used to reduce ITT/ESI contributions were \$153,413 for 2002 and \$207,201 for 2001. Total forfeitures available, which can be used to reduce future ITT/ESI contributions, were \$402,925 at December 31, 2002 and \$378,014 at December 31, 2001.

Vesting

Participants are 100% vested in their contributions and ITT/ESI retirement contributions, plus any actual earnings on those contributions. Vesting in the ITT/ESI matching contributions and the earnings on those contributions is based on the participant's years of continuous service with ITT/ESI. Effective January 1, 2002, the Plan was amended to provide that ITT/ESI's matching contributions and the earnings on those contributions vest as follows: (a) for a participant whose employment with ITT/ESI began prior to January 1, 2002, 20% for each of the first two full years and 60% for the third full year that the participant is employed by ITT/ESI; and (b) for a participant whose employment began on or after January 1, 2002, 0% for each of the first two full years and 100% for the third full year that the participant is employed by ITT/ESI.

Prior to January 1, 2002, ITT/ESI's matching contributions and the earnings on those contributions vested in accordance with the following table:

| Years of Service | Vested Percent |
|-----------------------------|-----------------------|
| Less than 1 | 0% |
| At least 1, but less than 2 | 20% |
| At least 2, but less than 3 | 40% |
| At least 3, but less than 4 | 60% |
| At least 4, but less than 5 | 80% |
| At least 5 | 100% |

Loans

A participant may borrow from his or her Plan account, while employed by ITT/ESI, up to the lesser of \$50,000 or 50% of the vested portion of the Plan account balance. Loan terms cannot exceed five years, unless the loan is to be used in conjunction with the purchase of a participant's primary residence. The loans are secured by the amounts transferred to the Loan Fund (as defined in the Plan) from the participant's Plan account (which cannot exceed 50% of the participant's vested portion) and bear interest at a rate determined by the Committee. Loan principal and interest are paid ratably by payroll deductions, or as otherwise agreed to by the participant and the Committee.

Investment Options

The Plan trustee has established and maintains 12 separate investment funds (i.e., ten mutual funds, a common/collective fund and a stock fund) into which participants may direct their contributions. Those 12 separate funds are as follows:

American Century Ultra Fund-Invests in a diversified portfolio of medium- and large-size companies that fund management considers to have above-average potential for appreciation.

American Century Real Estate Fund-Invests primarily in securities issued by real estate investment trusts with potential for long-term capital appreciation.

American Century Value Fund-Invests in equity securities of well-established companies that fund management believes to be undervalued at the time of purchase.

American Century International Growth Fund-Invests in a diversified range of foreign companies with above-average potential for appreciation.

American Century Strategic Allocation Fund: Conservative-Invests in equity securities and some bond and money market securities with the objective of moderate long-term growth.

American Century Strategic Allocation Fund: Moderate-Invests in equity securities and maintains a sizable stake in bonds and money market securities to provide long-term growth and some regular income.

American Century Strategic Allocation Fund: Aggressive-Invests in equity securities and some bonds and money market securities to provide long-term growth and a small amount of income.

American Century Income & Growth Fund-Invests in stocks of companies with strong dividend growth potential and large U.S. companies whose stocks appear under valued.

J.P. Morgan Pierpont U.S. Small Company Fund-Invests in equity securities of small companies considered to be likely to provide a high total return.

J.P. Morgan Pierpont Bond Fund-Invests in a diversified portfolio of fixed income securities, including, but not limited to, U.S. government and agency securities, corporate securities, private placements and asset-backed mortgage-related securities.

American Century Stable Asset Fund-Invests exclusively in a diversified pool of high-quality fixed income securities.

ESI Stock Fund-Invests in shares of ITT/ESI common stock.

Distributions

A participant is eligible to receive a distribution from the Plan upon the participant's termination of service, death, disability, retirement or demonstration of financial hardship. Payments are typically made in the form of a single lump sum. If the value of the participant's vested Plan account balance exceeds \$5,000, however, the participant may elect instead to receive payment in annual or monthly installments over a specified period of time not to exceed 20 years. There were \$57,807 of benefits at December 31, 2002 and \$100,625 at December 31, 2001 which had been approved but were not paid until the subsequent year.

2. Summary of Significant Accounting Policies

Basis of Accounting

The financial statements of the Plan are prepared under the accrual method of accounting.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and changes therein, and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Investments and Investment Income

Investments are stated at fair value as determined by the Plan trustee at the quoted market value or unit values based on quoted market values as of the last business day of the Plan year. Participant loans are valued at cost, which approximates fair value.

The Plan presents in its statements of changes in net assets available for benefits the net appreciation (depreciation) in the fair value of its investments, which consists of the realized gains and losses and the unrealized appreciation (depreciation) on those investments. Purchases and sales of investments are recorded on a trade-date basis.

Risks and Uncertainties

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The Plan provides for various investment options in funds that invest in stocks, bonds, fixed income securities and other investment securities. The underlying investment securities are exposed to various risks, such as interest rates, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, changes in risks in the near term could materially affect participants' account balances and the amounts reported in the statements of net assets available for benefits and the statements of changes in net assets available for benefits.

Payment of Benefits

Disbursements to participants are recorded when paid.

3. Investments

The following is a summary of the fair value of investments that represent 5% or more of net assets available for benefits at December 31, 2002 and 2001:

| | December 31, | |
|--|---------------------|--------------|
| | 2002 | 2001 |
| American Century Stable Asset Fund | \$ 9,822,057 | \$ 7,317,491 |
| American Century Strategic Allocation Fund: Moderate | 7,349,323 | 7,013,933 |
| American Century Income & Growth Fund | 8,738,048 | 10,892,027 |
| American Century Ultra Fund | 3,964,197 | 5,087,474 |
| ESI Stock Fund - participant-directed | 8,799,175 | 6,155,152 |
| ESI Stock Fund - nonparticipant-directed | 26,486,596 | 21,017,589 |

During 2002 and 2001, the Plan's investments (including gains and losses on investments bought and sold, as well as held during the year) appreciated (depreciated) in value by \$2,461,135 in 2002 and \$9,164,863 in 2001 as follows:

| | For the Years Ended December 31, | |
|---------------------------------|---|----------------|
| | 2002 | 2001 |
| Registered investment companies | \$ (5,363,224) | \$ (3,024,599) |
| Employer securities | 7,824,359 | 12,189,462 |
| | \$ 2,461,135 | \$ 9,164,863 |

4. Nonparticipant-Directed Investments

The Plan's ESI Stock Fund contains participant-directed and nonparticipant-directed investments, which consist of shares of common stock and cash equivalents. The net asset value of the nonparticipant-directed investments in the ESI Stock Fund was \$26,486,596 at December 31, 2002 and \$21,017,589 at December 31, 2001. The significant components of the changes in net assets relating to the nonparticipant-directed investments in the Plan's ESI Stock Fund are as follows:

| | For the Years Ended December 31, | |
|---|-------------------------------------|--------------|
| | 2002 | 2001 |
| Changes in Net Assets: | | |
| Contributions | \$ 3,006,533 | \$ 2,642,082 |
| Interest and dividends | 5,931 | 8,561 |
| Net appreciation | 5,357,736 | 8,657,956 |
| Benefits paid to participants | (1,640,422) | (1,870,146) |
| Transfers to participant-directed investments | (1,260,771) | (1,330,366) |
| | \$ 5,469,007 | \$ 8,108,087 |

5. Administrative Fees

Participant accounts were charged \$132,275 for administrative fees related to the Plan for the year ended December 31, 2002 and \$93,690 for the year ended December 31, 2001. ITT/ESI paid administrative fees of \$26,500 for the year ended December 31, 2002 and \$29,500 for the year ended December 31, 2001.

6. Related-Party Transactions

Certain Plan investments are shares of mutual funds managed by J.P. Morgan/American Century or its affiliates and, therefore, these investments qualify as party-in-interest transactions, which are exempt from the ERISA prohibited transaction rules. In addition, participants in the Plan may invest their contributions in the ESI Stock Fund, which primarily holds shares of ITT/ESI common stock. At December 31, 2002, the ESI Stock Fund held 1,497,626 shares with a historical cost of \$21,194,193 and a market value of \$35,269,884. At December 31, 2001, the ESI Stock Fund held 1,473,564 shares (restated to reflect the two-for-one stock split in 2002) with a historical cost of \$19,044,376 and a market value of \$27,165,147.

7. Plan Termination

Although it has not expressed any intent to do so, ITT/ESI has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants will become 100% vested in their Plan accounts.

8. Tax Status

The Internal Revenue Service issued a determination letter on April 13, 1999 stating that the Plan qualifies for tax-exempt status under the applicable provisions of the IRC. Although the Plan has been amended since receiving the determination letter, the Plan Administrator and the Plan's tax counsel believe the Plan design and operation comply with the applicable requirements of the IRC. The Plan Administrator has submitted the Plan as amended to the Internal Revenue Service requesting a new determination letter that the amended Plan continues to qualify for tax-exempt status under the applicable provisions of the IRC.

The accompanying financial statements differ from the related Form 5500, Return/Report on Employee Benefit Plan. Accrued benefits of \$57,807 at December 31, 2002 and \$100,625 at December 31, 2001 are included on the Form 5500 but not in the accompanying financial statements.

ESI 401(k) Plan**Schedule H line 4i:****Schedule of Assets (Held at End of Year)**

| Identity of Issue, Borrower, Lessor or Similar Party | Description of Investment Including Maturity Date, Rate of Interest, Collateral, Par, or Maturity Value | Cost** | Current Value |
|---|---|------------|------------------|
| * Participant loans | Rates range from 5.25-10.50% | \$ 0 | \$ 2,524,762 |
| * American Century Stable Asset Fund | Common/collective fund | | 9,822,057 |
| * American Century Ultra Fund | Registered investment company | | 3,964,197 |
| * American Century Real Estate Fund | Registered investment company | | 1,735,924 |
| * American Century Value Fund | Registered investment company | | 1,512,403 |
| * American Century International Growth Fund | Registered investment company | | 1,342,488 |
| * American Century Strategic Allocation Fund: Conservative | Registered investment company | | 536,906 |
| * American Century Strategic Allocation Fund: Moderate | Registered investment company | | 7,349,323 |
| * American Century Strategic Allocation Fund: Aggressive | Registered investment company | | 981,846 |
| * American Century Income & Growth Fund | Registered investment company | | 8,738,048 |
| * J.P. Morgan Pierpont Small Company Fund | Registered investment company | | 1,033,109 |
| * J.P. Morgan Pierpont Bond Fund | Registered investment company | | 2,406,104 |
| * ESI Stock Fund - Non-participant Directed | Common stock | 15,673,604 | 26,475,291 |
| * ESI Stock Fund - Participant Directed | Common stock | | 8,794,593 |
| * ESI Stock Fund - Non-participant Directed | Cash and cash equivalent | 11,305 | 11,305 |
| * ESI Stock Fund - Participant Directed | Cash and cash equivalent | | 4,582 |
| | | | \$ 77,232,938 |

* Denotes party-in-interest

** Cost information not required for participant directed funds

ESI 401(k) Plan

Schedule H line 4j:

Schedule of Reportable (5%) Transactions

for the year ended December 31, 2002

| Identity of Party | Description of Asset | Purchase Price | Selling Price | Lease Rental | Expense Incurred With Transaction | Cost of Asset | Current Value of Asset on Transaction Date | Net Gain or (Loss) |
|---|----------------------|----------------|---------------|--------------|-----------------------------------|---------------|--|--------------------|
| Category (iii) - Series of transactions in same investment which exceeds 5% of net assets at December 31, 2001*: | | | | | | | | |
| ESI Stock Fund | Common stock | \$ 3,013,984 | | | | \$ 3,013,984 | \$ 3,013,984 | |
| ESI Stock Fund | Common stock | | \$ 2,911,307 | | | \$ 2,050,334 | \$ 2,911,307 | \$ 860,973 |

* Includes nonparticipant-directed activity only.

SIGNATURES

The Plan. Pursuant to the requirements of the Securities Exchange Act of 1934, the ESI Employee Benefit Plan Administration and Investment Committee, the plan administrator of the ESI 401(k) Plan, has duly caused this annual report to be signed on its behalf by the undersigned, hereunto duly authorized.

ESI 401(k) PLAN

Date: May 9, 2003

By: /s/ Nina F. Esbin
Nina F. Esbin, *Chairperson of the ESI
Employee Benefit Plan Administration and
Investment Committee*

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INDEX TO EXHIBIT

| Exhibit No. | Description |
|------------------------|---|
| 23 | Consent of Independent Accountants |
| 99.1 | Chief Executive Officer's Certification Pursuant to 18 U.S.C. Section 1350. |
| 99.2 | Chief Financial Officer's Certification Pursuant to 18 U.S.C. Section 1350. |

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