# Getting stronger

# Getting stronger

## Operating and financial review

**Rona Fairhead** Chief financial officer

We've set ourselves the goal of achieving annual progress on earnings, cash and return on invested capital. We made good progress in tough markets in 2003, and you can see how we performed against each of our measures on the facing page.

### 2003 overview

In 2003 our sales declined by 4%. Our book businesses performed very strongly but could not make up for the absence of the one-off TSA contract, which contributed some £250m to our sales in 2002, and tough trading conditions for our advertising and technology-related businesses. We mitigated the impact of the £272m sales decline with significant cost reductions, so that operating profit was £3m lower at £490m and profit before tax improved to £410m (£399m in 2002). Our operating margins improved from 11.4% to 12.1%, helping adjusted earnings per share to grow to 32.0p, an increase of 6%.

On a statutory basis, we reported a profit before tax for the year of £152m (a £25m loss in 2002) and generated earnings per share of 6.9p (a loss per share of 13.9p in 2002). Our net borrowings were a further 3% lower, ending the year at £1,361m.

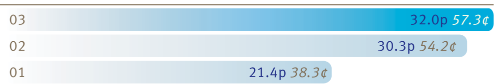
### Looking ahead

We are expecting further underlying progress on earnings, cash and returns this year, despite a weak adoption calendar for our school business and investments we are making to support organic growth. Looking further ahead to 2005 and beyond, we expect our performance on all three financial goals to accelerate, with the strengthening of the US School industry, $1bn of contract wins in 2003 and lower costs in our advertising and technology-related businesses.

Earnings, cash and returns are the bedrock of incentive plans throughout Pearson. The annual bonuses of our directors and our senior managers are based either directly on these three measures or on the elements of them which they control. For example, targets for our businesses and managers include underlying sales growth and trading margin – which are key drivers of adjusted earnings per share – as well as cash conversion and working capital – which underpin progress on cash flow and return on invested capital.

# Our financial goals

## Adjusted earnings per share




The measure We report our adjusted earnings per share (eps) after restructuring charges relating to our continuing businesses. These charges are reported within the operating results of our businesses, and included £20m in 2003 relating to the integration of our book publishing operations in Australia, Canada and the UK.

We exclude from our calculation of adjusted eps the non-cash goodwill charge, costs relating to the integration of major acquisitions and other non operating items. In 2003, we reported a goodwill charge of £264m (down from £340m in 2002), a non operating gain of £6m and no integration costs. This compares with a non operating loss of £37m and integration costs of £10m in 2002.

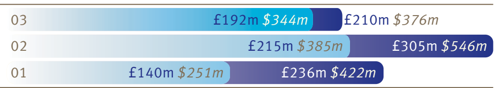
Our progress In 2003 we increased our adjusted eps by 6% (or 11% at constant currency).

In 2004, we expect to show further earnings growth in constant currency as good progress in the FT Group and further cost savings help us to offset the weaker dollar and a slow year for the US School publishing industry.

Looking further ahead, we expect a sharp acceleration in our earnings growth in 2005 and beyond as a rebound in the US School adoption cycle and a potential recovery in our cyclical advertising businesses combine with the cost reductions we've been making for the past three years.

## Free cash flow

Total free cash flow   Operating free cash flow



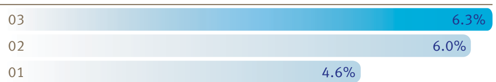

The measure Free cash flow is the measure of the cash that is available from our business operations, after the payment of interest and tax, for distribution to shareholders in the form of dividends or for reinvestment to grow our business. We monitor both operating free cash flow, which measures the cash performance of our businesses, and total free cash flow, which includes tax and finance charges and any non operating items.

We exclude proceeds of disposals and the cost of acquisitions from both these calculations.

Our progress Operating free cash flow was £210m (£305m in 2002) and free cash flow was £192m (£215m in 2002). Two major factors, both timing-related, masked an otherwise strong performance. Penguin's publishing schedule was particularly concentrated in the fourth quarter, pushing collections into 2004, and the TSA has not yet paid some $151m relating to the 2002 contract.

We expect our free cash flow to be ahead in 2004. Looking further ahead, we expect steady progress in cash generation.

## Return on invested capital




The measure Return on invested capital is our operating profit less tax expressed as a percentage of gross invested capital. Over the past few years, the transformation of Pearson has significantly increased the capital invested in the business (in the form of goodwill associated with acquisitions) and required substantial cash investment to integrate those acquisitions. With our portfolio largely in the shape we want, our goal is to meet and then exceed our cost of capital which is approximately 7.5%–8.0%.

Our progress Return on invested capital (ROIC) rose from 6.0% in 2002 to 6.3% in 2003. On this measure we were helped by currency movements – stripping out the exchange rate benefit our ROIC would have been 6.1%. We expect ROIC to be the toughest measure to improve in 2004, but expect significant progress in 2005 and 2006.

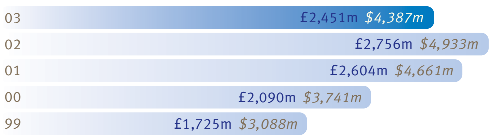
Note: Adjusted figures are presented as additional measures of business performance. They are stated before goodwill, integration costs and non operating items. Goodwill is amortised over no more than 20 years. Business performance measures are non-GAAP measures for UK reporting. Reconciliations of operating profit, adjusted earnings per share and operating free cash flow to the equivalent statutory heading under UK GAAP are included in notes 2, 9 and 27.

# Pearson Education

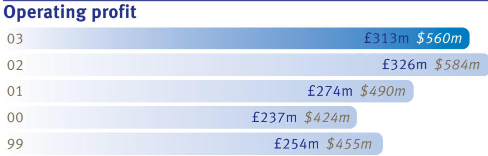
## Taking share in school and college publishing

Educating 100 million people every year, we are the world's leading publisher of textbooks and electronic learning tools for students of all ages from pre-school to college and on into their professional lives. We are the world's leading company in testing students and professionals and in software that helps teachers teach and schools to manage information about student performance. We provide all these products both in the US and around the world, where we are also the world's leading publisher of English language teaching materials.

**Sales**




**Operating profit**




Sales at Pearson Education were 6% lower than in 2002, as good growth in our School and Higher Education businesses could not fill the gap left by the absence of the £250m TSA contract. Profits were 2% lower, as progress in School and Higher Education largely offset a 51% decline in our Professional operations. Margins improved as we benefited from sales growth, operating efficiencies and the 2002 disposal of FT Knowledge.

In our School business, sales were 1% higher and operating profits up 13%. In the US, our textbook publishing business grew 2% as our basal imprints, Pearson Scott Foresman and Pearson Prentice Hall, increased revenues by 4% against basal market growth of some 1%. Our new elementary social studies programme took a market share of more than 50% in adoption states, helping Pearson to take the leading position in new adoptions with a share of approximately 29%.

**Peter Jovanovich** Chief executive, Pearson Education

Sales at our supplemental publishing business were lower than in 2002 as we discontinued some unprofitable product lines and were affected by industry-wide weakness in state budgets. Although the same pressures reduced sales at our School digital learning business, strong cost management enabled it to return to a small profit. In School testing 2003 revenues were a little ahead of the previous year and we won more than $300m worth of new multi-year contracts which will boost sales from 2005, when the Federal Government's No Child Left Behind accountability measures become mandatory.

Outside the US, revenues were up 7% with good growth in English Language Teaching and in our School publishing operations in Hong Kong, South Africa, the UK and the Middle East. Our UK testing business, London Qualifications, contributed revenues of £89m.

Our Higher Education business increased revenues by 6% and operating profits by 11%. In the US the Higher Education publishing business grew its revenues by 6%. Excluding

| Sales | 2003 £m | 2003 $m | 2002 £m | 2002 $m | Change – underlying % | Change – constant currency % | Change – headline % |
|---|---|---|---|---|---|---|---|
| School | **1,176** | ***2,105*** | 1,151 | *2,060* | 1 | 8 | 2 |
| Higher Education | **772** | ***1,382*** | 775 | *1,387* | 6 | 6 | 0 |
| Professional | **503** | ***900*** | 784 | *1,403* | (30) | (32) | (36) |
| FT Knowledge | – | – | 46 | 83 | – | – | – |
| Pearson Education | **2,451** | ***4,387*** | 2,756 | *4,933* | (6) | (5) | (11) |

| Operating profit | 2003 £m | 2003 $m | 2002 £m | 2002 $m | Change – underlying % | Change – constant currency % | Change – headline % |
|---|---|---|---|---|---|---|---|
| School | **127** | ***227*** | 115 | *206* | 13 | 17 | 10 |
| Higher Education | **148** | ***265*** | 142 | *254* | 11 | 11 | 4 |
| Professional | **38** | ***68*** | 81 | *145* | (51) | (52) | (53) |
| FT Knowledge | – | – | (12) | *(21)* | – | – | – |
| Pearson Education | **313** | ***560*** | 326 | *584* | (2) | 2 | (4) |

Pearson, the market grew by 3%. This comes on top of 14% revenue growth in 2002 and marks our fifth straight year of market share gains. Though industry growth slowed a little in 2003, the long-term fundamentals of growing enrolments, a boom in community colleges and a strong demand for post-secondary qualifications more than offset the impact of state budget weaknesses and rising tuition fees.

Our business benefited from a strong schedule of first editions including Faigley's *Penguin Handbook* in English Composition, Wood & Wood's *Mastering World Psychology* and Jones & Wood's *Created Equal* in American History. The use of technology continues to distinguish our learning programmes, with almost one million students now following their courses through our paid-for online sites, an increase of 30% on last year, and a further 1.4 million using our free online services. Our market-leading custom publishing business, which creates personalised textbooks and online packages for individual professors and faculties, grew revenues by 35%, with sales exceeding $100m for the first time.

Outside the US, our Higher Education imprints grew 7%, helped by strong growth in key markets including Europe and Canada, solid local publishing and the introduction of our custom publishing model.

Revenues and profits were significantly lower in our Professional business, caused by both the absence of the TSA contract and the associated close-out costs. The $151m receivable from the TSA remains outstanding and we are discussing with the TSA the post-contract audit and payment. We expect this process to be completed in 2004, and that we will receive payment of the amount due, although the timing of the receipt remains uncertain.

TSA apart, our Government Solutions business grew by 39%, benefiting from new contracts with the Department of Health and the USAC. The Professional Testing business won more than $600m of new long-term contracts. These include testing learner drivers for the UK's Driving Standards Agency, business school applicants for the Graduate Management Admissions Test and securities professionals for the National Association of Securities Dealers.

Our worldwide technology publishing operations maintained margins despite a 12% drop in revenues. After a severe three-year technology recession, in which our publishing revenues have fallen by 36%, the rate of decline now appears to be slowing, particularly in the US.

# The Financial Times Group

## Increasing profits despite weak advertising markets

The FT Group includes many of the world's most respected business information brands. Through the leading global business newspaper and online service, the pre-eminent national titles in many countries and a trusted provider of financial data and analysis, we reach a worldwide audience of 10 million people every day.

**Sales**

| | |
|---|---|
| 03 | £757m *$1,355m* |
| 02 | £726m *$1,300m* |
| 01 | £801m *$1,434m* |
| 00 | £844m *$1,511m* |
| 99 | £687m *$1,230m* |

**Operating profit**

| | |
|---|---|
| 03 | £86m *$154m* |
| 02 | £80m *$143m* |
| 01 | £72m *$129m* |
| 00 | £98m *$175m* |
| 99 | £114m *$204m* |

The Financial Times Group increased profits by 8% despite a 3% revenue decline as Interactive Data (IDC), our asset pricing business, posted an 18% profit increase. For our business newspapers, 2003 was the third year of a savage corporate advertising recession which has seen advertising volumes at the *Financial Times* fall almost two-thirds since their peak in 2000. Over the same period, we have reduced the FT's cost base by more than £100m.

Losses at the *Financial Times* were £9m higher than in 2002 as advertising revenues fell by £23m and we invested some £10m in the newspaper's continued expansion around the world. Advertising revenues were down 15% as industry conditions remained tough for the FT's key advertising categories of corporate finance, technology and business-to-business. The advertising declines were significantly worse immediately before and during the war in Iraq, but the rate of decline began to narrow towards the end of the year, helped by growth in US, online and recruitment advertising. The newspaper's circulation in the six months to January 2004 was 433,000, 4% lower than in the same period last year, although FT.com's subscribers are some 50% higher at 74,000. The launch of our Asia edition in September completed the FT's global network of four regional newspaper editions, backed up by a single editorial, commercial and technology infrastructure and by FT.com.

**Olivier Fleurot** Chief executive officer, The Financial Times Group

| **Sales** | 2003 £m | 2003 $m | 2002 £m | 2002 $m | Change – underlying % | Change – constant currency % | Change – headline % |
|---|---|---|---|---|---|---|---|
| Financial Times | 203 | 363 | 224 | 401 | (9) | (9) | (9) |
| Other FT publishing | 112 | 200 | 105 | 188 | (7) | 0 | 7 |
| Recoletos | 169 | 303 | 148 | 265 | 4 | 4 | 14 |
| IDC | 273 | 489 | 249 | 446 | 2 | 15 | 10 |
| Total | 757 | 1,355 | 726 | 1,300 | (3) | 3 | 4 |

| **Operating profit/(loss)** | 2003 £m | 2003 $m | 2002 £m | 2002 $m | Change – underlying % | Change – constant currency % | Change – headline % |
|---|---|---|---|---|---|---|---|
| Financial Times | (32) | (57) | (23) | (41) | (37) | (37) | (39) |
| Other FT publishing | 6 | 11 | 10 | 18 | (42) | (45) | (40) |
| Associates & Joint Ventures | 3 | 5 | (6) | (11) | – | – | – |
| Recoletos | 28 | 50 | 29 | 52 | (11) | (11) | (3) |
| IDC | 81 | 145 | 70 | 125 | 18 | 24 | 16 |
| Total | 86 | 154 | 80 | 143 | 8 | 13 | 8 |

Profits at *Les Echos* were behind last year, reflecting continuing declines in advertising revenues and investment in the newspaper's relaunch. Average circulation for the year was down 4% to 116,400, but the September relaunch generated a positive response, with newsstand sales in the final quarter up 4% against a market decline of 6%. Despite a continued decline in the advertising market, FT Business posted profit growth, due to tight cost management.

The FT's associates and joint ventures returned to profit (£6m loss in 2002) with good progress at *FT Deutschland*, our joint venture with Gruner + Jahr, and at the Economist Group, in which Pearson owns a 50% interest. *FT Deutschland's* average circulation for 2003 was 92,000, an increase of 9% on the previous year and advertising revenues increased in a declining market. The Economist Group increased its operating profit despite further revenue declines, reflecting additional measures to reduce costs. *The Economist's* circulation growth continued, with average weekly circulation 3% higher at 908,000.

Revenues at Recoletos (Bolsa Madrid: REC), our 79%-owned Spanish media group, were up 4% as its consumer titles including sports newspaper *Marca* performed strongly, more than offsetting further advertising revenue decline at business newspaper *Expansión*. Profits were 11% lower as Recoletos invested in existing and new titles. Average circulation at *Marca* increased 3% to 391,000, and at *Expansión* fell 3% to 46,000.

Interactive Data Corporation (NYSE: IDC), our 61%-owned asset pricing business, grew its underlying revenues in a declining market for the fourth consecutive year. Revenues increased by 2% and profits by 18%, despite continuing weakness in the market for financial services as institutions focused on containing costs. It was helped by strong institutional renewal rates, which continue to run at more than 95%, the addition of new asset classes to its core pricing services, and the successful launch of our Fair Value Pricing service, which is now installed in 35 leading institutions. IDC continued to extend its range of services through new products such as e-Finance Solutions, enhancements of existing products such as BondEdge and eSignal and bolt-on acquisitions including Comstock, a real-time financial data service, and Hyperfeed Technologies.

# The Penguin Group

## Breaking records with strongest ever publishing

Penguin is the most famous name in book publishing and a leader in all of the world's major English language markets. We publish some 3,500 books every year, for adults and children, in fiction and non-fiction, from timeless classics to the hottest bestsellers.

**Sales**

| | | |
|---|---|---|
| 03 | £840m | *$1,504m* |
| 02 | £838m | *$1,500m* |
| 01 | £820m | *$1,468m* |
| 00 | £755m | *$1,351m* |
| 99 | £565m | *$1,011m* |

**Operating profit**

| | | |
|---|---|---|
| 03 | £91m | *$163m* |
| 02 | £87m | *$156m* |
| 01 | £80m | *$143m* |
| 00 | £79m | *$141m* |
| 99 | £65m | *$116m* |

Penguin increased revenues and profits by 2%. In the US, our largest market, accounting for around two-thirds of sales, our best ever schedule of new titles enabled Penguin to grow ahead of the industry despite tough conditions for backlist publishing. In the UK our backlist performed well, helped by the relaunch of Penguin Classics and the BBC's *The Big Read*.

Penguin's best-selling books included:

> Sue Monk Kidd's debut novel *The Secret Life of Bees* (2.3 million copies sold)
> John Steinbeck's *East of Eden* (1.5 million )
> Al Franken's *Lies and the Lying Liars Who Tell Them* (1.1 million)
> Scott Berg's *Kate Remembered* (0.5 million)
> Paul Burrell's *A Royal Duty* (0.9 million)
> Madonna's *The English Roses* and *Mr Peabody's Apples* (1.2 million) and
> Michael Moore's *Stupid White Men* (0.8 million).

Dorling Kindersley faced a tough backlist market but benefited from three major new titles:
> *America 24/7*
> Tom Peters' *Re-Imagine!* and
> *e-Encyclopaedia* published in association with Google™.

We increased spending on authors' advances as we invested in a number of new imprints including Portfolio (business books), Gotham (non-fiction), and The Penguin Press (non-fiction), which has already signed over 90 authors, including Alexandra Fuller,

| Sales | 2003 £m | 2003 $m | 2002 £m | 2002 $m | Change – underlying % | Change – constant currency % | Change – headline % |
|---|---|---|---|---|---|---|---|
| | 840 | 1,504 | 838 | 1,500 | 2 | 4 | 0 |
| **Operating profit** | **2003 £m** | **2003 $m** | **2002 £m** | **2002 $m** | **Change – underlying %** | **Change – constant currency %** | **Change – headline %** |
| | 91 | 163 | 87 | 156 | 2 | 8 | 5 |

Note At the beginning of 2003 we transferred our Alpha consumer technology publishing business from Pearson Education's Professional division to Penguin. Our calculation of Penguin's underlying growth includes Alpha for both 2002 and 2003.

Ron Chernow and John Berendt. We signed new multi-book deals with a number of our most successful authors including Catherine Coulter and Nora Roberts, whose books have spent a total of 71 weeks at number one on the *New York Times* bestseller list.

In the year ahead we will also be investing in channel initiatives to build the Penguin and DK brands and to reach new consumers. These include Penguin TV, which will commission non-fiction and children's programmes based on DK and Penguin books, and a pilot direct selling programme in the US.

**John Makinson** Chairman and Chief executive, Penguin Group

Pearson is the world's largest book publisher and last year we continued to integrate our book publishing operations around the world. In Australia and Canada, the first two markets where we combined Penguin and Pearson Education into one company, profits were up 17% and 12% respectively. In the UK, we have moved the two businesses to a single shared warehousing and distribution centre and in the US we have begun to consolidate central functions. The costs of these integration moves were absorbed in the operating profits of Pearson Education and Penguin in 2002 and 2003, and we continue to expect them to deliver some £20m of annual cost savings from 2005.

# Financial review

| | **2003 £m** | ***2003 $m*** | 2002 £m | *2002 $m* |
|---|---|---|---|---|
| **Adjusted operating profit** | **490** | ***877*** | 493 | *882* |
| Goodwill amortisation | **(264)** | ***(473)*** | (330) | *(591)* |
| Goodwill impairment | **–** | ***–*** | (10) | *(18)* |
| Integration costs | **–** | ***–*** | (10) | *(18)* |
| Non operating items | **6** | ***11*** | (37) | *(66)* |
| Net interest payable | **(80)** | ***(143)*** | (94) | *(168)* |
| Early repayment of debt and termination of swap contracts | **–** | ***–*** | (37) | *(66)* |
| **Profit/(loss) before taxation** | **152** | ***272*** | (25) | *(45)* |
| Taxation | **(75)** | ***(134)*** | (64) | *(115)* |
| **Profit/(loss) after taxation** | **77** | ***138*** | (89) | *(160)* |
| Equity and minority interests | **(22)** | ***(39)*** | (22) | *(39)* |
| **Profit/(loss) for the financial year** | **55** | ***99*** | (111) | *(199)* |
| Dividends | **(192)** | ***(344)*** | (187) | *(335)* |
| **Loss retained** | **(137)** | ***(245)*** | (298) | *(534)* |

It is now coming up to four years since our last major acquisition (of NCS in September 2000), and more than two years since our last major disposal (of our 22% stake in RTL in January 2002). Our portfolio is now relatively stable and, as a result, our accounts are much simpler than they were during our transformation.

Our acquisitions during the year were relatively small, and we absorbed all costs of integrating new businesses and restructuring existing ones within our operating profit. Our internet businesses are fully integrated with their print counterparts, so their financial results are no longer reported separately.

In 2003 we are showing a statutory profit for the financial year of £55m, following losses in 2002 and 2001 and helped by a lower goodwill charge.

## Financial statements

*Goodwill amortisation* Goodwill is a balance sheet item which represents the difference between the price paid for acquisitions and the fair value of the assets acquired. Pearson amortises goodwill to the profit and loss account over whichever is the shorter of the estimated useful life of the acquisition and a period of 20 years. The goodwill amortisation charge fell by £66m last year to £264m, mainly due to Family Education Network and CBS Marketwatch, where the final amortisation charges were incurred in the first half of 2003. This goodwill charge is a non-cash item which would not be incurred under US GAAP.

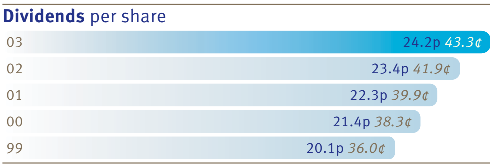
*Goodwill impairment* Goodwill is subject to an impairment review at the end of the first full year following an acquisition and at any other time if events or changes in circumstances indicate that the carrying value may not be recoverable. In 2003 no impairment charges were necessary. The charge in 2002 of £10m related to a subsidiary of Recoletos in Argentina.

*Integration costs* Integration costs are the one-off costs of integrating significant recent acquisitions into our existing businesses. The last of these significant acquisitions occurred in 2000 and the final costs of integration were incurred in 2002. In 2003 there were no integration charges and all other restructuring and related costs have been expensed through the profit and loss account as part of the ongoing operations of our businesses. The integration charges in 2002 were £7m related to the integration of NCS into Pearson Education and £3m incurred in integrating Dorling Kindersley into the Penguin Group.

*Non operating items* Non operating items relate to gains and losses on the sale or closure of businesses and on the sale of fixed assets. In 2003 we had an overall profit on non operating items of £6m, mainly relating to the sale of an associate investment in Unidesa by Recoletos. The principal items in 2002 were a profit of £18m relating to the completion of the sale of RTL and losses of £40m and £8m on the sale of the Forum business and PH Direct respectively.

*Interest* Net operating interest fell by £14m to £80m, with average net debt decreasing by £157m. Interest was further reduced by the effect of a general fall in interest rates during the year. The weighted average three month LIBOR rate, reflecting the Group's borrowings in US dollars, euros, and sterling, fell by 75 basis points, or 0.75%. The impact of these falls was dampened by our treasury policy of having 40–65% of net debt at fixed interest rates. As a result, the Group's net interest rate payable averaged approximately 4.6%, improving from 5% in the previous year. During 2002 we took a one-off charge of £37m for cancellation of certain swap contracts and the early repayment of debt following re-balancing of the Group's debt portfolio on the receipt of proceeds from the RTL disposal at the start of that year.

*Taxation* The tax charge for the year was £75m. As in previous years, this high rate of tax has come about mainly because there is only very limited tax relief available for goodwill amortisation charged in the accounts. The total tax charge of £75m includes credits of £56m relating to prior year items; these reflect a combination of settlements with Revenue authorities and changes to deferred tax balances.




The tax rate on adjusted earnings fell from 32.8% in 2002 to 31.2% in 2003. This decline reflects the factors above, the impact of the dollar exchange rate, and a more favourable mix of profits between higher and lower tax rate jurisdictions.

*Minority interests* Minority interests include a 39% minority share in IDC and a 21% minority share in Recoletos.

*Dividends* The dividend payment of £192m which we are recommending in respect of 2003 represents 24.2p per share – a 3.4% increase on 2002. The dividend is covered 1.3 times by adjusted earnings and 1.1 times by operating free cash flow. We seek to maintain a balance between the requirements of our shareholders, including our many private shareholders, for a rising stream of dividend income and the reinvestment opportunities that we see across Pearson. This balance has been expressed in recent years as a commitment to increase our annual dividend faster than the prevailing rate of inflation while progressively reinvesting a higher proportion of our distributable earnings in our business.

## Other financial items

*Pensions* Pearson operates a variety of pension schemes. Our UK fund is by far the largest and we also have some smaller defined benefit funds in the US and Canada. Outside the UK, most of our people operate 401K (essentially defined contribution) plans. Our most recent full valuation of the UK Pension Fund was in 2001 and the next full valuation will be completed during 2004. The pension funding level is kept under regular review by the company and the Fund trustees. After an informal indication in late 2002, and taking account of current stock market conditions at that time, the company increased contributions by £5m to £25m for 2003. The company also took an additional £6m charge to the profit and loss account. This additional contribution was designed to keep the scheme fully funded and to establish a contributing level (£25m) which is in line with expectations for the 2004 full valuation.

In this report we have again included additional disclosure in respect of FRS 17 ‘Retirement benefits’ for pensions and other post retirement benefits. FRS 17 approaches pension cost accounting from a balance sheet perspective with the net surplus or deficit in Pearson’s pension schemes being incorporated into the balance sheet. Changes in this surplus or deficit will flow through the profit and loss account and the statement of total recognised gains and losses. In this report we have disclosed the effect on the profit and loss account and balance sheet in the notes to the accounts (see note 10, page 85).

| Net trading assets | £m | $m |
|---|---|---|
| Intangible assets | 3,260 | 5,835 |
| Tangible assets | 468 | 838 |
| Operating working capital | 851 | 1,523 |
| Other net assets | (64) | (114) |
| **Total** | 4,515 | 8,082 |

| Capital employed | £m | $m |
|---|---|---|
| Shareholders' funds | 2,952 | 5,284 |
| Deferred tax, provisions and minorities | 202 | 362 |
| Net debt | 1.361 | 2,436 |
| **Total** | 4,515 | 8,082 |

*Accounting disclosures and policies* As described above we have again included additional disclosure in accordance with the transitional arrangements of FRS 17. In 2003 we have also considered the impact of the amendment to FRS 5 – Application Note G 'Revenue recognition' and we have revised our accounting policies in respect of multiple element sales. This change covers those contractual arrangements, such as the provision of supplementary materials with textbooks, where two or more separate elements are provided to customers. We now recognise revenue on these arrangements as if each component were an individual contractual arrangement. This revision has not given rise to a material adjustment to the financial statements.

## Managing our financial risks

This section explains the Group's approach to the management of financial risk.

*Treasury policy* The Group holds financial instruments for two principal purposes: to finance its operations and to manage the interest rate and currency risks arising from its operations and its sources of finance. The Group finances its operations by a mixture of cash flows from operations, short-term borrowings from banks and commercial paper markets, and longer term loans from banks and capital markets. The Group borrows principally in US dollars, euros and sterling, at both floating and fixed rates of interest, using derivatives, where appropriate, to generate the desired effective currency profile and interest rate basis. The derivatives used for this purpose are principally interest rate swaps, interest rate caps and collars, currency swaps and forward foreign exchange contracts. The main risks arising from the Group's financial instruments are interest rate risk, liquidity and refinancing risk, counterparty risk and foreign currency risk. These risks are managed by the chief financial officer under policies approved by the board which are summarised below. These policies have remained unchanged, except as disclosed, since the beginning of 2003. A treasury committee of the board receives reports on the Group's treasury activities, policies and procedures, which are reviewed periodically by a group of external professional advisers. The treasury department is not a profit centre and its activities are subject to internal audit.

*Interest rate risk* The Group's exposure to interest rate fluctuations on its borrowings is managed by borrowing on a fixed rate basis and by entering into interest rate swaps, interest rate caps and forward rate agreements. Since October 2002 the Group's policy objective has been to set a target proportion of its forecast borrowings (taken at the year end, with cash netted against floating rate debt) to be hedged (i.e. fixed or capped) over the next four years within a 40% to 65% range. At the end of 2003 that ratio was 61%. A 1% change in the Group's variable rate US dollar, euro and sterling interest rates would have a £5m effect on profit before tax.

*Liquidity and refinancing risk* The Group's objective is to procure continuity of funding at a reasonable cost. To do this it seeks to arrange committed funding for a variety of maturities from a diversity of sources. The Group's policy objective has been that the weighted average maturity of its core gross borrowings (treating short-term advances as having the final maturity of the facilities available to refinance them) should be between three and 10 years. At the end of 2003 the average maturity of gross borrowings was 4.9 years and non-banks provided £1,718m (89%) of them (up from 4.8 years and down from 90% respectively at the beginning of the year). The Group believes that ready access to different funding markets also helps to reduce its liquidity risk, and that published credit ratings and published financial policies improve such access. The Group manages the amount of its net debt, and the level of its net interest cover, principally by the use of a target range for its interest cover ratio. All of the Group's credit ratings remained unchanged during the year. The long-term ratings are Baa1 from Moody's and BBB+ from Standard & Poor's, and the short-term ratings are P2 and A2 respectively. The Group continues to operate on the basis that the board will take such action as it believes necessary to support and protect its current credit ratings. The Group also

| | £m | *$m* |
|---|---|---|
| Opening net debt | **(1,408)** | *(2,520)* |
| Cash inflow | | |
| Operating cash flow | **320** | *573* |
| Disposals | **52** | *93* |
| New equity | **5** | *9* |
| Cash outflow | | |
| Integration costs | **(8)** | *(14)* |
| Interest, tax, dividends and other | **(210)** | *(376)* |
| Acquisitions | **(112)** | *(201)* |
| Closing net debt | **(1,361)** | *(2,436)* |

Note: net debt excludes finance leases.

| Net borrowings fixed and floating rate | 2003 £m | $m | 2002 £m | $m |
|---|---|---|---|---|
| Fixed rate | **829** | ***1,484*** | 753 | *1,348* |
| Floating rate | **532** | ***952*** | 655 | *1,172* |
| Total | **1,361** | ***2,436*** | 1,408 | *2,520* |

| Gross borrowings | 2003 £m | $m | 2002 £m | $m |
|---|---|---|---|---|
| Bank debt | **204** | ***365*** | 193 | *345* |
| Bonds | **1,718** | ***3,075*** | 1,790 | *3,204* |
| Total | **1,922** | ***3,440*** | 1,983 | *3,549* |

| Gross borrowings by currency | 2003 £m | $m | 2002 £m | $m |
|---|---|---|---|---|
| US dollars | **1,427** | ***2,554*** | 1,350 | *2,417* |
| Sterling | **201** | ***360*** | 241 | *431* |
| Euro | **292** | ***523*** | 380 | *680* |
| Other | **2** | ***3*** | 12 | *21* |
| Total | **1,922** | ***3,440*** | 1,983 | *3,549* |

maintains undrawn committed borrowing facilities. At the end of 2003 these amounted to £950m and their weighted average maturity was 1.5 years.

*Counterparty risk* The Group's risk of loss on deposits or derivative contracts with individual banks is managed in part through the use of counterparty limits. These limits, which take published credit limits (among other things) into account, are approved by the chief financial officer. In addition, for certain longer-dated, higher-value derivative contracts, specifically, a currency swap that transforms a major part of the 6.125% eurobonds due 2007 into a US dollar liability, the Group has entered into mark-to-market agreements whose effect is to reduce significantly the counterparty risk of the relevant transactions.

*Currency risk* Although the Group is based in the UK, it has its most significant investment in overseas operations. The most significant currency for the Group is the US dollar, followed by the euro and sterling. The Group's policy on routine transactional conversions between currencies (for example, the collection of receivables, and the settlement of payables or interest) remains that these should be effected at the relevant spot exchange rate. No unremitted profits are hedged with foreign exchange contracts as the company judges it inappropriate to hedge non-cash flow translational exposure with cash flow instruments. However, the Group does seek to create a 'natural hedge' though its policy of aligning approximately the currency composition of its core borrowings in US dollars, euros and sterling with the split between those currencies of its forecast operating profit. This policy aims to dampen the impact of changes in foreign exchange rates on consolidated interest cover and earnings. Long-term core borrowing is limited to these three major currencies. However, the Group still borrows small amounts in other currencies, typically for seasonal working capital needs. At the year end the split of aggregate net borrowings in its three core currencies was US dollar 81%, euro 10% and sterling 9%.