General information

Pearson plc (the Company) and its subsidiaries (together the Group) are involved in the provision of information for the educational sector, consumer publishing and business information.

The Company is a limited liability company incorporated and domiciled in England. The address of its registered office is 80 Strand, London WC2R 0RL.

The Company has its primary listing on the London Stock Exchange but is also listed on the New York Stock Exchange.

These consolidated financial statements were approved for issue by the Board of Directors on 26 February 2006.

1 Accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below.

a. Basis of preparation

These consolidated financial statements have been prepared in accordance with EU-adopted International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations Committee (IFRIC) interpretations and with those parts of the Companies Act 1985 applicable to companies reporting under IFRS.

IFRS 1 'First-time Adoption of International Financial Reporting Standards' has been applied in preparing these financial statements. These consolidated financial statements are the Group's first financial statements to be prepared in accordance with IFRS as adopted by the EU.

The policies set out below have been consistently applied to all the years presented, with the exception of IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' which have been applied with effect from 1 January 2005.

Consolidated financial statements of Pearson plc until 31 December 2004 had been prepared in accordance with UK GAAP. UK GAAP differs in certain respects from IFRS.

When preparing the Group's 2005 consolidated financial statements, management has amended certain accounting, valuation and consolidation methods applied in the UK GAAP financial statements to comply with IFRS. The comparative figures in respect of 2004 and 2003 were restated to reflect these adjustments.

Note 34 describes how, in preparing these consolidated financial statements, the Directors have applied accounting standards as adopted for use in the EU under the first-time adoption provisions as set out in IFRS 1.

These consolidated financial statements have been prepared under the historical cost convention.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements, are disclosed below in 'Critical accounting assumptions and judgements'.

Interpretations and amendments to published standards effective in 2005

The following amendments and interpretations to standards are mandatory for the Group's accounting periods beginning on or after 1 January 2005:

– IFRIC 2 'Members' Shares in Co-operative Entities and Similar Instruments';

– SIC 12 (Amendment) 'Consolidation – Special Purpose Entities'; and

– IAS 39 (Amendment) 'Transition and Recognition of Financial Assets and Financial Liabilities'.

Management assessed the relevance of these amendments and interpretations with respect to the Group's operations and concluded that they are not relevant to the Group.

1 Accounting policies *continued*

Standards, interpretations and amendments to published standards that are not yet effective

Certain new standards, amendments and interpretations to existing standards have been published that are mandatory for the Group's accounting periods beginning on or after 1 January 2006 or later periods but which the Group has not early adopted. These are as follows:

– IFRS 7 'Financial Instruments: Disclosures' (effective from 1 January 2007). IFRS 7 introduces new disclosures of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk.

– A complementary amendment to IAS 1 'Presentation of Financial Statements – Capital Disclosures' (effective from 1 January 2007). The amendment to IAS 1 introduces disclosures about the level of an entity's capital and how it manages capital. Management is currently assessing the impact of IFRS 7 and the complementary amendment to IAS 1 on the Group's financial statements; and

– IFRIC 4 'Determining whether an Arrangement contains a Lease' (effective from 1 January 2006). IFRIC 4 requires the determination whether an arrangement is or contains a lease to be based on the substance of the arrangement. Management is currently assessing the impact of IFRIC 4 on the Group's operations, but does not expect it to be significant.

In addition, management assessed the relevance of the following amendments and interpretations with respect to the Group's operations and concluded that they are not relevant to the Group:

– IAS 39 (Amendment) 'Cash Flow Hedge Accounting of Forecast Intragroup Transactions' (effective from 1 January 2006);

– IAS 39 (Amendment) 'The Fair Value Option' (effective from 1 January 2006);

– IAS 39 (Amendment) and IFRS 4 (Amendment) 'Financial Guarantee Contracts' (effective from 1 January 2006);

– IFRS 1 (Amendment) 'First-time Adoption of International Financial Reporting Standards' (effective from 1 January 2006);

– IFRS 6 'Exploration for and Evaluation of Mineral Resources' (effective from 1 January 2006);

– IFRIC 5 'Rights of Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds' (effective from 1 January 2006); and

– IFRIC 6 'Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment' (effective from 1 December 2005).

b. Consolidation

(1) Subsidiaries – Subsidiaries are entities over which the Group has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. Subsidiaries are fully consolidated from the date on which control is transferred to the Group and are de-consolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. Acquisitions made prior to the date of transition to IFRS were accounted for in accordance with UK GAAP (see note 34). The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets and contingent assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired, after the identification of purchased intangible assets, is recorded as goodwill. See note 1e*(1)* for the accounting policy on goodwill.

(2) Joint ventures and associates – Joint ventures are entities in which the Group holds an interest on a long-term basis and which are jointly controlled, with one or more other ventures, under a contractual arrangement. Associates are entities over which the Group has significant influence but not the power to control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in joint ventures and associates are accounted for by the equity method of accounting and are initially recognised at cost. The Group's investment in associates includes related goodwill.

1 Accounting policies *continued*

The Group's share of its joint ventures' and associates' post-acquisition profits or losses is recognised in the income statement, and its share of post-acquisition movements in reserves is recognised in reserves. The Group's share of its joint ventures' and associates' results is recognised as a component of operating profit as these operations form part of the core publishing business of the Group and an integral part of existing wholly owned businesses. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the Group's share of losses in a joint venture or associate equals or exceeds its interest in the joint venture or associate, the Group does not recognise further losses, unless the Group has incurred obligations or made payments on behalf of the joint venture or associate.

c. Foreign currency translation

(1) Functional and presentation currency – Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The consolidated financial statements are presented in Sterling, which is the Company's functional and presentation currency.

(2) Transactions and balances – Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies, are recognised in the income statement, except when deferred in equity as qualifying net investment hedges.

Translation differences on other non-monetary items such as equities held at fair value are reported as part of the fair value gain or loss through the income statement. Fair value adjustments on non-monetary items such as equities classified as available for sale financial assets, are included in the fair value reserve in equity as from 1 January 2005.

(3) Group companies – The results and financial position of all Group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

i) assets and liabilities are translated at the closing rate at the date of the balance sheet;

ii) income and expenses are translated at average exchange rates;

iii) all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders' equity. The Group treats specific inter-company loan balances, which are not intended to be repaid for the foreseeable future, as part of its net investment. When a foreign entity is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale.

At the date of transition to IFRS the cumulative translation differences for foreign operations have been deemed to be zero. Any gains and losses on disposals of foreign operations will exclude translation differences arising prior to the transition date.

The principal overseas currency for the Group is the US Dollar. The average rate for the year against Sterling was $1.81 (2004: $1.83; 2003: $1.63) and the year end rate was $1.72 (2004: $1.92; 2003: $1.79).

d. Property, plant and equipment

Property, plant and equipment is stated at historical cost less depreciation. Land is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives as follows:

Buildings (freehold)	20–50 years
Buildings (leasehold)	50 years (or over the period of the lease if shorter)
Plant and equipment	3–20 years

The asset's residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

1 Accounting policies *continued*

e. Intangible assets

(1) Goodwill – Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary or associate at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of associates is included in investments in associates. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold. IFRS 3 'Business Combinations' has not been applied retrospectively to business combinations before the date of transition to IFRS. Subject to the transition adjustments to IFRS required by IFRS 1, the accounting for business combinations before the date of transition has been grandfathered.

(2) Software development costs – Costs directly associated with the production of identifiable and unique software products, where it is probable that they will generate economic benefits exceeding costs, are recognised as intangible assets and are amortised over their estimated useful lives not exceeding ten years from when the software is available for use.

(3) Acquired intangible assets – Acquired intangible assets comprise publishing rights, customer lists and relationships, technology, trade names and trademarks. These assets are capitalised on acquisition and included in intangible assets and amortised over their estimated useful lives between two and 30 years.

(4) Pre-publication costs – Pre-publication costs represent direct costs incurred in the development of educational programmes and titles prior to their publication. These costs are carried forward in current intangible assets where the title will generate probable future economic benefits and costs can be measured reliably. These costs are amortised upon publication of the title over estimated economic lives of five years or less, being an estimate of the expected operating life cycle of the title, with a higher proportion of the amortisation taken in the earlier years. The investment in pre-publication has been disclosed as part of the investing activities in the cash flow statement.

f. Other financial assets

Up to 31 December 2004 – Other financial assets include investments in companies other than subsidiaries and associates and other securities. Financial fixed assets are recorded at historical cost less provisions for diminution in value.

From 1 January 2005 – Other financial assets, designated as available for sale investments, are non-derivative financial assets measured at estimated fair value. Changes in the fair value are recorded in equity in the fair value reserve. On the subsequent disposal of the asset, the net fair value gains or losses are taken through the income statement.

g. Inventories

Inventories are stated at the lower of cost and net realisable value. Cost is determined using the first in first out (FIFO) method. The cost of finished goods and work in progress comprises raw materials, direct labour and other direct costs and related production overheads. Net realisable value is the estimated selling price in the ordinary course of business, less estimated costs necessary to make the sale. Provision is made for slow moving and obsolete stock.

h. Royalty advances

Advances of royalties to authors are included within trade and other receivables when the advance is paid less any provision required to bring the amount down to its net realisable value. The royalty advance is expensed at the contracted or effective royalty rate as the related revenues are earned. Royalty advances which will be consumed within one year are held in current assets. This represents the operating cycle of consumer publishing titles. Royalty advances which will be consumed after one year are held in non-current assets.

i. Newspaper development costs

Investment in the development of newspaper titles consists of measures to increase the volume and geographical spread of circulation. The measures include additional and enhanced editorial content, extended distribution and remote printing. These extra costs arising are expensed as incurred as they do not meet the criteria under IAS 38 to be capitalised as intangible assets.

1 Accounting policies *continued*

j. Cash and cash equivalents

Cash and cash equivalents in the statement of cash flows include cash in hand, deposits held at call with banks, other short term highly liquid investments with original maturities of three months or less, and bank overdrafts. Bank overdrafts are shown within borrowings in current liabilities in the balance sheet.

k. Share capital

Ordinary shares are classified as equity.

Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

Where any Group company purchases the Company's equity share capital (Treasury shares) the consideration paid, including any directly attributable incremental costs (net of income taxes) is deducted from equity attributable to the Company's equity holders until the shares are cancelled, reissued or disposed of. Where such shares are subsequently sold or reissued, any consideration received, net of any directly attributable incremental transaction costs and the related income tax effects, is included in equity attributable to the Company's equity holders.

l. Borrowings

Borrowings are recognised initially at fair value, which is proceeds received net of transaction costs incurred. Borrowings are subsequently stated at amortised cost with any difference between the proceeds (net of transaction costs) and the redemption value being recognised in the income statement over the period of the borrowings using the effective interest method. From 1 January 2005, accrued interest is also included as part of the borrowing. Where a debt instrument is in a fair value hedging relationship, an adjustment is made to the bond carrying value to reflect the hedged risk.

m. Derivative financial instruments

Up to 31 December 2004 – Amounts payable or receivable in respect of interest rate derivatives are accrued within net interest payable over the period of the contract. Where the derivative instrument is terminated early, the gain or loss is spread over the remaining maturity of the original instrument. Where the underlying exposure ceases to exist, any termination gain or loss is taken to the income statement. Foreign currency borrowings together with their related cross currency derivatives are carried in the balance sheet at the relevant exchange rates at the balance sheet date. Gains or losses in respect of the hedging of overseas subsidiaries are taken to reserves. Gains or losses arising from foreign exchange contracts are taken to the income statement in line with the transactions which they are hedging.

From 1 January 2005 – Derivatives are initially recognised at fair value at the date of transition to IAS 39 or, if later, on the date a derivative is entered into. Derivatives are subsequently remeasured at their fair value. The fair value of derivatives has been determined by using market data and the use of established estimation techniques such as discounted cashflow and option valuation models. The Group designates certain of the derivative instruments within its portfolio to be hedges of the fair value of its bonds (fair value hedges) or hedges of net investments in foreign operations (net investment hedges).

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

The effective portion of changes in the fair value of derivatives that are designated and qualify as net investment hedges are recognised in equity. Gains and losses accumulated in equity are included in the income statement when the corresponding foreign operation is disposed of. Gains or losses relating to the ineffective portion are recognised immediately in finance income or finance costs in the income statement.

1 Accounting policies *continued*

Certain derivatives do not qualify or are not designated as hedging instruments. Such derivatives are classified at fair value and any movement in their fair value is recognised in finance income or finance costs in the income statement immediately.

n. Taxation

Current tax is recognised on the amounts expected to be paid or recovered under the tax rates and laws that have been enacted or substantively enacted at the balance sheet date.

Deferred income tax is provided, using the liability method on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred tax asset is realised or the deferred income tax liability is settled.

Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred income tax is provided in respect of the undistributed earnings of subsidiaries other than where it is intended that those undistributed earnings will not be remitted in the foreseeable future.

Current and deferred tax are recognised in the income statement, except when the tax relates to items charged or credited directly to equity, in which case the tax is also recognised in equity.

o. Employee benefits

(1) Retirement benefit obligations – The Group has elected to early adopt the amendment to IAS 19 'Employee Benefits' with effect from the date of transition to IFRS. The liability in respect of defined benefit pension plans is the present value of the defined benefit obligations at the balance sheet date minus the fair value of plan assets. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting estimated future cash flows using yields on high quality corporate bonds which have terms to maturity approximating the terms of the related liability.

Actuarial gains and losses arising from differences between actual and expected returns on plan assets, experience adjustments on liabilities and changes in actuarial assumptions are recognised immediately in the statement of recognised income and expense.

The service cost, representing benefits accruing over the year, is included as an operating cost and the unwinding of the discount rate on the scheme liabilities and the expected return on scheme assets as a financing charge or financing income.

Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement as incurred.

(2) Other post-retirement obligations – The Group provides certain healthcare and life assurance benefits. The principal plans are unfunded. The expected costs of these benefits are accrued over the period of employment, using an accounting methodology which is the same as that for defined benefit pension plans. The liabilities and costs relating to other post-retirement obligations are assessed annually by independent qualified actuaries.

(3) Share-based compensation – The Group has a number of employee option and performance share schemes. The fair value of options granted is recognised as an employee expense after taking into account the Company's best estimate of the number of awards expected to vest. Fair value is measured at the date of grant and is spread over the vesting period of the instrument. The fair value of the options granted is measured using whichever of the Black-Scholes, Binomial and Monte Carlo model is most appropriate to the award. Any proceeds received are credited to share capital and share premium when the options are exercised. The Group has applied IFRS 2 'Share-based Payment' retrospectively to all options granted but not fully vested at the date of transition to IFRS.

p. Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is more likely than not that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated. Provisions are discounted to present value where the effect is material.

1 Accounting policies *continued*

The Group recognises a provision for deferred consideration in the period that an acquisition is made and the Group becomes legally committed to making the payment.

The Group recognises a provision for integration and reorganisation costs in the period in which the Group becomes legally or constructively committed to making the payment.

The Group recognises a provision for onerous lease contracts when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under the contract. The provision is based on the present value of future payments for surplus leased properties under non-cancellable operating leases, net of estimated sub-leasing revenue.

q. Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sale of goods and services net of value-added tax and other sales taxes, rebates and discounts, and after eliminating sales within the Group. Revenue is recognised as follows:

Revenue from the sale of books is recognised when title passes. Anticipated returns are estimated based primarily on historical return rates. Circulation and advertising revenue is recognised when the newspaper or other publication is published. Subscription revenue is recognised on a straight-line basis over the life of the subscription.

Where a contractual arrangement consists of two or more separate elements that can be provided to customers either on a stand-alone basis or as an optional extra, such as the provision of supplementary materials with textbooks, revenue is recognised for each element as if it were an individual contractual arrangement.

Revenue from multi-year contractual arrangements, such as contracts to process qualifying tests for individual professions and government departments, is recognised as performance occurs. Certain of these arrangements, either as a result of a single service spanning more than one reporting period or where the contract requires the provision of a number of services that together constitute a single project, are treated as long-term contracts with revenue recognised on a percentage of completion basis. Losses on contracts are recognised in the period in which the loss first becomes foreseeable. Contract losses are determined to be the amount by which estimated total costs of the contract exceed the estimated total revenues that will be generated by the contract.

On certain contracts, where the Group acts as agent, only commissions and fees receivable for services rendered are recognised as revenue. Any third party costs incurred on behalf of the principal that are rechargeable under the contractual arrangement are not included in revenue.

r. Leases

Leases of property, plant and equipment where the Group has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalised at the commencement of the lease at the lower of the fair value of the leased property and the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. The corresponding rental obligations, net of finance charges, are included in other long-term payables. The interest element of the finance cost is charged to the income statement over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. The property, plant and equipment acquired under finance leases is depreciated over the shorter of the useful life of the asset or the lease term.

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases by the lessee. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

s. Dividends

Dividends are recorded in the Group's financial statements in the period in which they are approved by the Company's shareholders. Interim dividends are recorded in the period in which they are approved and paid.

1 Accounting policies *continued*

t. Non-current assets held for sale and discontinued operations

Non-current assets are classified as assets held for sale and stated at the lower of carrying amount and fair value less costs to sell if it is intended to recover their carrying amount principally through a sale transaction rather than through continuing use. No depreciation is charged in respect of non-current assets classified as held for sale.

u. Trade receivables

Trade receivables are recognised at fair value less provision for bad and doubtful debts and anticipated future sales returns (see also note 1q).

Critical accounting assumptions and judgements

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting assumptions. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas requiring a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements, are discussed below.

Critical accounting estimates and assumptions

(1) Revenue recognition – Revenue from the sale of books is recognised when title passes. A provision for anticipated returns is made based primarily on historical return rates. If these estimates do not reflect actual returns in future periods then revenues could be understated or overstated for a particular period. The provision for sales returns is set out in note 19.

(2) Pre-publication costs – The assessment of the useful life of pre-publication costs and the calculation of amortisation involve a significant amount of judgement based on historical trends and management estimation of their future potential sales, in accordance with the accounting policy stated in note 1e*(4)*. The overstatement of useful lives could result in excess amounts being carried forward as intangible assets that would otherwise have been written off to the income statement in an earlier period. Reviews are performed regularly to estimate recoverability of pre-publication costs. The carrying amount of pre-publication costs is set out in note 17.

(3) Royalty advances – The realisable value of royalty advances relies on a degree of management judgement in determining the profitability of individual author contracts, in accordance with the accounting policy stated in note 1h. If the estimated realisable value of author contracts is overstated then this will have an adverse effect on operating profits as these excess amounts will be written off. The carrying amount of royalty advances is set out in note 19.

(4) Income taxes – The Group is subject to income taxes in numerous jurisdictions. Significant judgement is required in determining the estimates in relation to the worldwide provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. The Group recognises liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

(5) Goodwill – The Group tests annually whether goodwill has suffered any impairment, in accordance with the accounting policy stated in note 1e*(1)*. The recoverable amounts of cash generating units have been determined based on value in use calculations. These calculations require the use of estimates (see note 12).

Critical judgements in applying the Group's accounting policies

(1) Revenue recognition – Revenue from multi-year contractual arrangements is recognised as performance occurs. The assumptions, risks, and uncertainties inherent in long-term contract accounting can affect the amounts and timing of revenue and related expenses reported.

(2) Retirement benefit obligations – The determination of the pension cost and defined benefit obligation of the Group's defined benefit pension schemes depends on the selection of certain assumptions, which include the discount rate, inflation rate, salary growth, longevity and expected return on scheme assets. Differences arising from actual experience or future changes in assumptions will be reflected in subsequent periods.

1 Accounting policies *continued*

(3) Deferred income tax – Deferred tax assets and liabilities require management judgement in determining the amounts to be recognised. In particular, significant judgement is used when assessing the extent to which deferred tax assets should be recognised with consideration given to the timing and level of future taxable income together with any future tax planning strategies.

Financial risk management

The Group's treasury policy governs the management of financial risks within the Group. The policy, which is approved by the treasury committee, covers interest rate risk, liquidity and refinancing risk, counterparty risk and foreign currency risk. In accordance with the treasury policy, the Group actively monitors and manages its financial risk exposures. The policy permits the use of financial instruments such as derivatives, where appropriate. The policy only permits transactions related to underlying positions and speculative transactions are not permitted.

Interest rate risk – A change in market interest rates can cause fluctuations in the Group's net income or financial position. The Group is predominantly funded through bonds issued at fixed rates and nearly all of these bonds have been swapped to a floating rate for the term of the debt. The Group's policy (as updated in September 2005) requires that interest rates on its net debt position are fixed for the next four years such that the fixed rate portion is within a range of 65% to 40% in the first year, with the lower end of the range declining by 10% each year such that the fixed rate portion falls within a range of 65% to 10% in year four. The Group also uses derivatives to change the currency profile of its debt and to alter the timing of floating interest rate resets in order to comply with its policy. The Group manages the derivatives and debt to achieve policy objectives on a portfolio basis. The Group designates derivatives as hedges under IAS 39 where hedge accounting is possible, so long as a designation will not have an adverse effect on the balancing of the portfolio.

Liquidity and refinancing risk – The Group's funding objective is to ensure that committed funding is available to the Group at a reasonable cost, with an extended maturity profile and that funding is available from diverse sources. To assist with the diversity of funding objective, the Group has ratings with Moody's and Standard & Poor's, which provides greater access to international capital markets.

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 reflecting published credit ratings. Exposures to individual counterparties are monitored on a regular basis. Where appropriate, ISDA Master Agreements permitting the netting of transactions in the event of counterparty failure are entered into with derivative counterparties.

Foreign currency risk – The Group has operations overseas and is therefore exposed to movements in foreign currencies, particularly the US dollar. For transactional foreign exchange exposure, the policy allows the use of derivatives where appropriate. The Group mainly converts foreign currencies at spot rate and had no cash flow hedges in place at the balance sheet date. Translational foreign exchange exposure is of more significance to the Group. It seeks to offset this exposure through its policy of aligning approximately the currency composition of its core net borrowings with its forecast operating profit. This policy only applies where a currency accounts for more than 15% of Group operating profit and currently is only applicable to the US dollar. The Group uses its dollar denominated debt and the foreign exchange portion of certain cross currency rate derivatives as net investment hedges of foreign operations. Unremitted profits are not hedged with foreign exchange contracts, as the Company judges it inappropriate to hedge non-cash flow translational exposure with cash flow instruments.

2 Segment information

Due to the differing risks and rewards associated with each business segment and the different customer focus of each segment, business is the Group's primary reporting segment. At 31 December 2005 the Group is organised into five primary business segments, School, Higher Education, Penguin, FT Publishing and Interactive Data Corporation (IDC). The remaining business group, Professional, brings together a number of education publishing, testing and services businesses and does not meet the criteria for classification as a 'segment' under IFRS.

Primary reporting format – business segments

All figures in £ millions	School	Higher Education	Professional	Penguin	FT Publishing	IDC	Corporate	2005 Group
Continuing operations								
Sales (external)	1,295	779	589	804	332	297	–	4,096
Sales (inter-segment)	–	–	–	16	–	–	–	16
Operating profit before joint ventures and associates	138	156	44	60	49	75	–	522
Share of results of joint ventures and associates	4	–	1	–	9	–	–	14
Operating profit	142	156	45	60	58	75	–	536
Finance costs								(132)
Finance income								62
Profit before tax								466
Income tax								(124)
Profit for the year from continuing operations								342
Reconciliation to adjusted operating profit								
Operating profit	142	156	45	60	58	75	–	536
Amortisation of acquired intangibles	5	–	–	–	1	5	–	11
Other net gains and losses	–	–	–	–	(40)	–	–	(40)
Other net finance costs of associates	–	–	–	–	2	–	–	2
Adjusted operating profit – continuing operations	147	156	45	60	21	80	–	509
Segment assets	2,067	1,402	1,705	960	154	291	985	7,564
Joint ventures	6	–	–	2	4	–	–	12
Associates	6	–	–	–	18	–	–	24
Total assets	2,079	1,402	1,705	962	176	291	985	7,600
Total liabilities	(557)	(341)	(263)	(280)	(336)	(109)	(1,981)	(3,867)
Other segment items								
Capital expenditure (notes 11, 12 and 17)	114	96	43	34	14	19	–	320
Depreciation (note 11)	26	8	17	7	11	11	–	80
Amortisation (notes 12 and 17)	91	78	20	24	3	5	–	221

2 Segment information *continued*

All figures in £ millions	School	Higher Education	Professional	Penguin	FT Publishing	IDC	Corporate	2004 Group
Continuing operations								
Sales (external)	1,087	729	507	786	318	269	–	3,696
Sales (inter-segment)	–	–	–	15	–	–	–	15
Operating profit before joint ventures and associates	109	133	42	46	4	62	–	396
Share of results of joint ventures and associates	3	–	–	1	4	–	–	8
Operating profit	112	133	42	47	8	62	–	404
Finance costs								(96)
Finance income								17
Profit before tax								325
Income tax								(63)
Profit for the year from continuing operations								262
Reconciliation to adjusted operating profit								
Operating profit	112	133	42	47	8	62	–	404
Amortisation of acquired intangibles	–	–	–	–	–	5	–	5
Other net gains and losses	(4)	(4)	(2)	5	(4)	–	–	(9)
Adjusted operating profit – continuing operations	108	129	40	52	4	67	–	400
Segment assets	1,860	1,224	1,345	892	502	247	461	6,531
Joint ventures	7	–	–	5	2	–	–	14
Associates	5	–	–	–	28	–	–	33
Total assets	1,872	1,224	1,345	897	532	247	461	6,578
Total liabilities	(439)	(286)	(212)	(259)	(435)	(110)	(1,823)	(3,564)
Other segment items								
Capital expenditure (notes 11, 12 and 17)	104	79	62	36	15	12	–	308
Depreciation (note 11)	25	9	16	9	16	9	–	84
Amortisation (notes 12 and 17)	74	65	18	29	2	5	–	193

2 Segment information *continued*

All figures in £ millions	School	Higher Education	Professional	Penguin	FT Publishing	IDC	Corporate	2003 Group
Continuing operations								
Sales (external)	1,149	770	503	840	315	273	–	3,850
Sales (inter-segment)	–	–	1	15	–	–	–	16
Operating profit before joint ventures and associates	112	140	33	81	(28)	66	–	404
Share of results of joint ventures and associates	2	–	–	1	(1)	–	–	2
Operating profit	114	140	33	82	(29)	66	–	406
Finance costs								(100)
Finance income								7
Profit before tax								313
Income tax								(61)
Profit for the year from continuing operations								252
Reconciliation to adjusted operating profit								
Operating profit	114	140	33	82	(29)	66	–	406
Amortisation of acquired intangibles	–	–	–	–	–	4	–	4
Other net gains and losses	2	2	1	1	–	–	–	6
Adjusted operating profit – continuing operations	116	142	34	83	(29)	70	–	416
Segment assets	2,072	1,157	1,387	907	358	240	551	6,672
Joint ventures	6	–	–	4	2	–	–	12
Associates	5	–	–	–	47	–	–	52
Total assets	2,083	1,157	1,387	911	407	240	551	6,736
Total liabilities	(458)	(318)	(158)	(398)	(203)	(113)	(1,927)	(3,575)
Other segment items								
Capital expenditure (notes 11, 12 and 17)	101	65	21	47	26	17	–	277
Depreciation (note 11)	26	9	13	6	19	12	–	85
Amortisation (notes 12 and 17)	68	58	18	39	2	5	–	190

Corporate costs are allocated to business segments on an appropriate basis depending on the nature of the cost and therefore the segment result is equal to the Group result . Inter-segment pricing is determined on an arm's length basis. Segment assets consist primarily of property, plant and equipment, intangible assets, inventories, receivables and deferred taxation and exclude cash and cash equivalents and derivative assets. Segment liabilities comprise operating liabilities and exclude borrowings and derivative liabilities. Corporate assets and liabilities comprise cash and cash equivalents, borrowings and derivative financial instruments. Capital expenditure comprises additions to property, plant and equipment and intangible assets, including pre-publication but excluding goodwill (see notes 11, 12 and 17).

2 Segment information *continued*

Property plant and equipment and intangible assets acquired through business combinations were £111m (2004: £16m; 2003: £54m) (see notes 11, 12 and 17). Capital expenditure, depreciation and amortisation includes amounts relating to discontinued operations. In April 2005, Pearson sold its 79% interest in Recoletos Grupo de Communicación S.A. This operation is now disclosed as a 'discontinued' operation. The related assets and liabilities are disclosed within the FT Publishing segment in 2004 and 2003.

Secondary reporting format – geographical segments

Although the Group's business segments are managed on a worldwide basis, they all operate in the following main geographical areas:

	Sales			Total assets			Capital expenditure		
All figures in £ millions	2005	2004	2003	2005	2004	2003	2005	2004	2003
Continuing operations									
European countries	963	835	768	1,711	1,112	1,003	60	79	63
North America	2,717	2,504	2,742	5,476	4,716	5,015	242	208	188
Asia Pacific	300	263	255	325	302	301	13	10	11
Other countries	116	94	85	52	43	37	2	3	4
Total	4,096	3,696	3,850	7,564	6,173	6,356	317	300	266
Discontinued operations (European countries)	27	190	169	–	358	316	3	8	11
Joint ventures and associates	–	–	–	36	47	64	–	–	–
Total	4,123	3,886	4,019	7,600	6,578	6,736	320	308	277

Sales are allocated based on the country in which the customer is located. This does not differ materially from the location where the order is received. Total assets and capital expenditure are allocated to where the assets are located.

3 Discontinued operations

In April 2005, Pearson sold its 79% interest in Recoletos Grupo de Communicación S.A. to Retos Cartera, a consortium of investors. This operation is disclosed as a 'discontinued' operation (see note 28).

An analysis of the result and cash flows of discontinued operations is as follows:

All figures in £ millions	2005	2004	2003
Sales	27	190	169
Operating (loss)/profit	(3)	26	43
Net finance income	–	3	3
(Loss)/profit before tax	(3)	29	46
Attributable tax benefit/(expense)	1	(7)	(23)
(Loss)/profit after tax	(2)	22	23
Profit on disposal of discontinued operations (note 28)	306	–	–
Attributable tax expense	(2)	–	–
Profit for the year from discontinued operations	302	22	23
Operating cash flows	(6)	12	11
Investing cash flows	–	17	47
Financing cash flows	–	–	(92)
Total cash flows	(6)	29	(34)

4 Other net gains and losses

All figures in £ millions	2005	2004	2003
Profit on sale of interest in MarketWatch	40	–	–
Other items	–	9	(6)
Total other net gains and losses	40	9	(6)

Other net gains and losses represent profits and losses on the sale of subsidiaries, joint ventures, associates and other financial assets that are included within continuing operations.

5 Operating expenses

All figures in £ millions	2005	2004	2003
By function:			
Cost of goods sold	2,022	1,789	1,846
Operating expenses			
Distribution costs	249	201	206
Administrative and other expenses	1,384	1,365	1,439
Other income	(41)	(46)	(51)
Total operating expenses	1,592	1,520	1,594
Total	3,614	3,309	3,440
By nature:			
Utilisation of inventory	768	700	710
Depreciation of property, plant and equipment (note 11)	80	78	79
Amortisation of intangible assets – pre-publication (note 17)	192	168	158
Amortisation of intangible assets – other (note 12)	29	25	32
Employee benefit expense (note 6)	1,273	1,154	1,156
Operating lease rentals	119	126	148
Other property costs	88	73	61
Royalties expensed	363	331	354
Advertising, promotion and marketing	202	181	193
Information technology costs	84	76	85
Other costs	457	443	515
Other income	(41)	(46)	(51)
Total	3,614	3,309	3,440

5 Operating expenses *continued*

During the year the Group obtained the following services from the Group's auditor:

All figures in £ millions	2005	2004	2003
Statutory audit	4	3	3
Audit-related regulatory reporting services	1	1	–
Non-audit services:			
Tax compliance	1	1	1
Tax advisory	–	1	1
Other non-audit services	1	–	–

Audit-related regulatory reporting services were £700,000 (2004: £600,000; 2003: £nil). This relates to services in respect of the transition to IFRS and Sarbanes-Oxley section 404 compliance services. Other non-audit services were £700,000 (2004: £100,000; 2003: £400,000) and mainly relate to due diligence work performed at IDC.

Non-audit fees in the UK were £1.0m (2004: £1.0m; 2003: £300,000) and were in respect of tax advisory, tax compliance and other advisory services. The remainder of the non-audit fees related to overseas subsidiaries.

6 Employee information

All figures in £ millions	2005	2004	2003
Employee benefit expense			
Wages and salaries (including termination benefits and restructuring costs)	1,088	983	988
Social security costs	101	89	87
Share-based payment costs (note 24)	23	25	29
Pension costs – defined contribution plans (note 24)	35	32	28
Pension costs – defined benefit plans (note 24)	25	24	23
Other post-retirement benefits (note 24)	1	1	1
	1,273	1,154	1,156

The details of the emoluments of the directors of Pearson plc are shown on pages 21 to 37.

Average number employed	2005	2004	2003
School	10,133	10,403	9,348
Higher Education	4,196	4,087	3,912
Professional	8,342	7,491	6,434
Penguin	4,051	4,085	4,318
FT Publishing	1,952	1,989	2,283
IDC	1,956	1,826	1,628
Other	1,573	1,365	928
Continuing operations	32,203	31,246	28,851
Discontinued operations	–	1,840	1,733
	32,203	33,086	30,584

7 Net finance costs

All figures in £ millions	2005	2004	2003
Interest payable	(98)	(91)	(91)
Finance costs re employee benefits	(7)	(5)	(9)
Net foreign exchange losses	(9)	–	–
Other losses on financial instruments in a hedging relationship:			
– fair value hedges	(1)	–	–
– net investment hedges	–	–	–
Other losses on financial instruments not in a hedging relationship:			
– derivatives	(17)	–	–
Finance costs	(132)	(96)	(100)
Interest receivable	21	17	7
Net foreign exchange gains	21	–	–
Other gains on financial instruments in a hedging relationship:			
– fair value hedges	1	–	–
– net investment hedges	3	–	–
Other gains on financial instruments not in a hedging relationship:			
– amortisation of transitional adjustment on bonds	7	–	–
– derivatives	9	–	–
Finance income	62	17	7
Net finance costs	(70)	(79)	(93)
Analysed as:			
Net interest payable	(77)	(74)	(84)
Finance costs re employee benefits	(7)	(5)	(9)
Net finance costs reflected in adjusted earnings	(84)	(79)	(93)
Other net finance income	14	–	–
Total net finance costs	(70)	(79)	(93)

8 Income tax

All figures in £ millions	2005	2004	2003
Current tax			
Charge in respect of current year	(76)	(65)	(45)
Adjustments in respect of prior years	(1)	25	13
Total current tax charge	(77)	(40)	(32)
Deferred tax			
In respect of timing differences	(66)	(46)	(72)
Adjustments in respect of prior years	19	23	43
Total deferred tax charge (note 14)	(47)	(23)	(29)
Total tax charge	(124)	(63)	(61)

The tax on the Group's profit before tax differs from the theoretical amount that would arise using the UK tax rate as follows:

All figures in £ millions	2005	2004	2003
Profit before tax	466	325	313
Tax calculated at UK rate	(140)	(97)	(94)
Effect of overseas tax rates	(22)	(8)	(6)
Joint venture and associate income reported net of tax	5	2	–
Income not subject to tax	16	6	11
Expenses not deductible for tax purposes	(9)	(5)	(7)
Utilisation of previously unrecognised tax losses	11	5	15
Unutilised tax losses	(3)	(14)	(36)
Prior year adjustments	18	48	56
Total tax charge	(124)	(63)	(61)
UK	(26)	5	(13)
Overseas	(98)	(68)	(48)
Total tax charge	(124)	(63)	(61)
Add back: tax benefit on other gains and losses	(4)	(36)	(35)
Add back: tax benefit on amortisation of acquired intangibles	(4)	(2)	(1)
Add back: tax charge on other finance income	3	–	–
Adjusted income tax charge – continuing operations	(129)	(101)	(97)
Adjusted income tax charge – discontinued operations	1	(7)	(19)
Total adjusted income tax charge	(128)	(108)	(116)
Tax rate reflected in adjusted earnings	30.3%	30.9%	32.5%

8 Income tax *continued*

The tax benefit on items charged to equity is as follows:

All figures in £ millions	2005	2004	2003
Deferred tax on stock options	3	4	–
Current tax on foreign exchange gains and losses	9	5	–
	12	9	–

9 Earnings per share

Basic

Basic earnings per share is calculated by dividing the profit attributable to equity shareholders of the Company by the weighted average number of ordinary shares in issue during the year, excluding ordinary shares purchased by the Company and held as treasury shares.

Diluted

Diluted earnings per share is calculated by adjusting the weighted average number of ordinary shares to take account of all dilutive potential ordinary shares and adjusting the profit attributable, if applicable, to account for any tax consequences that might arise from conversion of those shares.

Adjusted

In order to show results from operating activities on a comparable basis, an adjusted earnings per share is presented.

The following items are excluded in the calculation of adjusted earnings:

Other gains and losses represent profits and losses on the sale of subsidiaries, joint ventures, associates and other financial assets that are included within operating profit or represent the profit or loss on sale of a discontinued operation. Such profits and losses are considered to distort the performance in any year.

Amortisation of acquired intangibles is the amortisation of intangible assets acquired through business combinations. The amortisation charge is not considered to be fully reflective of the underlying performance of the Group.

Other net finance income/costs are foreign exchange and other gains and losses that represent short-term fluctuations in market value and foreign exchange movements on transactions and balances that are no longer in a hedge relationship under IFRS. These gains and losses are subject to significant volatility and may not be realised in due course as it is normally the intention to hold these instruments to maturity. The increased volatility has been introduced as a result of adopting IAS 39 'Financial Instruments: Recognition and Measurement' as at 1 January 2005 (see note 34) and through the application of IAS 21 'The Effects of Changes in Foreign Exchange Rates'. Other net finance costs of Group companies are included in finance costs or finance income as appropriate. Other net finance costs of joint ventures and associates are included within the share of results of joint ventures and associates within operating profit.

The related tax and minority interest for the above items is also excluded from adjusted earnings.

The Company's definition of adjusted earnings per share may not be comparable to other similarly titled measures reported by other companies.

9 Earnings per share *continued*

All figures in £ millions	2005	2004	2003
Earnings	624	262	252
Adjustments to exclude profit for the year from discontinued operations:			
Profit for the year from discontinued operations	(302)	(22)	(23)
Minority interest share of above	–	5	5
Earnings – continuing operations	322	245	234
Earnings	624	262	252
Adjustments:			
Other gains and losses	(40)	(9)	(6)
Amortisation of acquired intangibles (note 12)	11	5	4
Other net finance costs of associates	2	–	–
Profit on sale of discontinued operations (note 3)	(306)	–	–
Other finance income (note 7)	(14)	–	–
Taxation on above items	(3)	(38)	(32)
Minority interest share of above items	(2)	(1)	1
Adjusted earnings	272	219	219
Amortisation of acquired intangibles (net of taxation and minority interest)	(5)	(2)	(2)
Adjusted earnings including effect of amortisation of acquired intangibles	267	217	217
Weighted average number of shares (millions)	797.9	795.6	794.4
Effect of dilutive share options (millions)	1.1	1.1	0.9
Weighted average number of shares (millions) for diluted earnings	799.0	796.7	795.3

9 Earnings per share *continued*

	2005	2004	2003
Earnings per share from continuing and discontinued operations			
Basic	78.2p	32.9p	31.7p
Diluted	78.1p	32.9p	31.7p
Earnings per share from continuing operations			
Basic	40.4p	30.8p	29.4p
Diluted	40.3p	30.8p	29.4p
Earnings per share from discontinued operations			
Basic	37.8p	2.1p	2.3p
Diluted	37.8p	2.1p	2.3p
Adjusted earnings per share	34.1p	27.5p	27.6p
Adjusted earnings per share including effect of amortisation of acquired intangibles	33.5p	27.3p	27.3p

10 Dividends

All figures in £ millions	2005	2004	2003
Final paid in respect of prior year 15.7p (2004: 14.8p; 2003: 14.3p)	125	119	115
Interim paid in respect of current year 10p (2004: 9.7p; 2003: 9.4p)	80	76	73
	205	195	188

The directors are proposing a final dividend in respect of the financial year ending 31 December 2005 of 17.0p per share which will absorb an estimated £136m of shareholders' funds. It will be paid on 5 May 2006 to shareholders who are on the register of members on 7 April 2006. These financial statements do not reflect this dividend payable (see note 34*k*).

11 Property, plant and equipment

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Cost				
At 1 January 2003	319	619	20	958
Exchange differences	(19)	(28)	(3)	(50)
Additions	12	52	14	78
Disposals	(15)	(55)	–	(70)
Acquisition through business combination	5	19	–	24
Disposal through business disposal	(2)	(6)	–	(8)
Reclassifications	1	9	(10)	–
At 31 December 2003	301	610	21	932
Exchange differences	(9)	(10)	(1)	(20)
Additions	14	81	8	103
Disposals	(13)	(39)	–	(52)
Acquisition through business combination	1	4	–	5
Disposal through business disposal	(4)	–	–	(4)
Reclassifications	–	13	(13)	–
Transfer to non-current assets held for sale	(14)	(81)	(2)	(97)
At 31 December 2004	276	578	13	867
Exchange differences	18	40	–	58
Transfers	–	13	–	13
Additions	32	41	1	74
Disposals	(5)	(28)	–	(33)
Acquisition through business combination	3	6	–	9
Reclassifications	–	7	(7)	–
At 31 December 2005	324	657	7	988

11 Property, plant and equipment *continued*

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Depreciation				
At 1 January 2003	(104)	(419)	–	(523)
Exchange differences	10	17	–	27
Charge for the year	(16)	(69)	–	(85)
Disposals	7	53	–	60
Acquisition through business combination	–	(14)	–	(14)
Disposal through business disposal	1	4	–	5
At 31 December 2003	(102)	(428)	–	(530)
Exchange differences	4	5	–	9
Charge for the year	(16)	(68)	–	(84)
Disposals	6	38	–	44
Acquisition through business combination	–	(4)	–	(4)
Disposal through business disposal	4	–	–	4
Transfer to non-current assets held for sale	2	47	–	49
At 31 December 2004	(102)	(410)	–	(512)
Exchange differences	(7)	(33)	–	(40)
Charge for the year	(17)	(63)	–	(80)
Disposals	–	30	–	30
Acquisition through business combination	–	(2)	–	(2)
At 31 December 2005	(126)	(478)	–	(604)
Carrying amounts				
At 1 January 2003	215	200	20	435
At 31 December 2003	199	182	21	402
At 31 December 2004	174	168	13	355
At 31 December 2005	198	179	7	384

Depreciation expense of £19m (2004: £17m; 2003: £15m) has been included in the income statement in cost of goods sold, £7m (2004: £6m; 2003: £6m) in distribution expenses and £54m (2004: £55m; 2003: £58m) in administrative and other expenses. In 2004 £6m (2003: £6m) relates to discontinued operations.

The Group leases certain equipment under a number of finance lease agreements. The net carrying amount of leased plant and equipment included within property, plant and equipment was £3m (2004: £3m; 2003: £5m).

12 Intangible assets

All figures in £ millions	Goodwill	Software	Acquired publishing rights	Other intangibles acquired	Total intangibles acquired	Total
Cost						
At 1 January 2003	3,610	146	–	–	–	3,756
Exchange differences	(275)	(10)	–	–	–	(285)
Additions	113	26	–	–	–	139
Disposals	(4)	(2)	–	–	–	(6)
Acquisition through business combination	–	–	–	44	44	44
At 31 December 2003	3,444	160	–	44	44	3,648
Exchange differences	(201)	(8)	–	(3)	(3)	(212)
Additions	22	24	–	–	–	46
Disposals	(4)	(11)	–	–	–	(15)
Acquisition through business combination	–	–	10	5	15	15
Transfer to non-current assets held for sale	(101)	–	–	–	–	(101)
At 31 December 2004	3,160	165	10	46	56	3,381
Exchange differences	345	15	2	4	6	366
Transfers	–	(13)	–	–	–	(13)
Additions	155	24	–	–	–	179
Disposals	(6)	(10)	–	–	–	(16)
Acquisition through business combination	–	–	56	33	89	89
At 31 December 2005	3,654	181	68	83	151	3,986

12 Intangible assets *continued*

All figures in £ millions	Goodwill	Software	Acquired publishing rights	Other intangibles acquired	Total intangibles acquired	Total
Amortisation						
At 1 January 2003	–	(75)	–	–	–	(75)
Exchange differences	–	7	–	–	–	7
Charge for the year	–	(28)	–	(4)	(4)	(32)
Disposals	–	2	–	–	–	2
Acquisition through business combination	–	–	–	–	–	–
At 31 December 2003	–	(94)	–	(4)	(4)	(98)
Exchange differences	–	8	–	1	1	9
Charge for the year	–	(20)	–	(5)	(5)	(25)
Disposals	–	11	–	–	–	11
Acquisition through business combination	–	–	–	–	–	–
At 31 December 2004	–	(95)	–	(8)	(8)	(103)
Exchange differences	–	(10)	–	–	–	(10)
Charge for the year	–	(18)	(5)	(6)	(11)	(29)
Disposals	–	10	–	–	–	10
Acquisition through business combination	–	–	–	–	–	–
At 31 December 2005	–	(113)	(5)	(14)	(19)	(132)
Carrying amounts						
At 1 January 2003	3,610	71	–	–	–	3,681
At 31 December 2003	3,444	66	–	40	40	3,550
At 31 December 2004	3,160	70	10	38	48	3,278
At 31 December 2005	3,654	68	63	69	132	3,854

Other intangibles acquired include customer lists and relationships, technology, trade names and trademarks. Amortisation of £4m (2004: £3m; 2003: £5m) is included in the income statement in cost of sales and £25m (2004: £22m; 2003: £27m) in administrative and other expenses.

Impairment tests for cash-generating units containing goodwill

Impairment tests have been carried out where appropriate as described below. The recoverable amount for each unit tested exceeds its carrying value.

12 Intangible assets *continued*

Goodwill is allocated to the Group's cash-generating units identified according to the business segment. Goodwill has been allocated as follows:

All figures in £ millions	2005	2004	2003
Higher Education	1,106	950	1,007
School Book	861	739	783
School Assessment and Testing	271	232	246
School Technology	385	330	350
Other Assessment and Testing	245	211	223
Other Government Solutions	234	201	213
Other Book	70	60	63
Pearson Education total	3,172	2,723	2,885
Penguin US	149	122	138
Penguin UK	146	146	146
Pearson Australia	45	42	44
Penguin total	340	310	328
IDC	138	123	127
FT Publishing	4	4	4
Recoletos	–	–	100
Total goodwill	3,654	3,160	3,444

The Group has adopted IFRS 3 'Business Combinations' with effect from the date of transition to IFRS. In accordance with IFRS 3, goodwill is no longer amortised but rather tested for impairment on an annual basis. Goodwill has been allocated for impairment purposes to twelve cash generating units. The recoverable amount of each cash generating unit is based on value in use calculations, with the exception of IDC which is assessed on a market value basis.

The value in use calculations use cash flow projections based on financial budgets approved by management covering a five year period. The key assumptions used by management in the value in use calculations were:

Discount rate – The discount rate is based on the risk-free rate for government bonds, adjusted for a risk premium to reflect the increased risk in investing in equities. The risk premium adjustment is assessed for each specific cash generating unit. The average pre-tax discount rates used are in the range of 8.5% to 11.5% for the Pearson Education businesses, 8% to 13% for the Penguin businesses and 8.5% to 11.5% for the FT Publishing businesses.

Perpetuity growth rates – The cash flows subsequent to the approval budget period are based upon the long-term historic growth rates of the underlying territories in which the cash generating unit operates and reflect the long-term growth prospects of the sectors in which the cash generating unit operates. The perpetuity growth rates used vary between 3.0% to 4.0%. The perpetuity growth rates are consistent with appropriate external sources for the relevant markets.

Cash flow growth rates – The cash flow growth rates are derived from forecast sales growth taking into consideration past experience of operating margins achieved in the cash generating unit. Historically, such forecasts have been reasonably accurate.

The valuation of IDC is determined using an observable market price for each share. Other than goodwill there are no intangible assets with indefinite lives.

13 Investments in joint ventures and associates

Joint ventures

All figures in £ millions	2005	2004	2003
At beginning of year	14	12	12
Exchange differences	(3)	1	4
Share of loss after tax	(1)	(5)	(9)
Dividends	(4)	(3)	(2)
Additions or further investment	6	9	7
At end of year	12	14	12

Investments in joint ventures are accounted for by the equity method of accounting and are initially recognised at cost.

The aggregate of the Group's share in its joint ventures, none of which are individually significant, are as follows:

All figures in £ millions	2005	2004	2003
Assets			
Non-current assets	3	3	–
Current assets	26	19	18
Liabilities			
Current liabilities	(17)	(8)	(6)
Net assets	12	14	12
Income	46	37	33
Expenses	(47)	(42)	(42)
Loss after income tax	(1)	(5)	(9)

Associates

All figures in £ millions	2005	2004	2003
At beginning of year	33	52	94
Share of profit after tax	15	15	13
Dividends	(10)	(9)	(8)
Loan repayment	–	–	(2)
Additions	–	1	–
Disposals	(14)	(24)	(45)
Transfer to non-current assets held for sale	–	(2)	–
At end of year	24	33	52

Investments in associates at 31 December 2005 include goodwill of £nil (2004: £6m; 2003: £7m). The share of profit after tax includes £nil (2004: £2m; 2003: £2m) in respect of discontinued operations.

13 Investments in joint ventures and associates *continued*

The Group's interests in its principal associates, all of which are unlisted, were as follows:

2005 All figures in £ millions	Country of incorporation	% Interest held	Assets	Liabilities	Revenues	Profit
The Economist Newspaper Ltd	England	50	79	(67)	105	12
Other			42	(30)	49	3
Total			121	(97)	154	15

2004 All figures in £ millions	Country of incorporation	% Interest held	Assets	Liabilities	Revenues	Profit
The Economist Newspaper Ltd	England	50	71	(62)	98	11
Other			42	(18)	192	4
Total			113	(80)	290	15

2003 All figures in £ millions	Country of incorporation	% Interest held	Assets	Liabilities	Revenues	Profit
The Economist Newspaper Ltd	England	50	103	(101)	95	9
Other			81	(31)	139	4
Total			184	(132)	234	13

14 Deferred income tax

All figures in £ millions	2005	2004	2003
Deferred tax assets			
Deferred tax asset to be recovered after more than 12 months	343	318	313
Deferred tax asset to be recovered within 12 months	42	41	29
	385	359	342
Deferred tax liabilities			
Deferred tax liability to be settled after more than 12 months	(204)	(139)	(140)
Deferred tax liability to be settled within 12 months	–	–	–
	(204)	(139)	(140)
Net deferred tax	181	220	202

Deferred income tax assets and liabilities may be offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority. The Group has unprovided deferred tax assets at 31 December 2005 in respect of UK losses (£32m) and US losses (£37m) and has not recognised a deferred tax asset on the net pension deficit on the basis that it is not sufficiently certain that suitable future profits will arise against which to offset the liability. The related unprovided deferred tax asset is £96m.

The recognition of the deferred tax assets is supported by management's forecasts of the future profitability of the relevant business units.

14 Deferred income tax *continued*

The gross movement on the deferred income tax account is as follows:

All figures in £ millions	2005	2004	2003
At beginning of year	220	202	255
Transition adjustment on adoption of IAS 39	5	–	–
Exchange differences	21	(13)	(34)
Acquisition through business combination	(21)	–	(15)
Transfer between current and deferred taxation	–	41	25
Income statement charge (note 8)	(47)	(23)	(29)
Tax benefit to equity (note 8)	3	4	–
Transfer to non-current assets held for sale	–	9	–
At end of year	181	220	202

The movement in deferred income tax assets and liabilities during the year is as follows:

All figures in £ millions	Tax losses	Goodwill and intangibles	Other	Total
Deferred income tax assets				
At 1 January 2003	131	57	186	374
Exchange differences	(16)	(4)	(22)	(42)
Transfer between current and deferred taxation	25	–	(17)	8
Income statement (charge)/release	(27)	(7)	36	2
At 31 December 2003	113	46	183	342
Exchange differences	(10)	(3)	(11)	(24)
Transfer between current and deferred taxation	41	–	(11)	30
Income statement release/(charge)	6	(6)	7	7
Tax benefit to equity	–	–	4	4
At 31 December 2004	150	37	172	359
Transition adjustment on adoption of IAS 39	–	–	5	5
Exchange differences	16	4	18	38
Acquisition through business combination	–	–	1	1
Transfer between current and deferred taxation	–	–	23	23
Income statement charge	(32)	(6)	(6)	(44)
Tax benefit to equity	–	–	3	3
At 31 December 2005	134	35	216	385

Other deferred tax assets include temporary differences on inventory, sales returns and other provisions.

14 Deferred income tax *continued*

All figures in £ millions	Goodwill and intangibles	Other	Total
Deferred income tax liabilities			
At 1 January 2003	(25)	(94)	(119)
Exchange differences	–	8	8
Acquisition through business combination	(15)	–	(15)
Transfer between current and deferred taxation	–	17	17
Income statement charge	(19)	(12)	(31)
At 31 December 2003	(59)	(81)	(140)
Exchange differences	8	3	11
Transfer between current and deferred taxation	–	11	11
Income statement charge	(8)	(22)	(30)
Transfer to non-current assets held for sale	–	9	9
At 31 December 2004	(59)	(80)	(139)
Exchange differences	(8)	(9)	(17)
Acquisition through business combination	(24)	2	(22)
Transfer between current and deferred taxation	–	(23)	(23)
Income statement (charge)/release	(26)	23	(3)
At 31 December 2005	(117)	(87)	(204)

Other deferred tax liabilities include temporary differences on capital allowances and royalty advances.

15 Other financial assets

All figures in £ millions	2005	2004	2003
At beginning of year	15	21	22
Exchange differences	1	(1)	(3)
Additions	4	5	3
Disposals	(2)	(8)	(1)
Transfer to non-current assets held for sale	–	(2)	–
At end of year	18	15	21

Other financial assets are non-current unlisted securities.

16 Derivative financial instruments

All figures in £ millions	2005 Assets	2005 Liabilities
Interest rate derivatives – in a fair value hedging relationship	31	(16)
Interest rate derivatives – not in a hedging relationship	18	(6)
Cross currency rate derivatives – in a net investment hedging relationship	13	–
Cross currency rate derivatives – not in a hedging relationship	21	–
	83	(22)
Analysed as:		
Non-current	79	(22)
Current (expiring in less than 1 year)	4	–
	83	(22)

The fair value of the above derivative financial instruments is the same as the carrying value.

The Group's portfolio of derivatives is diversified by maturity, counterparty and type. Natural offsets between transactions within the portfolio and the designation of certain derivatives as hedges, significantly reduces the risk of income statement volatility.

Counterparty exposure from derivatives is managed, together with that from deposits and bank account balances, within credit limits that reflect published credit ratings to ensure that there is no significant risk to any one counterparty. No single derivative transaction had a market value (positive or negative) at the balance sheet date that exceeded 3% of the Group's consolidated total equity.

At the year end the Group had received an amount of £43m equivalent as collateral under a mark-to-market agreement. This reflected the amount, at market rates prevailing at the end of October 2005, owed to the Group by the counterparty for a set of three related derivatives. Under these the Group is due to exchange $209m for €204m in February 2007. There are no restrictions on the Group's use of these funds, which have been recorded in borrowings as a current bank loan.

In accordance with IAS 39 'Financial Instruments: Recognition and Measurement', the Group has reviewed all its material contracts for embedded derivatives that are required to be separately accounted for if they do not meet certain requirements, and has concluded that there are no material embedded derivatives.

17 Intangible assets – pre-publication

All figures in £ millions	2005	2004	2003
Cost			
At beginning of year	1,109	1,104	1,189
Exchange differences	112	(63)	(90)
Acquisition through business combination	27	–	–
Additions	222	181	173
Disposals	(113)	(113)	(168)
At end of year	1,357	1,109	1,104
Amortisation			
At beginning of year	(753)	(742)	(809)
Exchange differences	(87)	44	57
Acquisition through business combination	(12)	–	–
Charge for the year	(192)	(168)	(158)
Disposals	113	113	168
At end of year	(931)	(753)	(742)
Carrying amounts			
At end of year	426	356	362

Amortisation is included in the income statement in cost of goods sold.

18 Inventories

All figures in £ millions	2005	2004	2003
Raw materials	23	23	19
Work in progress	43	35	30
Finished goods	307	256	270
	373	314	319

The cost of inventories recognised as an expense and included in the income statement in cost of goods sold amounted to £768m (2004: £700m; 2003: £710m). In 2005 £42m (2004: £41m; 2003: £37m) of inventory provisions were charged in the income statement. None of the inventory is pledged as security.

19 Trade and other receivables

All figures in £ millions	2005	2004	2003
Current			
Trade receivables	825	725	814
Royalty advances	124	114	110
Prepayments and accrued income	38	41	38
Other receivables	42	51	62
Receivables from related parties	2	2	1
	1,031	933	1,025
Non-current			
Royalty advances	67	70	83
Prepayments and accrued income	4	1	1
Other receivables	37	31	16
	108	102	100

Trade receivables are stated net of provisions for bad and doubtful debts and sales returns of £313m (2004: £354m; 2003: £339m). The carrying amounts are stated at their fair value. Concentrations of credit risk with respect to trade receivables are limited due to the Group's large number of customers, who are internationally dispersed.

20 Cash and cash equivalents (excluding overdrafts)

All figures in £ millions	2005	2004	2003
Cash at bank and in hand	393	338	302
Short-term bank deposits	509	123	249
	902	461	551

Short-term bank deposits are invested with banks and earn interest at the prevailing short-term deposit rates.

The currency split of cash and cash equivalents in 2005 is 31% US dollars (2004: 38%), 38% Sterling (2004: 31%), 24% Euro (2004: 12%) and other 7% (2004: 19%).

The fair value of cash and cash equivalents is the same as the carrying value.

Cash and cash equivalents include the following for the purpose of the cash flow statement:

All figures in £ millions	2005	2004	2003
Cash and cash equivalents	902	461	551
Cash and cash equivalents included in assets classified as held for sale	–	141	–
Bank overdrafts	(58)	(58)	(23)
	844	544	528

21 Financial liabilities – Borrowings

The Group's current and non-current borrowings are as follows:

All figures in £ millions	2005	2004	2003
Non-current			
Bank borrowings	–	62	85
7.375% US Dollar notes 2006 (nominal amount $250m)	–	130	139
6.125% Euro Bonds 2007 (nominal amount €591m)	436	390	343
10.5% Sterling Bonds 2008 (nominal amount £100m)	107	100	100
4.7% US Dollar Bonds 2009 (nominal amount $350m)	203	181	–
7% Global Dollar Bonds 2011 (nominal amount $500m)	307	260	278
7% Sterling Bonds 2014 (nominal amount £250m)	250	226	235
5.7% US Dollar Bonds 2014 (nominal amount $400m)	238	207	–
4.625% US Dollar notes 2018 (nominal amount $300m)	161	156	167
Finance lease liabilities	1	2	2
	1,703	1,714	1,349

Included in the above is £35m of accrued interest in 2005.

	2005	2004	2003
Current			
Due within one year or on demand:			
Bank loans and overdrafts	102	107	119
7.375% US Dollar notes 2006	152	–	–
9.5% Sterling Bonds 2004	–	–	108
4.625% Euro Bonds 2004	–	–	348
Finance lease liabilities	2	2	3
	256	109	578
Total borrowings	1,959	1,823	1,927

Included in the above is £3m of accrued interest in 2005.

The Group has elected to apply the provisions of IAS 32 and IAS 39 with effect from 1 January 2005. The comparative financial information is prepared in accordance with UK GAAP. The nature of the main adjustments that would make the information comply with IAS 32 and IAS 39 are set out in note 34.

The 2004 and 2003 figures for the 2007 Euro Bonds and 2014 Sterling Bonds (together with the 2004 Sterling and Euro Bonds which have now been redeemed) include the effect of accounting for the foreign exchange element of the related derivatives.

21 Financial liabilities – Borrowings *continued*

All of the Group's borrowings are unsecured. In respect of finance lease obligations (£3m in 2005; £4m in 2004 and £5m in 2003) the rights to the leased asset revert to the lessor in the event of default.

The maturity of the Group's non-current borrowing is as follows:

All figures in £ millions	2005	2004	2003
Between one and two years	437	131	86
Between two and five years	310	734	583
Over five years	956	849	680
	1,703	1,714	1,349

As at 31 December 2005 the exposure of the borrowings of the Group to interest changes when the borrowings re-price is as follows:

All figures in £ millions	Total	One year	One to five years	More than five years
Carrying value of borrowings	1,959	256	747	956
Effect of interest rate swaps	–	1,161	(473)	(688)
	1,959	1,417	274	268

The carrying amounts and fair values of non-current borrowings are as follows:

All figures in £ millions	Effective interest rate	Carrying amount 2005	Fair value 2005	Carrying amount 2004	Fair value 2004	Carrying amount 2003	Fair value 2003
Bank borrowings	n/a	–	–	62	62	85	85
7.375% US Dollar notes 2006	7.75%	–	–	130	138	139	157
6.125% Euro Bonds 2007	6.18%	436	419	390	409	343	448
10.5% Sterling Bonds 2008	10.53%	107	113	100	116	100	120
4.7% US Dollar Bonds 2009	4.86%	203	200	181	185	–	–
7% Global Dollar Bonds 2011	7.16%	307	310	260	293	278	317
7% Sterling Bonds 2014	7.20%	250	282	226	255	235	275
5.7% US Dollar Bonds 2014	5.88%	238	234	207	217	–	–
4.625% US Dollar notes 2018	4.69%	161	155	156	142	167	151
Finance lease liabilities	n/a	1	1	2	2	2	2
		1,703	1,714	1,714	1,819	1,349	1,555

The fair values are based on clean market prices at the year end or, where these are not available, on the quoted market prices of comparable debt issued by other companies. The effective interest rates above relate to the underlying debt instruments. The carrying amounts of current borrowings approximate their fair value.

21 Financial liabilities – Borrowings *continued*

The carrying amounts of the Group's borrowings are denominated in the following currencies:

All figures in £ millions	2005	2004	2003
US dollar	1,165	1,335	1,432
Sterling	357	202	201
Euro	437	284	292
Other currencies	–	2	2
	1,959	1,823	1,927

The maturity of the Group's finance lease obligations is as follows:

All figures in £ millions	2005	2004	2003
Finance lease liabilities – minimum lease payments			
Not later than one year	2	2	3
Later than one year and not later than five years	1	2	3
Later than five years	–	–	–
Future finance charges on finance leases	–	–	(1)
Present value of finance lease liabilities	3	4	5

The present value of finance lease liabilities is as follows:

All figures in £ millions	2005	2004	2003
Not later than one year	2	2	3
Later than one year and not later than five years	1	2	2
Later than five years	–	–	–
	3	4	5

The carrying amount of the Group's lease obligations approximates their fair value.

The Group has the following undrawn committed borrowing facilities as at 31 December:

All figures in £ millions	2005	2004	2003
Floating rate			
– expiring within one year	–	–	–
– expiring beyond one year	786	641	950
	786	641	950

In addition to the above facilities, there are a number of short-term facilities that are utilised in the normal course of business.

22 Provisions

All figures in £ millions	Deferred consideration	Integration	Re-organisations	Leases	Other	Total
At 1 January 2005	20	5	11	14	7	57
Exchange differences	2	–	1	1	–	4
Charged to consolidated income statement						
– Additional provisions	–	–	–	1	13	14
– Unused amounts reversed	–	–	(1)	(3)	(1)	(5)
On acquisition/disposal	5	–	–	–	–	5
Utilised during year	(1)	(2)	(6)	(1)	(1)	(11)
At 31 December 2005	26	3	5	12	18	64

All figures in £ millions	2005	2004	2003
Analysis of provisions			
Non-current	31	43	59
Current	33	14	18
	64	57	77

Deferred consideration – During the year, additional deferred consideration of £5m was incurred mainly relating to the acquisition of Index books.

Integration – During the year, £2m of this balance has been utilised, primarily in relation to properties, severance and IT systems. The remaining provision should be utilised in the next two years.

Reorganisations – There were no additional provisions in 2005 and £5m has been utilised, mainly in respect of redundancies.

Lease commitments – These relate primarily to onerous lease contracts, acquired through business combinations, which have various expiry dates up to 2010. The provision is based on current occupancy estimates.

23 Trade and other liabilities

All figures in £ millions	2005	2004	2003
Trade payables	348	316	405
Social security and other taxes	21	14	4
Accruals and deferred income	600	509	465
Other liabilities	156	128	139
	1,125	967	1,013
Less: non-current portion			
Accruals and deferred income	66	21	9
Other liabilities	85	78	61
	151	99	70
Current portion	974	868	943

The carrying value of the Group's trade and other liabilities approximates their fair value.

24 Employee benefits

Retirement benefit obligations

The Group operates a number of retirement benefit plans throughout the world, the principal ones being in the UK and US. The major schemes are self-administered with the schemes' assets being held independently of the Group. Retirement benefit costs are assessed in accordance with the advice of independent qualified actuaries. The UK Group scheme is a hybrid scheme with both defined benefit and defined contribution sections but, predominantly, consisting of defined benefit liabilities. There are a number of defined contribution schemes, principally overseas.

The most recent actuarial valuation of the UK Group scheme was completed on 1 January 2004.

The principal assumptions used for the UK Group scheme are shown below. Weighted average assumptions have been shown for the other schemes.

%	2005 UK Group scheme	2005 Other schemes	2004 UK Group scheme	2004 Other schemes	2003 UK Group scheme	2003 Other schemes
Inflation	2.80	2.95	2.80	2.98	2.75	2.98
Expected rate of increase in salaries	4.50	4.43	4.80	4.44	4.75	4.45
Expected rate of increase for pensions in payment and deferred pensions	2.50 to 4.00	–	2.80 to 4.00	–	2.75 to 4.00	–
Rate used to discount scheme liabilities	4.85	5.54	5.40	5.84	5.50	6.11
Expected return on assets	6.40	7.31	6.60	7.23	6.81	7.75

The amounts recognised in the income statement are as follows:

All figures in £ millions	UK Group scheme	Defined benefit other	Sub total	Defined contribution	2005 Total
Current service cost	(25)	(2)	(27)	(35)	(62)
Past service cost	–	–	–	–	–
Curtailments	–	2	2	–	2
Total operating charge	(25)	–	(25)	(35)	(60)
Expected return on plan assets	75	6	81	–	81
Interest on pension scheme liabilities	(79)	(6)	(85)	–	(85)
Net finance charge	(4)	–	(4)	–	(4)
Net income statement charge	(29)	–	(29)	(35)	(64)
Actual return on plan assets	214	7	221	–	221

24 Employee benefits *continued*

All figures in £ millions	UK Group scheme	Defined benefit other	Sub total	Defined contribution	2004 Total
Current service cost	(22)	(2)	(24)	(32)	(56)
Past service cost	–	–	–	–	–
Total operating charge	(22)	(2)	(24)	(32)	(56)
Expected return on plan assets	71	6	77	–	77
Interest on pension scheme liabilities	(72)	(6)	(78)	–	(78)
Net finance charge	(1)	–	(1)	–	(1)
Net income statement charge	(23)	(2)	(25)	(32)	(57)
Actual return on plan assets	135	9	144	–	144

All figures in £ millions	UK Group scheme	Defined benefit other	Sub total	Defined contribution	2003 Total
Current service cost	(21)	(2)	(23)	(28)	(51)
Past service cost	–	–	–	–	–
Total operating charge	(21)	(2)	(23)	(28)	(51)
Expected return on plan assets	65	4	69	–	69
Interest on pension scheme liabilities	(67)	(7)	(74)	–	(74)
Net finance charge	(2)	(3)	(5)	–	(5)
Net income statement charge	(23)	(5)	(28)	(28)	(56)
Actual return on plan assets	145	12	157	–	157

The total operating charge is included in administrative and other expenses.

24 Employee benefits *continued*

The amounts recognised in the balance sheet are as follows:

All figures in £ millions	2005 UK Group scheme	2005 Other funded plans	2005 Other unfunded plans	2005 Total	2004 UK Group scheme	2004 Other funded plans	2004 Other unfunded plans	2004 Total	2003 UK Group scheme	2003 Other funded plans	2003 Other unfunded plans	2003 Total
Fair value of plan assets	1,390	110	–	1,500	1,198	82	–	1,280	1,089	75	–	1,164
Present value of plan liabilities	(1,661)	(131)	(11)	(1,803)	(1,502)	(104)	(9)	(1,615)	(1,340)	(105)	(9)	(1,454)
Net pension liability	(271)	(21)	(11)	(303)	(304)	(22)	(9)	(335)	(251)	(30)	(9)	(290)
Other post-retirement medical benefit obligation				(60)				(58)				(61)
Other pension accruals				(26)				(15)				(13)
Total retirement benefit obligations				(389)				(408)				(364)

The following amounts have been recognised in the statement of recognised income and expense:

All figures in £ millions	2005	2004	2003
Amounts recognised for defined benefit schemes	21	(60)	(25)
Amounts recognised on post-retirement medical benefit schemes	5	(1)	(3)
Total recognised in year	26	(61)	(28)
Cumulative amounts recognised	(63)	(89)	(28)

The fair value of plan assets comprises the following:

%	2005 UK Group scheme	2005 Other funded plans	2005 Total	2004 UK Group scheme	2004 Other funded plans	2004 Total	2003 UK Group scheme	2003 Other funded plans	2003 Total
Equities	47.4	4.3	51.7	49.7	4.2	53.9	50.5	4.2	54.7
Bonds	24.7	2.0	26.7	21.5	2.1	23.6	22.5	2.1	24.6
Properties	8.9	–	8.9	8.9	–	8.9	9.2	–	9.2
Other	11.7	1.0	12.7	13.5	0.1	13.6	11.4	0.1	11.5

The plan assets do not include any of the Group's own financial instruments, nor any property occupied by the Group.

24 Employee benefits *continued*

Changes in the values of plan assets and liabilities are as follows:

All figures in £ millions	2005 UK Group scheme	2005 Other	2005 Total	2004 UK Group scheme	2004 Other	2004 Total	2003 UK Group scheme	2003 Other	2003 Total
Fair value of assets									
Opening fair value of plan assets	1,198	82	1,280	1,089	75	1,164	974	57	1,031
Exchange differences	–	9	9	–	(5)	(5)	–	(5)	(5)
Expected return on plan assets	75	6	81	71	6	77	65	4	69
Actuarial gains and losses	139	1	140	64	3	67	80	8	88
Contributions by employer	35	10	45	30	9	39	24	9	33
Contributions by employee	6	–	6	6	–	6	6	–	6
Benefits paid	(63)	(6)	(69)	(62)	(6)	(68)	(60)	(6)	(66)
Acquisition through business combination	–	8	8	–	–	–	–	8	8
Closing fair value of plan assets	1,390	110	1,500	1,198	82	1,280	1,089	75	1,164
Present value of defined benefit obligation									
Opening defined benefit obligation	(1,502)	(113)	(1,615)	(1,340)	(114)	(1,454)	(1,207)	(96)	(1,303)
Exchange differences	–	(12)	(12)	–	6	6	–	9	9
Current service cost	(25)	(2)	(27)	(22)	(2)	(24)	(21)	(2)	(23)
Curtailment	–	2	2	–	–	–	–	–	–
Interest cost	(79)	(6)	(85)	(72)	(6)	(78)	(67)	(7)	(74)
Contributions by employee	(6)	–	(6)	(6)	–	(6)	(6)	–	(6)
Acquisition through business combination	–	(10)	(10)	–	–	–	–	(10)	(10)
Benefits paid	63	6	69	62	6	68	60	6	66
Actuarial gains and losses	(112)	(7)	(119)	(124)	(3)	(127)	(99)	(14)	(113)
Closing defined benefit obligation	(1,661)	(142)	(1,803)	(1,502)	(113)	(1,615)	(1,340)	(114)	(1,454)

24 Employee benefits *continued*

The history of the defined benefit plans is as follows:

All figures in £ millions	2005	2004	2003
Present value of defined benefit obligation	(1,803)	(1,615)	(1,454)
Fair value of plan assets	1,500	1,280	1,164
Net pension liability	(303)	(335)	(290)
Experience adjustments on plan liabilities	(119)	(127)	(113)
Experience adjustments on plan assets	140	67	88

The expected rates of return on categories of plan assets are determined by reference to relevant indices. The overall expected rate of return is calculated by weighting the individual rates in accordance with the anticipated balance in the plan's investment portfolio.

The Group expects to contribute approximately £41m to its defined benefit plans in 2006.

Other post-retirement obligations

The Group operates a number of post-retirement medical benefit schemes, principally in the USA. These plans are unfunded. The method of accounting and the frequency of valuations are similar to those used for defined benefit pension schemes.

The principal assumptions used are shown below:

%	2005	2004	2003
Inflation	3.0	3.0	3.0
Initial rate of increase in healthcare rates	10.0	12.0	12.0
Ultimate rate of increase in healthcare rates	5.0	5.0	5.0
Rate used to discount scheme liabilities	5.6	6.1	6.1

The amounts recognised in the income statement are as follows:

All figures in £ millions	2005	2004	2003
Current service cost	(1)	(1)	(1)
Interest cost	(3)	(4)	(4)
Net income statement charge	(4)	(5)	(5)

The current service cost has been included in administrative and other expenses.

24 Employee benefits *continued*

All figures in £ millions	2005	2004	2003
Opening obligation	(58)	(61)	(63)
Exchange differences	(7)	6	6
Current service cost	(1)	(1)	(1)
Interest cost	(3)	(4)	(4)
Benefits paid	4	3	4
Actuarial gains and losses	5	(1)	(3)
Closing obligation	(60)	(58)	(61)

The effect of a one percentage point increase (and decrease) in the assumed medical cost trend rates is as follows:

All figures in £ millions	2005 1% increase	2005 1% decrease	2004 1% increase	2004 1% decrease	2003 1% increase	2003 1% decrease
Effect on:						
Aggregate of service cost and interest cost	0.2	(0.2)	0.2	(0.2)	0.3	(0.3)
Defined benefit obligation	4.7	4.1	4.1	(3.7)	4.8	(4.2)

Share-based compensation

The Group recognised the following charges in the income statement in respect of its share-based payment plans:

All figures in £ millions	2005	2004	2003
Pearson plans	13	15	20
IDC plans	10	10	9
Total share-based payment costs	23	25	29

The Group operates the following equity-settled employee option and performance plans:

Profit Sharing Plan – The Group operates a profit sharing plan for all employees, the payment of which is at the discretion of the Pearson board and may be made in cash or Pearson shares.

Save for Shares Plans – Since 1994 the Group has operated a Save-As-You-Earn plan for UK employees. In 1998, the Group introduced a Worldwide Save for Shares Plan. Under these plans, employees can save a portion of their monthly salary over periods of three, five or seven years. At the end of this period, the employee has the option to purchase ordinary shares with the accumulated funds at a purchase price equal to 80% of the market price prevailing at the time of the commencement of the employee's participation in the plan. Options that are not exercised within six months of the third, fifth or seventh anniversary after grant lapse unconditionally.

24 Employee benefits *continued*

Employee Stock Purchase Plan – In 2000, the Group established an Employee Stock Purchase Plan which allows all employees in the United States to save a portion of their monthly salary over six month periods. At the end of the period the employee has the option to purchase ADRs with their accumulated funds at a purchase price equal to 85% of the lower of the market price prevailing at the beginning or end of the period.

Executive Share Option Plan – Under this plan, options were granted to senior management at an exercise price equal to the market price of the shares on the date of grant. Options granted prior to 1996 are not subject to performance conditions. The exercise of options granted since 1996 is subject to growth in the Group's adjusted earnings per share over a three year period prior to exercise. Options become exercisable on the third anniversary of the date of grant and lapse if they remain unexercised at the tenth. No new awards will be made under this plan.

Reward Plan – Awards of premium priced options were made under this plan in 1999 and 2000 with an exercise price above the market value of the shares at the grant date. The exercise of options is subject to Pearson's share price remaining above certain thresholds for specified periods of time and to growth in the Group's adjusted earnings per share over the three year period prior to exercise. Options became exercisable on the third anniversary of the date of grant and lapse if they remain unexercised at the tenth. No new awards will be made under this plan.

Special Share Option Plan – In 2000, the Group made a special one-off award of share options with an exercise price equal to the market price of the shares on the grant date. They vested in tranches of 50% on the first anniversary of the date of grant and 25% on the second and third anniversaries of the grant date. Options lapse if they remain unexercised at the tenth anniversary of the grant date. No new awards will be made under this plan.

Long-Term Incentive Plan – This plan was introduced in 2001 and consists of two parts: share options and/or restricted shares.

Options were granted under this plan in 2001 based on a pre-grant earnings per share growth test and are not subject to further performance conditions on exercise. The options became exercisable in tranches and lapse if they remain unexercised at the tenth anniversary of the date of grant.

24 Employee benefits *continued*

The vesting of restricted shares is normally dependent upon the satisfaction of corporate performance targets over a three year period. These targets may be based on market and/or non-market performance criteria. Restricted shares granted in 2001 vested based on Pearson's three-year cumulative free cash flow per share performance. Awards made in December 2002 and September 2003 vest in tranches. One sixth of the award vests after three years with no performance conditions. The vesting of the balance depends on Pearson's share price performance over the seven year period following the grants. Restricted shares awarded in December 2004 and September 2005 vest dependent on the following market and non-market performance criteria: relative shareholder return, return on invested capital and a combination of earnings per share and sales growth. The award is split equally across all three measures.

Annual Bonus Share Matching Plan – This plan permits executive directors and senior executives around the Group to invest up to 50% of any after tax annual bonus in Pearson shares. If these shares are held and the Group meets an earnings per share growth target, the Company will match them on a gross basis of up to one share for every one held after three years and another one for two originally held after five years.

The number and weighted average exercise prices of share options granted under the Group's schemes are as follows:

	2005 Number of share options 000s	2005 Weighted average exercise price £	2004 Number of share options 000s	2004 Weighted average exercise price £	2003 Number of share options 000s	2003 Weighted average exercise price £
Outstanding at beginning of year	26,179	5.93	32,284	6.93	35,608	8.84
Granted during the year	606	5.06	886	4.56	2,309	5.16
Exercised during the year	(324)	6.78	(254)	10.10	(89)	10.60
Forfeited during the year	(4,352)	10.42	(6,301)	7.49	(5,053)	16.25
Expired during the year	(432)	–	(436)	–	(491)	–
Outstanding at end of year	21,677	5.05	26,179	5.93	32,284	6.93
Options exercisable at the end of year	7,634	7.80	9,071	9.23	9,882	9.44

Options were exercised regularly throughout the year. The weighted average share price during the year was £6.52 (2004: £6.25; 2003: £5.72). Early exercises are treated as an acceleration of vesting and the remaining charge is recognised at the date of exercise.

24 Employee benefits *continued*

The options outstanding at the end of the year have weighted average remaining contractual lives and exercise prices as follows:

Range of exercise prices £	2005 Number of share options 000s	2005 Weighted average contractual life Years	2004 Number of share options 000s	2004 Weighted average contractual life Years	2003 Number of share options 000s	2003 Weighted average contractual life Years
0 – 5	2,773	2.08	3,251	2.97	2,740	3.66
5 – 10	5,555	4.48	6,538	5.44	7,797	6.02
10 – 15	8,237	4.63	9,604	5.57	11,758	6.63
15 – 20	1,168	3.80	1,469	4.81	2,210	5.78
20 – 25	930	3.80	1,346	4.92	2,210	6.02
>25	3,014	4.22	3,971	4.65	5,569	5.79
	21,677	4.13	26,179	5.00	32,284	5.99

In 2005, 2004 and 2003 options were granted under the Worldwide Save for Shares Plan. The weighted average estimated fair value for the options granted was calculated using a Black-Scholes option pricing model.

The weighted average estimated fair values and the inputs into the Black-Scholes model are as follows:

	2005 Weighted average	2004 Weighted average	2003 Weighted average
Fair value	£2.34	£2.70	£1.82
Weighted average share price	£6.54	£6.58	£5.15
Weighted average exercise price	£5.08	£4.96	£4.25
Expected volatility	33.69%	41.95%	48.74%
Expected life	3.6 years	3.8 years	4.0 years
Risk free rate	4.48%	4.77%	3.84%
Expected dividend yield	2.40%	2.72%	4.55%
Forfeiture rate	20.0%	21.1%	18.7%

The expected volatility is based on the historic volatility of the Company's share price over the previous 3 – 7 years depending on the vesting term of the options.

During the year the following shares were granted under restricted share arrangements:

	2005 Number of shares 000s	2005 Weighted average fair value £	2004 Number of shares 000s	2004 Weighted average fair value £	2003 Number of shares 000s	2003 Weighted average fair value £
Annual Bonus Share Matching Plan	71	5.57	53	5.42	108	4.36
Long-term Incentive Plan	3,987	5.05	2,413	4.54	1,711	5.21

24 Employee benefits *continued*

The fair value of shares awarded under the Annual Bonus Share Matching Plan was determined using a Black-Scholes model. Shares awarded under the Long-Term Incentive Plan were also valued using a Black-Scholes model provided the shares vest unconditionally. The weighted average estimated fair values and the inputs into the Black-Scholes model are as follows:

	2005 Weighted average	2004 Weighted average
Fair value	£6.19	£4.54
Weighted average share price	£6.69	£6.13
Weighted average exercise price	–	–
Expected volatility	32.79%	38.39%
Expected life	3.3 years	3.0 years
Risk free rate	4.19%	4.59%
Expected dividend yield	2.35%	4.00%
Forfeiture rate	9.9%	4.5%

In 2003, no restricted shares granted were valued using a Black-Scholes model. The fair value of restricted shares that vest conditionally upon the fulfilment of a market condition were valued by an independent actuary using a Monte Carlo model. Shares with a non-market vesting condition were fair valued based on the share price at the date of grant taking into account any future dividend payments. The performance conditions were considered by adjusting the number of shares expected to vest based on the most likely outcome of the relevant performance criteria.

Subsidiary share option plans

IDC, a 61% subsidiary of the Group, operates the following share-based payment plans:

2001 Employee Stock Purchase Plan In 2001, IDC adopted the 2001 Employee Stock Purchase Plan for all eligible employees worldwide. The 2001 Employee Stock Purchase Plan allows employees to purchase stock at a discounted price at specific times.

2000 Long-Term Incentive Plan Under this plan, the Compensation Committee of the Board of Directors can grant share-based awards representing up to 20% of the total number of shares of common stock outstanding at the date of grant. The plan provides for the discretionary issuance of share-base awards to directors, officers and employees of IDC, as well as persons who provide consulting or other services to IDC. The exercise price for all options granted to date has been equal to the market price of the underlying shares at the date of grant. Options expire ten years from the date of grant and generally vest over a three to four year period without any performance criteria attached.

24 Employee benefits *continued*

In addition, grants of restricted stock can be made to certain executives and members of the Board of Directors of IDC. The awarded shares are available for distribution, at no cost, at the end of a three-year vesting period. No performance criteria are attached to shares granted under this plan.

The number and weighted average exercise prices of share options granted under the 2000 Long-Term Incentive Plan is as follows:

	2005 Number of share options 000s	2005 Weighted average exercise price $	2005 Weighted average exercise price £	2004 Number of share options 000s	2004 Weighted average exercise price $	2004 Weighted average exercise price £	2003 Number of share options 000s	2003 Weighted average exercise price $	2003 Weighted average exercise price £
Outstanding at beginning of year	9,832	13.46	7.36	9,358	12.15	7.44	8,619	10.43	6.38
Granted during the year	1,940	21.38	11.80	1,937	17.48	9.56	2,107	16.40	10.04
Exercised during the year	(1,412)	11.57	6.39	(1,157)	9.59	5.24	(1,195)	7.20	4.41
Forfeited during the year	(292)	16.86	9.31	(306)	13.32	7.28	(173)	12.36	7.57
Outstanding at end of year	10,068	15.16	8.37	9,832	13.46	7.36	9,358	12.15	7.44
Options exercisable at end of year	6,052	12.58	6.94	5,321	11.41	6.24	4,259	9.93	6.08

The options outstanding at the end of the year have a weighted average remaining contractual life and exercise price as follows:

Range of exercise prices $	2005 Number of share options 000s	2005 Weighted average contractual life Years	2004 Number of share options 000s	2004 Weighted average contractual life Years	2003 Number of share options 000s	2003 Weighted average contractual life Years
0 – 4.4	33	4.2	64	4.3	143	6.1
4.4 – 7.5	206	3.6	287	4.5	499	5.0
7.5 – 12	2,685	5.3	3,398	6.3	4,117	7.3
12 – 20	5,243	7.4	6,083	8.4	4,599	8.8
> 20	1,901	9.5	–	–	–	–
	10,068	5.4	9,832	7.5	9,358	7.9

During the year IDC granted the following shares under restricted share arrangements:

	2005 Number of shares 000s	2005 Weighted average fair value $	2005 Weighted average fair value £	2004 Number of shares 000s	2004 Weighted average fair value $	2004 Weighted average fair value £	2003 Number of shares 000s	2003 Weighted average fair value $	2003 Weighted average fair value £
2000 Long-Term Incentive Plan	148	20.57	11.35	69	17.57	9.61	76	16.97	10.39
2001 Employee Stock Purchase Plan	178	3.68	2.03	124	3.24	1.77	118	2.64	1.62

24 Employee benefits *continued*

Shares awarded under the 2000 Long-Term Incentive Plan were valued based on the share price prevailing at the date of grant. The fair value of the options granted under the Long-Term Incentive Plan and of the shares awarded under the 2001 Employee Stock Purchase Plan was estimated using a Black-Scholes model. The weighted average estimated fair values and the inputs into the Black-Scholes model are as follows:

	Long-Term Incentive Plan			Employee Stock Purchase Plan		
	2005 Weighted average	2004 Weighted average	2003 Weighted average	2005 Weighted average	2004 Weighted average	2003 Weighted average
Fair value	$5.56	$7.50	$8.09	$3.68	$3.24	$2.64
Weighted average share price	$21.38	$17.48	$16.40	$15.46	$14.48	$11.24
Weighted average exercise price	$21.38	$17.48	$16.40	$15.46	$14.48	$11.24
Expected volatility	24.50%	32.20%	61.10%	20.00%	20.00%	25.00%
Expected life	4.0 years	4.0 years	4.0 years	0.5 years	0.5 years	0.5 years
Risk free rate	3.86%	3.45%	2.00%	2.33%	1.03%	1.20%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Forfeiture rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

The expected volatility is based on the historic volatility of IDC's share price over the vesting term of the options.

25 Share capital and share premium

	Number of shares (thousands)	Ordinary Shares £m	Share Premium £m
At 1 January 2003	801,662	200	2,465
Issue of shares – share option schemes	726	1	4
At 31 December 2003	802,388	201	2,469
Issue of shares – share option schemes	862	–	4
At 31 December 2004	803,250	201	2,473
Issue of shares – share option schemes	770	–	4
At 31 December 2005	804,020	201	2,477

The total authorised number of ordinary shares is 1,186 million shares (2004: 1,182 million shares; 2003: 1,178 million shares) with a par value of 25 pence per share (2004: 25p per share; 2003: 25p per share). All issued shares are fully paid.

26 Other reserves

All figures in £ millions	Treasury shares	Translation reserve	Fair value reserve	Total other reserves	Retained earnings
At 1 January 2003	(121)	–	–	(121)	644
Net exchange differences on translation of foreign operations	–	(288)	–	(288)	–
Purchase of treasury shares	(1)	–	–	(1)	–
Profit for the year attributable to equity holders of the parent	–	–	–	–	252
Dividends paid	–	–	–	–	(188)
Equity settled transactions	–	–	–	–	29
Actuarial gains and losses on defined benefit schemes	–	–	–	–	(28)
Taxation on items taken directly to equity	–	–	–	–	–
At 31 December 2003	(122)	(288)	–	(410)	709
Net exchange differences on translation of foreign operations	–	(203)	–	(203)	–
Purchase of treasury shares	(10)	–	–	(10)	–
Profit for the year attributable to equity holders of the parent	–	–	–	–	262
Dividends paid	–	–	–	–	(195)
Equity settled transactions	–	–	–	–	25
Actuarial gains and losses on defined benefit schemes	–	–	–	–	(61)
Taxation on items taken directly to equity	–	–	–	–	9
At 31 December 2004	(132)	(491)	–	(623)	749
Net exchange differences on translation of foreign operations	–	327	–	327	–
Cumulative translation adjustment disposed	–	(14)	–	(14)	–
Purchase of treasury shares	(21)	–	–	(21)	–
Profit for the year attributable to equity holders of the parent	–	–	–	–	624
Dividends paid	–	–	–	–	(205)
Equity settled transactions	–	–	–	–	23
Actuarial gains and losses on defined benefit schemes	–	–	–	–	26
Taxation on items taken directly to equity	–	–	–	–	12
Transition adjustment on adoption of IAS 39 (note 34)	–	3	–	3	(15)
At 31 December 2005	(153)	(175)	–	(328)	1,214

The translation reserve includes exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments.

27 Business combinations

On 22 July 2005 the Group acquired 100% of the voting rights of AGS Publishing, an educational assessments and curriculum materials publisher. In addition, several other businesses were acquired in the current and prior years, none of which were individually material to the Group.

The assets and liabilities arising from acquisitions in each of the years are as follows:

All figures in £ millions	2005 AGS Carrying amount	2005 AGS Fair value adjs	2005 AGS Fair value	2005 Other Fair value	2005 Total Fair value	2004 Total Fair value	2003 Total Fair value
Tangible fixed assets	1	–	1	6	7	1	10
Intangible assets	–	58	58	31	89	15	44
Intangible assets – pre-publication	15	–	15	–	15	–	–
Inventory	3	–	3	7	10	2	–
Receivables	7	–	7	25	32	3	32
Payables	(5)	(1)	(6)	(36)	(42)	(4)	(95)
Provisions	(2)	–	(2)	(1)	(3)	1	(4)
Deferred taxation	–	(20)	(20)	(1)	(21)	–	(15)
Cash and cash equivalents	(1)	–	(1)	4	3	–	34
Equity minority interests	–	–	–	8	8	(3)	(8)
Net assets/(liabilities) acquired at fair value	18	37	55	43	98	15	(2)
Goodwill	105	–	105	50	155	22	113
Total			160	93	253	37	111
Satisfied by:							
Cash			(160)	(89)	(249)	(39)	(87)
Deferred cash consideration			–	(5)	(5)	–	(24)
Costs provided for			–	1	1	(1)	–
Net prior year adjustments			–	–	–	3	–
Total consideration			(160)	(93)	(253)	(37)	(111)
Book value of net assets/(liabilities acquired)			18	40	58	4	(32)
Fair value adjustments			37	3	40	1	30
Fair value to the Group			55	43	98	5	(2)

The fair value adjustments relating to the acquisition of AGS are provisional and will be finalised during 2006. They include the valuation of intangible assets, the related deferred tax effect and recognition of provisions. Adjustments to 2004 provisional fair values largely relate to the acquisition of Dominie Press.

Net cash outflow on acquisition:

All figures in £ millions	2005	2004	2003
Cash – current year acquisitions	(249)	(39)	(87)
Deferred payments for prior year acquisitions and other items	–	(2)	(7)
Cash and cash equivalents acquired	3	–	34
Cash outflow on acquisition	(246)	(41)	(60)

27 Business combinations *continued*

The goodwill arising on the acquisition of AGS is attributable to the profitability of the acquired business and the significant synergies expected to arise.

AGS contributed £21m of sales and £6m to the Group's profit before tax between the date of acquisition and the balance sheet date. Other businesses acquired contributed £1m to the Group's profit before tax between the date of acquisition and the balance sheet date.

If the acquisitions had been completed on 1 January 2005, total Group sales for the period would have been £4,168m, and profit before tax would have been £474m.

28 Disposals

In April 2005 the Group disposed of its 79% interest in Recoletos Grupo de Communicación S.A.

	2005			2004	2003
All figures in £ millions	Recoletos	Other	Total	Total	Total
Disposal of subsidiaries					
Property, plant and equipment	(48)	–	(48)	–	(3)
Other financial assets	(2)	–	(2)	–	–
Associates	(3)	–	(3)	–	–
Inventory	(4)	–	(4)	–	(2)
Receivables	(59)	–	(59)	(4)	(9)
Payables	68	3	71	2	10
Provisions	2	1	3	–	–
Deferred taxation	8	–	8	–	–
Net (cash and cash equivalents)/borrowings	(132)	(2)	(134)	1	1
Equity minority interests	60	(6)	54	(4)	–
Attributable goodwill	(98)	(6)	(104)	(4)	(4)
Currency translation adjustment	14	–	14	–	–
Net assets disposed of	(194)	(10)	(204)	(9)	(7)
Proceeds received	503	10	513	8	1
Costs	(3)	–	(3)	(2)	(1)
Deferred consideration	–	–	–	–	2
Net prior year adjustments	–	–	–	–	1
Profit/(loss) on sale	306	–	306	(3)	(4)

	2005	2004	2003
Cash flow from disposals			
Cash – current year disposals	513	8	1
Costs paid	(3)	(2)	(2)
Deferred receipts and payments from prior year disposals and other amounts	–	–	(3)
Cash and cash equivalents/net debt disposed of	(134)	1	1
Net cash outflow	376	7	(3)

29 Cash generated from operations

All figures in £ millions	2005	2004	2003
Net profit	644	284	275
Adjustments for:			
Tax	125	70	84
Depreciation	80	84	85
Amortisation of purchased intangible assets	11	5	4
Amortisation of other intangible assets	18	20	28
Amortisation of pre-publication investment	192	168	158
Loss on sale of property, plant and equipment	–	4	2
(Profit)/loss on sale of other financial assets	–	(16)	1
Net finance costs	70	76	90
Share of results of joint ventures and associates	(14)	(10)	(4)
(Profit)/loss on sale of subsidiaries and associates	(346)	3	(8)
Net foreign exchange losses/(gains) from transactions	39	(15)	(51)
Share-based payments	23	25	29
Inventories	(17)	(12)	10
Trade and other receivables	(4)	(18)	(92)
Trade and other payables	71	61	(50)
Provisions	(17)	(24)	(30)
Cash generated from operations	875	705	531
Dividends from joint ventures and associates	14	12	10
Purchase of property, plant and equipment	(76)	(101)	(79)
Purchase of intangibles	(24)	(24)	(26)
Capital element of finance leases	(3)	(2)	(3)
Sale of property, plant and equipment	3	4	8
Investment in pre-publication	(222)	(181)	(173)
Add back: Cash received relating to acquired deferred income	–	–	42
Add back: Non-operating property, plant and equipment	1	1	–
Add back: Integration costs	2	4	8
Operating cash flow	570	418	318
Operating tax paid	(65)	(55)	(34)
Operating finance charges paid	(65)	(85)	(76)
Operating free cash flow	440	278	208
Non operating tax received/(paid)	–	10	(10)
Non-operating finance charges paid	(7)	–	–
Integration costs	(2)	(4)	(8)
Total free cash flow	431	284	190
Dividends paid (including to minorities)	(222)	(197)	(207)
Net movement of funds from operations	209	87	(17)

29 Cash generated from operations *continued*

In the cash flow statement, proceeds from sale of property, plant and equipment comprise:

All figures in £ millions	2005	2004	2003
Net book amount	3	8	10
Loss on sale of property, plant and equipment	–	(4)	(2)
Proceeds from sale of property, plant and equipment	3	4	8
Non-cash transactions			
The principal non-cash transactions are movements in finance lease obligations	–	(1)	(1)

30 Contingencies

There are contingent Group liabilities that arise in the normal course of business in respect of indemnities, warranties and guarantees in relation to former subsidiaries and in respect of guarantees in relation to subsidiaries and associates. In addition there are contingent liabilities of the Group in respect of legal claims. None of these claims is expected to result in a material gain or loss to the Group.

31 Commitments

Capital commitments

Capital expenditure contracted for at the balance sheet date but not yet incurred is as follows:

All figures in £ millions	2005	2004	2003
Property, plant and equipment	1	6	1

The Group leases various offices and warehouses under non-cancellable operating lease agreements. The leases have varying terms and renewal rights. The Group also leases various plant and equipment under operating lease agreements, also with varying terms. The lease expenditure charged to the income statement during the year is disclosed in note 5.

The future aggregate minimum lease payments in respect of operating leases are as follows:

All figures in £ millions	2005	2004	2003
Not later than one year	129	117	123
Later than one year and not later than five years	397	353	375
Later than five years	869	584	529
	1,395	1,054	1,027

32 Related party transactions

Joint ventures and associates Amounts advanced to joint ventures and associates during the year and at the balance sheet date are set out in note 13. Amounts falling due from joint ventures and associates are set out in note 19.

Key management personnel are deemed to be the members of the board of directors of Pearson plc. It is this board which has responsibility for planning, directing and controlling the activities of the Group. Key management personnel compensation is disclosed in the directors' remuneration report.

There were no other material related party transactions.

No guarantees have been provided to related parties.

33 Events after the balance sheet date

On 9 January 2006 Pearson announced the purchase of 1,130,739 shares in Interactive Data Corporation (IDC) for $21.67 per share in cash. This purchase brings Pearson's total holding in IDC to almost 62%. On 23 January 2006 Pearson announced the acquisition of Promissor, a leading professional testing business from Houghton Mifflin Company for $42m in cash.

34 Explanation of transition to IFRS

These are the Group's first consolidated financial statements prepared in accordance with IFRS as adopted by the EU.

The accounting policies set out in note 1 have been applied in preparing the financial statements for the year ended 31 December 2005, the comparative information presented in these financial statements for the years ended 31 December 2004 and 31 December 2003 and the preparation of an opening IFRS balance sheet at 1 January 2003 (the Group's date of transition). IAS 39 'Financial Instruments: Recognition and Measurement' and IAS 32 'Financial Instruments: Disclosure and Presentation' have not been applied to the comparative periods because the Group has taken a transitional exemption and adopted those standards prospectively from 1 January 2005. The effect of the transitional adjustment on the balance sheet as at 1 January 2005 is set out in the tables below.

In preparing its opening IFRS balance sheet, the Group has made adjustments to amounts previously reported in its financial statements under UK GAAP. An explanation of how the transition from previous UK GAAP to IFRS has affected the Group's financial position and cash flows is set out in the tables and notes below. These adjustments include some reclassifications of items within the income statement and within the balance sheet in accordance with IFRS disclosure requirements.

Balance sheet as at 1 January 2003 (date of transition)

All figures in £ millions	UK GAAP	Adjs	IFRS
Assets			
Non-current assets			
Property, plant and equipment	503	(68)	435
Intangible assets	3,610	71	3,681
Investments in joint ventures and associates	113	(7)	106
Deferred income tax assets	–	374	374
Other financial assets	22	–	22
Other receivables	–	74	74
	4,248	444	4,692
Current assets			
Intangible assets – pre-publication	–	380	380
Inventories	734	(380)	354
Trade and other receivables	1,059	(79)	980
Deferred income tax assets	174	(174)	–
Cash and cash equivalents	575	(10)	565
	2,542	(263)	2,279
Total assets	6,790	181	6,971

34 Explanation of transition to IFRS *continued*

Balance sheet as at 1 January 2003 (date of transition) *continued*

All figures in £ millions	UK GAAP	Adjs	IFRS
Liabilities			
Non-current liabilities			
Financial liabilities – Borrowings	(1,734)	(2)	(1,736)
Deferred income tax liabilities	–	(119)	(119)
Retirement benefit obligations	–	(351)	(351)
Provisions for other liabilities and charges	(165)	120	(45)
Other liabilities	(60)	(10)	(70)
	(1,959)	(362)	(2,321)
Current liabilities			
Trade and other liabilities	(1,114)	178	(936)
Financial liabilities – Borrowings	(249)	(3)	(252)
Current income tax liabilities	–	(52)	(52)
Provisions for other liabilities and charges	–	(34)	(34)
	(1,363)	89	(1,274)
Total liabilities	(3,322)	(273)	(3,595)
Net assets	3,468	(92)	3,376
Equity			
Share capital	200	–	200
Share premium	2,465	–	2,465
Other reserves	(121)	–	(121)
Retained earnings	732	(88)	644
Total equity attributable to equity holders of the Company	3,276	(88)	3,188
Minority interest	192	(4)	188
Total equity	3,468	(92)	3,376

Balance sheet as at 31 December 2003

All figures in £ millions	UK GAAP	Adjs	IFRS
Assets			
Non-current assets			
Property, plant and equipment	468	(66)	402
Intangible assets	3,260	290	3,550
Investments in joint ventures and associates	64	–	64
Deferred income tax assets	–	342	342
Other financial assets	21	–	21
Other receivables	–	100	100
	3,813	666	4,479

34 Explanation of transition to IFRS *continued*

Balance sheet as at 31 December 2003 *continued*

All figures in £ millions	UK GAAP	Adjs	IFRS
Current assets			
Intangible assets – pre-publication	–	362	362
Inventories	683	(364)	319
Trade and other receivables	1,134	(109)	1,025
Deferred income tax assets	145	(145)	–
Cash and cash equivalents	561	(10)	551
	2,523	(266)	2,257
Total assets	6,336	400	6,736
Liabilities			
Non-current liabilities			
Financial liabilities – Borrowings	(1,347)	(2)	(1,349)
Deferred income tax liabilities	–	(140)	(140)
Retirement benefit obligations	–	(364)	(364)
Provisions for other liabilities and charges	(152)	93	(59)
Other liabilities	(45)	(25)	(70)
	(1,544)	(438)	(1,982)
Current liabilities			
Trade and other liabilities	(1,129)	186	(943)
Financial liabilities – Borrowings	(575)	(3)	(578)
Current income tax liabilities	–	(54)	(54)
Provisions for other liabilities and charges	–	(18)	(18)
	(1,704)	111	(1,593)
Total liabilities	(3,248)	(327)	(3,575)
Net assets	3,088	73	3,161
Equity			
Share capital	201	–	201
Share premium	2,469	–	2,469
Other reserves	(122)	(288)	(410)
Retained earnings	345	364	709
Total equity attributable to equity holders of the Company	2,893	76	2,969
Minority interest	195	(3)	192
Total equity	3,088	73	3,161

34 Explanation of transition to IFRS *continued*

Balance sheet as at 31 December 2004

All figures in £ millions	UK GAAP	Adjs	IFRS
Assets			
Non-current assets			
Property, plant and equipment	473	(118)	355
Intangible assets	2,890	388	3,278
Investments in joint ventures and associates	48	(1)	47
Deferred income tax assets	–	359	359
Other financial assets	17	(2)	15
Other receivables	–	102	102
	3,428	728	4,156
Current assets			
Intangible assets – pre-publication	–	356	356
Inventories	676	(362)	314
Trade and other receivables	1,104	(171)	933
Deferred income tax assets	165	(165)	–
Cash and cash equivalents	613	(152)	461
	2,558	(494)	2,064
Non-current assets classified as held for sale	–	358	358
	2,558	(136)	2,422
Total assets	5,986	592	6,578
Liabilities			
Non-current liabilities			
Financial liabilities – Borrowings	(1,712)	(2)	(1,714)
Deferred income tax liabilities	–	(139)	(139)
Retirement benefit obligations	–	(408)	(408)
Provisions for other liabilities and charges	(123)	80	(43)
Other liabilities	(60)	(39)	(99)
	(1,895)	(508)	(2,403)
Current liabilities			
Trade and other liabilities	(1,168)	300	(868)
Financial liabilities – Borrowings	(107)	(2)	(109)
Current income tax liabilities	–	(89)	(89)
Provisions for other liabilities and charges	–	(14)	(14)
	(1,275)	195	(1,080)
Liabilities directly associated with non-current assets classified as held for sale	–	(81)	(81)
Total liabilities	(3,170)	(394)	(3,564)
Net assets	2,816	198	3,014

34 Explanation of transition to IFRS *continued*

Balance sheet as at 31 December 2004 *continued*

All figures in £ millions	UK GAAP	Adjs	IFRS
Equity			
Share capital	201	–	201
Share premium	2,473	–	2,473
Other reserves	(132)	(491)	(623)
Retained earnings	61	688	749
Total equity attributable to equity holders of the Company	2,603	197	2,800
Minority interest	213	1	214
Total equity	2,816	198	3,014

Adjustments to equity

All figures in £ millions	Notes	1 Jan 2003	31 Dec 2003	31 Dec 2004
Total equity UK GAAP		3,468	3,088	2,816
Goodwill amortisation	*a*	66	228	394
Intangible assets acquired	*b*	–	40	48
Intangible assets – capitalised software costs	*c*	3	–	–
Intangible assets – pre-publication expenditure	*d*	–	–	–
Share-based payments	*e*	13	15	22
Employee benefits	*f*	(259)	(284)	(338)
Leases	*g*	(12)	(22)	(33)
Joint ventures	*h*	(3)	(5)	(6)
Associates	*i*	(10)	(10)	(8)
Income taxes	*j*	(3)	(5)	(7)
Dividends	*k*	115	119	125
Other		(2)	(3)	1
Discontinued operations	*l*	–	–	–
Total adjustments to equity		(92)	73	198
Total equity IFRS		3,376	3,161	3,014

34 Explanation of transition to IFRS *continued*

Income statement for the year to 31 December 2003

All figures in £ millions	UK GAAP	Adjs	IFRS
Continuing operations			
Sales	4,048	(198)	3,850
Cost of goods sold	(1,910)	64	(1,846)
Gross profit	2,138	(134)	2,004
Operating expenses	(1,912)	318	(1,594)
Other net gains and losses	6	(12)	(6)
Share of results of joint ventures and associates	–	2	2
Operating profit	232	174	406
Net finance costs	(80)	(13)	(93)
Profit before tax	152	161	313
Income tax	(75)	14	(61)
Profit for the year from continuing operations	77	175	252
Profit for the year from discontinued operations	–	23	23
Profit for the year	77	198	275

Income statement for the year to 31 December 2004

All figures in £ millions	UK GAAP	Adjs	IFRS
Continuing operations			
Sales	3,919	(223)	3,696
Cost of goods sold	(1,866)	77	(1,789)
Gross profit	2,053	(146)	1,907
Operating expenses	(1,832)	312	(1,520)
Other net gains and losses	9	–	9
Share of results of joint ventures and associates	10	(2)	8
Operating profit	240	164	404
Net finance costs	(69)	(10)	(79)
Profit before tax	171	154	325
Income tax	(62)	(1)	(63)
Profit for the year from continuing operations	109	153	262
Profit for the year from discontinued operations	–	22	22
Profit for the year	109	175	284

34 Explanation of transition to IFRS *continued*

Adjustments to profit

All figures in £ millions	Notes	2003	2004
Profit for the year UK GAAP		77	109
Goodwill amortisation	*a*	242	204
Intangible assets acquired	*b*	(4)	(5)
Intangible assets – capitalised software costs	*c*	(1)	(1)
Intangible assets – pre-publication expenditure	*d*	–	–
Share-based payments	*e*	(23)	(16)
Employee benefits	*f*	1	6
Leases	*g*	(10)	(12)
Joint ventures	*h*	(2)	(2)
Associates	*i*	(2)	(2)
Income taxes	*j*	(2)	(2)
Other		(1)	5
Discontinued operations	*l*	–	–
Total adjustments to profit for the year		198	175
Profit for the year IFRS		275	284

Cash flow for the year to 31 December 2003

All figures in £ millions	UK GAAP	Adjs	IFRS
Cash flows from operating activities	228	172	400
Cash flows from investing activities	(91)	(172)	(263)
Cash flows from financing activities	(228)	86	(142)
Effects of exchange rate changes on cash and cash equivalents	37	8	45
Net (decrease)/increase in cash and cash equivalents	(54)	94	40
Cash and cash equivalents at beginning of year	340	148	488
Cash and cash equivalents at end of year	286	242	528

Cash flow for the year to 31 December 2004

All figures in £ millions	UK GAAP	Adjs	IFRS
Cash flows from operating activities	387	175	562
Cash flows from investing activities	(102)	(179)	(281)
Cash flows from financing activities	(255)	(6)	(261)
Effects of exchange rate changes on cash and cash equivalents	(3)	(1)	(4)
Net increase/(decrease) in cash and cash equivalents	27	(11)	16
Cash and cash equivalents at beginning of year	286	242	528
Cash and cash equivalents at end of year	313	231	544

34 Explanation of transition to IFRS *continued*

Effect of IAS 32 and IAS 39 transitional adjustment *(note 1m)*

All figures in £ millions	31 Dec 2004	Adj	1 Jan 2005
Non-current assets			
Deferred income tax assets	359	5	364
Financial assets – Derivative financial instruments	–	145	145
Current assets			
Financial assets – Derivative financial instruments	–	1	1
Non-current liabilities			
Financial liabilities – Borrowings	(1,714)	(134)	(1,848)
Financial liabilities – Derivative financial instruments	–	(40)	(40)
Current liabilities			
Trade and other liabilities	(868)	14	(854)
Financial liabilities – Borrowings	(109)	–	(109)
Financial liabilities – Derivative financial instruments	–	(3)	(3)
Reserves	(126)	12	(114)

First-time adoption exemptions applied

IFRS 1 'First-time Adoption of International Financial Reporting Standards' sets out the transition rules which must be applied when IFRS is adopted for the first time in reporting IFRS financial information. In general the Group is required to select accounting policies in accordance with IFRS valid at its first IFRS reporting date and apply those polices retrospectively. The standard sets out certain mandatory exceptions to retrospective application and certain optional exemptions. The most significant optional exemptions adopted by the Group are set out below:

1 Business combinations

The Group has elected not to apply IFRS 3 'Business Combinations' retrospectively to business combinations that occurred before the date of transition. Subject to the transition adjustments to IFRS required by IFRS 1, the accounting for business combinations before the date of transition is grandfathered at the date of transition from the UK GAAP financial statements.

2 Employee benefits

All cumulative actuarial gains and losses have been recognised in full in the period in which they occur in the statement of recognised income and expense in accordance with IAS 19 'Employee Benefits' (as amended on 16 December 2004).

3 Share-based payments

The Group has elected to apply IFRS 2 'Share-based Payment' retrospectively to all options granted but not fully vested at the date of transition. Consequently the share-based payment charge from 2003 represents the charge for all options granted and not fully vested at 31 December 2002.

4 Financial instruments

The Group has elected to apply IAS 39 'Financial Instruments: Recognition and Measurement' and IAS 32 'Financial Instruments: Disclosure and Presentation' from 1 January 2005. After this date, where hedge accounting cannot be applied under IAS 39, changes in the market value of financial instruments will be taken to the income statement. No adjustment to the 2003 or 2004 UK GAAP financial statements was required due to the chosen adoption date of IAS 32 and IAS 39.

5 Cumulative translation differences

The Group has deemed the cumulative translation differences for foreign operations to be zero at the date of transition. Any gains and losses on disposals of foreign operations will exclude translation differences arising prior to the transition date.

34 Explanation of transition to IFRS *continued*

Significant adjustments

a. Goodwill amortisation – IFRS 3 'Business Combinations' requires that goodwill is not amortised but instead is subject to an impairment review annually or when there are indications that the carrying value may not be recoverable. The Group has elected not to apply IFRS 3 retrospectively to business combinations before the date of transition.

b. Intangible assets acquired – Business combinations since the date of transition have been accounted for in accordance with IFRS 3 'Business Combinations', with intangible assets recognised and amortised over their useful economic lives where they are separable or arise from a contractual or legal right. As part of the acquisition of Comstock Inc in February 2003, certain intangible assets were acquired, mainly relating to customer lists and acquired technology, which are being amortised over periods between two and 30 years. In addition, other less significant intangible assets, mainly relating to publishing rights, have been recognised for some of the smaller acquisitions made during 2004 and amortised over periods of up to 15 years.

c. Capitalised software costs – Under IAS 38 'Intangible Assets' computer software which is not integral to a related item of hardware should be classified as an intangible asset. As such, certain computer software costs have been re-classified from property, plant and equipment to intangible assets. In addition, certain costs relating to software development, previously expensed under UK GAAP, have been capitalised under IAS 38 and are being amortised over their estimated useful lives.

d. Pre-publication expenditure – Under IAS 38 'Intangible Assets', intangible assets are required to be recognised if they meet the criteria of identifiability, control over a resource and existence or probability of inflow of future economic benefits. As such pre-publication costs (the direct costs incurred in the development of educational programmes and titles prior to their publication) have been re-classified from inventory to intangible assets. They continue to be amortised upon publication of the title over estimated economic lives of five years or less, being an estimate of the expected operating life cycle of the title, with a higher proportion of the amortisation taken in the earlier years.

e. Share-based payments – IFRS 2 'Share-based Payment' requires that the expense incurred for equity instruments granted is recognised in the financial statements at their fair value measured at the date of grant and that the expense is recognised over the vesting period of the instrument. The Group has a number of employee option and performance share schemes. The Group has elected to apply IFRS 2 'Share-based Payment' retrospectively to all options granted but not fully vested at the transition date. Consequently the share-based payment charge from 2003 represents the charge for all options granted and not fully vested at 31 December 2002.

f. Employee benefits – IAS 19 'Employee Benefits' was amended on 16 December 2004. The Group has elected to adopt the December 2004 amendments to the standard early and differences between the actual and expected return on assets, changes in the retirement benefit obligation due to experience and changes in actuarial assumptions are included in full in equity in the statement of recognised income and expense. Therefore the amount recognised on the balance sheet in respect of liabilities for defined benefit pension and other post-retirement benefit plans represents the present value of the obligations for past service offset by the fair value of scheme assets.

The service cost of benefits accruing is accounted for as an operating cost and the unwinding of the discount rate on the scheme liabilities and the expected return on scheme assets as a financing charge or financing income. The Group has adopted the same assumptions under IAS 19 as were used for FRS 17 purposes under UK GAAP in 2003 and 2004.

The restated opening IFRS balance sheet reflects the fair value of the plan assets and the present value of the defined benefit obligation of the Group's defined benefit schemes.

g. Leases – IAS 17 'Leases' sets out additional criteria to be considered in ascertaining whether a lease is a finance or operating lease. Following a review of all lease agreements no properties have been re-classified.

In addition, IAS 17 requires that the expense is recognised on a straight line basis over the lease term, including any rent-free periods given at the inception of a lease. Contracted future lease increments must also be amortised evenly over the full period of the lease rather than the period to which the lease is estimated to revert to market rates. The profit and loss account has been adjusted to take into account the amortisation of lease

34 Explanation of transition to IFRS *continued*

incentives over longer periods than under UK GAAP and to accelerate the charge in respect of fixed contractual increments in lease payments.

h. Joint ventures – Following a review, the Group has concluded that its 50% holding in Maskew Miller Longman should be accounted for as a joint venture under IFRS rather than its classification as a subsidiary under UK GAAP.

i. Joint ventures and associates – The results of all joint ventures and associates have been adjusted to take into account IFRS adjustments within their own financial statements.

j. Income taxes – IAS 12 'Income Taxes', requires that deferred taxation also be provided on all temporary differences, not just timing differences as required under UK GAAP. Deferred tax is provided, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements unless the initial recognition exemption applies. Deferred tax is not recognised for temporary differences arising on initial recognition of an asset or liability in a transaction other than a business combination if at the time of transaction neither accounting nor taxable profit is affected. Deferred taxation has been provided on the post-acquisition difference between the book and tax bases of intangible assets and goodwill if its amortisation is tax deductible. A deferred tax liability has also been recognised in respect of the undistributed earnings of subsidiaries other than where it is intended that those undistributed earnings will not be remitted in the foreseeable future.

Deferred taxation has been recognised on the IFRS adjustments at the tax rates that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the asset is realised or the liability is settled. Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

k. Dividends – IAS 10 'Events after the Balance Sheet Date' requires that dividends declared after the balance sheet date should not be recognised as a liability at the balance sheet date as they do not represent a present obligation at that date as defined by IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'.

The final dividends relating to the years to 31 December 2002, 2003 and 2004 have been reversed and recognised as a liability in the years 2003, 2004 and 2005 respectively.

l. Discontinued operations – Consistent with the UK GAAP treatment, Recoletos has been treated as discontinued as at 31 December 2004 and met the criteria as 'held for sale' at that date. Accordingly the results are disclosed in one line in the income statement, 'Profit for the year from discontinued operations' for both 2003 and 2004 and, at 31 December 2004, it is disclosed in the balance sheet in two lines – 'Non-current assets classified as held for sale' and 'Liabilities associated with non-current assets classified as held for sale'.

When an asset's carrying value will be recovered principally through a sale transaction rather than through continuing use and certain criteria regarding probability and proximity of the sale are satisfied, it is classified as held for sale and stated at the lower of carrying value and fair value less costs to sell. No depreciation is charged in respect of non-current assets classified as held for sale.

COMPANY FINANCIAL STATEMENTS

Company statement of recognised income and expense
Year ended 31 December 2005

All figures in £ millions	2005	2004	2003
Net exchange adjustments offset in reserves net of tax	–	(20)	(23)
(Loss)/profit for the year	(362)	946	(10)
Total recognised income and expense for the year	(362)	926	(33)
Effect of transition adjustment on adoption of IAS 39 (see note 11)	(3)		