1 Accounting policies

a. Basis of preparation

The financial statements on pages 107 to 115 comprise the separate financial statements of Pearson plc. As permitted by section 230(4) of the Companies Act 1985, only the Group's income statement has been presented.

b. Group accounting policies

The accounting policies applied in the preparation of these Company financial statements are the same as those set out in Note 1 to the Group financial statements with the addition of the following:

Investments in subsidiaries are stated at cost less provisions for diminution in value.

2 Investments in subsidiaries

All figures in £ millions	2005	2004	2003
At beginning of year	7,134	6,343	6,422
Subscription for share capital in subsidiaries	61	915	–
External acquisition	30	–	15
Share repurchase from subsidiary	(331)	–	–
Disposal to subsidiary	(11)	–	(22)
Provision for diminution in value	–	(100)	(33)
Revaluations	–	(24)	(39)
At end of year	6,883	7,134	6,343

3 Cash and cash equivalents

All figures in £ millions	2005	2004	2003
Short-term bank deposits	598	332	378

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

	2005	2004	2003
Cash and cash equivalents	598	332	378
Bank overdrafts	(326)	(335)	(471)
	272	(3)	(93)

Short-term bank deposits are invested with banks and earn interest at the prevailing short-term deposit rates. The fair value of cash and cash equivalents is the same as the carrying value.

4 Financial liabilities – Borrowings

All figures in £ millions	2005	2004	2003
Non-current			
6.125% Euro Bonds 2007 (nominal amount €591m)	436	390	343
10.5% Sterling Bonds 2008 (nominal amount £100m)	107	100	100
7% Global Dollar Bonds 2011 (nominal amount $500m)	307	260	278
7% Sterling Bonds 2014 (nominal amount £250m)	250	226	235
4.625% US Dollar notes 2018 (nominal amount $300m)	161	156	167
	1,261	1,132	1,123
Current			
Due within one year or on demand:			
Bank loans and overdrafts	366	433	565
4.625% Euro Bonds 2004	–	–	348
	366	433	913
Total borrowings	1,627	1,565	2,036

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

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

Maturity of non-current borrowings:

All figures in £ millions	2005	2004	2003
Between one and two years	436	–	–
Between two and five years	107	490	443
Over five years	718	642	680
	1,261	1,132	1,123

All figures in £ millions	Total	One year	One to five years	More than five years
Carrying value of borrowings	1,627	366	543	718
Effect of interest rate swaps	–	1,160	(471)	(689)
	1,627	1,526	72	29

4 Financial liabilities – Borrowings *continued*

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
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
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
4.625% US Dollar notes 2018	4.69%	161	155	156	142	167	151
		1,261	1,279	1,132	1,215	1,123	1,311

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.

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

All figures in £ millions	2005	2004	2003
US dollar	834	761	1,083
Sterling	357	510	649
Euro	436	294	304
	1,627	1,565	2,036

5 Derivative financial instruments

	2005	
All figures in £ millions	Assets	Liabilities
Interest rate derivatives – in a fair value hedging relationship	31	(16)
Interest rate derivatives – not in a hedging relationship	14	(6)
Cross currency rate derivatives – in a net investment hedging relationship	13	–
Cross currency rate derivatives – not in a hedging relationship	21	–
	79	(22)

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

6 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.

7 Other reserves

All figures in £ millions	Treasury shares	Special reserve	Retained earnings	Total
Balance at 1 January 2003	(39)	447	1,050	1,458
Net exchange adjustments net of tax	–	–	(23)	(23)
Loss for the financial year	–	–	(10)	(10)
Dividends paid	–	–	(188)	(188)
Treasury shares purchased less Group contribution	6	–	–	6
Balance at 31 December 2003	(33)	447	829	1,243
Net exchange adjustments net of tax	–	–	(20)	(20)
Profit for the financial year	–	–	946	946
Dividends paid	–	–	(195)	(195)
Treasury shares purchased less Group contribution	9	–	–	9
Balance at 31 December 2004	(24)	447	1,560	1,983
Loss for the financial year	–	–	(362)	(362)
Dividends paid	–	–	(205)	(205)
Treasury shares purchased less Group contribution	5	–	-	5
Transition adjustment on adoption of IAS 39 (note 11)	–	–	(3)	(3)
Balance at 31 December 2005	(19)	447	990	1,418

The special reserve represents the cumulative effect of cancellation of the Company's share premium account. Included in the profit for the financial year 2004 are dividends received from subsidiaries. During 2005, a dividend of £407m was repaid to a subsidiary as it was subsequently found that the subsidiary did not have adequate distributable reserves as defined under the Companies Act and the guidance set out in the Institute of Chartered Accountants in England and Wales – Technical Release 7/03 ('Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 1985').

8 Contingencies

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

9 Audit fees

Statutory audit fees relating to the Company were £30,000 (2004: £20,000; 2003: £20,000). Audit-related regulatory reporting fees relating to the Company were £225,000 (2004: £225,000; 2003: £200,000).

10 Related party transactions

Subsidiaries The Company transacts and has outstanding balances with its subsidiaries. Amounts due from subsidiaries and amounts due to subsidiaries are disclosed on the face of the Company Balance Sheet. These loans are generally unsecured and interest is calculated based on market rates. The Company has interest payable to subsidiaries during the year of £111m (2004: £131m; 2003: £63m) and interest receivable from subsidiaries during the year of £36m (2004: £51m; 2003: £104m). Management fees payable to subsidiaries in respect of centrally provided services amounted to £37m (2004: £20m; 2003: £1m).

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

There were no other material related party transactions.

11 Explanation of transition to IFRS

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

The accounting policies set out in note 1 of the Pearson plc consolidated financial statements 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 Company'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 Company has taken a transitional exemption and adopted those standards prospectively 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 profit and loss account. 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. 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 Company 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 Company's financial position is set out below. IFRS has had no effect on the Company's cash flow.

Equity

All figures in £ millions	1 Jan 2003	31 Dec 2003	31 Dec 2004
Total equity UK GAAP	4,008	3,794	4,532
Dividends	115	119	125
Total equity IFRS	4,123	3,913	4,657

11 Explanation of transition to IFRS *continued*

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'.

Effect of IAS 32 and IAS 39 transitional adjustment

All figures in £ millions	31 Dec 2004	Adj	1 Jan 2005
Non-current assets			
Financial assets – Derivative financial instruments	–	135	135
Current assets			
Financial assets – Derivative financial instruments	–	1	1
Current income tax assets	66	1	67
Non-current liabilities			
Financial liabilities – Borrowings	(1,132)	(109)	(1,241)
Financial liabilities – Derivative financial instruments	–	(40)	(40)
Current liabilities			
Other liabilities	(13)	12	(1)
Financial liabilities – Borrowings	(433)	–	(433)
Financial liabilities – Derivative financial instruments	–	(3)	(3)
Reserves	(1,983)	3	(1,980)