

PEARSON PLC  
Form 20-F  
May 05, 2006

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON May 5, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 20-F

(Mark One)

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE  
SECURITIES EXCHANGE ACT OF 1934

or

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

for the fiscal year ended December 31, 2005

or

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

for the transition period from to

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report

If this is an annual report, indicate by check mark whether the registrant is a shell company  
(as defined in Rule 12-b2 of the Exchange Act). Yes  No

Commission file number 1-16055

PEARSON PLC

*(Exact name of Registrant as specified in its charter)*

England and Wales

*(Jurisdiction of incorporation or organization)*

80 Strand

London, England WC2R 0RL

*(Address of principal executive offices)*

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of Class

Name of Each Exchange on Which Registered

\*Ordinary Shares, 25p par value  
American Depositary Shares, each Representing One  
Ordinary Share, 25p per Ordinary Share

New York Stock Exchange  
New York Stock Exchange

\* Not for trading, but only in connection with the registration of American Depositary Shares, pursuant to the requirements of the SEC.

**Securities registered or to be registered pursuant to Section 12(g) of the Act:**  
**None**

**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:**  
**None**

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock at the close of the period covered by the annual report:

Ordinary Shares, 25p par value 804,020,000

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

Indicate by check mark which financial statement item the Registrant has elected to follow:

Item 17  Item 18

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes  No

Note: Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer", in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer       Accelerated filer       Non-accelerated filer

---

## TABLE OF CONTENTS

	<b>Page</b>
<u>Introduction</u>	4
<u>Forward-Looking Statements</u>	4
<b><u>PART I</u></b>	
<b><u>Item 1. Identity of Directors, Senior Management and Advisers</u></b>	6
<b><u>Item 2. Offer Statistics and Expected Timetable</u></b>	6
<b><u>Item 3. Key Information</u></b>	6
<u>Selected Consolidated Financial Data</u>	6
<u>Dividend Information</u>	8
<u>Exchange Rate Information</u>	8
<u>Risk Factors</u>	9
<b><u>Item 4. Information on the Company</u></b>	12
<u>Pearson</u>	12
<u>Overview of Operating Divisions</u>	12
<u>Our Strategy</u>	12
<u>Operating Divisions</u>	13
<u>Pearson Education</u>	13
<u>The FT Group</u>	14
<u>The Penguin Group</u>	16
<u>Competition</u>	16
<u>Intellectual Property</u>	17
<u>Raw Materials</u>	17
<u>Government Regulation</u>	17
<u>Licenses, Patents and Contracts</u>	17
<u>Recent Developments</u>	17
<u>Organizational Structure</u>	17
<u>Property, Plant and Equipment</u>	18
<b><u>Item 4A. Unresolved Staff Comments</u></b>	19
<b><u>Item 5. Operating and Financial Review and Prospects</u></b>	19
<u>General Overview</u>	19
<u>Results of Operations</u>	24
<u>Liquidity and Capital Resources</u>	37
<u>Accounting Principles</u>	39
<b><u>Item 6. Directors, Senior Management and Employees</u></b>	42
<u>Directors and Senior Management</u>	42
<u>Compensation of Senior Management</u>	44
<u>Share Options of Senior Management</u>	49
<u>Share Ownership of Senior Management</u>	51
<u>Employee Share Ownership Plans</u>	51
<u>Board Practices</u>	51
<u>Employees</u>	52
<b><u>Item 7. Major Shareholders and Related Party Transactions</u></b>	53
<b><u>Item 8. Financial Information</u></b>	53
<u>Legal Proceedings</u>	53
<b><u>Item 9. The Offer and Listing</u></b>	53
<b><u>Item 10. Additional Information</u></b>	54

<b><u>Item 11.</u></b>	<b><u>Quantitative and Qualitative Disclosures About Market Risk</u></b>	62
	<u>Introduction</u>	62
	<u>Interest Rates</u>	62
	<u>Currency Exchange Rates</u>	63
	<u>Forward Foreign Exchange Contracts</u>	63
<b><u>Item 12.</u></b>	<b><u>Description of Securities Other Than Equity Securities</u></b>	64

	<b>Page</b>	
<b><u>PART II</u></b>		
<b><u>Item 13.</u></b>	<b><u>Defaults, Dividend Arrearages and Delinquencies</u></b>	64
<b><u>Item 14.</u></b>	<b><u>Material Modifications to the Rights of Security Holders and Use of Proceeds</u></b>	64
<b><u>Item 15.</u></b>	<b><u>Controls and Procedures</u></b>	64
<b><u>Item 16A.</u></b>	<b><u>Audit Committee Financial Expert</u></b>	65
<b><u>Item 16B.</u></b>	<b><u>Code of Ethics</u></b>	65
<b><u>Item 16C.</u></b>	<b><u>Principal Accountant Fees and Services</u></b>	65
<b><u>Item 16D.</u></b>	<b><u>Exemptions from the Listing Standards for Audit Committees</u></b>	66
<b><u>Item 16E.</u></b>	<b><u>Purchases of Equity Securities by the Issuer and Affiliated Purchases</u></b>	66
<b><u>PART III</u></b>		
<b><u>Item 17.</u></b>	<b><u>Financial Statements</u></b>	66
<b><u>Item 18.</u></b>	<b><u>Financial Statements</u></b>	66
<b><u>Item 19.</u></b>	<b><u>Exhibits</u></b>	66

## INTRODUCTION

In this Annual Report on Form 20-F (the Annual Report ) references to Pearson or the Group are references to Pearson plc, its predecessors and its consolidated subsidiaries, except as the context otherwise requires. Ordinary Shares refer to the ordinary share capital of Pearson of par value 25p each. ADSs refer to American Depositary Shares which are Ordinary Shares deposited pursuant to the Deposit Agreement dated March 21, 1995, amended and restated as of August 8, 2000 among Pearson, The Bank of New York as depositary (the Depositary ) and owners and holders of ADSs (the Deposit Agreement ). ADSs are represented by American Depositary Receipts ( ADRs ) delivered by the Depositary under the terms of the Deposit Agreement.

We have prepared the financial information contained in this Annual Report in accordance with European Union ( EU )-adopted International Financial Reporting Standards ( IFRS ), which differ in certain significant respects from generally accepted accounting principles in the United States, or US GAAP. We describe these differences in Item 5. Operating and Financial Review and Prospects Accounting Principles , and in note 35 to our consolidated financial statements included in Item 17. Financial Statements of this Annual Report. Unless we indicate otherwise, any reference in this Annual Report to our consolidated financial statements is to the consolidated financial statements and the related notes, included elsewhere in this Annual Report.

We publish our consolidated financial statements in sterling. We have included, however, references to other currencies. In this Annual Report:

references to sterling , pounds , pence or £ are to the lawful currency of the United Kingdom,

references to euro or are to the euro, the lawful currency of the participating Member States in the Third Stage of the European Economic and Monetary Union of the Treaty Establishing the European Commission, and

references to US dollars , dollars , cents or \$ are to the lawful currency of the United States.

For convenience and except where we specify otherwise, we have translated some Sterling figures into US dollars at the rate of £1.00 = \$1.72, the noon buying rate in The City of New York for cable transfers and foreign currencies as certified by the Federal Reserve Bank of New York for customs purposes on December 30, 2005, the last business day of 2005. We do not make any representation that the amounts of sterling have been, could have been or could be converted into dollars at the rates indicated. On April 28, 2006 the noon buying rate for sterling was £1.00 = \$1.82.

## FORWARD-LOOKING STATEMENTS

You should not rely unduly on forward-looking statements in this Annual Report. This Annual Report, including the sections entitled Item 3. Key Information Risk Factors , Item 4. Information on the Company and Item 5. Operating and Financial Review and Prospects , contains forward-looking statements that relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terms such as may , will , should , expect , intend , plan , anticipate , believe , estimate , predict , potential , continue or the negat other comparable terminology. Examples of these forward-looking statements include, but are not limited to, statements regarding the following:

operations and prospects,

growth strategy,

funding needs and financing resources,

expected financial position,

market risk,

currency risk,

US federal and state spending patterns,  
debt levels, and  
general market and economic conditions.



These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our or our industry's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements. In evaluating them, you should consider various factors, including the risks outlined under Item 3. Key Information Risk Factors, which may cause actual events or our industry's results to differ materially from those expressed or implied by any forward-looking statement. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements.

## **PART I**

### **ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

### **ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

### **ITEM 3. KEY INFORMATION**

#### **Selected Consolidated Financial Data**

The table below shows selected consolidated financial data for each of the years in the five-year period ended December 31, 2005. The selected consolidated profit and loss account data for the years ended December 31, 2005, 2004 and 2003 and the selected consolidated balance sheet data as at December 31, 2005, 2004 and 2003 have been derived from our audited consolidated financial statements included in Item 17. Financial Statements in this Annual Report and have been prepared in accordance with IFRS.

Our consolidated financial statements for the year ended December 31, 2005 have been prepared in accordance with IFRS, which differs from US GAAP in certain significant respects. See Item 5. Operating and Financial Review and Prospects Accounting Principles and note 35 to the consolidated financial statements. The consolidated financial statements contain a reconciliation to US GAAP of profit/loss for the financial year, shareholders funds and certain other financial data.

The selected consolidated financial information should be read in conjunction with Item 5. Operating and Financial Review and Prospects and our consolidated financial statements and the related notes appearing elsewhere in this Annual Report. The information provided below is not necessarily indicative of the results that may be expected from future operations.

For convenience, we have translated the 2005 amounts into US dollars at the rate of £1.00 = \$1.72, the noon buying rate in The City of New York on December 30, 2005.

#### **Restatement**

In accordance with EU regulations, the Company has prepared the financial statements as at December 31, 2005 in accordance with EU-adopted International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations Committee interpretations (IFRIC). Consolidated financial statements of Pearson until December 31, 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. See note 34 to our consolidated financial statements for an explanation of the effects of transition to IFRS.

	Year Ended December 31			
	2005	2005	2004	2003
	IFRS	IFRS	IFRS	IFRS
		£	£	£
			\$	
	(In millions, except for per share amounts)			
<b>IFRS Information:</b>				
<b>Consolidated Profit and Loss Account Data</b>				
<b>Statutory Measures</b>				
Total sales	7,045	4,096	3,696	3,850
Total operating profit/(loss)	922	536	404	406
Profit/(loss) after taxation from continuing operations	588	342	262	252
Profit/(loss) for the financial year	1,108	644	284	275
Basic earnings/(loss) per equity share(4)	\$ 1.35	78.2p	32.9p	31.7p
Diluted earnings/(loss) per equity share(5)	\$ 1.34	78.1p	32.9p	31.7p
Dividends per ordinary share	\$ 0.46	27.0p	25.4p	24.2p
<b>Consolidated Balance Sheet Data</b>				
Total assets (Fixed assets plus Current assets)	13,072	7,600	6,578	6,736
Shareholders funds	6,130	3,564	2,800	2,969
Long-term obligations(6)	(4,300)	(2,500)	(2,403)	(1,982)
Capital stock(1)	346	201	201	201
Number of equity shares outstanding (millions of ordinary shares)	804	804	803	802

	Year Ended December 31					
	2005	2005	2004	2003	2002	2001
		£	£	£	£	£
	\$					
	(In m	illions, except for per share amounts)				
<b>US GAAP Information(7):</b>						
<b>Consolidated Profit and Loss Account Data</b>						
<b>Statutory Measures</b>						
Total sales	7,045	4,096	3,696	3,879	4,320	4,225
Total operating profit/(loss)(2)	746	434	260	364	453	(389)
Profit/(loss) after taxation from continuing operations	330	192	203	198	219	(1,483)
Profit/(loss) for the financial year(8)	707	411	182	173	189	(1,500)
Profit/(loss) from continuing operations for the financial year(3)	299	174	166	160	221	(424)
(Loss)/profit from discontinued operations(3)	(3)	(2)	16	16	(10)	(91)
	411	239		(3)	(1)	(985)

## Profit/(loss) on disposal of discontinued operations(3)

Basic earnings/(loss) per equity share(4)	\$ 0.89	51.5p	22.9p	21.8p	23.7p	(188.6)p
Diluted earnings/(loss) per equity share(5)	\$ 0.88	51.4p	22.8p	21.8p	23.7p	(188.6)p
Basic earnings/(loss) from continuing operations per equity share(1)(4)	\$ 0.37	21.8p	20.9p	20.1p	27.8p	(53.3)p
Diluted earnings/(loss) from continuing operations per equity shares(3)(5)	\$ 0.37	21.7p	20.8p	20.1p	27.8p	(53.3)p
Basic (loss)/earnings per share from discontinued operations(3)(4)	\$ 0.51	29.7p	2.0p	1.7p	(4.1)p	(135.3)p
Diluted (loss)/earnings per share from discontinued operations(3)(5)	\$ 0.51	29.7p	2.0p	1.7p	(4.1)p	(135.3)p
Dividends per ordinary share	\$ 0.46	27.0p	25.4p	24.2p	22.7p	21.9p

**Consolidated Balance Sheet Data**

Total assets	13,416	7,800	7,040	7,101	6,767	8,280
Shareholders funds	6,601	3,838	3,218	3,333	4,155	4,155
Long-term obligations(6)	(4,123)	(2,397)	(2,392)	(1,951)	(2,026)	(2,829)

- (1) Capital stock and the number of equity shares outstanding are the same under both IFRS and US GAAP.
- (2) Total operating profit under US GAAP includes a profit of £nil in 2005 (a profit of £14 million in 2004 and a loss of £7 million in 2003) on the sale of fixed assets and investments. Additionally, the US GAAP operating profit includes the operating profit impact of the GAAP adjustments discussed in note 35 in Item 17. Financial Statements .
- (3) Discontinued operations under both IFRS and US GAAP comprise the results of Recoletos Grupo de Comunicacion SA for all years presented and the results of RTL Group for 2002 and 2001. Discontinued operations under US GAAP also include the results of the Forum Corporation for 2003, 2002 and 2001.
- (4) Basic earnings/loss per equity share is based on profit/loss for the financial period and the weighted average number of ordinary shares in issue during the period.
- (5) Diluted earnings/loss per equity share is based on diluted earnings/loss for the financial period and the diluted weighted average number of ordinary shares in issue during the period. Diluted earnings/loss comprise earnings/loss adjusted for the tax benefit on the conversion of share options by employees and the weighted average number of ordinary shares adjusted for the dilutive effect of share options.
- (6) Long-term obligations comprise any liabilities with a maturity of more than one year, including medium and long-term borrowings, derivative financial instruments, pension obligations and deferred income tax liabilities.
- (7) See note 35 to the consolidated financial statements included in this Annual Report entitled Summary of principal differences between International Financial Reporting Standards and United States of America generally accepted accounting principles .
- (8) The loss of £1,500 million in 2001 is after charging goodwill amortization of £527 million. Since 2002, goodwill has no longer been subject to amortization under US GAAP. See note 35 in Item 17. Financial Statements .

#### Dividend Information

We pay dividends to holders of ordinary shares on dates that are fixed in accordance with the guidelines of the London Stock Exchange. Our board of directors normally declares an interim dividend in July or August of each year to be paid in September or October. Our board of directors normally recommends a final dividend following the end of the fiscal year to which it relates, to be paid in the following May or June, subject to shareholders approval at our annual general meeting. At our annual general meeting on April 21, 2006 our shareholders approved a final dividend of 17.0p per ordinary share for the year ended December 31, 2005.

The table below sets forth the amounts of interim, final and total dividends paid in respect of each fiscal year indicated, and is translated into cents per ordinary share at the noon buying rate in the city of New York on each of the respective payment dates for interim and final dividends. The final dividend for the 2005 fiscal year will be paid on 5 May 2006.

Fiscal Year	Interim	Final	Total	Interim	Final	Total
	(Pence per ordinary share)			(Cents per ordinary share)		
2005	10.0	17.0	27.0	17.2	29.2	46.4
2004	9.7	15.7	25.4	18.6	30.2	48.8
2003	9.4	14.8	24.2	16.7	26.4	43.1
2002	9.1	14.3	23.4	14.7	23.0	37.7

2001	8.7	13.6	22.3	12.6	19.7	32.3
------	-----	------	------	------	------	------

Future dividends will be dependent on our future earnings, financial condition and cash flow, as well as other factors affecting the Group.

**Exchange Rate Information**

The following table sets forth, for the periods indicated, information concerning the noon buying rate for sterling, expressed in dollars per pound sterling. The average rate is calculated by using the average of the noon buying rates in the city of New York on each day during a monthly period and on the last day of each month

during an annual period. On December 30, 2005, the noon buying rate for sterling was £1.00 = \$1.72. On April 28, 2006 the noon buying rate for sterling was £1.00 = \$1.82.

Month	High	Low
April 2006	\$ 1.82	\$ 1.74
March 2006	\$ 1.76	\$ 1.73
February 2006	\$ 1.78	\$ 1.73
January 2006	\$ 1.79	\$ 1.74
December 2005	\$ 1.77	\$ 1.72
November 2005	\$ 1.78	\$ 1.71

Year Ended December 31	Average Rate
2005	\$ 1.81
2004	\$ 1.84
2003	\$ 1.63
2002	\$ 1.51
2001	\$ 1.45

### Risk Factors

*You should carefully consider the risk factors described below, as well as the other information included in this Annual Report. Our business, financial condition or results from operations could be materially adversely affected by any or all of these risks, or by other risks that we presently cannot identify.*

***Our US educational textbook and testing businesses may be adversely affected by changes in state educational funding resulting from either general economic conditions, changes in government educational funding, programmes and legislation (both at the federal and state level), and/or changes in the state procurement process.***

The results of our US educational textbook and testing business depends on the level of US and state educational funding and this funding is a significant influence on our ability to grow.

With the improvement in the US economy state educational expenditure has increased as state tax receipts have increased, reducing or eliminating state budget deficits, thereby minimizing the risk that state educational expenditure is cut or deferred. Federal legislative changes can also affect the funding available for educational expenditure, e.g. the No Child Left Behind Act. These might also include changes in the procurement process for textbooks, learning material and student tests, particularly in the adoptions market. For example, changes in curricula, delays in the timing of the adoptions and changes in the student testing process can all affect these programs and therefore the size of our market in any given year.

There are multiple competing demands for educational funds and there is no guarantee that states will fund new textbooks or testing programs, or that we will win this business.

***Our newspaper businesses may be adversely affected by reductions in advertising revenues and/or circulation either due to weak general economic conditions or competing news information distribution channels, particularly online and digital formats.***

Our newspaper businesses are highly geared and remain dependent on advertising revenue; relatively small changes in revenue, positive or negative, have a disproportionate affect on profitability. We are beginning to see an increase in advertising revenues compared to prior years, however any downturn in corporate and financial advertising spend would negatively impact our results.

Changes in consumer purchasing habits, as readers look to alternative sources and/or providers of information, such as the internet and other digital formats, may change the way we distribute our content. We might see a decline in print circulation in our more mature markets as readership habits change and readers migrate online, although we see further opportunities for growth in our less mature markets outside Europe. If the migration of readers to new digital formats occurs more quickly than we expect, this is likely to affect print advertising spend by our customers, adversely affecting our profitability.



***Our intellectual property and proprietary rights may not be adequately protected under current laws in some jurisdictions and that may adversely affect our results and our ability to grow.***

Our products largely comprise intellectual property delivered through a variety of media, including newspapers, books and the internet. We rely on trademark, copyright and other intellectual property laws to establish and protect our proprietary rights in these products.

We cannot be sure that our proprietary rights will not be challenged, invalidated or circumvented. Our intellectual property rights in countries such as the United States and the United Kingdom, which are the jurisdictions with the largest proportions of our operations, are well established. However, we also conduct business in other countries where the extent of effective legal protection for intellectual property rights is uncertain, and this uncertainty could affect our future growth. Moreover, despite trademark and copyright protection, third parties may copy, infringe or otherwise profit from our proprietary rights without our authorization.

These unauthorized activities may be more easily facilitated by the internet. The lack of internet-specific legislation relating to trademark and copyright protection creates an additional challenge for us in protecting our proprietary rights relating to our online business processes and other digital technology rights. The loss or diminution in value of these proprietary rights or our intellectual property could have a material adverse effect on our business and financial performance. In that regard, Penguin Group (USA) Inc. and Pearson Education have joined three other major US publishers in a suit brought under the auspices of the Association of American Publishers to challenge Google's plans to copy the full text of all books ever published without permission from the publishers or the authors. This lawsuit seeks to demarcate the extent to which search engines and other internet operators may rely on the fair-use doctrine to copy content without authorization from the copyright proprietors, and may give publishers more control over on-line users of their intellectual property. If the lawsuit is unsuccessful, publishers and authors may not be able to control copying of their content for purposes of on-line searching, which could have an adverse impact on our business and financial performance.

***The contracting risks associated with our Professional division within Pearson Education are complex and could adversely affect our financial results and growth prospects.***

Our Professional division provides services ranging from call center operations to complete outsourcing of administrative functions. Customers are government agencies and professional organizations, mainly in the USA and the UK, and commercial businesses. These services are provided under contracts with values that vary significantly, from a few million to several hundred million pounds over the term of the contract, which can run from one to ten years in length. The results of our Professional division can be significantly dependent on a small number of large contracts.

As in any long-term contracting business, there are inherent risks associated with the bidding process, operational performance, contract compliance (including penalty clauses), indemnification (if available) and contract re-bidding, which could adversely affect our financial performance and/or reputation. In addition, US government contracts are subject to audit and investigation by the applicable contracting government entity and may otherwise be investigated by the government, and this can result in payment delays and, in certain circumstances, reductions in the amounts received, penalties or other sanctions.

***A control breakdown in our school testing businesses could result in financial loss and reputational damage.***

There are inherent risks associated with our school testing businesses, both in the USA and the UK. A breakdown in our testing and assessment products and processes could lead to a mis-grading of student tests and/or late delivery of test results to students and their schools. In either event we may be subject to legal claims, penalty charges under our contracts, non-renewal of contracts and in the case of our UK testing business, the suspension or withdrawal of our accreditation. It is also possible that such events would result in adverse publicity, which may affect our ability to retain existing contracts and/or obtain new customers.

We have recently experienced adverse publicity as a result of the rescoring of the October 2005 Scholastic Aptitude Test, or SAT, in the USA. We provide answer sheet scanning services for the College Board, which administers the SAT. We rescanned approximately 1.5 million tests taken in October 2005 through January 2006 and, as a result, the College Board reissued higher scores for about 4,400 out of



approximately 495,000 tests taken in October. We have also been named along with the College Board as a defendant in a class action lawsuit filed as a result of the revised scores.

***Changes in the Penguin business may restrict our ability to grow and our profitability.***

New distribution channels, e.g. digital format, the internet, used books, combined with the concentration of retailer power pose multiple threats to our traditional consumer publishing models. Penguin's financial performance can also be negatively affected if book return rates increase.

***We operate in a highly competitive environment that is subject to rapid change and we must continue to invest and adapt to remain competitive.***

Our education, business information and book publishing businesses operate in highly competitive markets. These markets constantly change in response to competition, technological innovations and other factors. To remain competitive we continue to invest in our authors, products and services. There is no guarantee that these investments will generate the anticipated returns or protect us from being placed at a competitive disadvantage with respect to scale, resources and our ability to develop and exploit opportunities. Specific competitive threats we face at present include:

Students seeking cheaper sources of content, e.g. on-line, used books or imported textbooks. To counter this trend we introduced our own on-line format (called SafariX) and are providing students with a greater choice and customization of our products.

Competition from major publishers and other educational material and service providers in our US educational textbook and testing businesses.

Penguin Authors' advances in consumer publishing. We compete with other publishing businesses for the rights to author manuscripts. In certain instances author advances can be bid up to a level at which we cannot generate a sufficient return on our investment.

***We operate in markets which are dependent on Information Technology systems and technological change.***

All our businesses, to a greater or lesser extent, are dependent on technology. We either provide software and/or internet services or we use complex information technology systems and products to support our business activities, particularly in business information publishing, back-office processing and infrastructure.

We face several technological risks associated with software product development and service delivery in our educational businesses, information technology security (including virus and hacker attacks), e-commerce, enterprise resource planning system implementations and upgrades and business continuity in the event of a disaster at a key data center.

***Our reported earnings may be adversely affected by changes in our pension costs and funding requirements due to poor investment returns and/or changes in pension regulations.***

We operate a number of pension schemes throughout the world, the principal ones being in the UK and US. The major schemes are self-administered with the schemes' assets held independently of the Group. Regular valuations, conducted by independent qualified actuaries, are used to determine pension costs and funding requirements.

It is our policy to ensure that each pension scheme is adequately funded to meet its ongoing and future liabilities. Our earnings may be adversely affected by lower investment returns due to a general deterioration in equity or bond markets, requiring increased company funding of these schemes to eliminate any deficits over time. Similarly, changes in pension regulations, including accounting rules, may affect our pension costs and funding status.

***Sarbanes-Oxley (SOX) 404 Compliance cost***

Beginning with our 2006 fiscal year, we will be required to comply with section 404 of SOX relating to internal control over financial reporting. Our SOX 404 implementation project commenced in 2003 and we believe we are on track to be compliant. However, the cost of complying with SOX 404 may reduce our earnings.

***We generate a substantial proportion of our revenue in foreign currencies, particularly the US dollar, and foreign exchange rate fluctuations could adversely affect our earnings.***

As with any international business our earnings can be materially affected by exchange rate movements. We are particularly exposed to movements in the US dollar to sterling exchange rate as approximately 65% of our revenue is generated in US dollars. We estimate that if 2004 average rates had prevailed in 2005, sales for 2005 would have been £46 million or 1% lower. This is predominantly a currency translation risk (i.e., non-cash flow item), and not a trading risk (i.e., cash flow item) as our currency trading flows are relatively limited. We estimate that a five cent change in the average exchange rate between the US dollar and sterling in any year could affect our reported earnings per share by approximately 1 pence.

**ITEM 4. INFORMATION ON THE COMPANY**

**Pearson**

Pearson is a global publishing company with its principal operations in the education, business information and consumer publishing markets. We have significant operations in the United States, where we generate over 65% of our revenues, and in the United Kingdom and continental Europe. We create and manage intellectual property, which we promote and sell to our customers under well-known brand names, to inform, educate and entertain. We deliver our content in a variety of forms and through a variety of channels, including books, newspapers and internet services. We increasingly offer services as well as content, from test processing to training.

Pearson was incorporated and registered in 1897 under the laws of England and Wales as a limited company and re-registered under the UK Companies Act as a public limited company in 1981. We conduct our operations primarily through our subsidiaries and other affiliates. Our principal executive offices are located at 80 Strand, London WC2R 0RL, United Kingdom (telephone: +44 (0) 20 7010 2000).

**Overview of Operating Divisions**

Although our businesses increasingly share markets, brands, processes and facilities, they consist of three core operations:

**Pearson Education** is a global leader in educational publishing and services. We are a leading international publisher of textbooks, supplementary materials and electronic education programs for elementary and secondary school, higher education and business and professional markets worldwide. We also play a major role in the testing and certification of school students and professionals, mainly in the US but increasingly in the UK. Pearson Education consists of the following three operating segments:

School publisher, provider of testing and software services for primary and secondary schools

Higher Education publishes textbooks and related course materials for colleges and universities

Professional publishes texts, reference and interactive products for industry professionals. Provides various testing and service arrangements for government departments and professional bodies.

**The FT Group** consists of our international newspaper, print and online financial information, business magazine and professional publishing interests. Our flagship product is the *Financial Times*, published internationally and known for its premium editorial content and international scope both in newspaper and internet formats. The FT Group comprises the following operating segments:

FT Publishing publishes the *Financial Times*, other business newspapers, magazines and specialist information

Interactive Data ( IDC ) provides financial and business information to financial institutions and retail investors.

**The Penguin Group** is one of the premier English language publishers in the world, with brand imprints such as Penguin, Putnam, Berkley, Viking and Dorling Kindersley ( DK ). We publish the works of many authors in an extensive portfolio of fiction, non-fiction, reference and illustrated works.

**Our Strategy**

Since 1997, we have reshaped Pearson by divesting a range of non-core interests and investing over \$7 billion in education, consumer publishing and business information companies. Each one of our businesses



aims to benefit from educating, informing and entertaining people in an increasingly knowledge-based economy. Our strategy is:

to focus on businesses which provide education, in the broadest sense of the word, through intellectual property;

to provide a combination of publishing, both in print and online, and related services that make our publishing more valuable and take us into new, faster-growing markets;

to continue to invest in the growth of our businesses, including:

extending our lead in education publishing, investing in new programs for students in School and Higher Education and in testing and software services that help educators to personalize the learning process, both in the US and around the world;

developing our fast-growing contracting businesses, which provide testing and other services to corporations and government agencies;

building the international reach of the *Financial Times* both in print through its four editions worldwide and online through FT.com and enhancing the market positions of our network of national business newspapers around the world; and

growing our position in consumer publishing, balancing our investment across our stable of best-selling authors, new talent and our own home-grown content;

to foster a collaborative culture which facilitates greater productivity and innovation by sharing processes, costs, technology, talent and assets across our business;

to capitalize on the growth prospects in our markets and on our leaner operations to improve profits, cash flows and returns on invested capital.

## **Operating Divisions**

### ***Pearson Education***

Pearson Education is one of the world's largest publishers of textbooks and online teaching materials based on published sales figures and independent estimates of sales. Pearson Education serves the growing demands of teachers, students, parents and professionals throughout the world for stimulating and effective education programs. With federal and state governments increasingly required to measure academic progress against clear objective standards, the market for educational testing services in the United States has grown significantly, as have markets around the world. Our integrated approach to education has helped us grow faster because of our breadth.

We report Pearson Education's performance by the three market segments it serves: School, Higher Education and Professional. In 2005, Pearson Education had sales of £2,663 million or 65% of Pearson's total sales (63% in 2004).

### ***School***

In the United States, our School business includes publishing, testing and software operations. Outside of the United States, we have a growing English Language Teaching business and we also publish school and college materials in local languages in a number of countries. In the United States, we publish for pre-kindergarten through 12th grade, with a comprehensive range of textbooks, supplementary materials and electronic education programs. Pearson Education's elementary school imprint, Pearson Scott Foresman, and secondary school imprint, Pearson Prentice Hall School, publish high quality programs covering subjects such as reading, literature, math, science and social studies. We also publish supplementary teaching aids for both elementary and secondary schools and teacher-written activity books. We are a leading publisher in online assessment and digital courseware through Pearson Digital Learning, whose offerings include SuccessMaker, NovaNet and the Waterford Early Reading Program. Through Pearson Achievement Solutions, we provide professional development for teachers in kindergarten through 12th grade with the use of the latest technologies and software tools to improve classroom teaching.

In the US, Pearson's assessments & testing operations are leading service providers in the markets for test development, processing and scoring and the provision of enterprise software solutions to schools. We score and process some 40 million student tests across the United States each year.

Pearson School Systems provides district-wide solutions that combine the power of assessment, student information, financial systems and actionable reporting to improve student performance. We are the market leader in student information with our solutions used by over 20% of schools nationwide and we are the provider of the newest technologies for benchmark testing and student progress analysis.

Over 90% of education spending for kindergarten through 12th grade in the United States is financed at the state or local level, with the remainder coming from federal funds. The School division's major customers are state education boards and local school districts. In the United States, 21 states, which account for over 50% of the total kindergarten through 12th grade US school population of some 53 million students, buy educational programs by means of periodic statewide adoptions. These adoptions cover programs in the core subject areas. Typically, a state committee selects a short-list of education programs from which the school districts then make individual choices. We actively seek to keep as many of our offerings as possible on the approved list in each state, and we sell directly to the school districts. In the states without adoptions, called open territories, local school districts choose education programs from the entire range available. We actively sell to school districts in open territories as well.

In 2004, Edexcel won a five year contract for the administration and marking of Key Stage testing for 11 and 14 year old students in the UK. Edexcel also began electronic scanning and marking of GCSE and A-level exams in 2004. 4 million scripts were marked electronically in 2005.

#### *Higher Education*

Pearson Education is the United States largest publisher, by sales, of textbooks and related course materials for colleges and universities. We publish across all of the main fields of study with imprints such as Pearson Prentice Hall, Pearson Addison Wesley, Pearson Allyn & Bacon and Pearson Benjamin Cummings. Our sales forces call on college educators, who choose the textbooks and online resources to be purchased by their students. In 2005, 1.8 million college students registered for our online offerings, which include homework and assessment products, online study guides and textbook companion websites. Many of our online offerings are integrated with course management systems that provide easy-to-use tools that enable professors to create online courses. In addition, our custom publishing business, Pearson Custom, works with professors to produce textbooks specifically adapted for their particular course.

#### *Professional*

We publish text, reference, and interactive products for IT industry professionals, graphics and design users of all types, and consumers interested in software applications and certification, professional business books, and strategy guides for those who use PC and console games. Publishing imprints in this area include Addison Wesley Professional, Prentice Hall PTR, and Cisco Press (IT professional imprints), Peachpit Press and New Riders Press (graphics and design imprints), Que/Sams (consumer and professional imprint) and Prentice Hall Financial Times (business imprint). We also generate revenues through our own website InformIT, and through Safari Books Online (a joint venture with O'Reilly Media). We also provide services to professional markets, managing several commercial contracts to implement and execute qualification and assessment systems for individual professions, including IT professionals and nurses.

Our Government Solutions group manages and processes student loan applications on behalf of the US Department of Education. It also provides a number of non-education and other testing and service-related contracts with various government agencies both within and outside the US.

We also provide a range of data collection and management services, including scanners, to a wide range of customers. We also provide corporate training courses to professionals.

Contracts include a seven year contract to develop and deliver the Graduate Management Admissions Test (GMAT) worldwide, beginning in January 2006 and a nine year, non-exclusive contract to deliver the National Association of Security Dealers exams.

#### *The FT Group*

The FT Group, one of the world's leading business information sources, aims to provide a broad range of data, analysis and services to an audience of internationally-minded business people. In 2005, the FT Group had sales of £629 million, or 15% of Pearson's total sales (16% in 2004). The FT Group's business is global,





producing a combination of news, data, comment, analysis and context. In addition to professional and business consumers, individuals worldwide are demanding such strategic business information.

#### *FT Publishing*

The *Financial Times* is a leading international daily business newspaper. Its average daily circulation of 439,563 copies in December 2005, as reported by the Audit Bureau of Circulation, gives the *Financial Times* the second largest circulation of any English language business daily in the world. The *Financial Times* derived approximately 67% of its revenue in 2005 from advertising and approximately 33% from print and online content sales. The geographic distribution of the *Financial Times* average daily circulation in 2005 was:

United Kingdom/ Republic of Ireland	32%
Continental Europe, Africa and Middle East	31%
Americas	29%
Asia	8%

The *Financial Times* is printed on contract in 23 cities around the world and our sales mix is increasingly international. The newspaper draws upon an extensive local network of correspondents to produce unique, informative and timely business information. For production and distribution, the *Financial Times* uses computer-driven communications and printing technology for timely delivery of the various editions of the newspaper to the appropriate geographic markets. The *Financial Times* is distributed through independent newsagents and direct delivery to homes and institutions.

The FT seeks to make its content available both in print and online, through FT.com, its internet service, and sales of electronic content to third parties. FT.com charges subscribers for detailed industry news, comment and analysis, while providing general news and market data to a wider audience. The business earns revenues by selling content directly, selling advertising and selling subscriptions. At the end of December 2005, FT.com had 84,000 paying subscribers and an average of 3.2 million unique monthly users.

Our other business publishing interests include France's leading business newspaper, *Les Echos* with an average daily 2005 circulation of 119,000 and lesechos.fr, its internet service.

FT Business produces specialist information on the retail, personal and institutional finance industries and publishes the UK's premier personal finance magazine, *Investors Chronicle*, together with *Money Management*, *Financial Advisor* and *The Banker* for professional advisers and financial sector professionals.

#### *Interactive Data Corporation*

Through our 62% interest in Interactive Data Corporation ( Interactive Data ), we are one of the world's leading global providers of financial market data, analytics and related services to financial institutions, active traders and individual investors. Interactive Data supplies time-sensitive pricing, dividend, corporate action, and descriptive information for more than 3.5 million securities traded around the world, including hard-to-value instruments. Customers subscribe to Interactive Data's services and use the company's analytical tools in support of their trading, analysis, portfolio management, and valuation activities.

#### *Recoletos*

On December 14, 2004, the Group announced that we had accepted an offer from Retos Cateria S.A. to sell our 79% stake in Recoletos, a publicly quoted Spanish media group that we built with its Spanish founding shareholders over a number of years, for gross proceeds of 743 million. The consortium of investors behind Retos Cartera included members of the Recoletos management team, individual Spanish investors and the Banesto banking group. We decided to accept the offer as Recoletos' strategy in sport, lifestyle and general publications had taken it further away from Pearson's core focus on financial and business news and information. The sale became unconditional in February, 2005 and net cash proceeds of £371 million were received on April 8, 2005 resulting in a profit on disposal of £306 million.

#### *Joint Ventures and Associates*

As at 2005 year end, the FT Group also had a number of other associates and joint ventures, including:

A 50% interest in *FT Deutschland*, launched in February 2000, in partnership with Gruner + Jahr. *FT Deutschland* is a German language newspaper with a fully integrated online business news, analysis and data service. Its circulation grew by 6% in 2005 to 102,000 copies.

A 50% interest in The Economist Group, which publishes the world's leading weekly business and current affairs magazine. Its circulation increased by 10% to 1,038,519 for the January to June 2005 period.

A 50% interest in FTSE International, a joint venture with the London Stock Exchange, which publishes a wide range of global indices, including the important FTSE index.

A 33% interest in *Vedomosti*, a leading Russian business newspaper and a partnership venture with Dow Jones and IMH Media Ltd.

A 50% interest in *Business Day* and *Financial Mail*, publishers of South Africa's leading financial newspaper and magazine.

A 14% interest in *Business Standard*, India's third largest daily financial newspaper.

### ***The Penguin Group***

Penguin is one of the premier English language book publishers in the world. We publish an extensive backlist and frontlist of titles, including some of the very best new fiction and non-fiction, literary prize winners and commercial bestsellers. Our titles range from history and science to essential reference. We are also one of the pre-eminent classics publishers and publish some of the most highly prized and enduring brands in children's publishing, featuring popular characters such as Spot, Peter Rabbit and Madeline, as well as the books of Roald Dahl. We rank in the top three consumer publishers, based upon sales, in all major English speaking and related markets—the United States, the United Kingdom, Australia, New Zealand, Canada, India and South Africa.

Penguin publishes under many imprints including, in the adult market, Allen Lane, Avery, Berkley Books, Dorling Kindersley, Dutton, Hamish Hamilton, Michael Joseph, Plume, Putnam, Riverhead and Viking. Our leading children's imprints include Puffin, Ladybird, Warne and Grosset & Dunlap. In 2005, Penguin's US imprints placed 129 titles on *The New York Times* bestseller list. In the United Kingdom, 54 Penguin titles featured on the Nielsen Bookscan top ten bestseller list. Our illustrated reference business, Dorling Kindersley, or DK, is the leading global publisher of high quality illustrated reference books. DK has built a unique graphic style that is now recognized around the world. It produces books for children and adults covering a huge variety of subjects including childcare, health, gardening, food and wine, travel, business and sports. Not only does DK's lexigraphic design approach make its books easily translatable across cultures, but it has also formed the basis of a library of 2.5 million wholly-owned images which have many applications—in print and online.

In 2005, Penguin had sales of £804 million, representing 20% of Pearson's total sales (21% in 2004). Revenues are balanced between frontlist and backlist titles. The Penguin Group earns over 95% of its revenues from the sale of hard cover and paperback books. The balance comes from audio books and from the sale and licensing of intellectual property rights, such as the Beatrix Potter series of fictional characters, and acting as a book distributor for a number of smaller publishing houses.

We sell directly to bookshops and through wholesalers. Retail bookshops normally maintain relationships with both publishers and wholesalers and use the channel that best serves the specific requirements of an order. We also sell online through third parties such as Amazon.com.

The Penguin Group's gateway internet site, Penguin.com, provides access to its focused websites in the United States, Canada, United Kingdom and Australia. Websites have also been developed to target certain niche audiences. For example, Penguinclassics.com has an entire online service for the classics, with anthologies, original essays, interviews and discussions and links to other classics sites.

### **Competition**

All of Pearson's businesses operate in highly competitive environments.

Pearson Education competes with other publishers and creators of educational materials and services. These companies include some small niche players and some large international companies, such as McGraw-Hill, Reed Elsevier, Houghton Mifflin and Thomson. Competition is based on the ability to deliver quality products and services that address the specified curriculum needs and appeal to the school boards, educators and government officials making purchasing decisions.

The FT Group's newspapers and magazines compete with newspapers and other information sources, such as *The Wall Street Journal*, by offering timely and expert journalism. It competes for advertisers with



other forms of media based on the ability to offer an effective means for advertisers to reach their target audience. The efficiency of its cost base is also a competitive factor.

The Penguin Group competes with other publishers of fiction and non-fiction books. Principal competitors include Random House, HarperCollins, and Hachette Livre. Publishers compete by developing a portfolio of books by established authors and by seeking out and promoting talented new writers.

### **Intellectual Property**

Our principal intellectual property assets consist of our trademarks and other rights in our brand names, particularly the *Financial Times* and the various imprints of Penguin and Pearson Education, as well as all copyrights in our content and our patents held in the testing business in the name of Pearson NCS. We believe we have taken all appropriate available legal steps to protect our intellectual property in all relevant jurisdictions.

### **Raw Materials**

Paper is the principal raw material used by each of Pearson Education, the FT Group and the Penguin Group. We purchase most of our paper through our central purchasing department located in the United States. We have not experienced and do not anticipate difficulty in obtaining adequate supplies of paper for our operations, with sourcing available from numerous suppliers. While local prices fluctuate depending upon local market conditions, we have not experienced extensive volatility in fulfilling paper requirements. In the event of a sharp increase in paper prices, we have a number of alternatives to minimize the impact on our operating margins, including modifying the grades of paper used in production.

### **Government Regulation**

The manufacture of certain of our products in various markets is subject to governmental regulation relating to the discharge of materials into the environment. Our operations are also subject to the risks and uncertainties attendant to doing business in numerous countries. Some of the countries in which we conduct these operations maintain controls on the repatriation of earnings and capital and restrict the means available to us for hedging potential currency fluctuation risks. The operations that are affected by these controls, however, are not material to us. Accordingly, these controls have not significantly affected our international operations. Regulatory authorities may have enforcement powers that could have an impact on us. We believe, however, that we have taken and continue to take measures to comply with all applicable laws and governmental regulations in the jurisdictions where we operate so that the risk of these sanctions does not represent a material threat to us.

### **Licenses, Patents and Contracts**

We are not dependent upon any particular licenses, patents or new manufacturing processes that are material to our business or profitability. Likewise, we are not materially dependent upon any contracts with suppliers or customers, including contracts of an industrial, commercial or financial nature.

### **Recent Developments**

On January 9, 2006 Pearson announced the purchase of 1,130,739 shares in Interactive Data from an individual shareholder for \$21.67 per share in cash. This purchase brings Pearson's total holding in Interactive Data to almost 62%.

On January 23, 2006 Pearson announced the acquisition of Promissor, a leading professional testing business from Houghton Mifflin Company for \$42m in cash.

On April 25, 2006 Pearson announced the acquisition of National Evaluation Systems, Inc, a leading teacher certification testing company in the US.

On May 5, 2006 Pearson announced the acquisition of an 80% stake in Paravia Bruno Mondadori, one of Italy's leading educational publishing companies.

### **Organizational Structure**

Pearson plc is a holding company which conducts its business primarily through subsidiaries and other affiliates throughout the world. Below is a list of our significant subsidiaries as at December 31, 2005, including name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held.

Name	Country of Incorporation/ Residence	Percentage Interest/ Voting Power
<b>Pearson Education</b>		
Pearson Education Inc	United States (Delaware)	100%
Pearson Education Ltd	England and Wales	100%
NCS Pearson Inc	United States (Minnesota)	100%
<b>FT Group</b>		
The Financial Times Limited	England and Wales	100%
Financial Times Business Ltd	England and Wales	100%
Interactive Data Corporation	United States (Delaware)	61%
Les Echos SA	France	100%
<b>The Penguin Group</b>		
Penguin Group (USA) Inc	United States (Delaware)	100%
The Penguin Publishing Co Ltd	England and Wales	100%
Dorling Kindersley Holdings Ltd	England and Wales	100%

**Property, Plant and Equipment**

Our headquarters is located at leasehold premises in London, England. We own or lease approximately 650 properties in more than 50 countries worldwide, the majority of which are located in the United Kingdom and the United States.

All of the properties owned and leased by us are suitable for their respective purposes and are in good operating condition.

We own the following principal properties:

General Use of Property	Location	Area in Square Feet
Warehouse	Pittstown, Pennsylvania, USA	510,000
Warehouse	Kirkwood, New York, USA	409,000
Offices	Iowa City, Iowa, USA	310,000
Offices	Old Tappan, New Jersey, USA	210,100
Warehouse/ office	Cedar Rapids, Iowa, USA	205,000
Offices	Reading, Massachusetts, USA	177,800
Offices	London, UK	155,000
Printing/ Processing	Owatonna, Minnesota, USA	128,000
Printing/ Processing	Columbia, Pennsylvania, USA	121,400
Offices	Eagan, Minnesota, USA	109,500
Offices	Mesa, Arizona, USA	96,000

We lease the following principal properties:

General Use of Property	Location	Area in Square Feet
Warehouses/ Offices	Lebanon, Indiana, USA	1,091,400
Warehouse/ Offices	Cranbury, New Jersey, USA	886,700
Warehouse	Indianapolis, Indiana, USA	737,850
Warehouse/ Offices	Newmarket, Ontario, Canada	518,128
Offices	Upper Saddle River, New Jersey, USA	474,801
Warehouse/ Offices	Rugby, UK	446,000
Offices	London, UK	375,000
Offices	Hudson St., New York, USA	302,000
Warehouse/ Offices	Austin, Texas, USA	226,100
Offices	Boston, Massachusetts, USA	225,299
Warehouse	Scoresby, Victoria, Australia	215,820
Offices	Boston, Massachusetts, USA	191,360
Offices	Glenview, Illinois, USA	187,500
Offices	Bloomington, Minnesota, USA	151,056
Offices	Parsippany, New Jersey, USA	143,800
Offices	Harlow, UK	137,900
Offices	Chester, Virginia, USA	123,200
Warehouse	San Antonio Zomeyucan, Mexico	113,638
Offices	London, UK	112,000
Offices	New York, New York, USA	107,939

#### **ITEM UNRESOLVED STAFF COMMENTS**

##### **4A.**

There are no unresolved staff comments.

#### **ITEM OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

##### **5.**

The following discussion and analysis is based on and should be read in conjunction with the consolidated financial statements, including the related notes, appearing elsewhere in this Annual Report. The financial statements have been prepared in accordance with IFRS, which differs in certain significant respects from US GAAP. Note 35 to our consolidated financial statements, included in Item 17. Financial Statements, provides a description of the significant differences between IFRS and US GAAP as they relate to our business and provides a reconciliation to US GAAP. These consolidated financial statements are the Group's first financial statements to be prepared in accordance with IFRS, as adopted by the EU. Consolidated financial statements of Pearson up to and including December 31, 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 included in Item 17. Financial Statements, describes how, in preparing the consolidated financial statements, the Group has applied accounting standards as adopted for use in the EU under the first-time adoption provisions as set out in IFRS 1.

#### **General Overview**

##### **Introduction**

Sales increased from £3,696 million in 2004 to £4,096 million in 2005, an increase of 11%. The increase reflected growth across all the businesses with a particularly strong performance at Pearson Education. The year on year growth



was impacted by exchange rates but less so than in previous years. The average US dollar exchange rate strengthened slightly in 2005, which had the effect of increasing reported sales in 2005 by £46 million when compared to the equivalent figure at constant 2004 rates. Reported operating profit increased by 33% from £404 million in 2004 to £536 million in 2005. Pearson Education benefited from strong sales growth and improved margins in the School and Higher Education businesses. FT Group benefited from improved profits largely as a result of increases in advertising revenues at FT Publishing and IDC's continued strong organic growth and synergies from the integration of recent acquisitions. Penguin profits benefited from

the effect of exchange rates but still improved from the prior year, with margins increasing despite only a small increase in sales. Included within operating profit in 2005 was the profit on the sale of MarketWatch of £40 million. Equivalent sales of businesses and investments in 2004 saw a profit of £9 million. Reported operating profit in 2005 was £12m higher than the equivalent figure reported at constant 2004 exchange rates.

Profit before taxation in 2005 of £466 million compares to a profit before taxation of £325 million in 2004. The increase of £141 million reflects the improved operating performance and a reduction in net finance costs. Net finance costs reduced from £79 million in 2004 to £70 million in 2005. Net interest payable benefited from the reduction in average net debt following receipt of the proceeds from the sale of Recoletos and MarketWatch and good cash generation from the businesses. Partially offsetting this effect was an increase in the group's average net interest rate payable driven principally by the strong rise in US dollar interest rates in the year. As at January 1, 2005 we adopted IAS 39 *Financial Instruments: Recognition and Measurement* in our financial statements. This has had the effect of introducing increased volatility into the net finance cost and in 2005 the adoption of IAS 39 reduced net finance costs by £14 million. There was no equivalent benefit in 2005 to the one-off credit of £9 million for interest on a repayment of tax that occurred in 2004.

In April 2005, Pearson sold its 79% interest in Recoletos Grupo de Comunicacion S.A. to Retos Cartera, a consortium of investors, as part of a tender offer for all of Recoletos. The transaction became unconditional on approval from the Spanish regulatory authorities in February 2005. The results of Recoletos have been consolidated for the period to February 28, 2005 and have been shown as discontinued operations in the consolidated income statement for 2005, 2004 and 2003.

Net cash generated from operating activities increased to £709 million in 2005 from £562 million in 2004 with very strong cash generation across all the businesses. Cash flow in 2004 benefited from collection of the \$151 million receivable in respect of the Transportation Security Administration (TSA) contract, a contract to create a qualification, assessment, staffing and placement system for security screeners at airports in the US. The relative strength of the US dollar also increased the value of our cash flows in Sterling. Capital expenditure was down from 2004 following the up-front expenditure on professional testing contracts in that year but investment in pre-publication increased. On an average basis, the use of working capital continued to improve. The net cash inflow from disposals net of acquisitions was £175 million in 2005 compared to a net cash outflow of £4 million in 2004. Dividends paid of £222 million in 2005 (including £17 million paid to minority interests) compares to £197 million in 2004 and, after an adverse currency movement of £121 million, overall net borrowings fell 18% from £1,221 million at the end of 2004 to £996 million at the end of 2005.

### ***Outlook***

We expect 2006 to be another good year for Pearson as we anticipate increasing margins and growth ahead of our markets. We expect to achieve strong earnings growth, good cash generation and a further significant improvement in return on invested capital.

#### *Pearson Education*

We expect Pearson Education to achieve sales growth in the 3-5% range, with similar rates of growth in each of its three worldwide businesses (School, Higher Education and Professional). We expect margins to improve in School and Professional and remain stable in the Higher Education business. School testing is strengthened by 2005 contract wins with a lifetime value of \$700 million (including Texas, Virginia, Michigan and Minnesota) and the US School new adoption market is expected to grow strongly over the period 2007 to 2009.

We expect our US Higher Education business to continue to benefit from its scale, the strength of its publishing and its lead in technology. 2006 is expected to be a strong year for first editions, with major new titles in statistics, algebra, psychology, economics, health and writing. We plan to launch online homework and assessment programs in new curriculum areas including economics, psychology and development writing and to extend our highly successful customized print publishing model to online curriculum and course management programs.

We expect our Professional business to deliver sustained growth on the basis of long-term contracts in Government Solutions and Professional Testing and to improve margins after the successful start-up of major new contracts in 2004 and 2005. We also expect to maintain our leading market share in professional



publishing with a stronger schedule of releases in the professional and consumer technology market in 2006 and a strong list within the business publishing imprints.

#### *FT Group*

We expect further profit improvement at the FT Group. The *Financial Times* continues to show good momentum with circulation up 4% and advertising revenues continue to show double digit growth in the early part of 2006. IDC expects another good year, benefiting from similar business conditions to 2005, strong organic growth and the contribution of recent acquisitions.

#### *The Penguin Group*

Penguin is expected to grow at a similar rate in 2006 to 2005 with continued investment in new markets and international talent and with a strong list of new titles from best selling authors. Margins are expected to improve steadily as we benefit from efficiency gains.

#### *Exchange rates*

We generate around two-thirds of total sales in the US and a five cent change in the average exchange rate for the full year (which in 2005 was £1: \$1.81) will have an impact of approximately 1p on earnings per share.

#### ***Sales Information by Operating Division***

The following table shows sales information for each of the past three years by operating division:

	Year Ended December 31		
	2005	2004	2003
	£m	£m	£m
Education:			
School	1,295	1,087	1,149
Higher Education	779	729	770
Professional	589	507	503
FT Group:			
FT Publishing	332	318	315
IDC	297	269	273
Penguin	804	786	840
Total	4,096	3,696	3,850

#### ***Sales Information by Geographic Market supplied***

The following table shows sales information for each of the past three years by geographic region:

	Year Ended December 31		
	2005	2004	2003
	£m	£m	£m
European countries	963	835	768
North America	2,717	2,504	2,742
Asia Pacific	300	263	255
Other countries	116	94	85
Pearson Group	4,096	3,696	3,850

***Exchange Rate Fluctuations***

We earn a significant proportion of our sales and profits in overseas currencies, principally the US dollar. Sales and profits are translated into sterling in the consolidated financial statements using average rates. The average rate used for the US dollar was \$1.81 in 2005, \$1.83 in 2004 and \$1.63 in 2003. Fluctuations in exchange rates can have a significant impact on our reported sales and profits. The Group generates approximately 65% of its sales in US dollars and a five cent change in the average exchange rate for the full year has an impact of approximately 1 pence on earnings per share. See Item 11. Quantitative and Qualitative Disclosures About Market Risk for more information.

### ***Critical Accounting Policies***

Our consolidated financial statements, included in Item 17. Financial Statements , are prepared based on the accounting policies described in note 1 to the consolidated financial statements which are in accordance with IFRS, which differs in certain significant respects from US GAAP.

The preparation of our consolidated financial statements in accordance with IFRS, and the reconciliation of these financial statements to US GAAP as described in note 35, requires management to make estimates and assumptions that affect the carrying value of assets and liabilities at the date of the consolidated financial statements and the reported amount of sales and expenses during the periods reported in these financial statements. Certain of our accounting policies require the application of management judgment in selecting assumptions when making significant estimates about matters that are inherently uncertain. Management bases its estimates on historical experience and other assumptions that it believes are reasonable.

We believe that the following are the more critical accounting policies used in the preparation of our consolidated financial statements that could have a significant impact on our future consolidated results of operations, financial position and cash flows. Actual results could differ from estimates.

#### ***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 recognized as follows:

Revenue from the sale of books is recognized 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.

Circulation and advertising revenue is recognized when the newspaper or other publication is published. Subscription revenue is recognized 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 recognized 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 recognized 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 revenues recognized on a percentage of completion basis. Losses on contracts are recognized in the period in which the loss first becomes foreseeable. Contract losses are determined to be the amount by which estimated direct and indirect costs of the contract exceed the estimated total revenues that will be generated by the contract. The assumptions, risks and uncertainties inherent in long-term contract accounting can affect the amounts and timing of revenue and related expenses reported.

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

#### ***Pre-publication Costs***

Pre-publication costs represent direct costs incurred in the development of educational programs 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 amortized upon publication of the title over estimated economic lives of five years or less, being an estimate of the expected life cycle of the title, usually with a higher proportion of the amortization taken in the earlier years. The investment in pre-publication has been disclosed as part of the investing activities in the cash flow statement. The assessment of useful life and the calculation of amortization involve a significant amount of estimation and management judgment based on historical trends and management estimation of their future potential sales. The overstatement of useful lives could result in excess amounts being carried forward in



intangible assets that would otherwise have been written off to the profit and loss account in an earlier period. Reviews are performed regularly to estimate recoverability of pre-publication costs.

#### *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 realizable value. The royalty advance is expensed at the contracted 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. The realizable value of royalty advances relies on a degree of management judgement in determining the profitability of individual author contracts. If the estimated realizable value of author contracts is overstated then this will have an adverse effect on operating profits as these excess amounts will be written off.

#### *Defined Benefit Pension Obligations*

The liability in respect of defined benefit pension plans is the present value of the defined benefit obligation 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 recognized immediately in the statement of recognized 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 recognized as an expense in the income statement as incurred.

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 (see note 24 in Item 17 Financial Statements) 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.

#### *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.

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 realized or the deferred income tax liability is settled.

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

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.

Deferred tax is recognized in the income statement, except when the tax relates to items charged or credited directly to equity, in which case the tax is also recognized in equity.



*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 and US GAAP**

We prepare our financial statements in accordance with IFRS, which differs in certain significant respects from US GAAP. Profit attributable to equity holders of the Company and equity shareholders' funds under IFRS and US GAAP were as follows for the respective period:

	December 31, 2005	December 31, 2004	December 31, 2003
	£m	£m	£m
<i>Profit for the financial year</i>			
IFRS	624	262	252
US GAAP	411	182	173
<i>Equity shareholders' funds</i>			
IFRS	3,564	2,800	
US GAAP	3,838	3,218	

The main differences between IFRS and US GAAP relate to goodwill and intangible assets, acquisition and disposal adjustments, derivatives, pensions, stock based compensation and taxation. These differences are discussed in further detail under 'Accounting Principles' and in note 35 to the consolidated financial statements.

**Results of Operations*****Year ended December 31, 2005 compared to year ended December 31, 2004******Consolidated Results of Operations******Sales***

Our total sales increased by £400 million, or 11%, to £4,096 million in 2005, from £3,696 million in 2004. Sales growth was due to strong performance in our markets, helped in part by a favourable exchange rate impact. We estimate that had the 2004 average rates prevailed in 2005, sales would have been approximately £4,050 million.

Pearson Education had a strong year with an increase in sales of 15%. The School and Professional businesses were the biggest contributors to this growth with increases of 19% and 16% respectively. Higher Education growth was 5% in total and 6% in the US. Pearson's US Higher Education business has grown faster than the industry for seven straight years. The School publishing business benefited from a large share of the new adoption market in the US and testing sales were up more than 20% as the business made significant market share gains and benefited from mandatory state testing in the US under No Child Left Behind. In the Professional business, Professional testing and Government Solutions sales were both up by more than a third on last year with the successful start-up of major new contracts. Worldwide sales of technology-related books were again lower than the previous year although weakness in the professional markets was partly offset by growth in consumer technology publishing.

The FT Group sales were 7% ahead of last year. FT Publishing sales were up by 4% driven by higher advertising revenues at the *Financial Times* and IDC sales were up by 10% with organic growth at all its businesses aided by a full year contribution from FutureSource, acquired in September 2004, and the strength of the US dollar. Penguin's sales grew by 2% with successful format innovation helping to offset the weakness in the mass market category in the US, down a further 4% for the industry in 2005.

Pearson Education, our largest business sector, accounted for 65% of our sales in 2005, compared to 63% in 2004. North America continued to be the most significant source of our sales although sales there decreased, as a proportion of total sales, to 66% in 2005, compared to 68% in 2004.



**Cost of Sales and Operating Expenses**

The following table summarizes our cost of sales and net operating expenses:

	Year Ended December 31	
	2005	2004
	£m	£m
Cost of goods sold	2,022	1,789
Distribution costs	249	201
Administrative and other expenses	1,384	1,365
Other operating income	(41)	(46)
<b>Total operating expenses</b>	<b>1,592</b>	<b>1,520</b>

*Cost of Sales.* Cost of sales consists of costs for raw materials, primarily paper, printing costs, amortization of pre-publication costs and royalty charges. Our cost of sales increased by £233 million, or 13%, to £2,022 million in 2005, from £1,789 million in 2004. The increase mainly reflected the increase in sales over the period although the overall gross margin declined slightly from 52% in 2004 to 51% in 2005.

*Distribution Costs.* Distribution costs consist primarily of shipping costs, postage and packing and are typically a fairly constant percentage of sales.

*Administration and Other Expenses.* Our administration and other expenses increased by £19 million, or 1%, to £1,384 million in 2005, from £1,365 million in 2004, although as a percentage of sales they decreased to 34% in 2005, from 37% in 2004. The increase in administration and other costs comes principally from additional employee benefit expense, but cost savings and more modest increases in other administration expenses has enabled overall operating margins to improve.

*Other operating Income.* Other operating income mainly consists of sub-rights and licensing income and distribution commissions. Other operating income decreased 11% to £41 million in 2005 from £46 million in 2004, with the decrease mainly representing the continued decline in commissions received for distribution of third party books.

**Other Net Gains and Losses**

Profits or losses on the sale of businesses, associates and investments that are included in our continuing operations are reported as other net gains and losses. In 2005 the only item in this category was the £40 million profit on the sale of our associate interest in MarketWatch. In 2004, other gains and losses amounted to £9 million, with the principal items being profits on the sale of stakes in Capella and Business.com.

**Share of results of joint ventures and associates**

The contribution from our joint ventures and associates increased from £8 million in 2004 to £14 million in 2005. The increase was due to profit improvement at The Economist Group and a reduction in losses at FT Deutschland.

**Operating Profit**

The total operating profit increased by £132 million, or 32.7%, to £536 million in 2005 from £404 million in 2004. This £132 million or 33% increase was due to increases across all the businesses, the one-off gain from the sale of MarketWatch of £40 million and a beneficial impact of exchange. We estimate that had the 2004 average rates prevailed in 2005, operating profit would have been £12 million lower.

Operating profit attributable to Pearson Education increased by £56 million, or 20%, to £343 million in 2005, from £287 million in 2004. The increase was due to strong sales and improved margins in both the School and Higher Education businesses. Operating profit attributable to the FT Group increased by £63 million, or 90%, to £133 million

in 2005, from £70 million in 2004. £40 million of the increase was due to the profit from the sale of MarketWatch but there were also increases at IDC of £13 million and FT Publishing of £10 million. Operating profit attributable to the Penguin Group increased by £13 million, or 28%, to £60 million in 2005, from £47 million in 2004. The increase at Penguin was due in part to increased efficiencies and improved margins and also due to exchange gains and one-off items in 2004. Penguin s

operating profit in 2004 was reduced by costs associated with disruption in UK distribution following the move to a new warehouse and closure costs associated with Penguin TV.

### ***Net Finance Costs***

Net finance costs reduced from £79 million in 2004 to £70 million in 2005. Net interest payable in 2005 was £77 million, up from £74 million in 2004. The group's net interest rate payable rose by 0.9% to 5.9%. Although we were partly protected by our fixed rate policy, the strong rise in US dollar floating interest rates had an adverse effect. Year on year, average three month LIBOR (weighted for the Group's borrowings in US dollars, euro and sterling) rose by 1.9% to 3.4%. This was largely offset by the £260m fall in average net debt, reflecting in particular the proceeds from the disposal of Recoletos and good cash generation. In addition, in 2005 we did not benefit from a one-off credit of £9m for interest on a repayment of tax that occurred in 2004. As at January 1, 2005 we adopted IAS 39 *Financial Instruments: Recognition and Measurement* in our financial statements. This has had the effect of introducing increased volatility into the net finance cost and in 2005 the adoption of IAS 39 reduced net finance costs by £14 million. For a more detailed discussion of our borrowings and interest expenses see [Liquidity and Capital Resources](#), [Capital Resources](#) and [Borrowing](#) below and [Item 11. Quantitative and Qualitative Disclosures About Market Risk](#).

### ***Taxation***

The total tax charge for the year was £124 million, representing a 27% rate on pre-tax profits of £466 million. This compares with a 2004 rate of 19% (or £63m on a pre-tax profit of £325m). In 2004, the tax charge reflected credits of £48m relating to previous years, a substantial element of which was non-recurring; adjustments relating to previous years in 2005 resulted in a credit of £18m. The 2005 rate benefited from the fact that the profit of £40m on the sale of Marketwatch.com was free of tax.

### ***Minority Interests***

Following the disposal of our 79% holding in Recoletos in April 2005 and the purchase of the 25% minority stake in Edexcel in February 2005, our minority interests now mainly comprise the 39% minority share in IDC.

### ***Discontinued Operations***

The results of Recoletos have been consolidated for the period up to February 28, 2005 and included in discontinued operations in 2005 and 2004. The results for 2005 include an operating loss for the two months to February 28, 2005 of £3 million compared to an operating profit in the full year to December 31, 2004 of £26 million. The profit on disposal of Recoletos reported in 2005 was £306 million.

### ***Profit for the Financial Year***

The total profit for the financial year in 2005 was £644 million compared to a profit in 2004 of £284 million. The overall increase of £360 million was mainly due to the profit on disposal of Recoletos and MarketWatch together with significant improvement in operating profits reported across all the Pearson businesses. These increases were only partially offset by the increase in the tax charge in 2005.

### ***Earnings per Ordinary Share***

The basic earnings per ordinary share, which is defined as the profit for the financial year divided by the weighted average number of shares in issue, was 78.2 pence in 2005 compared to 32.9 pence in 2004 based on a weighted average number of shares in issue of 797.9 million in 2005 and 795.6 million in 2004. This increase in earnings per share was due to the additional profit for the financial year described above and was not significantly affected by the movement in the weighted average number of shares.

The diluted earnings per ordinary share of 78.1 pence in 2005 and 32.9 pence in 2004 was not significantly different from the basic earnings per share in those years as the effect of dilutive share options was again not significant.

### ***Exchange Rate Fluctuations***

The strengthening of the US dollar against sterling on an average basis had a positive impact on reported sales and profits in 2005 compared to 2004. We estimate that if the 2004 average rates had prevailed in 2005, sales would have been lower by £46 million and operating profit would have been lower by £12 million. See



Item 11. Quantitative and Qualitative Disclosures About Market Risk for a discussion regarding our management of exchange rate risks.

*Sales and Operating Profit by Division*

The following table summarizes our operating profit and results from operations for each of Pearson's divisions. Adjusted operating profit is included as it is a key financial measure used by management to evaluate performance and allocate resources to business segments, as reported under SFAS 131. Since 1998 we have reshaped the Pearson portfolio by divesting of non-core interests and investing in educational publishing and testing, consumer publishing and business information companies. During this period of transformation management has used adjusted operating profit to track underlying core business performance.

In our adjusted operating profit we have excluded amortization of acquired intangibles, other gains and losses and other net finance costs of associates. The amortization of acquired intangibles is not considered to be fully reflective of the underlying performance of the group. Other gains and losses represent profits and losses on the sale of subsidiaries, joint ventures, associates and investments that are included within continuing operations but which distort the performance for the year. Other net finance costs of associates are foreign exchange and other gains and losses that represent short-term fluctuations in market value and are subject to significant volatility. These gains and losses may not be realized in due course as it is normally the intention to hold these instruments to maturity. Increased volatility has been introduced as a result of adopting IAS 39 Financial Instruments: Recognition and Measurement as at January 1, 2005. Finance costs and income of joint ventures and associates are reported within the share of results of joint ventures and associates that is included within operating profit. Group finance costs and income are reported separately in the income statement below the operating profit line.

Adjusted operating profit enables management to more easily track the underlying operational performance of the group. A reconciliation of operating profit to adjusted operating profit is included in the table below:

	Year Ended December 31			
	2005		2004	
	£m	%	£m	%
<b>Total operating profit</b>				
Pearson Education:				
School	142	27	112	27
Higher Education	156	29	133	33
Professional	45	8	42	10
FT Group:				
FT Publishing	58	11	8	2
IDC	75	14	62	16
Penguin	60	11	47	12
Total	536	100	404	100
<b>Add back:</b>				
<b>Amortization of acquired intangibles</b>				
School	5			
Higher Education				
Professional				
Penguin				
FT Publishing	1			
IDC	5		5	
Total	11		5	
<b>Other net gains and losses</b>				
School			(4)	
Higher Education			(4)	
Professional			(2)	
Penguin			5	
FT Publishing	(40)		(4)	
IDC				
Total	(40)		(9)	
<b>Other net finance costs of associates</b>				
School				
Higher Education				
Professional				
Penguin				
FT Publishing	2			
IDC				



Total	2			
<b>Adjusted operating profit</b>				
Pearson Education:				
School	147	29	108	27
Higher Education	156	31	129	32
Professional	45	9	40	10
FT Group:				
FT Publishing	21	4	4	1
IDC	80	15	67	17
Penguin	60	12	52	13
Total	509	100	400	100

### *School*

School business sales increased by £208 million, or 19%, to £1,295 million in 2005, from £1,087 million in 2004 and adjusted operating profit increased by £39 million, or 36%, to £147 million in 2005 from £108 million in 2004. The School results in 2005 benefit from the inclusion of AGS Publishing, acquired in July 2005 and the strengthening of the US dollar, which we estimate added £34 million to sales and £2 million to adjusted operating profit when compared to the equivalent figures at constant 2004 exchange rates.

In the US school market, Pearson's school publishing business grew 12% ahead of the Association of American Publishers' estimate of industry growth of 10.5%. New adoption market share was 33% in the adoptions where Pearson competed (and 24% of the total new adoption market). The School business now has leading positions in math, science, literature and foreign languages. School testing sales were up more than 20%, benefiting from significant market share gains and mandatory state testing under No Child Left Behind. School software also had a strong year with good sales and profit growth on curriculum and school administration services.

Outside the US, the School publishing sales increased in high single digits. The worldwide English Language Teaching business benefited from strong demand for English language learning and investments in new products, including *English Adventure* (with Disney) for the primary school market, *Sky* for secondary schools, *Total English* for adult learners and *Intelligent Business* (with *The Economist*) for the business markets. There was also strong growth in the international school testing markets. Four million UK GCSE, AS and A-Level scripts were marked onscreen and 2005 saw the first year of running the UK National Curriculum tests and a new contract for a national school testing pilot in Australia.

School margins were up by 1.5% points to 11.4% with efficiency gains in central costs, production, distribution and software development.

### *Higher Education*

Sales in Higher Education increased by £50 million, or 7%, to £779 million in 2005, from £729 million in 2004. Adjusted operating profit increased by £27 million, or 21%, to £156 million in 2005 from £129 million in 2004. Both sales and adjusted operating profit benefited from the strengthening US dollar which we estimate added £14 million to sales and £3 million to adjusted operating profit when compared to the equivalent figures at constant 2004 exchange rates.

In the US, the Higher Education sales were up by 6% ahead of the Association of American Publishers' estimate of industry growth of 5%. 2005 is the seventh consecutive year that Pearson's US Higher Education business has grown faster than the industry. The US business benefited from continued growth from market-leading authors in key academic disciplines including biology (Campbell & Reece), chemistry (Brown & LeMay), sociology (Macionis), marketing (Kotler & Keller), math (Tobey & Slater), developmental math (Martin-Gay) and English composition (Faigley's *Penguin Handbook*). There was also expansion in the career and workforce education sector, with major publishing initiatives gaining market share in allied health, criminal justice, paralegal, homeland security and hospitality. The online learning and custom publishing businesses saw rapid growth. Approximately 3.6 million US college students are studying through one of our online programs, an increase of 20% on 2004; and custom publishing, which builds customized textbooks and online services around the courses of individual faculties or professors, had double digit sales growth.

International Higher Education publishing sales grew by 4%, benefiting from the local adaptation of global authors, including Campbell and Kotler, and the introduction of custom publishing and online learning capabilities into new markets in Asia and the Middle East.

Higher Education margins were up by 2.3% points to 20%. Good margin improvement in the US and in international publishing was helped by shared services and savings in central costs, technology, production and manufacturing.

### *Professional*

Professional sales increased by £82 million, or 16%, to £589 million in 2005 from £507 million in 2004. Adjusted operating profit increased by £5 million, or 13%, to £45 million in 2005, from £40 million in 2004. Sales benefited from the strengthening US dollar, which we estimate added £8 million to sales when compared to the equivalent figures at constant 2004 exchange rates.



Professional testing sales were up more than 40% in 2005 benefiting from the successful start-up of major new contracts including the Driving Standards Agency, National Association of Securities Dealers and the Graduate Management Admissions Council. Government Solutions grew sales by 38%, helped by new contracts with the US Department of Education and the Social Security Administration worth over \$800 million, together with strong growth from add-ons to existing programs, including those with the US Department of Health and Human Services.

Overall margins in the Professional business were a little lower in 2005 compared to 2004 mainly due to new contract start-up costs at Government Solutions. Margins in the Professional publishing businesses were maintained despite falling sales.

#### *FT Publishing*

Sales at FT Publishing (excluding discontinued businesses) increased by £14 million or 4%, from £318 million in 2004 to £332 million in 2005. Adjusted operating profit increased by £17 million, from £4 million in 2004 to £21 million in 2005. Much of the sales and profit increase was at the FT newspaper; sales at the other business newspapers were broadly level with 2004 with a small increase in adjusted operating profit compared to 2004.

FT newspaper sales were up 6% while adjusted operating profit increased £14 million to register a profit of £2 million in 2005 compared to a loss of £12 million in 2004. FT advertising revenues were up 9% for the year with sustained growth in luxury goods and worldwide display advertising. FT.com advertising sales were up 27% as some of the FT's biggest advertisers shifted to integrated print and online advertising. The FT's worldwide circulation was 2% lower for the year at 426,453 average copies per day although the second half of the year showed improvement to 430,635 average copies per day. FT.com's paying subscribers increased by 12% to 84,000 and the average unique monthly users was up 7% to 3.2 million.

Les Echos advertising and circulation revenues for 2005 were level with 2004 despite tough trading conditions. FT Business improved margins with growth in its international finance titles. Our share of the results of the FT's joint ventures and associates improved as *FT Deutschland* reduced its losses and increased its average circulation despite a weak advertising market in Germany and *The Economist* increased profits helped by an increase in circulation (10% to an average weekly circulation of 1,038,519 for the January-June ABC period).

#### *Interactive Data*

Interactive Data, grew its sales by 10% from £269 million in 2004 to £297 million in 2005. Adjusted operating profit grew by 19% from £67 million in 2004 to £80 million in 2005. Both sales and adjusted operating profit benefited from the strengthening US dollar, which we estimate added £2 million to sales and £1 million to adjusted operating profit when compared to the equivalent figures at constant 2004 exchange rates.

FT Interactive Data, IDC's largest business (approximately two-thirds of IDC revenues) generated strong growth in North America and returned to growth in Europe. There was more modest growth at Comstock, IDC's business providing real-time data for global financial institutions, and at CMS BondEdge, its fixed income analytics business. Renewal rates for IDC's institutional businesses remain at around 95%. eSignal, IDC's active trader services business, increased sales by 27% with continued growth in the subscriber base and a full year contribution from FutureSource, acquired in September 2004.

#### *The Penguin Group*

The Penguin Group sales were up 2% to £804 million in 2005 from £786 million in 2004 and adjusted operating profit up 15% to £60 million in 2005 from £52 million in 2004. Both sales and adjusted operating profit benefited from the strengthening US dollar which we estimate added £9 million to sales and £6 million to adjusted operating profit when compared to the equivalent figures at constant 2004 exchange rates. 2005 adjusted operating profit also benefited from reduced operating costs at our UK distribution center.

In the US, successful format innovation helped to address weakness in the mass market category that saw a further decline of 4% for the industry in 2005. The first seven Penguin Premium paperbacks were published in 2005, priced at \$9.99, and all became bestsellers, with authors including Nora Roberts, Clive Cussler and Catherine Coulter.

Penguin authors received a number of awards during the year: A Pulitzer Prize (for Steve Coll's *Ghost Wars*), a National Book Award (William T. Vollman's *Europe Central*), the Whitbread Book of the Year (Hilary Spurling's *Matisse the Master*), the Whitbread Novel of the Year (Ali Smith's *The Accidental*) and the FT & Goldman Sachs Business Book of the Year Award (Thomas Friedman's *The World is Flat*). In 2005, there were 129 New York Times bestsellers and 54 top 10 bestsellers in the UK. Major bestselling authors include Patricia Cornwell, John Berendt, Sue Grafton, Jared Diamond, Jamie Oliver, Gillian McKeith, Jeremy Clarkson and Gloria Hunniford.

In 2005, there was also a strong contribution from new imprints and first-time authors. The new imprint strategy continued to gather pace and Penguin published more than 150 new authors in the US and approximately 250 worldwide - its largest ever investment in new talent. Sue Monk Kidd's first novel, *The Secret Life of Bees*, has been a New York Times bestseller for almost two years; her second, *The Mermaid Chair*, reached number one in 2005. *The Kite Runner*, Khaled Hosseini's first book, stayed on the New York Times bestseller list for all of 2005, selling an additional two million copies (three million in total). In the UK, there was also strong performance from new fiction authors including Jilliane Hoffman, PJ Tracy, Karen Joy Fowler and Marina Lewycka.

## Results of Operations

### *Year ended December 31, 2004 compared to year ended December 31, 2003*

#### *Consolidated Results of Operations*

##### *Sales*

Our total sales decreased by £154 million to £3,696 million in 2004, from £3,850 million in 2003. This decrease of 4% was attributable to the effect of foreign currency exchange. The strength of sterling compared to the US dollar had a significant negative effect on sales, and we estimate that had the 2003 average rates prevailed in 2004, sales would have been higher by £301 million. In constant exchange rate terms Pearson Education had a strong year with an increase in sales of 5%. The Higher Education and Professional businesses were the main contributors to this growth with the Higher Education business growing faster than its market for the sixth straight year and Professional benefiting from new contracts and add-ons to existing contracts at Pearson Government Solutions. The School business was helped by a full year contribution from Edexcel, the UK testing business, but otherwise sales were flat as new adoption spending in the US fell by approximately \$200 million. The FT Group sales were ahead of last year after another good year at Interactive Data and a return to sales growth for the Financial Times newspaper in a more stable business advertising environment. Penguin's results were disappointing with sales down 6% as reported, but flat on a constant currency basis after disruption to UK distribution and a weakness in the US consumer publishing market.

Pearson Education, our largest business sector, accounted for 63% of our sales in 2004 and in 2003. North America continued to be the most significant source of our sales although sales in the region decreased, as a proportion of total sales, to 68% in 2004, compared to 71% in 2003. This decrease in 2004, however, reflects the comparative strength of sterling and the euro compared to the US dollar.

##### *Cost of Sales and Net Operating Expenses*

The following table summarizes our cost of sales and net operating expenses:

	<b>Year Ended December 31</b>	
	<b>2004</b>	<b>2003</b>
	<b>£m</b>	<b>£m</b>
Cost of goods sold	<b>1,789</b>	1,846
Distribution costs	<b>201</b>	206
Administrative and other expenses	<b>1,365</b>	1,439
Other income	<b>(46)</b>	(51)

Total operating expenses	<b>1,520</b>	1,594
--------------------------	--------------	-------

*Cost of Sales.* Cost of sales consists of costs for raw materials, primarily paper, printing costs, amortization of pre-publication costs and royalty charges. Our cost of sales decreased by £57 million, or 3%, to

31

---

£1,789 million in 2004, from £1,846 million in 2003. The decrease mainly reflected the decrease in sales over the period with overall gross margin remaining constant.

*Distribution Costs.* Distribution costs consist primarily of shipping costs, postage and packing.

*Administration and Other Expenses.* Our administration and other expenses decreased by £74 million, or 5%, to £1,365 million in 2004, from £1,439 million in 2003. Administration and other expenses as a percentage of sales remained constant at 37%. The decrease in administration and other expenses comes from both the effect of exchange and increased efficiencies, in particular from the cost actions taken at the Financial Times in recent years.

*Other Operating Income.* Other operating income mainly consists of sub-rights and licensing income and distribution commissions. Other operating income decreased 10% to £46 million in 2004 from £51 million in 2003 with the decrease mainly representing the continued decline in distribution commissions received for distribution of third party books.

#### *Other Net Gains and Losses*

Profits or losses on the sale of businesses, associates and investments that are included in our continuing operations are reported as other net gains and losses. In 2004, other gains and losses amounted to £9 million with the principal items being profits on the sale of stakes in Capella and Business.com. In 2003 there were small losses on a number of items totaling £6 million.

#### *Share of results of joint ventures and associates*

The contribution from our joint ventures and associates increased from £2 million in 2003 to £8 million in 2004. The increase was largely due to a reduction in losses at FT Deutschland together with some improvement in profit at the Economist.

#### *Operating Profit/Loss*

The total operating profit in 2004 of £404 million compares to a profit of £406 million in 2003. This marginal decrease was due to the impact of exchange rates. We estimate that had the 2003 average rates prevailed in 2004, operating profit would have been £51 million greater. Operating profit attributable to Pearson Education remained constant at £287 million in both 2004 and 2003. There was an estimated reduction in profit of £29 million from exchange. After accounting for exchange rates, operating profit was ahead in each of the School, Higher Education and Professional businesses. Operating profit attributable to the FT Group increased by £33 million, or 89%, to £70 million in 2004, from £37 million in 2003. The increase was largely due to another strong performance from Interactive Data and significant cost savings at the Financial Times newspaper. Operating profit attributable to the Penguin Group decreased by £35 million, or 43%, to £47 million in 2004, from £82 million in 2003. The biggest single factor in the profit decline was exchange rates, which are estimated to have accounted for £14 million of the difference. There were also a number of other factors, including disruption in UK distribution following the move to a new warehouse and the weakness of the US consumer publishing market.

#### *Net Finance Costs*

Net finance costs decreased by £14 million to £79 million in 2004 from £93 million in 2003. Net interest payable decreased by £10 million, or 12%, to £74 million in 2004, from £84 million in 2003. The reduction is due to lower average net debt levels in 2004, which more than offset the effect of a general increase in floating interest rates, and a one-off credit of £9 million for interest on a repayment of tax in France which reduced the net interest cost in 2004. Year end indebtedness decreased to £1,221 million in 2004 compared to £1,376 million in 2003 due to funds generated from operations and foreign exchange movements. The weighted average three month London Interbank Offered ( LIBOR ) rate, reflecting our borrowings in US dollars, euros and sterling, rose by 40 basis points, or 0.4%. The company is partially protected from these increases by our treasury policy, which put £736 million of the year end debt on a fixed rate basis. As a result the net interest rate payable (excluding the £9 million credit referred to above) rose by only 25 basis points or 0.25% to 5% in 2004. For a more detailed discussion of our borrowings and interest expenses see Liquidity and Capital Resources Capital Resources and Borrowing and Item 11. Quantitative and Qualitative Disclosures About Market Risk .

### *Taxation*

The overall taxation charge for 2004 was £63 million, compared to a charge of £61 million in 2003. In 2004 the Group recorded a total pre-tax profit of £325 million giving a tax rate of 19% compared to a similar rate of 19% on total pre-tax profits of £313 million in 2003. These low rates of tax were mainly a result credits of £56 million and £48 million respectively relating to prior year items; these reflect a combination of settlements with the Inland Revenue authorities and changes to deferred tax balances.

### *Minority Interests*

Minority interests principally consist of the public's 39% interest in Interactive Data.

### *Discontinued Operations*

Following the disposal of Recoletos in 2005, the results of Recoletos have been included in discontinued operations in 2004 and 2003. The results for 2004 include an operating profit of £26 million compared to an operating profit in 2003 of £43 million. The profit in 2003 includes a profit of £12 million on the sale of the Recoletos interest in El Mundo.

### *Profit for the Financial Year*

The total profit for the financial year in 2004 was £284 million compared to a profit in 2003 of £275 million. The overall increase of £9 million was mainly due to the decrease in net finance costs in 2004 after adverse movements in exchange had eroded the underlying increase in operating profit.

### *Earnings per Ordinary Share*

The basic earnings per ordinary share, which is defined as the profit for the financial year divided by the weighted average number of shares in issue, was 32.9 pence in 2004 compared to 31.7 pence in 2003 based on a weighted average number of shares in issue of 795.6 million in 2004 and 794.4 million in 2003. This increase in earnings per share was due to the additional profit for the financial year described above and was not significantly affected by the movement in the weighted average number of shares.

The diluted earnings per ordinary share of 32.9 pence in 2004 and 31.7 pence in 2003 was not significantly different from the basic earnings per share in those years as the effect of dilutive share options was again not significant.

### *Exchange Rate Fluctuations*

The weakening of the US dollar against sterling on an average basis had a negative impact on reported sales and profits in 2004 compared to 2003. We estimate that if the 2003 average rates had prevailed in 2004, sales would have been higher by £301 million and operating profit would have been higher by £51 million. See Item 11. Quantitative and Qualitative Disclosures About Market Risk for a discussion regarding our management of exchange rate risks.

### ***Sales and Operating Profit by Division***

The following table summarizes our operating profit and results from operations for each of Pearson's divisions. Adjusted operating profit is included as it is a key financial measure used by management to evaluate performance and allocate resources to business segments, as reported under SFAS 131. Since 1998 we have reshaped the Pearson portfolio by divesting of non-core interests and investing in educational publishing and testing, consumer publishing and business information companies. During this period of transformation management has used adjusted operating profit to track underlying core business performance.

In our adjusted operating profit we have excluded amortization of acquired intangibles, other gains and losses and other net finance costs of associates. The amortization of acquired intangibles is not considered to be fully reflective of the underlying performance of the group. Other gains and losses represent profits and losses on the sale of subsidiaries, joint ventures, associates and investments that are included within continuing operations but which distort the performance for the year.



Adjusted operating profit enables management to more easily track the underlying operational performance of the group. A reconciliation of operating profit to adjusted operating profit is included in the table below:

**Year Ended December 31**