Business Review

About Pearson

Pearson is an international media and education company with world-leading businesses in education, business information and consumer publishing.

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 online services. We increasingly offer services as well as content, from test administration and processing to teacher development and school software.

Though we operate in more than 50 countries around the world, today our largest markets are the US (65% of sales) and Europe (25% of sales).

Our businesses

Pearson consists of three major worldwide businesses:

Pearson Education is the world's leading education company. We are a leading publisher of textbooks, supplementary learning materials and electronic education programmes for teachers and students of all ages, and we play a major role in the testing and certification of school students and professionals. Pearson Education operates through three worldwide segments, serving School, Higher Education and Professional markets.

The Financial Times Group is a leading provider of international business and financial news, data, comment and analysis, in print and online. It has two major parts:

- FT Publishing includes the *Financial Times* and FT.com, one of the world's premier sources of business information, alongside our network of national business newspapers, financial magazines and online financial information companies.
- Interactive Data Corporation (IDC) provides specialist financial data to financial institutions and retail investors. Pearson owns a 62% interest in IDC, which is publicly listed on the New York Stock Exchange (NYSE:IDCO).

The Penguin Group is one of the world's foremost English language publishers. We publish the works of many authors in an extensive portfolio of fiction, non-fiction and reference titles, under imprints including Penguin, Hamish Hamilton, Putnam, Berkley, Viking and Dorling Kindersley.

Our strategy

Over the past decade we have transformed Pearson by focusing on companies which provide 'education' in the broadest sense of the word; companies that educate, inform and entertain. Through a combination of organic investment and acquisitions, we have built each one of our businesses into a leader in its market, and we have integrated our operations so that our businesses can share assets, brands, processes, facilities, technology and central services.

Our goal is to produce sustainable growth on our three key financial measures – adjusted earnings per share, cash generation and return on invested capital – which we believe are, together, good indicators that we are building the long-term value of Pearson.

We do this by investing consistently in four areas, which are common to all our businesses:

- Content We invest steadily in unique, valuable publishing content and keep replenishing it. Over the past five years, for example, we have invested $1.6bn in new content in our education business alone.
- Technology and services We invested early and consistently in technology, believing that, in the digital world, content alone would not be enough. In 2006, we generated more than $1bn in sales from technology products and services, and our testing and assessment businesses, serving school students and professionals, made more than $1bn of sales, up from around $200m seven years ago.
- International markets Though we currently generate two-thirds of our sales in the US, our brands, content and technology-plus-services models work around the world. All parts of Pearson are investing in selected emerging markets, where the demand for information and education is growing particularly fast.
- Efficiency We've invested to become a leaner, more efficient company, through savings in our individual businesses and through a strong centralised operations structure. Over the past five years, we have increased our profit margins from 9.9% to 13.4% and reduced average working capital as a percentage of sales in Pearson Education and Penguin from 30.7% to 26.3%, freeing up cash for further investment.

We believe this strategy can create a virtuous circle – efficiency, investment, market share gains and scale – which in turn can produce sustainable growth on our financial goals and the value of the company.

2006 financial overview

Pearson's three key financial measures are adjusted earnings per share, cash flow and return on invested capital. In 2006, adjusted EPS and cash flow reached record levels, and our return on invested capital increased from 6.7% in 2005 to 8.0%, above our weighted average cost of capital of 7.7%.

Pearson's sales increased by 4% to £4.4bn and adjusted operating profit was up 15% to a record £592m. All parts of Pearson contributed, with good sales growth, further margin improvement and double-digit profit increases in each business. Adjusted earnings per share were 40.2p, up 18%.

Operating cash flow increased by £5m to £575m and free cash flow by £2m to £433m. Cash conversion was strong at 97% of operating profit (even after an exceptional 113% cash conversion rate in 2005). The ratio of average working capital to sales at Pearson Education and Penguin improved by 1.1% points to 26.3%.

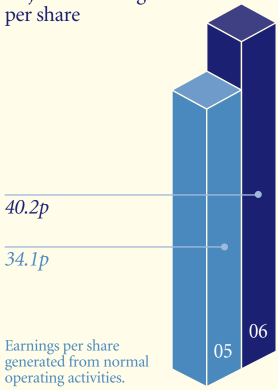
Statutory results show an increase in operating profit to £540m (£516m in 2005). Basic earnings per share were 55.9p (compared with 78.2p in 2005, which included the £302m profit on the sale of Recoletos). Net debt rose by £63m to £1,059m (from £996m in 2005).

During the year, we completed a series of bolt-on acquisitions in Education (including Promissor, Paravia Bruno Mondadori, National Evaluation Systems, PowerSchool and Chancery) and the FT Group (Quote.com and Mergermarket). Our total investment in acquisitions in 2006 was £363m. Together, these acquisitions contributed £147m of sales and £17m of operating profit to our 2006 results (after integration costs, which are expensed).

In December 2006 we announced the sale of Government Solutions to Veritas Capital for $560m in cash, $40m in preferred stock and a 10% interest in the company. In 2006 Government Solutions contributed £286m of sales and £22m of operating profit to Pearson. The sale was completed in February 2007. As part of our plan to reduce our UK pension deficit, we will inject £100m of the cash proceeds from the sale of Government Solutions into our UK Group pension plan during 2007.

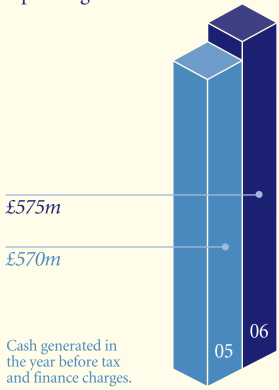
Key Financial Measures and Performance Indicators

Adjusted earnings per share



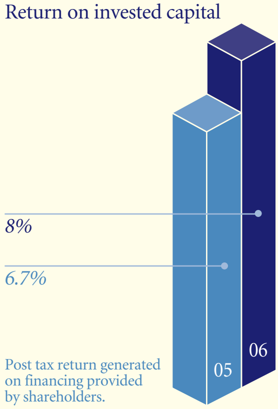
Earnings per share generated from normal operating activities.

Operating cash flow



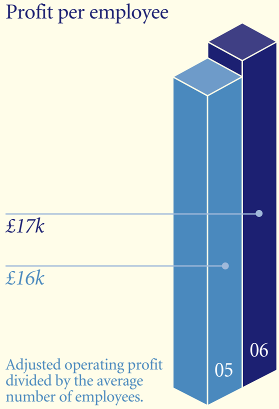
Cash generated in the year before tax and finance charges.

Return on invested capital



Post tax return generated on financing provided by shareholders.

Profit per employee



Adjusted operating profit divided by the average number of employees.

Note: throughout this review, we refer to a series of 'Key Performance Indicators' alongside our key financial measures. Management uses these Indicators to track performance on non-financial measures such as market share or growth relative to our industries.

The board is proposing a dividend increase of 8.5% to 29.3p, the largest increase for a decade. Subject to shareholder approval, 2006 will be Pearson's 15th straight year of increasing our dividend above the rate of inflation, and in the past five years alone we have returned approximately £1bn to shareholders through the dividend.

Pearson outlook 2007

We expect 2007 to be another good year for Pearson with continued margin improvement and growth ahead of our markets. We expect to achieve good underlying earnings growth, cash generation well ahead of our 80% threshold, and a further improvement in return on invested capital.

In 2007 we continue to invest in the growth and market-leading positions of our businesses, including:

- extending our lead in education, investing in new programmes for students in School and Higher Education and in testing and software services that help educators to personalise the learning process, both in the US and internationally;
- developing our fast-growing assessment businesses, which provide testing and related services to educational bodies;
- building the international reach of the *Financial Times* – both in print through its four editions worldwide and online through FT.com;
- developing a business concentrating on providing financial information services for financial institutions, corporations and their advisers;
- growing our position in consumer publishing, balancing our investment across our stable of bestselling authors, new talent and our own home-grown content.

Pearson Education: overview

Pearson Education is the world's largest publisher of textbooks and online teaching materials. It serves the growing demands of teachers, students, parents and professionals throughout the world for stimulating and effective education programmes, in print and online.

In 2006 Pearson Education had sales of £2,877m or 65% of Pearson's total. Of these, £2.2bn (75%) were generated in North America and £0.7bn (25%) in the rest of the world. Pearson Education generated 68% of Pearson's operating profit.

Pearson Education competes with other publishers and creators of educational materials and services. These competitors include large international companies, such as McGraw-Hill, Reed Elsevier, Houghton Mifflin Riverdeep Group and Thomson, alongside smaller niche players that specialise in a particular academic discipline or focus on a learning technology. 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.

We report Pearson Education's performance by the three market segments it serves: School, Higher Education and Professional.

Pearson Education: outlook 2007

We expect School to achieve underlying sales growth in the 4-6% range; Higher Education to grow in the 3-5% range; and Professional sales to be broadly level with 2006. We expect margins to improve again in School and Professional, and to be stable in Higher Education.

School: overview

Our School business contains a unique mix of publishing, testing and technology products, which are increasingly integrated. It generates around two-thirds of its sales in the US.

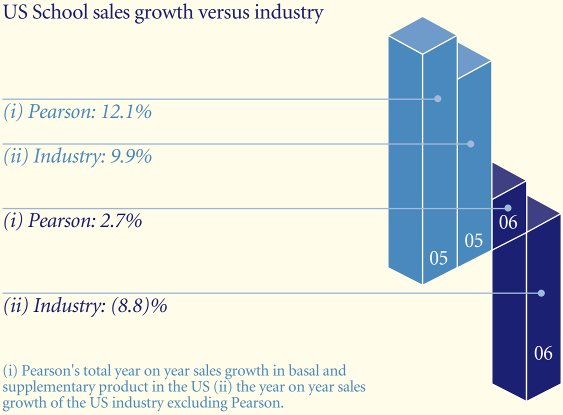
In the US, we publish high quality curriculum programmes for school students covering subjects such as reading, literature, maths, science and social studies. We publish under a range of well-known imprints that include Scott Foresman in the elementary school market and Prentice Hall in secondary. Our school testing business is the leading provider of test development, processing and scoring services to US states and the federal government, processing some 40 million tests each year.

We are also the leading provider of electronic learning programmes for schools, and of 'Student Information Systems' technology which enables schools and districts to record and manage information about student attendance and performance.

In the US, more than 90% of school funds come from state or local government, with the remainder coming from federal sources. Our School company's major customers are state education boards and local school districts.

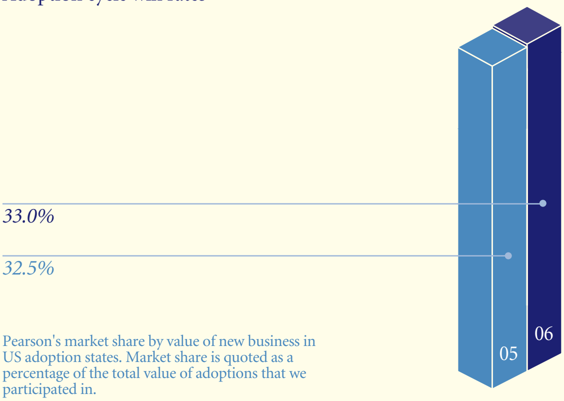
School Key Performance Indicators

US School sales growth versus industry



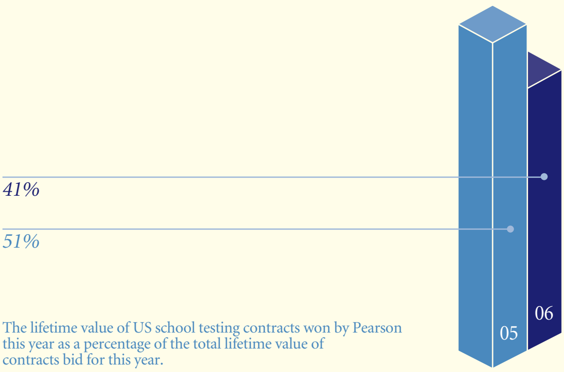
(i) Pearson's total year on year sales growth in basal and supplementary product in the US (ii) the year on year sales growth of the US industry excluding Pearson.

Adoption cycle win rates



Pearson's market share by value of new business in US adoption states. Market share is quoted as a percentage of the total value of adoptions that we participated in.

Testing contract win rates



The lifetime value of US school testing contracts won by Pearson this year as a percentage of the total lifetime value of contracts bid for this year.

Outside the US, we publish school materials in local languages in a number of countries. We are the world's leading provider of English Language Teaching materials for children and adults, published under the well-known Longman imprint. We are also a leading provider of testing, assessment and qualification services. Our key markets outside the US include Canada, the UK, Australia, Italy, Spain, South Africa, Hong Kong and the Middle East.

School: 2006 performance

£ millions	2006	2005	Headline growth	Underlying growth
Sales	1,455	1,295	12%	6%
Adjusted operating profit	184	147	25%	17%

Significant share gains in US School publishing

- Pearson US School publishing business up 3%, against an industry decline of 9% (excluding Pearson; 6% decline including Pearson) (source: Association of American Publishers), as we benefit from our sustained investment in new basal programmes and innovative digital services.
- Pearson takes the leading share of the new adoption market*: 30% of the total market and 33% where we competed. #1 or #2 market share in reading, maths, science and social studies. Total new adoption opportunity of approximately $670m in 2006, down from $900m in 2005.
- Innovative digital programme for California takes #1 position and a 43% market share in elementary social studies. Digital curriculum services being developed for new adoptions.
- US School new adoption market expected to grow strongly over the next three years (estimated at $760m in 2007; $900m in 2008; $950m in 2009).

* In the US, 20 'adoption' states buy textbooks and related programmes on a planned contract schedule or 'adoption' cycle. The level of spending varies from year to year with this schedule, depending on the number of adoptions in the largest states and subjects. In 'open territory' states, school districts or individual schools buy textbooks according to their own schedules, rather than on a statewide basis.

Strong growth and continued share gains in school testing

- US School testing sales up in the high single digits (after 20%+ growth in 2005), benefiting from further contract wins, market share gains and leadership in onscreen marking, online testing and embedded (formative) assessment.
- Acquisition of National Evaluation Systems (NES), the leading provider of customised assessments for teacher certification in the US, with contracts in 16 states including Florida (won in 2006) and California (renewed in 2006). NES expands our testing capabilities in an attractive adjacent market.

School technology business broadened

- Acquisition of Chancery and PowerSchool enhances our leading position in the US Student Information Systems (SIS) market. Integration on track and good growth prospects as schools upgrade information systems to manage and report data on student attendance and performance.
- Organic growth and margin improvement continues in digital curriculum business, Pearson Digital Learning. Continued investment in new generation digital products to meet demands of school districts for personalised classroom learning.
- Four product nominations in six categories, more than any other education company, for the Software and Information Industry Association 'Codie' awards. The products are: *Prosper*, a formative assessment tool for 'at-risk' students; *Write to Learn*, a web-based tool for learning to read and write; *Chancery SMS*, a student information system for middle and large school districts; and *California History-Social Studies*.
- Our technology now touches the lives of many students. The SIS business provides assessment, reporting and business solutions to over 29,000 schools servicing more than 25 million students. PDL's digital curriculum solutions have helped raise the achievement levels of over 20 million students. We have around 3 million students and teachers registered to use one of our online school learning platforms in the US.

Good growth in international school

- International testing businesses continue to benefit from technology leadership. In the UK, we have marked over 9 million GCSE, AS and A-Level scripts on screen. In 2007 we will roll out *Results Plus* across the UK, providing students, teachers and parents with online access to question-level examination performance data.
- In school publishing, UK launch of ActiveTeach technology provides multimedia resources for maths and science teaching and brings market share gains. Market-leading school companies in Hong Kong and South Africa outperform their markets.
- Acquisition of Paravia Bruno Mondadori (PBM), one of Italy's leading education publishers. Good progress in integrating publishing, sales and marketing, distribution and back office operations with our existing Italian business, and in sharing content and technology.
- Successful launch of regional adaptations of *English Adventure* (with Disney), our worldwide English Language Training programme for elementary schools, in Asia and Latin America.

Higher Education: overview

Pearson is the US' largest publisher of textbooks and related course materials for colleges and universities. We publish across all of the main fields of study with imprints such as Prentice Hall, Addison Wesley, Allyn & Bacon and Benjamin Cummings. Typically, professors or other instructors select or 'adopt' the textbooks and online resources they recommend for their students, which students then purchase either in a bookstore or online. Today the majority of our textbooks are accompanied by online services which include homework and assessment tools, study guides and course management systems that enable professors to create online courses. We have also introduced new formats such as downloadable audio study guides and electronic textbooks which are sold on subscription. In addition, we have a fast-growing custom publishing business which works with professors to produce textbooks and online resources specifically adapted for their particular course.

Business Review *Continued*

In 2006, our Higher Education business generated approximately 80% of its sales in the US. Outside the US, we adapt our textbooks and technology services for individual markets, and we have a growing local publishing programme. Our key markets outside the US include Canada, the UK, Benelux, Mexico, Germany, Hong Kong, Korea, Taiwan and Malaysia.

Higher Education: 2006 performance

£ millions	2006	2005	Headline growth	Underlying growth
Sales	795	779	2%	4%
Adjusted operating profit	161	156	3%	3%

Steady growth momentum

- US Higher Education up 4%, ahead of the industry once again.
- Over the past eight years, Pearson's US Higher Education business has grown at an average annual rate of 7%, compared to the industry's average growth rate of 4%.

Rapid growth in online learning and custom publishing

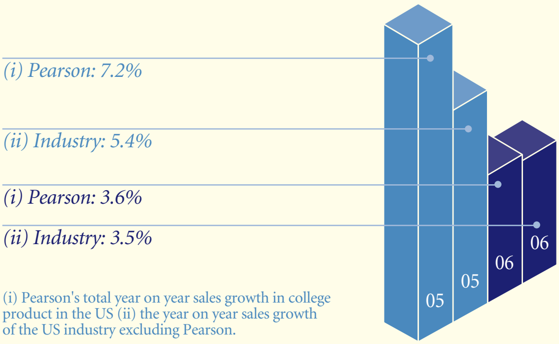
- Approximately 4.5m US college students using one of our online programmes. Of these, approximately 2.3m (up almost 30% on 2005) register for an online course on one of our 'MyLab' online homework and assessment programmes.
- 16 subject-specific 'MyLab' online homework and assessment programmes now available supporting more than 200 titles. Research studies show significant gains in student success rates and productivity improvements for institutions.
- Strong market share, student performance and institutional productivity gains in college maths, supported by MyMathLab.
- In psychology and economics, two of the three largest markets in US higher education, Pearson publishes successful first edition bestsellers: Cicarrelli's *Psychology* together with MyPsychLab and Hubbard's *Economics* together with MyEconLab. Cicarrelli's *Psychology* increases Pearson's market share by 3% to 25% and is the bestselling launch of a first edition in the discipline in the past decade.
- Continued strong double digit growth in custom publishing – which builds customised textbooks and online services around the courses of individual faculties or professors.

Good progress in international markets

- Good growth in local language publishing programmes. Increasing focus on custom publishing and technology based assessment services with the MyLab suite of products.

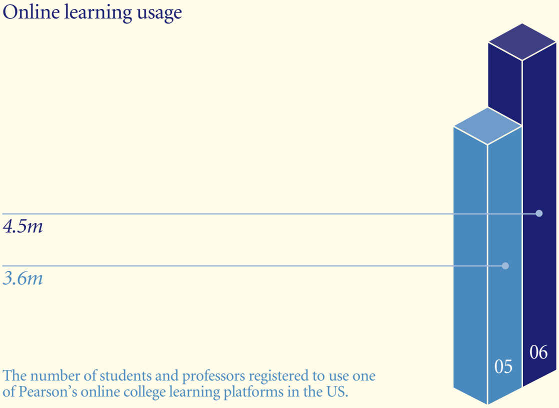
Higher Education Key Performance Indicators

US College sales growth versus industry



(i) Pearson's total year on year sales growth in college product in the US (ii) the year on year sales growth of the US industry excluding Pearson.

Online learning usage



The number of students and professors registered to use one of Pearson's online college learning platforms in the US.

Professional: overview

Our Professional education business* publishes educational materials and provides testing and qualifications services for adults. Our publishing imprints include Addison Wesley Professional, Prentice Hall PTR, Cisco Press (for IT professionals), Peachpit Press and New Riders Press (for graphics and design professionals), Que/Sams (consumer and professional imprint) and Prentice Hall Financial Times (for the business education market). We have a fast-growing Professional Testing business, Pearson VUE, which manages major long-term contracts to provide qualification and assessment services through its network of test centres around the world. Key customers include major technology companies, the Graduate Management Admissions Council, the National Association of Securities Dealers and the UK's Driving Standards Agency. We also provide a range of data collection and management services, including scanners, to a wide range of customers.

Professional: 2006 performance

£ millions	2006	2005	Headline growth	Underlying growth
Sales	627	589	6%	3%
Adjusted operating profit	60	45	33%	29%

Note: includes Government Solutions

Professional Testing: rapid organic sales and profit growth

- Professional Testing sales up more than 30% in 2006 (and have doubled over the past two years). Approximately 4m secure online tests delivered in more than 5,000 test centres worldwide in 2006.
- Successful start-up of the worldwide Graduate Management Admissions Test. 220,000 examinations delivered in 400 test centres in 96 countries, in first year of new contract.
- Professional Testing moves from around breakeven in 2005 to profitability in 2006.
- Successful integration of Promissor, acquired in January 2006. Combination brings together two leading international professional testing companies and takes Pearson into new US state and federal regulatory markets.

Professional publishing: further margin improvement

- Technology publishing profits up as further cost actions offset continued industry weakness.
- Strong performance from Wharton School Publishing and FT Press imprints, aided by Pearson's global distribution and strong retail relationships. 41 titles published in 2006 including Jerry Porras, Stewart Emery and Mark Thompson's *Success Built To Last* (the sequel to *Built To Last*) and Jeffrey Gitomer's *The Little Red Book of Sales Answers, The Little Gold Book of Yes Attitude*. Three *Wall Street Journal* business bestsellers, two *BusinessWeek* bestsellers and one *New York Times* bestseller in 2006.

Government Solutions: sale completed in February 2007

- Sale of Government Solutions to Veritas Capital for £560m in cash, £40m in preferred stock and a 10% interest in the company completed in February 2007.
- Government Solutions contributed £286m of sales and £22m of operating profit to Pearson in 2006.

* Professional education is not technically a segment under IFRS and therefore has no segment specific key performance indicators.

Financial Times Group: overview

The FT Group provides a broad range of data, analysis and services to an audience of internationally-minded business people and financial institutions. In 2006, the FT Group had sales of £698m, or 16% of Pearson's total sales (15% in 2005), and contributed 21% of Pearson's operating profit.

It has two major parts: FT Publishing, our network of international and national business newspapers and online services; and Interactive Data Corporation, our 62%-owned financial information company. The FT Group's newspapers, magazines and websites 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. IDC competes with Reuters, Bloomberg and Thomson Financial on a global basis for the provision of financial data to the back office. In Europe Telekurs is also a direct competitor for these services.

FT Publishing

The *Financial Times* is the world's leading international daily business newspaper. Its average daily circulation of 430,469 copies in December 2006, is split between the UK (31% of circulation), Continental Europe (27%), the US (31%), Asia (9%) and the rest of the world (2%). In 2006, approximately 70% of the FT's revenues were generated through advertising. The FT also sells content and advertising online through FT.com.

FT.com charges subscribers for detailed industry news, comment and analysis, while providing general news and market data to a wider audience.

FT Publishing also includes: FT Business, which publishes specialist information on the retail, personal and institutional finance industries through titles including *Investors Chronicle, Money Management, Financial Adviser* and *The Banker; Les Echos,* France's leading business newspaper, and a number of joint ventures and associates in business publishing.

In August 2006, we acquired Mergermarket, an online financial data and intelligence provider. The acquisition strengthens the FT Group, adding proprietary content, a premium customer base, reliable growth from new revenue sources and attractive financial characteristics to the organisation.

FT Publishing joint ventures and associates

Our joint ventures and associates include:

- 50% interest in The Economist Group, publisher of the world's leading weekly business and current affairs magazine;
- 50% interest in *FT Deutschland,* a German language business newspaper with a fully integrated online news, analysis and data service;
- 50% interest in FTSE International, a joint venture with the London Stock Exchange, which publishes a wide range of global indices, including the FTSE index;
- 50% interest in *Business Day* and *Financial Mail,* publishers of South Africa's leading business newspaper and magazine;
- 33% interest in *Vedomosti,* a leading Russian business newspaper;
- 14% interest in *Business Standard,* one of India's leading business newspapers.

Interactive Data Corporation

Interactive Data Corporation is a leading provider of financial market data, analytics and related services to financial institutions, active traders and individual investors. The company's businesses supply time-sensitive pricing, evaluations and reference data for more than 3.5 million securities traded around the world, including hard-to-value instruments such as illiquid bonds.

FT Group: 2006 performance

£ millions	2006	2005	Headline growth	Underlying growth
Sales:				
FT Publishing	366	332	10%	8%
IDC	332	297	12%	4%
Total	698	629	11%	6%
Adjusted operating profit:				
FT Publishing	32	21	52%	52%
IDC	89	80	11%	9%
Total	121	101	20%	18%

Continued growth and profit improvement at the Financial Times and FT.com

- FT newspaper and FT.com sales up 8% to £238m; £9m profit improvement to £11m.
- FT advertising revenues up 9%, with rapid growth in online, luxury goods and corporate finance categories, all up more than 30%.
- FT's worldwide circulation up 1% to 430,469 (Source: ABC, average for six months to December 2006). FT.com's paying subscribers up 7% to 90,000 and December audience up 29% to 4.2m.
- Growing international presence and readership. 47% growth in readership in the US Mendelsohn Affluent Survey (MAS) and 26% growth in the Asian Business Readership Survey (ABRS). The FT ranked number one European business title in Europe for the fifteenth time (European Business Readership Survey (EBRS)).

  Readership surveys are one of the key measures of the FT's performance as indicated above. Both the EBRS and the ABRS are biennial. In 2006 the FT readership reach of the EBRS was 13.1% of the surveyed population (unchanged compared to 2004), and for the ABRS 7.1% (up from 5.7% in 2004). The MAS which is annual, was up to 1.1% (0.7% in 2005). Other key performance indicators are shown in tabular form on page 10.
- Continued benefits of international expansion: approximately three-quarters of the FT's advertising booked in two or more international editions; almost half of the FT's advertising booked for all four editions worldwide.
- 'New newsroom' creates an integrated multimedia newsroom, improving commissioning, reporting, editing and production efficiency, and providing further cost savings.

Sustained progress across FT Publishing

- Acquisition and integration of Mergermarket, an online financial data and intelligence provider. On a pro forma basis, Mergermarket's revenues grew 80% in 2006, with 90% customer renewals. Margins improving as expected in spite of significant investment in new products and geographic markets.
- FT Business shows good growth and improves margins driven by strong performance in events, UK retail finance titles (*Investment Adviser*, *Financial Adviser*) and internationally by *The Banker*, which celebrated its 80th year. FT Business integrated with the *Financial Times* early in 2007.
- *Les Echos* achieves modest circulation (average circulation of 119,117) and advertising growth in a weak market ahead of the 2007 French presidential elections; *FT Deutschland* outperforms the German newspaper market once again, increasing circulation 2% to 104,000.
- *The Economist*, increases its circulation by 9% to 1.2m (for the July-December ABC period).

Interactive Data Corporation

Faster organic growth

- FT Interactive Data, IDC's largest business (approximately two-thirds of IDC revenues), generates strong, consistent growth in North America and Europe.
- Improving momentum at ComStock and eSignal. Comstock enjoys good new sales progress with institutional clients and lower cancellation levels. eSignal produces continued growth in its base of direct subscription terminals.
- Renewal rates for IDC's institutional businesses remain at around 95%.

Continued focus on high value services

- FT Interactive Data's growth driven by sustained demand for fixed income evaluated pricing services and related reference data. Continues to expand its market coverage, adding independent valuations of credit default swaps and other derivative securities.
- CMS BondEdge launches fixed income analytical data feed service. Enables CMS BondEdge to deliver new applications for sophisticated risk measures.
- ComStock real-time services power algorithmic trading applications. ComStock's highly reliable, low-latency consolidated data-feed service supports increasingly sophisticated institutional electronic trading applications.
- IDC divisions unified under the Interactive Data brand to emphasise the breadth of its comprehensive range of products and services across the front, middle and back offices of customers.

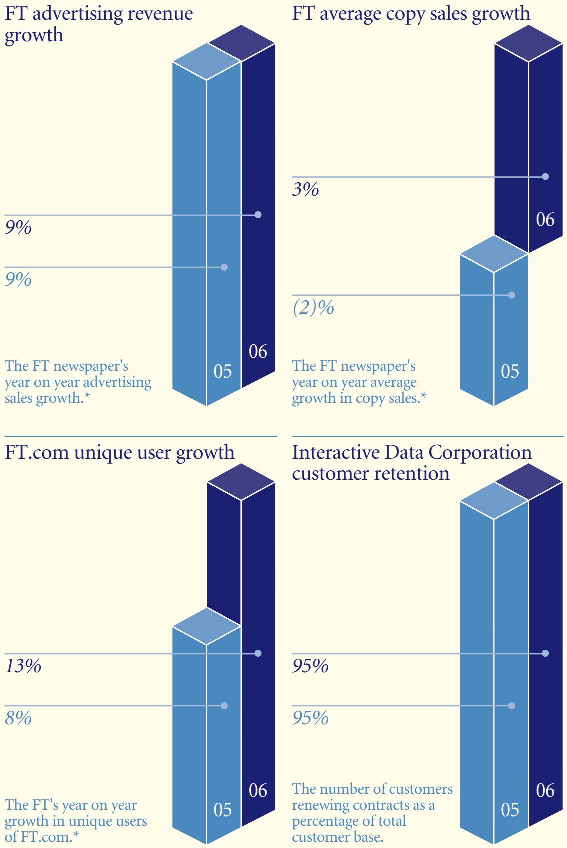
Further expansion into adjacent markets

- Following the acquisition of IS.Teledata (re-branded Interactive Data Managed Solutions in July 2006), IDC now provides customised, web-based financial information systems for retail banking and private client applications as well as for infomedia portals and online brokers.
- The acquisition of Quote.com in March 2006, which expanded eSignal's suite of real-time market data platforms and analytics, added two financial websites. As a result, eSignal is generating strong growth in online advertising.
- Interactive Data Managed Solutions and Quote.com contribute over $50m to IDC's 2006 revenue.

FT Group: outlook 2007

The FT Group is expected to continue its strong profit growth. At FT Publishing, advertising trends remain difficult to predict, but we expect our cost measures, integration actions and revenue diversification to push margins into double-digits in 2007. IDC has stated that it expects to achieve revenue growth in the 6-9% range and net income growth in the high single-digits to low double-digits (headline growth under US GAAP).

FT Group Key Performance Indicators



*Internal statistics.

The Penguin Group: overview

Penguin is one of the world's premier English language book publishers. We publish an extensive backlist and frontlist of titles, including fiction and non-fiction, literary prize winners, commercial bestsellers, classics and children's titles. We rank in the top three consumer publishers, based upon sales, in all major English speaking and related markets – the US, the UK, Australia, New Zealand, Canada, India and South Africa.

Penguin publishes under many imprints including, in the adult market, Allen Lane, Avery, Berkley, Dorling Kindersley (DK), Dutton, Hamish Hamilton, Michael Joseph, Plume, Putnam, Riverhead and Viking. Our leading children's imprints include Puffin, Ladybird, Warne and Grosset & Dunlap.

In 2006, Penguin had sales of £848m, representing 19% of Pearson's total sales (20% in 2005) and contributed 11% of Pearson's operating profit. Its largest market is the US, which generated around 60% of Penguin's sales in 2006. The Penguin Group earns around 99% 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 through online retailers such as Amazon.com.

Penguin 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.

The Penguin Group: 2006 performance

£ millions	2006	2005	Headline growth	Underlying growth
Sales	848	804	5%	3%
Adjusted operating profit	66	60	10%	22%

Record literary success and bestseller performance

- Record number of bestsellers for record number of weeks – Penguin US places 139 books on The *New York Times* bestseller list, ten more than in 2005, and keeps them there for 809 weeks overall, up 119 weeks from 2005; Penguin UK places 59 titles in the BookScan Top Ten bestseller list, up 5 from 2005, and keeps them there for 361 weeks, up 42 weeks from 2005.

- Penguin authors win a large number of prestigious literary awards including: a Pulitzer Prize for Fiction (*March* by Geraldine Brooks); a National Book Critics Circle Award (*THEM: A Memoir of Parents* by Francine du Plessix Gray); the Michael L. Printz award (*Looking for Alaska* by John Green); the Whitbread Book of the Year Award (*Matisse the Master* by Hilary Spurling); the Orange Prize for Fiction (*On Beauty* by Zadie Smith); and the Man Booker Prize (*The Inheritance of Loss* by Kiran Desai).

- Penguin UK's focus on fiction rewarded with a substantial increase in market share, led by Marina Lewycka's *A Short History of Tractors in Ukrainian.*

- Penguin US premium paperback format continues to accelerate revenue growth and improves profitability in the important mass market category. Strong performance from paperbacks with Penguin authors holding the #1 position on *The New York Times* paperback fiction list for a record 22 successive weeks.

Continued focus on quality and efficiency

- Pearson-wide renegotiation of major global paper, print and binding contracts brings cost savings in 2006 and beyond.

- Integration of Australia and New Zealand warehouses and back office operations produces further scale benefits.
- Investment in India as a pre-production and design centre for reference titles.

Strong international growth

- Penguin India, which celebrates its 20th anniversary in 2007, continues its rapid growth and extends its market leadership. Penguin authors win all the prizes in India's national book awards: Vikram Chandra in fiction for *Sacred Games*, Vikram Seth in non-fiction for *Two Lives* and Kiran Desai in readers' choice for *The Inheritance of Loss*.
- Penguin China continues to acquire rights to between four and six Chinese titles each year, following acquisition of Jian Rong's *Wolf Totem*, due to be published in English in 2008. Penguin enters the Chinese market with the launch of ten translated Penguin Classic titles in 2007.
- Penguin South Africa grows strongly in 2006 and continues to increase market share.

Investing in digital to engage consumers

- Strong growth in online revenues and unique visitors to Penguin and DK websites.
- Penguin leading the market in developing new content creation and distribution models. In 2006 Penguin won the Revolution Award for Best Brand Building using Digital Channels and the Neilsen Nibbie for Innovation in the Book Business for the Penguin Remixed competition and the Penguin Podcast. These two initiatives have been followed by further campaigns including the launch of the acclaimed Penguin Blog, Penguin's presence in Second Life and the recent wiki-novel, *A Million Penguins*, which hosted 60,000 unique visitors in its first week. DK Travel content made available on MSN and Rough Guides distributed through mobile phones.
- Subscribers to Penguin and DK opt-in newsletters building rapidly, allowing Penguin consumers to personalise areas of interest and strengthening relationships with Penguin brand.
- Jamie Oliver's 'Cookcast' was the first ever live streamed cookery webcast and one of the most successful webcasts ever in the UK.

Strong 2007 publishing schedule

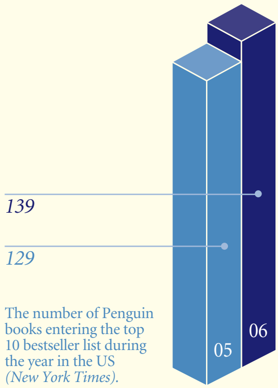
- Strong list of new titles for 2007 from bestselling and new authors including Alan Greenspan, Khaled Hosseini, Jamie Oliver, Al Gore, Jeremy Clarkson, Patricia Cornwell, Marina Lewycka and Naomi Klein.

The Penguin Group: outlook 2007

The Penguin Group is expected to improve margins further, as its publishing investment and efficiency programmes continue to bear fruit.

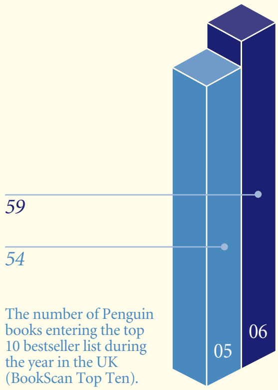
Penguin Key Performance Indicators

US Bestsellers



The number of Penguin books entering the top 10 bestseller list during the year in the US *(New York Times)*.

UK Bestsellers



The number of Penguin books entering the top 10 bestseller list during the year in the UK (BookScan Top Ten).

Group financial review

Operating profit

Total adjusted operating profit increased by £86m or 17% on a headline basis, to £592m in 2006 from £506m in 2005. Adjusted operating profit excludes amortisation and adjustment of acquired intangibles and other gains and losses on the sale of subsidiaries, joint ventures, associates and other financial assets that are included within continuing operations. For the purposes of our adjusted operating profit we add back the profits from discontinued operations. In 2006 these relate to the disposal of the Group's interest in Government Solutions and in 2005 to both the disposal of Government Solutions and Recoletos.

Statutory operating profit increased by £24m or 5%. This was a lower increase than seen in the adjusted operating profit due to an increased intangible amortisation charge and the absence of the Marketwatch profit on disposal recorded in 2005.

Net finance costs

Net finance costs reported in our adjusted earnings comprise net interest payable and net finance income relating to post-retirement plans. Net interest payable in 2006 was £94m, up from £77m in 2005. Although we were partly protected by our fixed rate policy (see page 21), the strong rise in average 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, euros and sterling at the year end) rose by 1.5% to 4.9%. Combining the rate rise with an increase in the Group's average net debt of £40m, the Group's average net interest rate payable rose by 1.1% to 7.0%. In 2006 the net finance income relating to post-retirement plans was an income of £4m compared to a cost of £7m in the previous year, giving an overall net finance cost reflected in adjusted earnings of £90m in 2006 compared to £84m in 2005.

Our interest charge in 2007 will reflect the receipt of the sale proceeds from Government Solutions, a £100m cash payment into our UK Group pension plan, and higher interest rates.

Taxation

The tax rate on adjusted earnings increased slightly from 30.3% in 2005 to 30.9%. Our overseas profits, which arise mainly in the US, are generally subject to tax rates which are higher than the UK corporation tax rate of 30%. But this factor was again offset by releases of provisions following further progress in agreeing our tax affairs with the authorities and reassessment of the provisions required for uncertain items.

For 2007, we expect our effective tax rate on adjusted earnings per share to be in the 28-30% range. Our tax position benefits from deductions relating to amortisation of goodwill arising on acquisitions, and from 2007 we will reflect these deductions in adjusted earnings per share. The amount of tax paid (£59m in 2006) is not affected.

The reported tax charge on a statutory basis of £11m represents just over 2% of reported profits. This low tax rate was mainly accounted for by two factors. First, in the light of the announcement of the disposal of Government Solutions, we are required to recognise a deferred tax asset in relation to capital losses in the US where previously we were not confident that the benefit of the losses would be realised prior to their expiry. Second, in the light of our trading performance in 2006 and our strategic plans, together with the expected utilisation of US net operating losses in the Government Solutions sale, we have re-evaluated the likely utilisation of operating losses both in the US and the UK; this has enabled us to increase the amount of the deferred tax asset carried forward in respect of such losses. The combined effect of these two factors was to create a non-recurring credit of £127m.

The Group's reported statutory tax rate for 2007 is expected to be significantly higher than normal, as a result of the tax on the disposal of Government Solutions; taxable profit will be higher than the statutory profit expected to be reported, although actual cash tax on the transaction will be substantially reduced by the losses brought forward, recognised in 2006.

Minority interests

Following the disposal of our 79% holding in Recoletos and the purchase of the 25% minority stake in Edexcel in 2005, our minority interests now comprise mainly the minority share in IDC. In January 2006 we increased our stake in IDC reducing the minority interest from 39% to 38%.

Dividends

The dividend accounted for in our 2006 financial statements totalling £220m, represents the final dividend (17.0p) in respect of 2005 and the 2006 interim dividend of 10.5p.

We are proposing a final dividend for 2006 of 18.8p, bringing the total paid and payable in respect of 2006 to 29.3p, a 8.5% increase on 2005. This final 2006 proposed dividend was approved by the board in February 2007, is subject to shareholder approval at the forthcoming AGM and will be charged against 2007 profits. For 2006, the dividend is covered 1.4 times by adjusted earnings.

We seek to maintain a balance between the requirements of our shareholders for a rising stream of dividend income and the reinvestment opportunities which we identify around the Group.

In recent years, our dividend policy has been to increase the dividend ahead of the rate of inflation. Looking ahead, the board expects to raise the dividend more in line with earnings growth, while building our dividend cover towards two times earnings.

Pensions

Pearson operates a variety of pension plans. Our UK Group plan is by far the largest and includes a significant defined benefit section. We also have some smaller defined benefit plans in the US and Canada. Outside the UK, most of our companies operate defined contribution plans.

The income statement expense for defined benefit plans is determined using annually derived assumptions as to salary inflation, investment returns and discount rates, based on prevailing conditions at the start of the year. The assumptions for 2006 are disclosed in note 24 to our accounts, along with the year end deficits in our defined benefit plans. We recognise actuarial gains and losses arising when assumptions diverge from reality through the statement of recognised income and expense (SORIE).

Our charge to profit in respect of worldwide pensions and post-retirement benefits amounted to £60m in 2006 (2005: £68m) of which a charge of £64m (2005: £61m) was reported in operating profit and the net finance benefit of £4m (2005: charge £7m) was reported against interest.

Pension funding levels are kept under regular review by the company and the Fund trustees. Following the completion of the latest actuarial valuation of the UK Group pension plan as at January 2006, it was agreed that during 2007 additional payments amounting to £100m would be made by the company to the plan.

Corporate responsibility

Alongside our commitment to our financial goals, Pearson has a clear social purpose: to provide education, information and entertainment and help our customers get on in their lives. Each one of our businesses pays great attention to the quality and accuracy of its content and services; in education, for example, we are investing in a series of long-term studies to measure the efficacy of our programmes in enhancing student achievement.

Beyond those basic products and services, we invest in a range of activities to enhance Pearson's overall contribution to society and to minimise any negative impacts. These activities include the work of our charitable arm, The Pearson Foundation; our efforts to reduce our environment impact; and our policies on employment, diversity, labour standards and the supply chain. We publish a detailed annual report on corporate responsibility providing details of our progress and plans in all these areas, which is available at www.pearson.com/community/csr_report2006

Pearson is a founder member of the UN Global Compact on labour standards, human rights, the environment and anti-corruption. We have also been selected for inclusion in the FTSE4Good, Dow Jones Sustainability and Business in the Community Corporate Responsibility indices.

People

The following table shows for 2006 and 2005 the average number of people employed in each of our operating divisions.

Average number employed	2006	2005
School	11,064	10,133
Higher Education	4,368	4,196
Professional	3,754	3,809
Penguin	3,943	4,051
FT Publishing	2,285	1,952
IDC	2,200	1,956
Other	1,669	1,573
Continuing operations	29,283	27,670
Discontinued operations	5,058	4,533
Total	34,341	32,203

Our goal is to be the best company to work for and each year we get closer to achieving that. We provide benefits, incentive plans and opportunities that rival those offered by our competitors.

We maintain our policies to reflect a good work-life balance, and introduce new initiatives to reflect the changing expectations of our people, and we continue to provide training and management development opportunities around the world to help people progress. We believe that all this helps to build a strong culture and reinforces our values of being brave, imaginative and decent.

Communicating with our people is high on our list of priorities. We have an internal communications programme which enables us to reach people through e-mails, employee roadshows and visits from our senior managers. We try to listen as much as we talk so that we can act upon ideas, suggestions and views.

In addition to the training and development we provide in each part of the business, we have a number of cross-Pearson initiatives to help build the skills and knowledge of our people for the future. Building the skills base of our company also includes knowing who our very best talent are and how they plan to make the most of their skills to reach their potential.

We believe that the best way for people to profit from the success of the company is for them to become shareholders. Further detail of our employee share plans is shown on page 30 of the Directors' Report.

We undertook Pearson's biennial employee survey in September 2006. Over 9,700 Pearson colleagues from around the world, and from every part of our business, responded to the survey. Each operating company reviewed the feedback in detail as it affected their part of Pearson. We shared the overall results of the survey via the Pearson intranet.

We aim to be a diverse company – a company that reflects the societies in which we operate. We want to attract the very best candidates, at all levels, regardless of race, gender, age, physical ability, religion or sexual orientation. We do not set specific, numerical targets for recruitment or promotion of particular groups, but we place great emphasis on ensuring that the pool of applicants for our jobs is diverse. We also aim to be a fair company – where pay, retention, promotions and redundancies are determined without discrimination – and a company which uses diversity to help achieve our commercial goals and targets new opportunities in growing markets.

Suppliers

To be a successful and sustainable business we have to ensure that we balance our objective of securing cheaper supplies without compromising our standards of quality, causing harm to the environment or damaging our suppliers and their workers wherever they are in the world.

We were one of the founder signatories to the United Nations Global Compact. This sets out a series of principles on labour standards, human rights, the environment and anti-corruption. We have set out a series of commitments that reflect these principles against which we monitor and report our performance.

We carry out supplier audits against our commitments and ensure that our commercial purchasing teams have received training on our supply chain labour standards.

Details of our supplier payment policy are shown on page 30 of the Directors' Report.

Environment

Pearson does not directly operate in industries where there is a potential for serious industrial pollution. Our main products are based on intellectual property. However, our offices and distribution centres do have an impact and we are committed to playing our part in tackling climate change. We set targets to reduce our energy use and emissions. We also work with our suppliers to help understand and reduce their environmental impact.

For further information you can read about our Environmental policy and practices at www.pearson.com/environment

Risk Management

We conduct regular risk reviews to identify risk factors which may affect our business and financial performance. Our internal audit function reviews these risks with each business, agreeing measures and controls to mitigate these risks wherever possible. It is not possible to identify every risk that could affect our businesses, similarly the actions taken to mitigate the risks described below cannot provide absolute assurance that a risk will not materialise and/or adversely affect our business or financial performance. Our principal risks and uncertainties are outlined on the following pages.

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.

Principal risks and uncertainties

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 US and UK, jurisdictions covering the largest proportion 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 authorisation.

These unauthorised 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 authors. This lawsuit seeks to demarcate the extent to which search engines, other internet operators and libraries may rely on the fair-use doctrine to copy content without authorisation from the copyright proprietors, and may give publishers more control over online users of their intellectual property. If the lawsuit is unsuccessful, publishers and authors may be unable to control copying of their content for purposes of online searching, which could have an adverse impact on our business and financial performance.

We seek to mitigate this type of risk through general vigilance, co-operation with other publishers and trade associations, as well as recourse to law as necessary.

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 and growth of our US educational textbook and testing business is dependent on the level of US and state educational funding, which in turn is dependent on the robustness of state finances and the level of funding allocated to educational programmes. Federal and/or state legislative changes can also affect the funding available for educational expenditure, e.g. the No Child Left Behind Act.

Similarly changes in the state procurement process for textbooks, learning material and student tests, particularly in the adoptions market can also affect our markets. For example, changes in curricula, delays in the timing of adoptions and changes in the student testing process can all affect these programmes 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 programmes, or that we will win this business.

Education remains a priority across the US political spectrum. Our customer relationship teams have detailed knowledge of each state market. We are investing in new and innovative ways to expand and combine our product and services to provide a superior customer offering than our competitors, thereby reducing our reliance on any particular funding stream in the US market.

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

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 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.

The diversification of the FT Group into other business models and revenue streams, e.g. subscription based businesses, conferences and its global reach, goes some way to offsetting reliance on newspaper advertising, particularly in the UK.

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 US and 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/or the suspension or withdrawal of our accreditation to conduct tests. 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.

Our robust testing procedures and controls, combined with our investment in technology, project management and skills development of our people minimise the risk of a breakdown in our student marking.

Our professional services and school testing businesses involve complex contractual relationships with both government agencies and commercial customers for the provision of various testing services. Our financial results, growth prospects and/or reputation may be adversely affected if these contracts and relationships are not managed.

These businesses are characterised by multi-million pound contracts spread over several years. As in any contracting business, there are inherent risks associated with the bidding process, start-up, operational performance and contract compliance (including penalty clauses) which could adversely affect our financial performance and/or reputation.

Several of these businesses are dependent on either single or a small number of large contracts. Failure to retain these contracts at the end of the contract term would adversely impact our future revenue growth. At Edexcel, our UK Examination board and testing business, any change in UK Government policy to exam marking and student testing could have a significant impact on our present business model.

In addition to the internal business procedures and controls implemented to ensure we successfully deliver on our contractual commitments, we also seek to develop and maintain good relationships with our customers, whether they be commercial or governmental. We also look to diversify our portfolio to minimise reliance on any single contract.

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, services and people. 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. online, used books or re-imported textbooks. To counter this trend we introduced our own digital text book programme (called SafariX) and are providing students with a greater choice and customisation 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 to purchase the rights to author manuscripts. Our competitors may bid to a level at which we could not generate a sufficient return on our investment, and so, typically, we would not purchase these rights.

– People: the investments we make in our employees, combined with our employment policies and practices, we believe are critical factors enabling us to recruit and retain the very best people in our business sectors. However, some of our markets are presently undergoing radical restructuring with several of our competitors up for sale, particularly in the Education sector. New owners, particularly private equity, may try to recruit our key talent as part of this industry restructuring.

At Penguin, changes in product distribution channels, increased book returns and/or customer bankruptcy may restrict our ability to grow and affect our profitability.

New distribution channels, e.g. digital format, the internet, used books, combined with the concentration of retailer power pose multiple threats (and opportunities) to our traditional consumer publishing models, potentially impacting both sales volumes and pricing.

Penguin's financial performance can also be negatively affected if book return rates increase above historical average levels. Similarly, the bankruptcy of a major retail customer would disrupt short-term product supply to the market as well as result in a large debt write off.

We develop new distribution channels wherever possible by adapting our product offering and investing in new formats. We take steps to challenge illegal distribution sources. To minimise returns we are careful about how we supply orders, taking account of expected sell through. The application of strict credit control policies is used to monitor customer debt.

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 to our customers 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. The failure to recruit and retain staff with relevant skills may constrain our ability to grow as we combine traditional publishing products with online and service offerings.

We mitigate these IT risks by employing project management techniques to manage new software developments and/or system implementations and have implemented an array of security measures to protect our IT assets from attack.

Operational disruption to our business caused by a major disaster and/or external threat such as Avian Flu, restricting our ability to supply products and services to our customers.

Across all our businesses we manage complex operational and logistical arrangements including distribution centres, third-party print sites, data centres and large office facilities. Failure to recover from a major disaster, e.g. fire, flood etc, at a key facility or the disruption of supply from a key third-party vendor could restrict our ability to service our customers. Similarly external threats, such as Avian Flu, terrorist attacks, strikes etc, could all affect our business and employees, disrupting our daily business activities.

We have developed business continuity arrangements, including IT disaster recovery plans, to minimise any business disruption in the event of a major disaster. However, despite regular updates and testing of these plans there is no guarantee that our financial performance will not be adversely affected in the event of a major disaster and/or external threat to our business. Insurance coverage may minimise any losses in certain circumstances.

Investment returns outside our traditional core US and UK markets may be lower than anticipated.

To minimise dependence on our core markets, particularly the US, we are seeking growth opportunities outside these markets, building on our existing substantial international presence. Certain markets we may target for growth are inherently more risky than our traditional markets. Political, economic, currency and corporate governance risks (including fraud) as well as unmanaged expansion are all factors which could limit our returns on investments made in these non-traditional markets.

We draw on our experience of developing businesses outside our core markets and our existing international infrastructure to manage specific country risks. The diversification of our international portfolio, and relative size of 'emerging markets' in relation to the group, further minimises the effect any one territory could have on the overall group results.

Our reported earnings and cash flows may be adversely affected by changes in our pension costs and funding requirements.

We operate a number of pension plans throughout the world, the principal ones being in the UK and US. The major plans are self-administered with the plans' 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 plan is adequately funded, over time, to meet its ongoing and future liabilities. Our earnings and cash flows may be adversely affected by the need to provide additional funding to eliminate pension fund deficits in our defined benefit plans. Our greatest exposure relates to our UK defined benefit pension plan. Pension fund deficits have/may arise because of inadequate investment returns, increased member life expectancy, changes in actuarial assumptions and changes in pension regulations, including accounting rules and minimum funding requirements.

The latest valuation of our UK defined benefit pension plan has been completed and future funding arrangements have been agreed between the company and the pension fund Trustee. Additional payments amounting to £100m will be made by the company in 2007. We review these arrangements every three years and are confident that the pension funding plans are sufficient to meet future liabilities without unduly affecting the development of the company.

Social, environmental and ethical risk

We consider social, environmental and ethical (SEE) risks no differently to the way we manage any other business risk. Our 2006 risk assessments did not identify any significant under-managed SEE risks, nor have any of our most important SEE risks, many concerned with reputational risk, changed year on year. These are:

- Journalistic/author integrity;
- Ethical business behaviour;
- Compliance with UN Global Compact principles on labour standards, human rights, environment and anti-corruption;
- Environmental impact;
- People;
- Data privacy.

Our risk reporting systems together with our approach to managing the key SEE risks above are described in 'Our Business and Society', the Pearson corporate responsibility report. The web link is available at www.pearson.com/community/csr_report2006

Changes in our tax position can significantly affect our reported earnings and cash flows.

There are several risk factors which may affect our reported tax rate and/or level of tax payments in the future. The most important are as follows:

– Changes in corporate tax rates and/or other relevant tax laws in the UK and/or the US could have a material impact on our future reported tax rate and/or our future tax payments.

– A material shortfall in profits of our US businesses below the level projected in our strategic plans would require us to reconsider the amount of the deferred tax asset relating to US net operating losses in our balance sheet (£126m at 31 December 2006). This could lead to a material increase in the reported tax rate.

We have internal tax professionals in the UK and US who review all significant arrangements around the world and respond to changes in tax legislation. They work closely with local management and external tax advisers.

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 and the strength of our balance sheet.

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 2005 average rates had prevailed in 2006, sales for 2006 would have been £48m or 1% higher.

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.

Pearson generates about two-thirds of its sales in the US and each 5¢ change in the average £:$ exchange rate for the full year (which in 2006 was £1:$1.84) would have an impact of 1p on adjusted earnings per share.

We estimate that a 5¢ change in the closing exchange rate between the US dollar and sterling in any year could affect our reported adjusted earnings per share by 1p and shareholders' funds by approximately £85m.

The Group's policy on managing currency risk is described on page 23.

Financial risk

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

Treasury policy

The Group holds financial instruments for two principal purposes: to finance its operations and to manage the interest rate and currency risks arising from its operations and its sources of finance. The Group finances its operations by a mixture of cash flows from operations, short-term borrowings from banks and commercial paper markets, and longer term loans from banks and capital markets.

The Group borrows principally in US dollars, euros and sterling, at both floating and fixed rates of interest, using derivative financial instruments ('derivatives'), where appropriate, to generate the desired effective currency profile and interest rate basis. The derivatives used for this purpose are principally rate swaps, rate caps and collars, currency rate swaps and forward foreign exchange contracts.

The main risks arising from the Group's financial instruments are interest rate risk, liquidity and refinancing risk, counterparty risk and foreign currency risk. These risks are managed by the chief financial officer under policies approved by the board, which are summarised below. All the treasury policies remained unchanged throughout 2006. As described in the section below, in February 2007 the board approved a change in a definition used in the currency of debt policy. The audit committee and a group of external treasury advisers, receives reports on the Group's treasury activities, policies and procedures. The treasury department is not a profit centre and its activities are subject to regular internal audit.

Interest rate risk

The Group's exposure to interest rate fluctuations on its borrowings is managed by borrowing on a fixed rate basis and by entering into rate swaps, rate caps and forward rate agreements. The Group's policy objective has continued to be to set a target proportion of its forecast borrowings (taken at the year end, with cash netted against floating rate debt) to be hedged (i.e. fixed or capped) over the next four years, subject to a maximum of 65% and a minimum that starts at 40% and falls by 10% at each year end. At the end of 2006 the hedging ratio was approximately 49%. A simultaneous 1% change on 1 January in the Group's variable interest rates in each of US dollar, euro and sterling, taking into account forecast seasonal debt, would have a £7m effect on profit before tax.

Use of interest rate derivatives
The policy in the section above creates a group of derivatives, under which the Group is a payer of fixed rates and a receiver of floating rates. The Group also aims to avoid undue exposure to a single interest rate setting. Reflecting this, it swaps its fixed rate bond issues to floating rate at their launch. These create a second group of derivatives, under which the Group is a receiver of fixed rates and a payer of floating rates.

The Group's accounting objective in its use of interest rate derivatives is to minimise the impact on the income statement of changes in the mark-to-market value of its derivative portfolio as a whole. It uses duration calculations to estimate the sensitivity of the derivatives to movements in market rates. The Group also identifies which derivatives are eligible for fair value hedge accounting (which reduces sharply the income statement impact of changes in the market value of a derivative). The Group then divides the total portfolio between hedge-accounted and pooled segments, so that the expected movement on the pooled segment is minimal.

Liquidity and refinancing risk
The Group's objective is to secure continuity of funding at a reasonable cost. To do this it seeks to arrange committed funding for a variety of maturities from a diversity of sources. The Group's policy objective has been that the weighted average maturity of its core gross borrowings (treating short-term advances as having the final maturity of the facilities available to refinance them) should be between three and ten years. At the end of 2006 the average maturity of gross borrowings was 4.5 years and non-banks provided £1,566m (90%) of these borrowings (down from five years and 95% respectively at the beginning of the year).

The Group believes that ready access to different funding markets also helps to reduce its liquidity risk, and that published credit ratings and published financial policies improve such access. All of the Group's credit ratings remained unchanged during the year. The long-term ratings are Baa1 from Moody's and BBB+ from Standard & Poor's, and the short-term ratings are P2 and A2 respectively.

The Group's policy is to strive to maintain a rating of BBB+/Baa1 over the long term. The Group will also continue to use internally a range of ratios to monitor and manage its finances. These include interest cover, net debt to operating profit and cash flow to debt measures. The Group also maintains undrawn committed borrowing facilities. During the year the Group renegotiated its revolving credit facility which increased the amount and extended the maturity date. At the end of 2006 the committed facilities amounted to £894m and their weighted average maturity was 4.5 years.

Net borrowings fixed and floating rate stated after the impact of rate derivatives:

All figures £ millions	2006	2005
Fixed rate	514	549
Floating rate	545	447
Total	1,059	996

Gross borrowings:

All figures £ millions	2006	2005
Bank debt	177	105
Bonds	1,566	1,854
Total	1,743	1,959

Gross borrowings by currency:

All figures £ millions	As reported 2006	Currency derivatives 2006	Combined 2006	2005
US dollar	966	287	1,253	1,455
Sterling	356	(150)	206	207
Euro	421	(137)	284	297
Total	1,743	–	1,743	1,959

Counterparty risk
The Group's risk of loss on deposits or derivative contracts with individual banks is managed in part through the use of counterparty limits. These limits, which take published credit limits (among other things) into account, are approved by the chief financial officer within guidelines approved by the board. In addition, prior to their maturity

in February 2007, for a currency rate swap that transformed a major part of the 6.125% Euro Bonds due 2007 into a US dollar liability, the Group entered into a mark-to-market agreement which significantly reduced the counterparty risk of that rate swap transaction.

Currency risk
Although the Group is based in the UK, it has its most significant investment in overseas operations. The most significant currency for the Group is the US dollar. The Group's policy on routine transactional conversions between currencies (for example, the collection of receivables, and the settlement of payables or interest) remains that these should be completed at the relevant spot exchange rate. The majority of our operations are domestic within their country of operation. No unremitted profits are hedged with foreign exchange contracts, as the company judges it inappropriate to hedge non-cash flow translational exposure with cash flow instruments. However, the Group does seek to create a natural hedge of this exposure through its policy of aligning approximately the currency composition of its core net borrowings with its forecast operating profit (from February 2007 the policy was amended slightly to align core net borrowings with forecast operating profit before depreciation and amortisation). This policy aims to dampen the impact of changes in foreign exchange rates on consolidated interest cover and earnings.

The policy above applies only to currencies that account for more than 15% of Group operating profit before depreciation and amortisation, which currently is only the US dollar. However, the Group still borrows small amounts in other currencies, typically for seasonal working capital needs. In addition, the Group currently expect to hold legacy borrowings in euro and sterling to their maturity dates: our policy does not require existing currency debt to be terminated to match declines in that currency's share of Group operating profit before depreciation and amortisation. Included within year end net debt, the net borrowings/(cash) in the three principal currencies above (taking into account the effect of cross currency swaps) were: US dollar £979m, euro £158m and sterling £30m. The euro-denominated bonds mature in 2007 and the net debt profile will then more closely match the currency profile of group operating profit before depreciation and amortisation.

Use of currency debt and derivatives
The Group uses both currency denominated debt and derivative instruments to implement the above policy. Its intention is that gains/losses on the derivatives and debt offset the losses/gains on the foreign currency assets and income. Each quarter the value of hedging instruments is monitored against the assets in the relevant currency and, where practical, a decision is made whether to treat the debt or derivative as a net investment hedge (permitting foreign exchange movements on it to be taken to reserves) for the purposes of IAS 39.

Robin Freestone, *Chief financial officer*