Notes to the Consolidated Financial Statements

General information

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

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

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

These consolidated financial statements were approved for issue by the board of directors on 9 March 2007.

1 Accounting policies

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

a. Basis of preparation

These consolidated financial statements have been prepared in accordance with EU-adopted International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations Committee (IFRIC) interpretations and with those parts of the Companies Act 1985 applicable to companies reporting under IFRS. The Group transitioned from UK GAAP to IFRS on 1 January 2003.

These consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of financial assets and liabilities (including derivative instruments) at fair value.

(1) Interpretations and amendments to published standards effective in 2006 – The following amendments and interpretations to standards are mandatory for the Group's accounting periods beginning on or after 1 January 2006:

– IAS 21 'The Effects of Changes in Foreign Currency';

– IAS 39 (Amendment) 'Cash Flow Hedge Accounting of Forecast Intragroup Transactions';

– IAS 39 (Amendment) 'The Fair Value Option';

– IAS 39 and IFRS 4 (Amendment) 'Financial Guarantee Contracts';

– IFRS 6 'Exploration for and Evaluation of Mineral Resources';

– IFRIC 4 'Determining whether an Arrangement contains a Lease';

– IFRIC 5 'Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds';

– IFRIC 6 'Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment'.

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

(2) Standards, interpretations and amendments to published standards that are not yet effective – Certain new standards, amendments and interpretations to existing standards have been published that are mandatory for the Group's accounting periods beginning on or after 1 January 2007 or later periods. The Group has not early adopted any of the new pronouncements which are as follows:

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

– A complementary amendment to IAS 1 'Presentation of Financial Statements – Capital Disclosures' (effective from 1 January 2007). The amendment to IAS 1 introduces disclosures about the level and the management of the capital of an entity.

1 Accounting policies *continued*

– IFRS 8 'Operating Segments' (effective 1 January 2009). IFRS 8 requires an entity to adopt the 'management approach' to reporting on the financial performance of its operating segments, revise explanations of the basis on which the segment information is prepared and provide reconciliations to the amounts recognised in the income statement and balance sheet.

Management is currently assessing the impact of IFRS 7, IFRS 8 and the complementary amendment to IAS 1 on the Group's financial statements.

In addition, management has assessed the relevance of the following amendments and interpretations with respect to the Group's operations:

– IFRIC 8 'Scope of IFRS 2' (effective for annual periods beginning on or after 1 May 2006). IFRIC 8 requires consideration of transactions involving the issuance of equity instruments – where the identifiable consideration received is less than the fair value of the equity instruments issued – to establish whether or not they fall within the scope of IFRS 2. The Group will apply IFRIC 8 from 1 January 2007, but it is not expected to have any impact on the Group's accounts;

– IFRIC 10 'Interim Financial Reporting and Impairment' (effective for annual periods beginning on or after 1 November 2006). IFRIC 10 prohibits impairment losses recognised in an interim period on goodwill, investments in equity instruments and investments in financial assets carried at cost to be reversed at a subsequent balance sheet date. The Group will apply IFRIC 10 from 1 January 2007;

– IFRIC 7 'Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies' (effective for annual reporting periods beginning on or after 1 March 2006). IFRIC 7 provides guidance on how to apply the requirements of IAS 29 in a reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, when the economy was not hyperinflationary in the prior period. As none of the Group entities have a currency of a hyperinflationary economy as their functional currency, IFRIC 7 is not relevant to the Group's operations; and

– IFRIC 9 'Reassessment of Embedded Derivatives' (effective for annual periods beginning on or after 1 June 2006). IFRIC 9 requires an entity to assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. The Group does not expect IFRIC 9 to have a material impact.

(3) Critical accounting assumptions and judgements – The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting assumptions. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas requiring a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements, are discussed in the relevant accounting policies under the following headings:

– Intangible assets: Goodwill
– Intangible assets: Pre-publication assets
– Royalty advances
– Taxation
– Employee benefits: Retirement benefit obligations
– Revenue recognition.

b. Consolidation

(1) Business combinations – The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets and contingent assets acquired and identifiable liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. For material acquisitions, the fair value of the acquired intangible assets is determined by an external, independent valuer. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired, after the identification of purchased intangible assets, is recorded as goodwill. See note 1e*(1)* for the accounting policy on goodwill.

1 Accounting policies *continued*

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

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

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

c. Foreign currency translation

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

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

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

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

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

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

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

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

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

The principal overseas currency for the Group is the US dollar. The average rate for the year against sterling was $1.84 (2005: $1.81) and the year end rate was $1.96 (2005: $1.72).

d. Property, plant and equipment

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

Buildings (freehold): 20–50 years

Buildings (leasehold): 50 years (or over the period of the lease if shorter)

Plant and equipment: 3–20 years

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

The carrying value of an asset is written down to its recoverable amount if the carrying value of the asset is greater than its estimated recoverable amount.

e. Intangible assets

(1) Goodwill – Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary or associate at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of associates is included in investments in associates. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. The recoverable amounts of cash generating units have been determined based on value in use calculations. These calculations require the use of estimates (see note 12). Goodwill is allocated to cash generating units for the purpose of impairment testing. The allocation is made to those cash generating units that are expected to benefit from the business combination in which the goodwill arose. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold. IFRS 3 'Business Combinations' has not been applied retrospectively to business combinations before the date of transition to IFRS. Subject to the transition adjustments to IFRS required by IFRS 1, the accounting for business combinations before the date of transition has been grandfathered.

(2) Acquired software – Software separately acquired for internal use is capitalised at cost. Software acquired in material business combinations is capitalised at its fair value as determined by an independent valuer. Acquired software is amortised on a straight line basis over its estimated useful life of between three and five years.

(3) Internally developed software – Internal and external costs incurred during the preliminary stage of developing computer software for internal use are expensed as incurred. Internal and external costs incurred to develop computer software for internal use during the application development stage are capitalised if the Group expects economic benefits from the development. Capitalisation in the application development stage begins once the Group can reliably measure the expenditure attributable to the software development and has demonstrated its intention to complete and use the software. Internally developed software is amortised on a straight-line basis over its estimated useful life of between three and five years.

(4) Acquired intangible assets – Acquired intangible assets comprise publishing rights, customer lists and relationships, technology, trade names and trademarks. These assets are capitalised on acquisition at cost and included in intangible assets. Intangible assets acquired in material business combinations are capitalised at their fair value as determined by an independent valuer. Intangible assets are amortised over their estimated useful lives of between two and 20 years, using a depreciation method that reflects the pattern of their consumption.

(5) Pre-publication assets – Pre-publication costs represent direct costs incurred in the development of educational programmes and titles prior to their publication. These costs are recognised as current intangible assets where the title will generate probable future economic benefits and costs can be measured reliably. Pre-publication assets are amortised upon publication of the title over estimated economic lives of five years or less, being an estimate of the expected operating life cycle of the title, with a higher proportion of the amortisation taken in the earlier years. The investment in pre-publication assets has been disclosed as part of the cash generated from operations in the cash flow statement (see note 31).

1 Accounting policies *continued*

The assessment of the recoverability of pre-publication assets and the determination of the amortisation profile involve a significant degree of judgement based on historical trends and management estimation of future potential sales. An incorrect amortisation profile could result in excess amounts being carried forward as intangible assets that would otherwise have been written off to the income statement in an earlier period. Reviews are performed regularly to estimate recoverability of pre-publication assets. The carrying amount of pre-publication assets is set out in note 17.

f. Other financial assets

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

g. Inventories

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

h. Royalty advances

Advances of royalties to authors are included within trade and other receivables when the advance is paid less any provision required to adjust the advance to its net realisable value. The realisable value of royalty advances relies on a degree of management judgement in determining the profitability of individual author contracts. If the estimated realisable value of author contracts is overstated then this will have an adverse effect on operating profits as these excess amounts will be written off. The recoverability of royalty advances is based upon an annual detailed management review of the age of the advance, the future sales projections for new authors and prior sales history of repeat authors. The royalty advance is expensed at the contracted or effective royalty rate as the related revenues are earned. Royalty advances which will be consumed within one year are held in current assets. Royalty advances which will be consumed after one year are held in non-current assets.

i. Newspaper development costs

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

j. Cash and cash equivalents

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

k. Share capital

Ordinary shares are classified as equity.

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

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

1 Accounting policies *continued*

l. Borrowings

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

m. Derivative financial instruments

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

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

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

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

n. Taxation

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

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

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

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

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

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.

1 Accounting policies *continued*

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

o. Employee benefits

(1) Retirement benefit obligations – The liability in respect of defined benefit pension plans is the present value of the defined benefit obligations at the balance sheet date less 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.

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

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

The service cost, representing benefits accruing over the year, is included in the income statement as an operating cost. The unwinding of the discount rate on the scheme liabilities and the expected return on scheme assets are presented as finance costs or finance income.

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

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

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

p. Provisions

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

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

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

1 Accounting policies *continued*

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

q. Revenue recognition

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

Revenue from the sale of books is recognised when title passes. 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 recognised when the newspaper or other publication is published. Subscription revenue is recognised on a straight-line basis over the life of the subscription.

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

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

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

Income from recharges of freight and other activities which are incidental to the normal revenue generating activities is included in other income.

r. Leases

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

1 Accounting policies *continued*

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

s. Dividends

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

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

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

u. Trade receivables

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

2 Segment information

Due to the differing risks and rewards associated with each business segment and the different customer focus of each segment, the Group's primary segment reporting format is by business. The Group is organised into the following five business segments:

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

Higher Education – publisher of textbooks and related course materials for colleges and universities;

Penguin – publisher with brand imprints such as Penguin, Putnam, Berkley, Viking, Dorling Kindersley;

FT Publishing – publisher of the *Financial Times*, other business newspapers, magazines and specialist information;

Interactive Data Corporation (IDC) – provider of financial and business information to financial institutions and retail investors.

The remaining business group, Professional, brings together a number of education publishing, testing and services businesses that publish texts, reference and interactive products for industry professionals and does not meet the criteria for classification as a 'segment' under IFRS. For more detail on the services and products included in each business segment refer to the Business Review.

2 Segment information *continued*

Primary reporting format – business segments

All figures in £ millions	Notes	School	Higher Education	Professional	Penguin	FT Publishing	IDC	Corporate	2006 Group
Continuing operations									
Sales (external)		1,455	795	341	848	366	332	–	4,137
Sales (inter-segment)		1	–	–	18	–	–	–	19
Operating profit before joint ventures and associates		161	161	36	58	18	82	–	516
Share of results of joint ventures and associates		6	–	1	–	17	–	–	24
Operating profit		167	161	37	58	35	82	–	540
Finance costs	7								(133)
Finance income	7								59
Profit before tax									466
Income tax	8								(11)
Profit for the year from continuing operations									455
Reconciliation to adjusted operating profit									
Operating profit		167	161	37	58	35	82	–	540
Adjustment to goodwill on recognition of pre-acquisition deferred tax		–	–	–	7	–	–	–	7
Amortisation of acquired intangibles		17	–	1	1	2	7	–	28
Other net gains and losses of associates		–	–	–	–	(4)	–	–	(4)
Other net finance costs of associates		–	–	–	–	(1)	–	–	(1)
Adjusted operating profit – continuing operations		184	161	38	66	32	89	–	570
Segment assets		2,684	1,347	580	954	317	314	703	6,899
Joint ventures	13	5	–	–	3	4	–	–	12
Associates	13	4	–	–	–	4	–	–	8
Assets – continuing operations		2,693	1,347	580	957	325	314	703	6,919
Assets – discontinued operations		–	–	294	–	–	–	–	294
Total assets		2,693	1,347	874	957	325	314	703	7,213
Total liabilities		(662)	(268)	(177)	(269)	(300)	(131)	(1,762)	(3,569)
Other segment items									
Capital expenditure	11, 12, 17	124	88	30	38	19	20	–	319
Depreciation	11	21	8	19	7	9	13	–	77
Amortisation	12, 17	117	78	21	34	4	7	–	261

2 Segment information *continued*

All figures in £ millions	Notes	School	Higher Education	Professional	Penguin	FT Publishing	IDC	Corporate	2005 Group
Continuing operations									
Sales (external)		1,295	779	301	804	332	297	–	3,808
Sales (inter-segment)		–	–	–	16	–	–	–	16
Operating profit before joint ventures and associates		138	156	24	60	49	75	–	502
Share of results of joint ventures and associates		4	–	1	–	9	–	–	14
Operating profit		142	156	25	60	58	75	–	516
Finance costs	7								(132)
Finance income	7								62
Profit before tax									446
Income tax	8								(116)
Profit for the year from continuing operations									330
Reconciliation to adjusted operating profit									
Operating profit		142	156	25	60	58	75	–	516
Amortisation of acquired intangibles		5	–	–	–	1	5	–	11
Other net gains and losses		–	–	–	–	(40)	–	–	(40)
Other net finance costs of associates		–	–	–	–	2	–	–	2
Adjusted operating profit – continuing operations		147	156	25	60	21	80	–	489
Segment assets		2,347	1,648	1,179	960	154	291	985	7,564
Joint ventures	13	6	–	–	2	4	–	–	12
Associates	13	6	–	–	–	18	–	–	24
Total assets		2,359	1,648	1,179	962	176	291	985	7,600
Total liabilities		(557)	(341)	(263)	(280)	(336)	(109)	(1,981)	(3,867)
Other segment items									
Capital expenditure	11, 12, 17	114	96	43	34	14	19	–	320
Depreciation	11	26	8	17	7	11	11	–	80
Amortisation	12, 17	91	78	20	24	3	5	–	221

In 2006, sales from the provision of goods were £3,117m (2005: £2,956m) and sales from the provision of services were £1,020m (2005: £852m). Sales from the Group's educational publishing, consumer publishing and newspaper business are classified as being from the provision of goods and sales from its assessment and testing, market pricing, corporate training and management service businesses are classified as being from the provision of services.

2 Segment information *continued*

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

Property, plant and equipment and intangible assets acquired through business combinations were £173m (2005: £111m) (see notes 11, 12 and 17). Capital expenditure, depreciation and amortisation include amounts relating to discontinued operations. In April 2005, Pearson sold its 79% interest in Recoletos Grupo de Communicación S.A.. This operation is disclosed as a discontinued operation in 2005 (see note 3). In December 2006 Pearson announced its intention to sell Pearson Government Solutions. This operation is disclosed as a discontinued operation (see note 3) and the assets and liabilities are classified as held for sale (see note 29).

Secondary reporting format – geographic segments

The Group's business segments are managed on a worldwide basis and operate in the following main geographic areas:

	Sales		Total assets		Capital expenditure	
All figures in £ millions	2006	2005	2006	2005	2006	2005
Continuing operations						
European countries	1,089	951	1,608	1,711	70	63
North America	2,642	2,451	4,908	5,476	231	242
Asia Pacific	298	300	327	325	12	13
Other countries	108	106	56	52	2	2
Total	4,137	3,808	6,899	7,564	315	320
Discontinued operations						
European countries	17	39	9	–	1	–
North America	257	266	281	–	2	–
Other countries	12	10	4	–	1	–
Total	286	315	294	–	4	–
Joint ventures and associates	–	–	20	36	–	–
Total	4,423	4,123	7,213	7,600	319	320

Sales are allocated based on the country in which the customer is located. This does not differ materially from the location where the order is received.

3 Discontinued operations

On 11 December 2006, Pearson announced that it had agreed to sell Pearson Government Solutions to Veritas Capital, a private equity firm. This operation is disclosed as discontinued and the assets and liabilities of Pearson Government Solutions have been reclassified to non-current assets held for sale (see notes 29 and 35).

Discontinued operations in 2005 also relate to the sale of Pearson's 79% interest in Recoletos Grupo de Communicación S.A..

3 Discontinued operations *continued*

An analysis of the results and cash flows of discontinued operations are as follows:

All figures in £ millions	2006 Pearson Government Solutions	2005 Pearson Government Solutions	2005 Recoletos	2005 Total
Sales	286	288	27	315
Operating profit/(loss)	22	20	(3)	17
Net finance income	–	–	–	–
Profit/(loss) before tax	22	20	(3)	17
Attributable tax (expense)/benefit	(8)	(8)	1	(7)
Profit/(loss) after tax	14	12	(2)	10
Profit on disposal of discontinued operations before tax	–	–	306	306
Attributable tax expense	–	–	(2)	(2)
Profit for the year from discontinued operations	14	12	302	314
Operating cash flows	20	22	(6)	16
Investing cash flows	(8)	(13)	–	(13)
Financing cash flows	(1)	(1)	–	(1)
Total cash flows	11	8	(6)	2

4 Other net gains and losses

All figures in £ millions	2006	2005
Profit on sale of interest in MarketWatch	–	40

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

5 Operating expenses

All figures in £ millions	2006	2005
By function:		
Cost of goods sold	1,917	1,787
Operating expenses		
Distribution costs	299	292
Administrative and other expenses	1,504	1,351
Other income	(99)	(84)
Total operating expenses	1,704	1,559
Total	3,621	3,346

5 Operating expenses *continued*

All figures in £ millions	Notes	2006	2005
By nature:			
Utilisation of inventory	18	820	767
Depreciation of property, plant and equipment	11	71	76
Amortisation of intangible assets – pre-publication	17	210	192
Amortisation of intangible assets – other	12	48	26
Employee benefit expense	6	1,280	1,177
Operating lease rentals		125	111
Other property costs		121	84
Royalties expensed		360	363
Advertising, promotion and marketing		212	198
Information technology costs		90	81
Other costs		383	355
Other income		(99)	(84)
Total		3,621	3,346

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

All figures in £ millions	2006	2005
Audit services		
Fees payable to the Company's auditor for the audit of parent company and consolidated accounts	1	1
Non-audit services		
Fees payable to the Company's auditor and its associates for other services:		
– The audit of the Company's subsidiaries pursuant to legislation	4	3
– Other services pursuant to legislation	4	–
– Tax services	1	1
– Services relating to corporate finance transactions	1	1
– All other services	–	1
	11	7

'Other services pursuant to legislation' represents fees payable for services in relation to other statutory filings or engagements that are required to be carried out by the appointed auditor. In particular, this includes fees for reports under section 404 (S-404) of the US Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley) which are required for the first time in 2006.

'Services relating to corporate finance transactions' relate to a carve-out audit of Pearson Government Solutions in 2006. In 2005 this largely related to due diligence work at IDC.

'All other services' in 2005 relate to IFRS transition work and Sarbanes-Oxley section 404 compliance services.

Audit fees in relation to the IDC SEC filings have been entirely included in 'The audit of the Company's subsidiaries pursuant to legislation'. The audit fee relates to an integrated S-404 review and audit in which the audit work takes leverage from the results of S-404 testing. The fees for the S-404 review and the audit are not separate, therefore no IDC fees have been included in 'Other services pursuant to legislation'.

6 Employee information

All figures in £ millions	Notes	2006	2005
Employee benefit expense			
Wages and salaries (including termination benefits and restructuring costs)		1,080	993
Social security costs		111	100
Share-based payment costs	24	25	23
Pension costs – defined contribution plans	24	36	35
Pension costs – defined benefit plans	24	29	25
Other post-retirement benefits	24	(1)	1
		1,280	1,177

The details of the emoluments of the directors of Pearson plc are shown on pages 32 to 51 which form part of these financial statements.

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
	34,341	32,203

7 Net finance costs

All figures in £ millions	Notes	2006	2005
Interest payable		(117)	(98)
Finance costs re employee benefits	24	–	(7)
Net foreign exchange losses		(2)	(9)
Other losses on financial instruments in a hedging relationship:			
– fair value hedges		–	(1)
– net investment hedges		(2)	–
Other losses on financial instruments not in a hedging relationship:			
– derivatives		(12)	(17)
Finance costs		(133)	(132)
Interest receivable		23	21
Finance income re employee benefits	24	4	–
Net foreign exchange gains		21	21
Other gains on financial instruments in a hedging relationship:			
– fair value hedges		–	1
– net investment hedges		–	3
Other gains on financial instruments not in a hedging relationship:			
– amortisation of transitional adjustment on bonds		8	7
– derivatives		3	9
Finance income		59	62
Net finance costs		(74)	(70)
Analysed as:			
Net interest payable		(94)	(77)
Finance income/(costs) re employee benefits	24	4	(7)
Net finance costs reflected in adjusted earnings		(90)	(84)
Other net finance income		16	14
Total net finance costs		(74)	(70)

8 Income tax

All figures in £ millions	Notes	2006	2005
Current tax			
Charge in respect of current year		(88)	(68)
Recognition of previously unrecognised trading losses		23	–
Other adjustments in respect of prior years		35	(1)
Total current tax charge		(30)	(69)
Deferred tax			
In respect of timing differences		(73)	(66)
Recognition of previously unrecognised capital losses		76	–
Recognition of previously unrecognised trading losses		37	–
Other adjustments in respect of prior years		(21)	19
Total deferred tax benefit/(charge)	14	19	(47)
Total tax charge		(11)	(116)

8 Income tax *continued*

In 2006, the Group has recognised a deferred tax asset in relation to capital losses in the US which will be utilised on the sale of Pearson Government Solutions. Previously it had not been possible to foresee the utilisation of these losses prior to their expiry. In addition, due to improved trading performance and revised strategic plans together with the expected utilisation of US net operating losses in the Pearson Government Solutions sale, the Group has re-evaluated the likely utilisation of operating losses both in the US and UK and as a consequence has increased 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 tax benefit of £127m.

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

All figures in £ millions	2006	2005
Profit before tax	466	446
Tax calculated at UK rate	(140)	(134)
Effect of overseas tax rates	(19)	(20)
Joint venture and associate income reported net of tax	7	5
Income not subject to tax	5	16
Expenses not deductible for tax purposes	(18)	(9)
Utilisation of previously unrecognised tax losses	7	11
Recognition of previously unrecognised tax losses	136	–
Unutilised tax losses	(3)	(3)
Prior year adjustments	14	18
Total tax charge	(11)	(116)
UK	(15)	(26)
Overseas	4	(90)
Total tax charge	(11)	(116)
Add back: tax benefit on other gains and losses	(4)	(4)
Add back: tax benefit on amortisation of acquired intangibles	(10)	(4)
Add back: tax charge on other finance income	5	3
Recognition of tax losses	(127)	–
Adjusted income tax charge – continuing operations	(147)	(121)
Adjusted income tax charge – discontinued operations	(8)	(7)
Total adjusted income tax charge	(155)	(128)
Tax rate reflected in adjusted earnings	30.9%	30.3%

The tax benefit/(charge) on items charged to equity is as follows:

All figures in £ millions	2006	2005
Deferred tax on share based payments	2	3
Deferred tax on net investment hedges	3	–
Deferred tax on actuarial gains and losses	9	–
Current tax on foreign exchange gains and losses	(2)	9
	12	12

9 Earnings per share

Basic

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

Diluted

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

Adjusted

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

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

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

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

Other net finance income/costs are foreign exchange and other gains and losses that represent short-term fluctuations in market value and foreign exchange movements on transactions and balances that are no longer in a hedge relationship. These gains and losses are subject to significant volatility and may not be realised in due course as it is normally the intention to hold these instruments to maturity. Other net finance costs of Group companies are included in finance costs or finance income as appropriate. Other net finance costs of joint ventures and associates are included within the share of results of joint ventures and associates within operating profit.

Tax on the above items is excluded from adjusted earnings. The Company has also excluded tax benefits from the recognition of its tax losses which due to their size and non-recurring nature are not considered to be fully reflective of the underlying tax rate of the Group.

Minority interest for the above items is excluded from adjusted earnings.

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

9 Earnings per share *continued*

All figures in £ millions	Notes	2006	2005
Earnings		446	624
Adjustments to exclude profit for the year from discontinued operations:			
Profit for the year from discontinued operations	3	(14)	(314)
Earnings – continuing operations		432	310
Earnings		446	624
Adjustments:			
Other gains and losses	4	–	(40)
Other gains and losses of associates		(4)	–
Adjustment to goodwill on recognition of pre-acquisition deferred tax	12	7	–
Amortisation of acquired intangibles	12	28	11
Other net finance (income)/costs of associates		(1)	2
Profit on sale of discontinued operations	3	–	(306)
Other net finance income	7	(16)	(14)
Taxation on above items		(9)	(3)
Recognition of tax losses		(127)	–
Minority interest share of above items		(3)	(2)
Adjusted earnings		321	272
Weighted average number of shares (millions)		798.4	797.9
Effect of dilutive share options (millions)		1.5	1.1
Weighted average number of shares (millions) for diluted earnings		799.9	799.0

	2006	2005
Earnings per share from continuing and discontinued operations		
Basic	55.9p	78.2p
Diluted	55.8p	78.1p
Earnings per share from continuing operations		
Basic	54.1p	38.9p
Diluted	54.0p	38.8p
Earnings per share from discontinued operations		
Basic	1.8p	39.3p
Diluted	1.8p	39.3p
Adjusted earnings per share	40.2p	34.1p

10 Dividends

All figures in £ millions	2006	2005
Final paid in respect of prior year 17p (2005: 15.7p)	136	125
Interim paid in respect of current year 10.5p (2005: 10p)	84	80
	220	205

The directors are proposing a final dividend in respect of the financial year ending 31 December 2006 of 18.8p per share which will absorb an estimated £151m of shareholders' funds. It will be paid on 11 May 2007 to shareholders who are on the register of members on 10 April 2007. These financial statements do not reflect this dividend.

11 Property, plant and equipment

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Cost				
At 1 January 2005	280	604	13	897
Exchange differences	18	40	–	58
Transfers	–	13	–	13
Additions	32	41	1	74
Disposals	(5)	(28)	–	(33)
Acquisition through business combination	3	6	–	9
Reclassifications	–	7	(7)	–
At 31 December 2005	328	683	7	1,018
Exchange differences	(20)	(54)	–	(74)
Transfers	–	(11)	(1)	(12)
Additions	12	52	13	77
Disposals	(9)	(32)	–	(41)
Acquisition through business combination	9	12	–	21
Reclassifications	–	8	(8)	–
Transfer to non-current assets held for sale	(7)	(27)	–	(34)
At 31 December 2006	313	631	11	955

11 Property, plant and equipment *continued*

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Depreciation				
At 1 January 2005	(106)	(436)	–	(542)
Exchange differences	(7)	(33)	–	(40)
Charge for the year	(17)	(63)	–	(80)
Disposals	–	30	–	30
Acquisition through business combination	–	(2)	–	(2)
At 31 December 2005	(130)	(504)	–	(634)
Exchange differences	10	41	–	51
Transfers	–	5	–	5
Charge for the year	(17)	(60)	–	(77)
Disposals	4	27	–	31
Acquisition through business combination	–	(8)	–	(8)
Transfer to non-current assets held for sale	5	20	–	25
At 31 December 2006	(128)	(479)	–	(607)
Carrying amounts				
At 1 January 2005	174	168	13	355
At 31 December 2005	198	179	7	384
At 31 December 2006	185	152	11	348

Depreciation expense of £18m (2005: £19m) has been included in the income statement in cost of goods sold, £6m (2005: £7m) in distribution expenses and £53m (2005: £54m) in administrative and other expenses. In 2006 £6m (2005: £4m) relates to discontinued operations.

The Group leases certain equipment under a number of finance lease agreements. The net carrying amount of leased plant and equipment included within property, plant and equipment was £4m (2005: £3m).

12 Intangible assets

All figures in £ millions	Goodwill	Software	Acquired publishing rights	Other intangibles acquired	Total intangibles acquired	Total
Cost						
At 1 January 2005	3,160	181	10	46	56	3,397
Exchange differences	345	15	2	4	6	366
Transfers	–	(13)	–	–	–	(13)
Additions	–	24	–	–	–	24
Disposals	(6)	(10)	–	–	–	(16)
Acquisition through business combination	155	–	56	33	89	244
At 31 December 2005	3,654	197	68	83	151	4,002
Exchange differences	(396)	(17)	(8)	(8)	(16)	(429)
Transfers	–	6	–	–	–	6
Additions	–	29	–	–	–	29
Disposals	(5)	(2)	–	–	–	(7)
Acquisition through business combination	246	4	36	117	153	403
Adjustment on recognition of pre-acquisition deferred tax	(7)	–	–	–	–	(7)
Transfer to non-current assets held for sale	(221)	(16)	–	–	–	(237)
At 31 December 2006	3,271	201	96	192	288	3,760

All figures in £ millions	Goodwill	Software	Acquired publishing rights	Other intangibles acquired	Total intangibles acquired	Total
Amortisation						
At 1 January 2005	–	(111)	–	(8)	(8)	(119)
Exchange differences	–	(10)	–	–	–	(10)
Charge for the year	–	(18)	(5)	(6)	(11)	(29)
Disposals	–	10	–	–	–	10
At 31 December 2005	–	(129)	(5)	(14)	(19)	(148)
Exchange differences	–	13	1	2	3	16
Transfers	–	(5)	–	–	–	(5)
Charge for the year	–	(23)	(11)	(17)	(28)	(51)
Disposals	–	1	–	–	–	1
Acquisition through business combination	–	(1)	–	–	–	(1)
Transfer to non-current assets held for sale	–	9	–	–	–	9
At 31 December 2006	–	(135)	(15)	(29)	(44)	(179)
Carrying amounts						
At 1 January 2005	3,160	70	10	38	48	3,278
At 31 December 2005	3,654	68	63	69	132	3,854
At 31 December 2006	3,271	66	81	163	244	3,581

12 Intangible assets *continued*

Other intangibles acquired include customer lists and relationships, software rights, technology, trade names and trademarks. Amortisation of £4m (2005: £4m) is included in the income statement in cost of goods sold and £47m (2005: £25m) in administrative and other expenses. In 2006 £3m of software amortisation (2005: £3m) relates to discontinued operations.

Impairment tests for cash-generating units containing goodwill

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

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

All figures in £ millions	Notes	2006	2005
Higher Education		780	903
School Book		683	714
School Assessment and Testing		342	310
School Technology		356	408
Other Assessment and Testing		490	531
Other Government Solutions		–	249
Other Book		56	57
Pearson Education total		2,707	3,172
Penguin US		156	179
Penguin UK		114	114
Pearson Australia		44	47
Penguin total		314	340
IDC		149	138
Mergermarket	28	97	–
Other FT Publishing		4	4
FT Publishing total		101	4
Total goodwill – continuing operations		3,271	3,654
Goodwill held for sale	29	221	–
Total goodwill		3,492	3,654

Goodwill has been allocated for impairment purposes to 13 cash-generating units. The recoverable amount of each cash-generating unit is based on value in use calculations, with the exception of IDC which is assessed on a market value basis. Goodwill is tested for impairment annually. Following a review in 2006, the allocation of corporate items has been revised. The 2005 comparative has been revised accordingly.

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

Discount rate – The discount rate is based on the risk-free rate for government bonds, adjusted for a risk premium to reflect the increased risk in investing in equities. The risk premium adjustment is assessed for each specific cash-generating unit. The average pre-tax discount rates used are in the range of 10.3% to 11.9% for the Pearson Education businesses, 7.8% to 10.3% for the Penguin businesses and 10.5% to 11.0% for the FT Publishing businesses.

12 Intangible assets *continued*

Perpetuity growth rates – The cash flows subsequent to the approved budget period are based upon the long-term historic growth rates of the underlying territories in which the cash-generating unit operates and reflect the long-term growth prospects of the sectors in which the cash-generating unit operates. The perpetuity growth rates used vary between 2.5% and 3.5%. The perpetuity growth rates are consistent with appropriate external sources for the relevant markets.

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

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

13 Investments in joint ventures and associates

Joint ventures

All figures in £ millions	2006	2005
At beginning of year	12	14
Exchange differences	(3)	(3)
Share of profit/(loss) after tax	3	(1)
Dividends	(4)	(4)
Additions and further investment	4	6
At end of year	12	12

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

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

All figures in £ millions	2006	2005
Assets		
Non-current assets	3	3
Current assets	24	26
Liabilities		
Current liabilities	(15)	(17)
Net assets	12	12
Income	52	46
Expenses	(49)	(47)
Profit/(loss) after income tax	3	(1)

13 Investments in joint ventures and associates *continued*

Associates

All figures in £ millions	2006	2005
At beginning of year	24	33
Exchange differences	(1)	–
Share of profit after tax	21	15
Dividends	(41)	(10)
Disposals	–	(14)
Distribution from associate in excess of carrying value	5	–
At end of year	8	24

There is no acquisition goodwill relating to the Group's investments in associates.

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

2006 All figures in £ millions	Country of incorporation	% Interest held	Assets	Liabilities	Revenues	Profit
The Economist Newspaper Ltd	England	50	64	(64)	122	18
Other			28	(20)	48	3
Total			92	(84)	170	21

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

The interest held in associates is equivalent to voting rights.

14 Deferred income tax

All figures in £ millions	2006	2005
Deferred tax assets		
Deferred tax assets to be recovered after more than 12 months	288	343
Deferred tax assets to be recovered within 12 months	129	42
	417	385
Deferred tax liabilities		
Deferred tax liabilities to be settled after more than 12 months	(245)	(204)
Deferred tax liabilities to be settled within 12 months	–	–
	(245)	(204)
Net deferred tax	172	181

Deferred tax assets to be recovered within 12 months relate to the utilisation of losses in the US. Included within the losses to be utilised in 2007 are capital and operating losses of £93m which it is anticipated will be utilised on the sale of Pearson Government Solutions.

Deferred income tax assets and liabilities may be offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority. The Group has unrecognised deferred tax assets at 31 December 2006 in respect of UK losses of £35m and has not recognised a deferred tax asset amounting to £47m on the net pension deficit on UK plans on the basis that it is not sufficiently certain that suitable future profits will arise against which to offset the liability. None of these unrecognised deferred tax assets have expiry dates associated with them.

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

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

All figures in £ millions	Notes	2006	2005
At beginning of year		181	220
Transition adjustment on adoption of IAS 39		–	5
Exchange differences		(16)	21
Acquisition through business combination	28	(26)	(21)
Income statement release/(charge)	8	19	(47)
Tax benefit to equity		14	3
At end of year		172	181

14 Deferred income tax *continued*

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

All figures in £ millions	Capital losses	Trading losses	Goodwill and intangibles	Other	Total
Deferred income tax assets					
At 1 January 2005	–	150	37	172	359
Transition adjustment on adoption of IAS 39	–	–	–	5	5
Exchange differences	–	16	4	18	38
Acquisition through business combination	–	–	–	1	1
Transfer between current and deferred taxation	–	–	–	23	23
Income statement charge	–	(32)	(6)	(6)	(44)
Tax benefit to equity	–	–	–	3	3
At 31 December 2005	–	134	35	216	385
Exchange differences	–	(17)	(4)	(21)	(42)
Income statement release/(charge)	76	12	(6)	(19)	63
Tax benefit to equity	–	–	–	11	11
At 31 December 2006	76	129	25	187	417

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

All figures in £ millions	Goodwill and intangibles	Other	Total
Deferred income tax liabilities			
At 1 January 2005	(59)	(80)	(139)
Exchange differences	(8)	(9)	(17)
Acquisition through business combination	(24)	2	(22)
Transfer between current and deferred taxation	–	(23)	(23)
Income statement (charge)/release	(26)	23	(3)
At 31 December 2005	(117)	(87)	(204)
Exchange differences	15	11	26
Acquisition through business combination	(20)	(6)	(26)
Income statement charge	(27)	(17)	(44)
Tax benefit to equity	–	3	3
At 31 December 2006	(149)	(96)	(245)

Other deferred tax liabilities include temporary differences in respect of depreciation and royalty advances.

15 Other financial assets

All figures in £ millions	2006	2005
At beginning of year	18	15
Exchange differences	(1)	1
Additions	–	4
Disposals	–	(2)
At end of year	17	18

Other financial assets comprise non-current unlisted securities.

16 Derivative financial instruments

The Group's approach to the management of financial risks is set out on pages 21 to 23 of these financial statements. The Group's outstanding derivative financial instruments are as follows:

	2006		
All figures in £ millions	Gross notional amounts	Assets	Liabilities
Interest rate derivatives – in a fair value hedge relationship	953	20	(17)
Interest rate derivatives – not in a hedge relationship	1,026	9	(2)
Cross currency rate derivatives – in a net investment hedge relationship	230	40	–
Cross currency rate derivatives – not in a hedge relationship	180	17	–
Total	2,389	86	(19)
Analysed as expiring:			
In less than one year	976	50	–
Later than one year and not later than five years	1,005	26	(4)
Later than five years	408	10	(15)
Total	2,389	86	(19)

	2005		
All figures in £ millions	Gross notional amounts	Assets	Liabilities
Interest rate derivatives – in a fair value hedge relationship	1,109	31	(16)
Interest rate derivatives – not in a hedge relationship	1,330	18	(6)
Cross currency rate derivatives – in a net investment hedge relationship	230	13	–
Cross currency rate derivatives – not in a hedge relationship	180	21	–
Total	2,849	83	(22)
Analysed as expiring:			
In less than one year	250	4	–
Later than one year and not later than five years	1,823	57	(8)
Later than five years	776	22	(14)
Total	2,849	83	(22)

16 Derivative financial instruments *continued*

The carrying value of the above derivative financial instruments equals their fair value. Fair values are determined by using market data and the use of established estimation techniques such as discounted cash flow and option valuation models.

At the end of 2006, the currency split of the mark-to-market values of rate derivatives, including the exchange of principal on cross currency rate derivatives, was US dollar £(247)m, euro £157m and sterling £157m (2005: US dollar £(269)m, euro £166m and sterling £164m).

The fixed interest rates on outstanding rate derivative contracts at the end of 2006 range from 3.02% to 7.00% (2005: 3.02% to 7.23%) and the floating rates are based on LIBOR in US dollar, sterling and euro (EURIBOR).

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

The following sensitivity analysis of derivative financial instruments to interest rate movements is based on the assumption of a 1% change in interest rates for all currencies and maturities, with all other variables held constant.

			2006
All figures in £ millions	Net carrying amount	1% rate increase	1% rate decrease
Interest rate derivatives – in a fair value hedge relationship	3	(28)	31
Interest rate derivatives – not in a hedge relationship	7	1	(1)
Cross currency rate derivatives – in a net investment hedge relationship	40	–	–
Cross currency rate derivatives – not in a hedge relationship	17	(1)	1
Total	67	(28)	31
Effect of fair value hedge accounting	–	28	(31)
Sensitivity after the application of hedge accounting	67	–	–

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

At the year end the Group held an amount of £29m equivalent as collateral under a mark-to-market agreement. This reflected the amount, at market rates prevailing at the end of October 2006, owed to the Group by a counterparty for a set of three related rate derivatives. Under these derivatives the Group is due to exchange $209m for €204m at the beginning of February 2007, with the repayment of the €591m bond. There are no restrictions on the Group's use of these funds, which have been recorded in borrowings as a current bank loan.

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

17 Intangible assets – Pre-publication

All figures in £ millions	2006	2005
Cost		
At beginning of year	1,357	1,109
Exchange differences	(148)	112
Transfers	6	–
Additions	213	222
Disposals	(280)	(113)
Acquisition through business combination	4	27
At end of year	1,152	1,357
Amortisation		
At beginning of year	(931)	(753)
Exchange differences	111	(87)
Charge for the year	(210)	(192)
Disposals	280	113
Acquisition through business combination	–	(12)
At end of year	(750)	(931)
Carrying amounts		
At end of year	402	426

Included in the above are pre-publication assets amounting to £243m (2005: £261m) which will be realised in more than 12 months.

Amortisation is included in the income statement in cost of goods sold. There was no amortisation relating to discontinued operations in 2006 and 2005.

18 Inventories

All figures in £ millions	2006	2005
Raw materials	26	23
Work in progress	28	43
Finished goods	300	307
	354	373

The cost of inventories, all relating to continuing operations, recognised as an expense and included in the income statement in cost of goods sold amounted to £820m (2005: £767m). In 2006 £46m (2005: £42m) of inventory provisions were charged in the income statement. None of the inventory is pledged as security.

19 Trade and other receivables

All figures in £ millions	2006	2005
Current		
Trade receivables	768	825
Royalty advances	91	124
Prepayments and accrued income	34	38
Other receivables	58	42
Receivables from related parties	2	2
	953	1,031
Non-current		
Royalty advances	80	67
Prepayments and accrued income	4	4
Other receivables	40	37
	124	108

Trade receivables are stated net of provisions for bad and doubtful debts and anticipated future sales returns of £284m (2005: £313m). The carrying amounts are stated at their fair value. Concentrations of credit risk with respect to trade receivables are limited due to the Group's large number of customers, who are internationally dispersed.

20 Cash and cash equivalents (excluding overdrafts)

All figures in £ millions	2006	2005
Cash at bank and in hand	421	393
Short-term bank deposits	171	509
	592	902

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

At the end of 2006 the currency split of cash and cash equivalents is US dollars 31% (2005: 31%), sterling 35% (2005: 38%), euros 21% (2005: 24%) and other 13% (2005: 7%).

Cash and cash equivalents have fair values that approximate to their carrying amounts due to their short-term nature.

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

All figures in £ millions	2006	2005
Cash and cash equivalents	592	902
Bank overdrafts	(61)	(58)
	531	844

21 Financial liabilities – Borrowings

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

All figures in £ millions	2006	2005
Non-current		
6.125% Euro Bonds 2007 (nominal amount €591m)	–	436
10.5% Sterling Bonds 2008 (nominal amount £100m)	105	107
4.7% US Dollar Bonds 2009 (nominal amount $350m)	178	203
7% Global Dollar Bonds 2011 (nominal amount $500m)	266	307
7% Sterling Bonds 2014 (nominal amount £250m)	251	250
5.7% US Dollar Bonds 2014 (nominal amount $400m)	206	238
4.625% US Dollar notes 2018 (nominal amount $300m)	139	161
Finance lease liabilities	3	1
	1,148	1,703
Current		
Due within one year or on demand:		
Bank loans and overdrafts	173	102
7.375% US Dollar notes 2006	–	152
6.125% Euro Bonds 2007 (nominal amount €591m)	421	–
Finance lease liabilities	1	2
	595	256
Total borrowings	1,743	1,959

Included in the non-current borrowings above is £12m of accrued interest (2005: £35m).
Included in the current borrowings above is £22m of accrued interest (2005: £3m).

All of the Group's borrowings are unsecured. In respect of finance lease obligations (2006: £4m; 2005: £3m) the rights to the leased asset revert to the lessor in the event of default.

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

All figures in £ millions	2006	2005
Between one and two years	107	437
Between two and five years	445	310
Over five years	596	956
	1,148	1,703

As at 31 December 2006 the exposure of the borrowings of the Group to interest rate changes when the borrowings re-price is as follows:

All figures in £ millions	Total	One year	One to five years	More than five years
Carrying value of borrowings	1,743	595	552	596
Effect of rate derivatives	–	629	(221)	(408)
	1,743	1,224	331	188

21 Financial liabilities – Borrowings *continued*

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

All figures in £ millions	Effective interest rate	Carrying amount 2006	Market value 2006	Carrying amount 2005	Market value 2005
6.125% Euro Bonds 2007	6.18%	–	–	436	419
10.5% Sterling Bonds 2008	10.53%	105	106	107	113
4.7% US Dollar Bonds 2009	4.86%	178	176	203	200
7% Global Dollar Bonds 2011	7.16%	266	269	307	310
7% Sterling Bonds 2014	7.20%	251	265	250	282
5.7% US Dollar Bonds 2014	5.88%	206	203	238	234
4.625% US Dollar notes 2018	4.69%	139	135	161	155
Finance lease liabilities	n/a	3	3	1	1
		1,148	1,157	1,703	1,714

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

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

All figures in £ millions	2006	2005
US dollar	966	1,165
Sterling	356	357
Euro	421	437
	1,743	1,959

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

All figures in £ millions	2006	2005
Finance lease liabilities – minimum lease payments		
Not later than one year	1	2
Later than one year and not later than five years	3	1
Later than five years	–	–
Future finance charges on finance leases	–	–
Present value of finance lease liabilities	4	3

The present value of finance lease liabilities is as follows:

All figures in £ millions	2006	2005
Not later than one year	1	2
Later than one year and not later than five years	3	1
Later than five years	–	–
	4	3

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

21 Financial liabilities – Borrowings *continued*

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

All figures in £ millions	2006	2005
Floating rate		
– expiring within one year	–	–
– expiring beyond one year	894	786
	894	786

During the year, the Group renegotiated its revolving credit facility which increased the amount and extended the maturity date.

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

22 Provisions for other liabilities and charges

All figures in £ millions	Deferred consideration	Integration	Re-organisations	Leases	Other	Total
At 1 January 2006	26	3	5	12	18	64
Exchange differences	–	–	–	(2)	(2)	(4)
Charged to consolidated income statement						
– Additional provisions	–	–	1	4	7	12
– Unused amounts reversed	(9)	–	(2)	–	(4)	(15)
On acquisition	17	–	–	–	3	20
Utilised during year	(9)	(1)	(3)	(2)	(10)	(25)
At 31 December 2006	25	2	1	12	12	52

All figures in £ millions	2006	2005
Analysis of provisions		
Non-current	29	31
Current	23	33
	52	64

Deferred consideration – Additional deferred consideration of £17m was incurred during the year relating to the acquisition of Mergermarket.

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

23 Trade and other liabilities

All figures in £ millions	2006	2005
Trade payables	343	348
Social security and other taxes	18	21
Accruals	345	363
Deferred income	276	237
Other liabilities	178	156
	1,160	1,125
Less: non-current portion		
Accruals	24	15
Deferred income	47	51
Other liabilities	91	85
	162	151
Current portion	998	974

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

The deferred income balances comprise:

– multi-year obligations to deliver workbooks to adoption customers in school businesses;
– advance payments in contracting businesses;
– subscription income in school, newspaper and market pricing businesses; and
– advertising income relating to future publishing days in newspaper businesses.

24 Employee benefits

Retirement benefit obligations

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

The most recent actuarial valuation of the UK Group plan was completed as at 1 January 2006.

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

%	2006 UK Group plan	2006 Other plans	2005 UK Group plan	2005 Other plans
Inflation	3.00	2.91	2.80	2.95
Expected rate of increase in salaries	4.70	4.37	4.50	4.43
Expected rate of increase for pensions in payment and deferred pensions	2.10 to 4.60	–	2.50 to 4.00	–
Rate used to discount plan liabilities	5.20	5.70	4.85	5.54
Expected return on assets	6.40	7.18	6.40	7.31

Assumptions regarding future mortality experience are set based on advice, published statistics and experience in each territory. In 2006, the Group used the PMFA92 (medium-cohort) series mortality tables for the UK Group plan modified for age-rating adjustments to recalibrate the tables against observed experience of the plan, and allowing for the future improvement effect from the medium cohort approach.

The remaining average life expectancy in years of a pensioner retiring at age 65 on the balance sheet date is as follows for the UK Group plan:

	2006	2005
Male	20.9	19.5
Female	21.3	21.5

The remaining average life expectancy in years of a pensioner retiring at age 65, 20 years after the balance sheet date, is as follows for the UK Group plan:

	2006	2005
Male	22.2	20.2
Female	22.5	22.1

24 Employee benefits *continued*

The amounts recognised in the income statement are as follows:

All figures in £ millions	UK Group plan	Defined benefit other	Sub total	Defined contribution	2006 Total
Current service cost	27	2	29	36	65
Total operating costs	27	2	29	36	65
Expected return on plan assets	(85)	(7)	(92)	–	(92)
Interest on pension scheme liabilities	78	7	85	–	85
Net finance income	(7)	–	(7)	–	(7)
Net income statement charge	20	2	22	36	58
Actual return on plan assets	153	13	166	–	166

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

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

24 Employee benefits *continued*

The amounts recognised in the balance sheet are as follows:

All figures in £ millions	2006 UK Group plan	2006 Other funded plans	2006 Other unfunded plans	2006 Total	2005 UK Group plan	2005 Other funded plans	2005 Other unfunded plans	2005 Total
Fair value of plan assets	1,528	105	–	1,633	1,390	110	–	1,500
Present value of defined benefit obligation	(1,683)	(115)	(12)	(1,810)	(1,661)	(131)	(11)	(1,803)
Net pension liability	(155)	(10)	(12)	(177)	(271)	(21)	(11)	(303)
Other post-retirement medical benefit obligation				(48)				(60)
Other pension accruals				(25)				(26)
Total retirement benefit obligations				(250)				(389)

The following gains/(losses) have been recognised in the statement of recognised income and expense:

All figures in £ millions	2006	2005
Amounts recognised for defined benefit plans	102	21
Amounts recognised for post-retirement medical benefit plans	5	5
Total recognised in year	107	26
Cumulative amounts recognised	44	(63)

The fair value of plan assets comprises the following:

%	2006 UK Group plan	2006 Other funded plans	2006 Total	2005 UK Group plan	2005 Other funded plans	2005 Total
Equities	46.6	3.9	50.5	47.4	4.3	51.7
Bonds	23.8	2.1	25.9	24.7	2.0	26.7
Properties	9.2	–	9.2	8.9	–	8.9
Other	14.0	0.4	14.4	11.7	1.0	12.7

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

24 Employee benefits *continued*

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

All figures in £ millions	2006 UK Group plan	2006 Other	2006 Total	2005 UK Group plan	2005 Other	2005 Total
Fair value of plan assets						
Opening fair value of plan assets	1,390	110	1,500	1,198	82	1,280
Exchange differences	–	(12)	(12)	–	9	9
Expected return on plan assets	85	7	92	75	6	81
Actuarial gains and losses	68	6	74	139	1	140
Contributions by employer	43	2	45	35	10	45
Contributions by employee	7	–	7	6	–	6
Benefits paid	(65)	(8)	(73)	(63)	(6)	(69)
Acquisition through business combination	–	–	–	–	8	8
Closing fair value of plan assets	1,528	105	1,633	1,390	110	1,500
Present value of defined benefit obligation						
Opening defined benefit obligation	(1,661)	(142)	(1,803)	(1,502)	(113)	(1,615)
Exchange differences	–	15	15	–	(12)	(12)
Current service cost	(27)	(2)	(29)	(25)	(2)	(27)
Curtailment	–	–	–	–	2	2
Interest cost	(78)	(7)	(85)	(79)	(6)	(85)
Actuarial gains and losses	25	3	28	(112)	(7)	(119)
Contributions by employee	(7)	–	(7)	(6)	–	(6)
Benefits paid	65	8	73	63	6	69
Acquisition through business combination	–	(2)	(2)	–	(10)	(10)
Closing defined benefit obligation	(1,683)	(127)	(1,810)	(1,661)	(142)	(1,803)

24 Employee benefits *continued*

The history of the defined benefit plans is as follows:

All figures in £ millions	2006	2005	2004	2003
Fair value of plan assets	1,633	1,500	1,280	1,164
Present value of defined benefit obligation	(1,810)	(1,803)	(1,615)	(1,454)
Net pension liability	(177)	(303)	(335)	(290)
Experience adjustments on plan assets	74	140	67	88
Experience adjustments on plan liabilities	28	(119)	(127)	(113)

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

The Group expects to contribute approximately £150m to its defined benefit plans in 2007, which includes an additional contribution of £100m to the UK Group plan.

The effect of a one percentage point increase and decrease in the discount rate is as follows:

All figures in £ millions	2006 1% increase	2006 1% decrease
Effect on:		
(Decrease)/increase in defined benefit obligation	(242)	297

Other post-retirement obligations

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

The principal assumptions used are shown below:

%	2006	2005
Inflation	3.00	3.00
Initial rate of increase in healthcare rates	10.00	10.00
Ultimate rate of increase in healthcare rates	5.00	5.00
Rate used to discount scheme liabilities	5.85	5.60

The amounts recognised in the income statement are as follows:

All figures in £ millions	2006	2005
Current service cost	1	1
Past service cost	(2)	–
Total operating (income)/costs	(1)	1
Interest cost	3	3
Net income statement charge	2	4

The current and past service costs have been included in administrative and other expenses.

24 Employee benefits *continued*

All figures in £ millions	2006	2005
Opening defined benefit obligation	(60)	(58)
Exchange differences	8	(7)
Reclassifications	(3)	–
Current service cost	(1)	(1)
Past service cost	2	–
Interest cost	(3)	(3)
Benefits paid	4	4
Actuarial gains and losses	5	5
Closing defined benefit obligation	(48)	(60)

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

All figures in £ millions	2006 1% increase	2006 1% decrease	2005 1% increase	2005 1% decrease
Effect on:				
Increase/(decrease) of aggregate of service cost and interest cost	0.1	(0.1)	0.2	(0.2)
(Decrease)/increase in defined benefit obligation	(4.7)	5.1	(4.7)	4.1

Share-based payments

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

All figures in £ millions	2006	2005
Pearson plans	18	13
IDC plans	7	10
Total share-based payment costs	25	23

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

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

24 Employee benefits *continued*

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

Long-Term Incentive Plan – This plan was introduced in 2001 and renewed in 2006 and consists of two parts: share options and/or restricted shares.

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

The vesting of restricted shares is normally dependent on continuing service and/or upon the satisfaction of corporate performance targets over a three-year period. These targets may be based on market and/or non-market performance criteria. Restricted shares awarded to senior management in October 2006 vest dependent on relative shareholder return, return on invested capital and a combination of earnings per share growth. The award was split equally across all three measures. Other restricted shares awarded in 2006 vest depending on continuing service over a three-year period.

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

In addition to the above, share options remain outstanding under Executive Share Option, Reward and Special Share Option Plans. These are legacy plans which were replaced with the introduction of the Long-Term Incentive Plan in 2001.

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

	2006 Number of share options 000s	2006 Weighted average exercise price £	2005 Number of share options 000s	2005 Weighted average exercise price £
Outstanding at beginning of year	21,677	13.15	26,179	13.62
Granted during the year	837	6.30	606	4.92
Exercised during the year	(1,396)	5.36	(324)	6.01
Forfeited during the year	(1,828)	15.39	(4,352)	15.75
Expired during the year	(429)	6.72	(432)	9.17
Outstanding at end of year	18,861	13.36	21,677	13.15
Options exercisable at end of year	15,595	14.14	17,420	13.90

Options were exercised regularly throughout the year. The weighted average share price during the year was £7.45 (2005: £6.52). Early exercises arising from redundancy, retirement or death are treated as an acceleration of vesting and the Group therefore recognises in the income statement the amount that otherwise would have been recognised for services received over the remainder of the original vesting period.

24 Employee benefits *continued*

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

Range of exercise prices £	2006 Number of share options 000s	2006 Weighted average contractual life Years	2005 Number of share options 000s	2005 Weighted average contractual life Years
0 – 5	1,649	1.94	2,773	2.32
5 – 10	5,254	3.85	5,555	4.57
10 – 15	7,638	3.63	8,237	4.64
15 – 20	1,050	2.88	1,168	3.81
20 – 25	424	3.19	930	3.80
>25	2,846	3.22	3,014	4.22
	18,861	3.42	21,677	4.19

In 2006 and 2005 options were granted under the Worldwide Save for Shares Plan. The weighted average estimated fair value for the options granted was calculated using a Black-Scholes option pricing model.

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

	2006 Weighted average	2005 Weighted average
Fair value	£1.92	£2.41
Weighted average share price	£7.66	£6.54
Weighted average exercise price	£6.30	£5.08
Expected volatility	23.12%	35.47%
Expected life	4.0 years	4.1 years
Risk free rate	4.42%	4.48%
Expected dividend yield	3.52%	3.93%
Forfeiture rate	5.0%	6.3%

The expected volatility is based on the historic volatility of the Company’s share price over the previous three to seven years depending on the vesting term of the options.

The following shares were granted under restricted share arrangements:

	2006 Number of shares 000s	2006 Weighted average fair value £	2005 Number of shares 000s	2005 Weighted average fair value £
Annual Bonus Share Matching Plan	90	6.27	71	5.57
Long-Term Incentive Plan	3,585	6.96	3,987	5.05

24 Employee benefits *continued*

In 2005, the fair value of restricted shares awarded under the Annual Bonus Share Matching Plan and the Long-Term Incentive Plan was determined using a Black-Scholes model to reflect dividends foregone using a dividend yield of 3.85%. From 2006 onwards, participants of the Long-Term Incentive Plan are entitled to dividends during the vesting period. Following a review of the accounting policies for share-based payments in 2006, the restricted shares granted in 2006 under the Annual Bonus Share Matching Plan are valued using the share price at the date of grant discounted by the dividend yield (3.66%) to take into account any dividends foregone. The fair value of shares granted under the Long-Term Incentive Plan that vest unconditionally was determined using the share price at the date of grant. The number of shares to vest was adjusted based on historical experience to account for any potential forfeitures. Restricted shares with a market performance condition were valued by an independent actuary using a Monte Carlo model. Restricted shares with a non-market performance condition were fair valued based on the share price at the date of grant. Non-market performance conditions were considered by adjusting the number of shares expected to vest based on the most likely outcome of the relevant performance criteria.

Subsidiary share option plans

IDC, a 62% subsidiary of the Group, operates the following share-based payment plans:

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

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

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

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

	2006 Number of share options 000s	2006 Weighted average exercise price $	2006 Weighted average exercise price £	2005 Number of share options 000s	2005 Weighted average exercise price $	2005 Weighted average exercise price £
Outstanding at beginning of year	10,068	15.16	8.37	9,832	13.46	7.36
Granted during the year	1,835	20.58	10.52	1,940	21.38	11.80
Exercised during the year	(1,252)	12.88	6.58	(1,412)	11.57	6.39
Forfeited during the year	(139)	19.02	9.72	(292)	16.86	9.31
Expired during the year	(6)	11.46	5.86	–	–	–
Outstanding at end of year	10,506	16.33	8.34	10,068	15.16	8.37
Options exercisable at end of year	6,547	14.11	7.21	6,052	12.58	6.94

24 Employee benefits *continued*

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

Range of exercise prices $	2006 Number of share options 000s	2006 Weighted average contractual life Years	2005 Number of share options 000s	2005 Weighted average contractual life Years
0 – 4.4	30	3.1	33	4.2
4.4 – 7.5	157	2.3	206	3.6
7.5 – 12	2,164	4.4	2,685	5.3
12 – 20	4,640	6.4	5,243	7.4
> 20	3,515	9.0	1,901	9.5
	10,506	6.8	10,068	5.4

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

	2006 Number of shares 000s	2006 Weighted average fair value $	2006 Weighted average fair value £	2005 Number of shares 000s	2005 Weighted average fair value $	2005 Weighted average fair value £
2000 Long-Term Incentive Plan	196	20.82	10.64	148	20.57	11.35
2001 Employee Stock Purchase Plan	206	3.98	2.03	178	3.68	2.03

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

	Long-Term Incentive Plan		Employee Stock Purchase Plan	
	2006 Weighted average	2005 Weighted average	2006 Weighted average	2005 Weighted average
Fair value	$6.57	$5.56	$3.98	$3.68
Weighted average share price	$20.58	$21.38	$15.58	$15.46
Weighted average exercise price	$20.58	$21.38	$15.58	$15.46
Expected volatility	25.90%	24.50%	18.32%	20.00%
Expected life	4.7 years	4.0 years	0.5 years	0.5 years
Risk free rate	4.56% to 5.11%	3.86%	3.66% to 5.22%	2.33%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Forfeiture rate	0.0%	0.0%	0.0%	0.0%

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

25 Share capital and share premium

	Number of shares 000s	Ordinary shares £m	Share premium £m
At 1 January 2005	803,250	201	2,473
Issue of ordinary shares – share option schemes	770	–	4
At 31 December 2005	804,020	201	2,477
Issue of ordinary shares – share option schemes	2,089	1	10
At 31 December 2006	806,109	202	2,487

The total authorised number of ordinary shares is 1,190m shares (2005: 1,186m shares) with a par value of 25p per share (2005: 25p per share). All issued shares are fully paid. All shares have the same rights.

26 Treasury shares

	Pearson plc		IDC		Total
	Number of shares 000s	£m	Number of shares 000s	£m	£m
At 1 January 2005	4,623	105	3,145	27	132
Purchase of treasury shares	626	5	1,407	16	21
At 31 December 2005	5,249	110	4,552	43	153
Purchase of treasury shares	4,700	36	1,500	16	52
Release of treasury shares	(1,188)	(16)	–	–	(16)
At 31 December 2006	8,761	130	6,052	59	189

The Group holds its own shares in trust to satisfy its obligations under its restricted share plans (see note 24). These shares are held as treasury shares and have a par value of 25p per share.

IDC hold their own shares in respect of share buy-back programmes. These shares are held as treasury shares and have a par value of $0.01.

The nominal value of Pearson plc treasury shares amounts to £2.2m (2005: £2.1m). The nominal value of IDC treasury shares amounts to £0.3m (2005: £0.3m).

At 31 December 2006 the market value of Pearson plc treasury shares was £67.6m (2005: £36.2m) and the market value of IDC treasury shares was £74.3m (2005: £60.2m).

27 Other reserves and retained earnings

All figures in £ millions	Notes	Translation reserve	Fair value reserve	Total other reserves	Retained earnings
At 1 January 2005		(491)	–	(491)	749
Net exchange differences on translation of foreign operations		327	–	327	–
Cumulative translation adjustment disposed		(14)	–	(14)	–
Profit for the year attributable to equity holders of the Company		–	–	–	624
Dividends paid to equity holders of the Company	10	–	–	–	(205)
Equity settled transactions	24	–	–	–	23
Actuarial gains on post-retirement plans	24	–	–	–	26
Taxation on items charged to equity	8	–	–	–	12
Transition adjustment on adoption of IAS 39		3	–	3	(15)
At 31 December 2005		(175)	–	(175)	1,214
Net exchange differences on translation of foreign operations		(417)	–	(417)	–
Profit for the year attributable to equity holders of the Company		–	–	–	446
Dividends paid to equity holders of the Company	10	–	–	–	(220)
Equity settled transactions	24	–	–	–	25
Actuarial gains on post-retirement plans	24	–	–	–	107
Treasury shares released under employee share plans	26	–	–	–	(16)
Taxation on items charged to equity	8	–	–	–	12
At 31 December 2006		(592)	–	(592)	1,568

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

28 Business combinations

On 30 September 2006, the Group acquired 100% of the voting rights of Mergermarket, a financial information company providing information to financial institutions, corporations and their advisers. In addition, several other businesses were acquired in the current year including Promissor, Paravia Bruno Mondadori (PBM), National Evaluation Systems (NES), PowerSchool and Chancery in the Education business and Quote.com in IDC. None of these other acquisitions were individually material to the Group. In 2005, the amounts shown below mainly relate to the acquisition of AGS Publishing.

The assets and liabilities arising from acquisitions are as follows:

						2006	2005
All figures in £ millions	Notes	Mergermarket Carrying amount	Mergermarket Fair value adjs	Mergermarket Fair value	Other Fair value	Total Fair value	Total Fair value
Property, plant and equipment	11	1	–	1	12	13	7
Intangible assets	12	–	34	34	122	156	89
Intangible assets – Pre-publication	17	–	–	–	4	4	15
Inventories		–	–	–	14	14	10
Trade and other receivables		11	–	11	13	24	32
Cash and cash equivalents		14	–	14	14	28	3
Trade and other liabilities		(21)	–	(21)	(31)	(52)	(42)
Financial liabilities – Borrowings		–	–	–	(3)	(3)	–
Deferred income tax liabilities	14	–	(10)	(10)	(16)	(26)	(21)
Retirement benefit obligations	24	–	–	–	(2)	(2)	(2)
Provisions for other liabilities and charges	22	–	–	–	(3)	(3)	(1)
Equity minority interest		–	–	–	(9)	(9)	8
Net assets acquired at fair value		5	24	29	115	144	98
Goodwill				97	149	246	155
Total				126	264	390	253
Satisfied by:							
Cash				(109)	(273)	(382)	(249)
Deferred consideration				(17)	–	(17)	(5)
Net prior year adjustments				–	9	9	1
Total consideration				(126)	(264)	(390)	(253)
Book value of net assets acquired				5	43	48	58
Fair value adjustments				24	72	96	40
Fair value to the Group				29	115	144	98

The fair value adjustments relating to the acquisition of Mergermarket are provisional and will be finalised during 2007. They include the valuation of intangible assets and the related deferred tax effect. Adjustments to 2005 provisional fair values largely relate to the acquisition of AGS Publishing.

28 Business combinations *continued*

Net cash outflow on acquisition:

All figures in £ millions	2006	2005
Cash – Current year acquisitions	(382)	(249)
Deferred payments for prior year acquisitions and other items	(9)	–
Cash and cash equivalents acquired	28	3
Cash outflow on acquisition	(363)	(246)

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

Mergermarket contributed £9m of sales and £2m to the Group's profit before tax between the date of acquisition and the balance sheet date. Other businesses acquired contributed £15m to the Group's profit before tax between the date of acquisition and the balance sheet date.

If the acquisitions had been completed on 1 January 2006, Group sales for the period would have been £4,199m and profit before tax would have been £478m.

29 Non-current assets classified as held for sale

As described in note 3, on 11 December 2006 the Group announced the disposal of Pearson Government Solutions. This disposal was completed on 15 February 2007 (see note 35). The major classes of assets and liabilities comprising the operations classified as held for sale at the balance sheet date are as follows:

All figures in £ millions	Notes	2006
Property, plant and equipment	11	9
Intangible assets – Goodwill	12	221
Intangible assets – Other	12	7
Inventories		1
Trade and other receivables		56
Non-current assets classified as held for sale		294
Other liabilities		(26)
Liabilities directly associated with non-current assets classified as held for sale		(26)
Net assets classified as held for sale		268

30 Disposals

All figures in £ millions	2006	2005
Disposal of subsidiaries		
Property, plant and equipment	–	(48)
Investments in associates	–	(3)
Deferred income tax assets	–	8
Other financial assets	–	(2)
Inventories	–	(4)
Trade and other receivables	–	(59)
Trade and other liabilities	(1)	71
Provisions for other liabilities and charges	–	3
Cash and cash equivalents	–	(134)
Equity minority interests	(4)	54
Attributable goodwill	(5)	(104)
Currency translation adjustment	–	14
Net assets disposed of	(10)	(204)
Proceeds received	10	513
Costs	–	(3)
Profit on sale	–	306

	2006	2005
Cash flow from disposals		
Cash – Current year disposals	10	513
Costs paid	–	(3)
Cash and cash equivalents disposed of	–	(134)
Net cash inflow	10	376

The 2006 disposal relates to share options exercised in IDC.

2005 disposals relate mainly to the disposal of the Group's 79% interest in Recoletos Grupo de Communicación S.A..

31 Cash generated from operations

All figures in £ millions	Notes	2006	2005
Net profit		469	644
Adjustments for:			
Tax		19	125
Depreciation	11	77	80
Amortisation of purchased intangible assets	12	28	11
Adjustment on recognition of pre-acquisition deferred tax	12	7	–
Amortisation of other intangible assets	12	23	18
Investment in pre-publication assets	17	(213)	(222)
Amortisation of pre-publication assets	17	210	192
Loss on sale of property, plant and equipment		2	–
Net finance costs	7	74	70
Share of results of joint ventures and associates	13	(24)	(14)
Profit on sale of subsidiaries and associates	3, 4	–	(346)
Net foreign exchange (losses)/gains from transactions		(37)	39
Share-based payment costs	24	25	23
Inventories		(16)	(17)
Trade and other receivables		(60)	(4)
Trade and other liabilities		54	71
Provisions		(17)	(17)
Cash generated from operations		621	653
Dividends from joint ventures and associates	13	45	14
Purchase of property, plant and equipment		(68)	(76)
Purchase of intangible assets		(29)	(24)
Finance lease principal payments		(3)	(3)
Proceeds from sale of property, plant and equipment		8	3
Add back: Non-operating property, plant and equipment		–	1
Add back: Cash spent against integration and fair value provisions		1	2
Operating cash flow		575	570
Operating tax paid		(59)	(65)
Net operating finance costs paid		(82)	(65)
Operating free cash flow		434	440
Non-operating finance costs paid		–	(7)
Cash spent against integration and fair value provisions		(1)	(2)
Total free cash flow		433	431
Dividends paid (including to minorities)		(235)	(222)
Net movement of funds from operations		198	209

31 Cash generated from operations *continued*

Following a review of accounting presentation in 2006, the Group has chosen to reclassify investment in pre-publication assets as cash generated from operations. This aligns the classification in the cash flow with the treatment of comparable items in other industries and provides more relevant information on the Group cash flow. The comparative has been reclassified accordingly.

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

All figures in £ millions	2006	2005
Net book amount	10	3
Loss on sale of property, plant and equipment	(2)	–
Proceeds from sale of property, plant and equipment	8	3

The principal non-cash transactions are movements in finance lease obligations of £4m (2005: £nil).

32 Contingencies

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

33 Commitments

Capital commitments

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

All figures in £ millions	2006	2005
Property, plant and equipment	–	1

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

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

All figures in £ millions	2006	2005
Not later than one year	123	132
Later than one year and not later than two years	113	117
Later than two years and not later than three years	103	108
Later than three years and not later than four years	90	97
Later than four years and not later than five years	83	81
Later than five years	857	915
	1,369	1,450

34 Related party transactions

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

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

There were no other material related party transactions.

No guarantees have been provided to related parties.

35 Events after the balance sheet date

On 15 February 2007 the Group completed the disposal of Pearson Government Solutions, its Government services business, to Veritas Capital. Sale proceeds consist of $560m in cash, $40m in preferred stock and 10% of the equity of the business. The Group expects to make a post-tax loss on the disposal as the capital gain for tax purposes will exceed any book gain.