Chief executive's review

If you're reading this, you're a Pearson shareholder, and you may be wondering how things *really* are in your company.

Our share price is at a low ebb; one of our finest brands, the *Financial Times*, is becalmed in the advertising doldrums; and the political and economic atmosphere we're working in doesn't look as if it's going to fill with sunshine any time soon.

But Pearson is, in the midst of this gloom, in fine shape. There is every reason for you to be very proud of your connection to the company and confident about your investment. Let me give you just ten:

1 ▸ **Our profits took a turn for the better in 2002 and we can make yearly progress hereafter.** From 1997 to 2000 we produced record sales, profits and cash, and a rising dividend. In 2001, the advertising slump began to be an advertising collapse, and our business newspapers' profits collapsed as well. We still made a profit and still maintained a rising dividend; but it wasn't anywhere near what we'd been used to.

So 2002 was a year when we had to fight back. And we did. We kept our promise of an earnings recovery in spite of a global economy and business climate that just got worse and worse.

2 ▸ **Each of our businesses is a leader in its field.** All of them have sustainable, best-in-class positions in their markets. They are not only leaders in size; they also have strong brands and franchises – something special in the products they make or the way they do things that sets them apart from their competitors.

3 ▸ **We are in 'knowledge' markets, good markets to be in when the world is moving from relying mostly on muscle power to relying mostly on brain power.** Those markets require news and information to run businesses or countries; education – cradle to grave, pre-school to professional; entertainment and elucidation – at least what can be found in books, one of the most cost-effective ways there is to have a good time. Our businesses use two methods to appeal to people's intellects: great publishing and the ability to mix that publishing with services to help customers use the words and data and ideas.

4 ▸ **Pearson is now an operating company rather than a holding company.** That means our businesses have enough in common that we can all work on the business at hand, not on *overseeing* disparate enterprises. Including management. We go out with salesmen and dig for new product ideas and talk to customers. We look for ways to do new things, or to do old things differently. We look for ways for the parts of the company to share talents and assets and costs inside the company.

Of course, you can only share things if you have a set of businesses that work together and help each other. And that's what we finally have. Our businesses all make sense together, and so they can work toward the same goals together. Collaboration is an everyday occurrence at Pearson.

5 ▸ **We are entirely reliant on the inventiveness and character of our people.** If tomorrow we didn't have offices, or warehouses, or we lost all our manuscripts

MARJORIE SCARDINO • CHIEF EXECUTIVE, PEARSON

and all our software code, we'd still be in business. We'd still have our major stock in trade – our people's ability to reinvent the business and their willingness to confront tough chores.

We've set our sights on being a great place to work, a place everyone *can* leave because they're in such demand, but no one *does* because this place is better. We do everything we can to make sure that we recruit the best people and then give them the training and career development they need to do their job... and the next job they're going to have. When they join us, they can expect to be paid fairly for doing their job and to receive rewards for extraordinary work. They can also expect to have a safe place to work, free from any kind of bullying or unfair pressures. And they can, on most days, expect to enjoy their work.

6 ▸ **We have a board of directors who understand that their job is to help the enterprise prosper, and who do just that.** These days boards face more rules to ensure they act responsibly and check up on management regularly. Our board has an informal and intimate frankness that ensures they do both without pulling any punches. They know management needs their help, and they give it generously. They know the shareholders count on them to make sure their investment is being well taken care of, and they do that uncompromisingly.

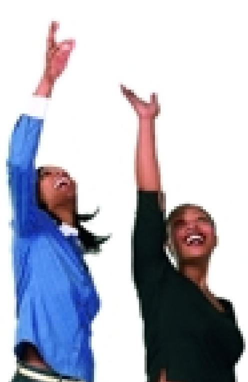
7 ▸ **We try to make it as easy as possible for people to understand our business and our performance.** In a world where companies have lost their way through a confusion of accounting rules and

special purpose vehicles, and where business stories are told in jargon and pension details are covered with caveats, we try to tell our stories – including our strengths and weaknesses – in plain English and plain data. We think that will protect our shareholders and give us advantages.

8 ▸ **We believe corporations are risk-taking organisations whose aim is to become more valuable over time because they produce valuable products and services at a profit.** Our company doesn't discover miracle drugs or miracle technology. But we do discover and publish new ideas; make information available and understandable; strive to provide truly 'universal' education – that teaches *each* child. We in Pearson work because of that possibility, and believe that if we're able to change the world, our shareholders will profit as well.

9 ▸ **We count on the fact that culture and conduct – what beliefs we share and how we conduct business – have a great deal to do with success.** Like all companies, we say we are ethical and try to do our duty to society and our employees. But we've been saying our aims were to be 'brave, imaginative, and decent' so long now we've all begun to know what that means. And when we don't act that way, we know it and try to make sure that it doesn't happen again.

10 ▸ **We have a clear goal and a strategy for achieving it.** Our goal is outlined in the theme of this report. It is to add to people's knowledge to help them live and learn.



Pearson Education and Penguin US have partnered to create a new college book series: Penguin Academics. Ranging from anthologies of literature to history books, the series makes Penguin's unique backlist available in new forms to professors and students of literature.

LATOYA SIMS * PENGUIN

To entertain and enlighten them; to teach them new skills and inform them about their professions. We believe it's a good goal, and we've now got the company that can accomplish it. But the measure of whether we're accomplishing it is our financial performance.

So now our strategy for achieving it is not just getting the right pieces, as it has been for the last five or six years. It is having annual improvement in sales, profits and cash; and increasing our return on invested capital. It is exerting what Thomas Edison once said genius required: **1% inspiration and 99% perspiration.**

2002

Last year, to achieve the earnings rebound, we relied on all those attributes of Pearson to get the job done.

We were helped in our profit improvement by cost reductions, lower internet losses and lower interest charges (because we paid off some debt when we sold our television business). We were hurt by the weaker dollar, and, of course, by the advertising environment.

Since 1997 we have measured our success three ways – sales, margins and cash. In 2002, we began to work even harder on cash and, with a special emphasis on managing our working capital, we were able to increase our operating free cash flow by 29%.

Good competitive performances ▸ We gained significant shares in four of our biggest markets: higher education, consumer publishing, asset valuation and government services. We made modest gains in most of our other markets, too. The only market where we lost share slightly was in US schools, and that was because we decided to sit out of bidding for some school book opportunities we thought would be unprofitable for us.

Aggressive cost management and asset allocation ▸ We had to reduce spending across Pearson, especially in our business newspapers and in technology publishing, areas hit hard by the recession in advertising and in technology. We also began to see the early investment costs of new businesses come down, particularly those reliant on the internet. As we managed costs, we tried to balance the risks and the rewards. We did not treat people as sacrifices to be made for financial markets that wanted the short-term to be better.

Continued investment ▸ At the same time we cut costs, we invested. We put more than £250m into new product development, which will sustain our top-line in the future. And we spent £30m integrating our businesses and their shared functions in ways that will add to our bottom line in the years to come.

SCOTT CHAN * PENGUIN

2003

For this year, we're confident that, except in the most extreme political and economic conditions, we can deliver further significant earnings growth, even at current exchange rates, and also further cash and an increasing return on capital. And we're confident we can go on to sustain annual progress on all three measures, working hard, task by task, day by day. Where will we be exerting our 99% perspiration?

More investing ▸ We'll allocate our resources first to our markets that are growing the fastest: higher education, English language teaching, children's publishing, testing, governments as customers, investors who need our data and pricing help in an unpredictable market.

We'll also invest to take advantage of our franchise and market share where we see our competitors are weakened by the environment. This is especially true in our business newspapers. Of course we'll make these investments carefully, but no franchise can continue – even one a century old – without nourishment.

Growing our own ▸ Now that we have all the right parts in our company, we plan to rely more on our ingenuity than on acquisitions for new products and services. So we'll be working to create some for existing brands and to customise some. Customisation is already booming in our education business, where professors want their own unique books. It also works for FT.com subscribers who want their investments monitored, or their data fed to them their way. Organic investment means we will also have to be even more disciplined in our allocation of assets – not shying away from taking risks, but taking those with the most reliable and enduring returns.

Streamlining operations ▸ We started on this last year. We've been pretty good at getting integration benefits from our acquisitions – we've always done better, faster than planned. Now we do that with our existing companies as well, sharing processes and back offices and efficiencies of all kinds; improving sales efforts and marketing ideas thanks to the expertise of one part of the company teaching another.

BEYOND 2003

Pearson was started by an entrepreneurial contractor in Yorkshire in 1844. Over the last century and a half its assets and its businesses have been built up by descendants of that adventurer and then by others they brought in as the enterprise grew. It has had its high periods and its low periods. It has gone through digging railroad tunnels and drilling for oil and starting airlines and providing lighting for the public monuments of Athens. It has made wine and fine china and amusements in wax. And for nearly a century it has been a devoted and courageous publisher.

But whatever it has done, its owners and managers have always prided themselves in the thought that the assets of the company were to be improved in value and passed on to the shareholders of the next day. And that is still our aim today.

We know that, in order to do our part for the enterprise, we have to make the decisions that will make the company more valuable as it passes down the line than it was when we took it over. That means we have to invest our capital in ventures that will bring in more value than they cost and that will endure. And that is what we aim to do in 2003 and well beyond.

Marjorie Scardino

In a year of tough commercial conditions, the FT set out to treat its readers and customers better than ever. In the UK and US, the FT conducted extensive market research, held an internal customer awareness seminar and put a customer service ranking system in place to raise the quality of customer service. As a result, overall satisfaction with the FT is now consistently 9 out of 10.

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