# Operating review

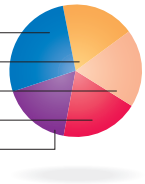
JOSÉ LUIS MORALES * PAULO ROVAI * PEARSON EDUCATION

In 2002, sales increased by 6% to £4,320m and operating profit from continuing operations improved by £67m to £493m, an increase of 18%. Adjusted earnings per share grew to 30.3p, a headline increase of 42%. Operating free cash flow improved by £69m to £305m. Average use of working capital improved by £53m in our book publishing businesses, even as we increased investment in new authors, titles and programmes.

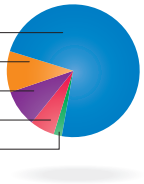
On a statutory basis, Pearson reported a loss before tax for the year of £25m (a £436m loss in 2001) and generated a loss per share of 13.9p (a loss per share of 53.2p in 2001). The loss includes a (non-cash) goodwill charge of £340m. Net borrowings fell by £971m to end the year at £1,408m. The board is recommending a 5% increase in the dividend to 23.4p per share.

**SALES** total £4,320m *$6,955m*

sector analysis

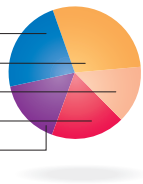



geographical analysis




**OPERATING PROFIT*** total £493m *$794m*

sector analysis

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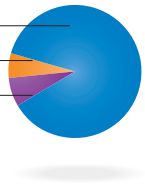



* continuing operations before goodwill and exceptional items.

In 2002, Pearson launched its first ever corporate advertising campaign. While our publishing imprints are known the world over, research suggests that there is little awareness that names like Scott Foresman, Prentice Hall, Penguin and The Financial Times are all part of the Pearson family. The campaign – which only runs in our own publications – aims to show how all of our businesses help people 'live and learn'.

JOHN FALLON * CEO, PEARSON EDUCATION, EUROPE, MIDDLE EAST AND AFRICA
PAMELA MUSICK * PEARSON EDUCATION

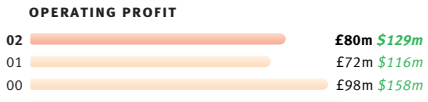
# The Financial Times Group

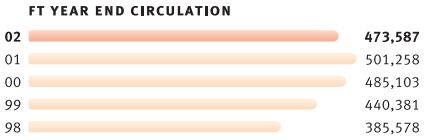
The Financial Times Group is a network of some of the world's finest newspapers and a fast-growing web of online services. Built around the *Financial Times* newspaper – a unique voice on the key financial, economic and business issues of the day – we are the most international source of business news and analysis in the world.

- *The Financial Times* is the most international business newspaper in the world. It is printed in 20 cities across the globe with a daily circulation of over 470,000 and a readership of more than 1.6m people in 140 countries.
- FT.com, the newspaper's internet partner, combines agenda-setting editorial and financial data with a broad range of business tools, including the most extensive business news search function on the internet. FT.com attracts 3.5m unique monthly visitors and has a growing subscriber base of 45,000.
- Our pan-European network includes the leading business newspapers and websites in France (*Les Echos* and lesechos.fr) and Spain (*Expansión* and expansiondirecto.es). In 2000 we launched a new German language newspaper, *FT Deutschland*, a joint venture with Gruner + Jahr, which has built a circulation of 90,000 in just three years.
- Our Interactive Data Corporation (NYSE: IDC) is a leading provider of financial data to institutional and retail investors. IDC collects, maintains and models data on more than 3.5m securities for its customers which include 49 of the world's top 50 financial institutions.
- FT Business produces specialist information on the retail, personal and institutional finance industries including *Investors Chronicle* and the UK's premier finance magazine, *The Banker*.
- The FT Group has a 50% stake in the Economist Group, which publishes the world's leading weekly business and current affairs journal.
- The FT also has a stake in a number of joint ventures, including FTSE International, a joint venture with the London Stock Exchange; *Vedomosti*, Russia's leading business newspaper and a partnership venture with Dow Jones and Independent Media; and a 50% stake in BDFM, publishers of South Africa's leading financial newspapers and websites.

The FT Group saw revenues fall £75m (8%) as the global economic downturn continued to hit advertising revenues and, to a much lesser extent, newsstand sales. Despite the revenue decline, operating profits increased 8% to £80m due to double digit profit growth at IDC and Recoletos (the FT Group's two businesses least affected by the downturn), successful cost reduction programmes across the Group, and sharply lower internet losses of £34m (down from £60m in 2001).

The *Financial Times* newspaper and its internet partner, FT.com, are now fully integrated. A 14% reduction in their combined cost base mitigated – but could not offset – a sharp reduction in advertising revenues at the newspaper. A further advertising deterioration in the second half, together with some one-off costs, meant that, although the newspaper remained in profit for the full year, it operated at a loss in the second half. Industry conditions remained tough for the *FT*'s major advertising categories,


source: ABC

In 2002 FT.com launched a new range of services and began to convert loyal users into paying customers. The entire site was redesigned, offering an improved user experience and new value-added services. Subscribers enjoy complete access to specialist FT comment and analysis including Lex Live and in-depth data on over 18,000 listed companies worldwide. This helped FT.com reach its target of break-even in the fourth quarter of 2002. And it added a new revenue stream (alongside advertising & content sales) with 45,000 subscribers signing up by the end of the year.

CLARE PAYNE * FINANCIAL TIMES

including financial services, technology and business-to-business. Advertising volumes fell by 24% (on top of a 29% fall in 2001) and advertising revenues by 23% (after a 20% decline in 2001). The newspaper ended the year with average daily circulation of 473,587, a decline of 6% on the previous year primarily due to lower sales in the UK.

FT.com broke even in the fourth quarter of 2002. Revenues were up 9% to £25m. Despite the introduction of paid-for elements of the site, FT.com's popularity continued to grow, up 30% to a record 3.5m unique monthly users in January 2003.

*Les Echos* made a profit of £7m (down 34% on 2001) as advertising revenues fell sharply. Average daily circulation was 121,000, a 6% decline, but well ahead of its market. FT Business delivered double digit margins as its major titles – *Investors Chronicle, The Banker* and *Financial Adviser* – all strengthened their market positions.

Losses from the FT's associates and joint ventures were less than half the level of the previous year due to continued progress at *FT Deutschland*, our joint venture with Gruner + Jahr. Despite the tough German advertising market, *FT Deutschland* grew its advertising revenues slightly and increased its circulation by 14% to 89,000 at the end of the year. The Economist Group also contributed to the improvement, offsetting falling advertising revenues with tight cost controls. *The Economist's* worldwide weekly circulation grew by 6% to 881,259.

Recoletos (Bolsa Madrid: REC), our Spanish media group, increased profits by 21%, benefiting from actions taken in 2001 to reduce costs. After a successful re-launch *Marca*, Spain's leading sports newspaper, grew its circulation by 2% to 382,000 and increased advertising revenues and profits. Circulation at business newspaper *Expansion* was 9% lower and advertising revenues 25% lower.

Interactive Data Corporation (NYSE: IDC), our 60%-owned asset pricing business, increased revenues by 7% as contract renewal rates in its institutional business – which accounts for 90% of revenues – continued to run at 95%. IDC also benefited from the launch of several new products and the integration of Merrill Lynch's Securities Pricing business, the latest in a series of successful bolt-on acquisitions. In January 2003, IDC announced the acquisition of S&P Comstock, which adds real-time pricing to IDC's existing end-of-day services.

| SALES | 2002 | | 2001 | | UNDERLYING % CHANGE |
|---|---|---|---|---|---|
| FT NEWSPAPER | £202m | *$326m* | £250m | *$403m* | (19) |
| OTHER FT PUBLISHING* | £102m | *$164m* | £138m | *$222m* | (14) |
| INTERNET ENTERPRISES** | £48m | *$77m* | £51m | *$82m* | (5) |
| RECOLETOS | £148m | *$238m* | £150m | *$242m* | (4) |
| IDC | £226m | *$364m* | £212m | *$341m* | 7 |
| **TOTAL** | **£726m** | ***$1,169m*** | **£801m** | ***$1,290m*** | **(8)** |

| OPERATING PROFIT | 2002 | | 2001 | | UNDERLYING % CHANGE |
|---|---|---|---|---|---|
| FT NEWSPAPER | £1m | *$2m* | £31m | *$50m* | (92) |
| OTHER FT PUBLISHING* | £13m | *$21m* | £21m | *$34m* | (39) |
| ASSOCIATES AND JOINT VENTURES | £(3)m | *$(5)m* | £(10)m | *$(16)m* | 65 |
| INTERNET ENTERPRISES** | £(34)m | *$(55)m* | £(60)m | *$(97)m* | 46 |
| RECOLETOS | £29m | *$47m* | £23m | *$37m* | 21 |
| IDC | £74m | *$119m* | £67m | *$108m* | 12 |
| **TOTAL** | **£80m** | ***$129m*** | **£72m** | ***$116m*** | **8** |

* *Les Echos and FT Business*

** *The FT Group's internet enterprises include online businesses related to the FT, Les Echos, Recoletos, FT Deutschland, The Economist, IDC and CBSMarketWatch.*

JON MCMANUS * FINANCIAL TIMES

# The Penguin Group

CELESTE BROWN • PENGUIN

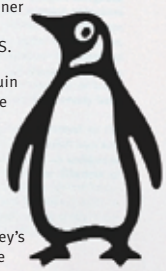
Penguin is one of the world's great names in consumer publishing. From literary prize winners to commercial blockbusters; from a child's first picture book to the classics of literature; from fantastic fiction to beautiful reference works, Penguin publishes an unrivalled range of books in 100 countries. Penguin is the world's pre-eminent English language publisher – number one or two in the US, UK, Australia, New Zealand, India and Canada.

› Over the last four years, Penguin has doubled its presence on the bestseller lists in the US and UK thanks to writers such as Tom Clancy, Patricia Cornwell, Jan Karon, Nora Roberts, Nick Hornby and Jamie Oliver.

› We are the world's leading children's publisher, helping characters such as Peter Rabbit, The Little Engine That Could and Spot capture the imagination of children all over the world through imprints such as Puffin, Grosset & Dunlap and Ladybird.

› Dorling Kindersley's beautifully illustrated reference books help children and adults of all ages to learn about the world around them in more than 90 countries and 40 languages.

› Penguin is working hard to discover the writing stars of tomorrow. In 2002 our debut authors included Hari Kunzru and Jonathan Safran Foer, winner of the *Guardian* First Book Award, in the UK, and Gary Shteyngart, winner of the Stephen Crane First Fiction Award, and Sue Monk Kidd in the US.



› In 2003 we relaunched the Penguin Classics range which includes more than 1,000 titles from Homer's *The Odyssey* to George Orwell's *Nineteen Eighty Four*.

› People discover the world using our travel guides. Together, our Rough Guides and Dorling Kindersley's *Eyewitness* Guides, have sold more than 15 million copies worldwide.

**SALES**




**OPERATING PROFIT**




The Penguin Group increased sales by 5% and operating profits by 11%, in spite of Penguin's £10m share of our £30m investment in new back office systems and processes.

In the US, Penguin published 24 titles that became *New York Times* number one bestsellers, more than any other publisher and a 25% increase on 2001. In the UK, Penguin posted its best performance on the bestseller lists for a decade as 45 titles reached the Neilsen Bookscan top 15, a 10% increase on 2001. This strong performance enabled Penguin to gain share in both the US and the UK.

Dorling Kindersley increased sales by 8% and profits by £15m as it benefited from its integration within Penguin, the revitalisation of DK's creative style and our investment in a stronger frontlist of key titles.

Pearson is now, by some distance, the world's largest book publisher and Pearson Education and Penguin are working on a number of initiatives to maximise the scale advantages that this brings.

| | 2002 | | 2001 | | UNDERLYING % CHANGE |
|---|---|---|---|---|---|
| SALES | £838m | *$1,349m* | £820m | *$1,320m* | 5 |
| OPERATING PROFIT | £87m | *$140m* | £80m | *$129m* | 11 |

JOHN MAKINSON • CHAIRMAN AND CHIEF EXECUTIVE, PENGUIN GROUP

# Pearson Education

JOE SMALL * PEARSON EDUCATION

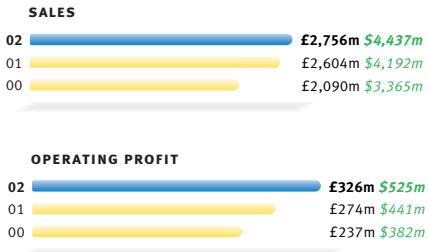
Pearson Education is the world's leading education company. We serve every age and level of student from early learning right through to professional life. We offer the broadest range of publishing and services from the most comprehensive list of textbooks, to leadership in testing, assessment and enterprise software and the very best in online consumer and professional learning.

- Through our Scott Foresman and Prentice Hall School imprints, one in three American schoolchildren studies English or Maths with one of our textbooks.
- We are America's leading test scoring and reporting company, scoring and processing 40 million student tests across the US every year.
- More than 40,000 schools in the US use at least one of our online programmes and more than 14 million parents, students and teachers connect to our learning tools from home using the internet.
- We are the largest college publisher in the world, with imprints such as Prentice Hall, Addison Wesley, Longman, Allyn & Bacon and Benjamin Cummings. These publishers represent around one in three of all the text and online programmes studied on US campuses.
- Our professional and technology group publishes leading computer and business titles through imprints such as Addison-Wesley Professional, Peachpit Press, Prentice Hall PTR and Cisco Press.
- Pearson Government Solutions is our fastest-growing business providing data management information and education-related services to the US federal Government.
- We teach more people English as a second language than any other company in the world – 40 million of them. We're also the leading education company outside the US, operating in 55 countries and 17 languages.

Underlying sales at Pearson Education increased 11% and profits 22%. Profits were helped by a £52m reduction in internet losses but offset by Pearson Education's £20m share of investment in new back-office systems and processes and an £11m increase in pension contributions. **NCS Pearson** is now an integral part of Pearson Education. On a standalone basis, revenues increased 42% to £843m and profits increased 46% to £92m.

In our **School** business sales were down 5% and operating profits down 15%. In the US, our School business includes publishing, testing and software operations. School publishing revenues were down 6% due to the slower adoption cycle* and our decision to compete for just 65% of the available new adoption dollars. Our school imprints, Scott Foresman and Prentice Hall, took a 23% share of the total new adoption market and a 36% share of the adoptions in which we participated. Overall, our share of the US School publishing market was 24% (24.5% in 2001).

* In the US, 21 'adoption' states buy textbooks and related programmes to a planned contract schedule, which means the level of spending varies from year to year according to this schedule. The 'open territory' states are those that buy textbooks on an as-needed basis rather than on a published adoption schedule.




| SALES | 2002 | | 2001 | | UNDERLYING % CHANGE |
|---|---|---|---|---|---|
| SCHOOL | £1,151m | $1,853m | £1,266m | $2,038m | (5) |
| HIGHER EDUCATION | £775m | $1,248m | £721m | $1,161m | 13 |
| PROFESSIONAL | £784m | $1,262m | £558m | $898m | 48 |
| FT KNOWLEDGE | £46m | $74m | £59m | $95m | (18) |
| **TOTAL** | **£2,756m** | **$4,437m** | **£2,604m** | $4,192m | **11** |

| OPERATING PROFIT | 2002 | | 2001 | | UNDERLYING % CHANGE |
|---|---|---|---|---|---|
| SCHOOL | £140m | $225m | £167m | $269m | (15) |
| HIGHER EDUCATION | £142m | $229m | £127m | $204m | 17 |
| PROFESSIONAL | £81m | $130m | £80m | $129m | 8 |
| INTERNET | £(25)m | $(40)m | £(77)m | $(124)m | – |
| FT KNOWLEDGE | £(12)m | $(19)m | £(23)m | $(37)m | – |
| **TOTAL** | **£326m** | **$525m** | **£274m** | **$441m** | **22** |

We are the number one educational testing company in the US, and in 2002 we extended that lead as we won several new state testing contracts. We plan to use that experience to build our testing business outside the US.

MICHAEL KAYSER * NCS PEARSON
CLAUDINE O'LEARY * NCS PEARSON

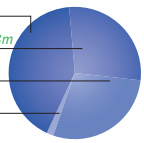
After 13% growth in 2001, our school testing business grew by a further 3%. It renewed and expanded two of its largest multi-year statewide contracts – California and Ohio – as well as the National Assessment of Educational Progress contract from the US Department of Education. It won new contracts in California and six other states that will start to contribute to revenues in 2003. Revenues were down at our school software business, primarily due to the deferral of a number of contracts into 2003, but losses fell as we outsourced more of our software development needs.

Outside the US, our school publishing businesses performed strongly in Hong Kong, Japan, Singapore and Spain. Strong growth in English Language Teaching sales in Europe and Asia was partially offset by some weakness in US and Latin American markets.

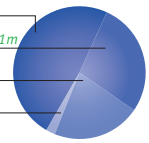
Our **Higher Education** business increased revenues by 13% and operating profits by 17%. In the US the Higher Education publishing business grew its revenues by 14%, ahead of market growth of 10% (8% excluding Pearson). The business benefited from a booming college population, its publishing and salesforce strength and its lead in making online services an integral part of its products. Our custom publishing business, which produces text books and course materials custom-made for individual college professors, continued its rapid growth, with sales up 50% in the year (and 300% over the past three years). Around the world, our Higher Education operations benefited from the same trends we saw in the US, with a particularly strong performance in Europe where revenues were up in double digits.

The **Professional** business increased sales by 48% and profits by 8%. A major investment in 200 professional certification centres across the US, along with a change in business mix and a further decline in our higher-margin technology publishing businesses, and double digit growth in the lower margin Government Solutions division, meant that profits grew considerably slower than revenues. In the US, we helped the newly-formed Transportation Security Administration to recruit 64,000 security personnel for US airports, a one-year contract worth more than $300m in revenues to our Government Solutions business. A series of smaller, longer-term contract wins – with the Immigration and Naturalization Service, the Department of Health and Human Services and the US Department of Defense – gives the business a strong pipeline for 2003 and future years. With IT and technology markets continuing to be bleak, sales at our technology publishing arm were down 12% in the US (following a 20% fall in 2001) and margins declined, although due to further cost actions they were still in double digits. In Europe, where technology publishing sales were down more than 20% in 2002, we have taken similar actions to reduce costs.

**SALES ANALYSIS** total £2,756m *$4,437m* **2002**




**SALES ANALYSIS** total £2,604m *$4,192m* 2001





Pearson Broadband has partnered with Pearson Education to develop KnowledgeBox, a digital learning system that helps teachers create multimedia lessons in reading, maths, science and social studies. It contains over 1,500 digital resources and material from leading publishers including Longman, Puffin, Penguin and Dorling Kindersley. KnowledgeBox is being used by schools in 21 states across the US and was launched in the UK in early 2003.

**KELLIE LANE * LAURA JONES * WENDY KERR * ROBIN GAY** * PEARSON BROADBAND

# Financial review

EMMA JAMES * DK, PENGUIN

| | 2002 | | 2001 | |
|---|---|---|---|---|
| **OPERATING PROFIT FROM CONTINUING OPERATIONS** | **£493m** | *$794m* | **£426m** | *$686m* |
| OPERATING PROFIT FROM DISCONTINUED OPERATIONS (RTL) | – | – | £37m | *$59m* |
| GOODWILL AMORTISATION | £(330)m | *$(531)m* | £(375)m | *$(604)m* |
| GOODWILL IMPAIRMENT | £(10)m | *$(16)m* | £(61)m | *$(98)m* |
| INTEGRATION COSTS | £(10)m | *$(16)m* | £(74)m | *$(119)m* |
| NON OPERATING ITEMS | £(37)m | *$(60)m* | £(128)m | *$(206)m* |
| AMOUNTS WRITTEN OFF INVESTMENTS | – | – | £(92)m | *$(148)m* |
| NET INTEREST PAYABLE | £(94)m | *$(151)m* | £(169)m | *$(272)m* |
| EARLY REPAYMENT OF DEBT AND TERMINATION OF SWAP CONTRACTS | £(37)m | *$(60)m* | – | – |
| **LOSS BEFORE TAXATION** | **£(25)m** | ***$(40)m*** | **£(436)m** | ***$(702)m*** |
| TAXATION | £(64)m | *$(103)m* | £33m | *$53m* |
| **LOSS AFTER TAXATION** | **£(89)m** | ***$(143)m*** | **£(403)m** | ***$(649)m*** |
| MINORITY INTERESTS | £(22)m | *$(35)m* | £(20)m | *$(32)m* |
| **LOSS FOR THE FINANCIAL YEAR** | **£(111)m** | ***$(178)m*** | **£(423)m** | ***$(681)m*** |
| DIVIDENDS | £(187)m | *$(301)m* | £(177)m | *$(285)m* |
| **RETAINED LOSS FOR THE YEAR** | **£(298)m** | ***$(479)m*** | **£(600)m** | ***$(966)m*** |

The sale of our 22% share in RTL was concluded at the end of January 2002 allowing us to pay down our debt to under £1.5bn and marking the beginning of a period of portfolio stability. This also results in the Pearson profit and loss account becoming more straightforward as our significant acquisition and disposal activity and our start-up internet investments are largely behind us. 2002 also marks the end of the integration charges on our major acquisitions. Moreover, the goodwill amortisation arising from those acquisitions will be more predictable.

Our operating profits from continuing operations in 2002 increased from 2001 by 18% to £493m. However, almost entirely as a result of our (non-cash) goodwill amortisation charge, we still show an overall loss for the financial year.

### FINANCIAL STATEMENTS

**goodwill amortisation ▸** Goodwill is a balance sheet item which represents the difference between the price paid for acquisitions and the fair value of the assets acquired. Pearson amortises goodwill to the profit and loss account over the estimated useful life of the acquisition, or a period of 20 years whichever is the shorter. The goodwill amortisation charge fell by £45m last year to £330m mainly due to the disposal of the RTL Group.

**goodwill impairment ▸** Goodwill is subject to an impairment review at the end of the first full year following an acquisition and at any other time if events or changes in circumstances indicate that the carrying value may not be recoverable. In 2002 we took a £10m impairment charge, relating to a subsidiary of Recoletos in Argentina.


We're combining forces to grow our bilingual publishing programme. In just four years we've become the leading publisher of bilingual materials for the US elementary school market. We've taken the market-leading position in elementary Spanish reading and we hope to do the same in social studies.

**JOANNE DRESNER** * PRESIDENT, ELT, PEARSON EDUCATION
**DEBRA HOPKINS** * BILINGUAL PRODUCT MANAGER, PEARSON EDUCATION
**MERCEDES MURATORIO** * SPANISH PUBLISHING CO-ORDINATOR, PEARSON EDUCATION

**integration costs ▸** Integration costs are the one-off costs of integrating significant recent acquisitions into our existing businesses. In 2002 £3m was incurred in integrating Dorling Kindersley into the Penguin Group (compared to £45m in 2001) and £7m related to the integration of NCS into Pearson Education (compared to £29m in 2001). This expenditure was in line with our forecasts at the time of the transactions and there will be no further charges in respect of these acquisitions in 2003. All other restructuring and related costs are expensed through the profit and loss account as part of the ongoing operations of our businesses.

**non-operating items ▸** In 2002, we took a charge of £37m for non-operating items relating to losses on the sale or closure of businesses and fixed assets. The principal items are a profit of £18m relating to the completion of the sale of RTL in January 2002 and a provision of £40m for the loss on sale of our Forum business, which completed in January 2003. This provision largely relates to unamortised goodwill at the balance sheet date. Other items include a loss on sale of PH Direct of £8m, a profit of £3m on finalisation of the sale of *Journal of Commerce* by the Economist and various smaller losses on investments and property.

**amounts written off investments ▸** In 2002, we continued to review our fixed asset investments and concluded that there have been no further material impairments. This compares to a charge of £92m taken in 2001 relating to the carrying value of Pearson shares held to secure employee share option plans and equity investments in a number of internet businesses.

**interest ▸** Net interest fell by £75m to £94m, with average net debt decreasing by £748m following the receipt of proceeds from the RTL disposal. Interest was further reduced by the effect of a general fall in interest rates during the year. The weighted average three month LIBOR rate, reflecting the Group's borrowings in US dollars, euros, and sterling, fell by 160 basis points, or 1.6%. The effect of these falls was mitigated by our existing portfolio of interest rate swaps, which converted over half our variable rate commercial paper and bank debt to a fixed rate basis. As a result, the Group's net interest rate payable averaged approximately 5.0%, falling 1.4% from the previous year. During 2002 we took an additional one-off charge of £37m for cancellation of certain swap contracts and the early repayment of debt following re-balancing of the group's debt portfolio on the receipt of the RTL proceeds.

| INTEGRATION COSTS | 2002 | | 2001 | | 2000 | | 1999 | |
|---|---|---|---|---|---|---|---|---|
| SIMON & SCHUSTER | – | – | – | – | £9m | *$14m* | £95m | *$153m* |
| NCS | £7m | *$11m* | £29m | *$47m* | £4m | *$6m* | – | – |
| DK | £3m | *$5m* | £45m | *$72m* | £27m | *$44m* | – | – |
| **TOTAL** | **£10m** | ***$16m*** | **£74m** | ***$119m*** | **£40m** | ***$64m*** | **£95m** | ***$153m*** |

Reading is fundamental to Pearson. We help more people learn to read – and enjoy doing it – than any other company. Our programmes cover every stage of learning from Dorling Kindersley's pre-school picture books to basic school literacy programmes, to customised electronic reading software to Longman's world-famous English language teaching resources.

**SHANE BREAUX** • PEARSON EDUCATION

**JULIE SAUSEN** • PEARSON EDUCATION

ALEX KIRKHAM ▪ DK, PENGUIN

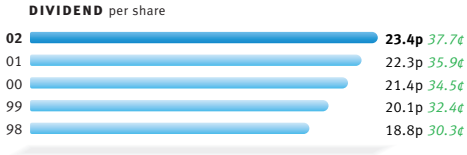
**taxation ▸** The Group recorded a total pre-tax loss of £25m in 2002 but there was a tax charge for the year of £64m. This situation reflects the fact that there is only limited tax relief available for the goodwill amortisation charged in the accounts. The total tax charge was in fact reduced by a non-operating credit of £45m attributable to the resolution of the tax position on the disposal of the group's remaining interest in BSkyB.

The tax charge reflects the adoption of FRS 19 'Deferred Tax'. FRS 19 requires full provisioning for deferred tax and this has had a significant effect on Pearson's effective tax rate. This is mainly because Pearson has recognised a deferred tax asset in respect of US tax losses and other timing differences. Previously the tax benefit of US tax losses was accounted for as the losses were utilised.

The tax rate on adjusted earnings, after restating for FRS 19, decreased from 34.0% to 32.8%. The decrease was attributable to two main factors. There was a more favourable mix of profits between higher and lower tax regimes than in 2001; in addition there was a benefit from prior year adjustments.

**minority interests ▸** Minority Interests include a 40% minority share in IDC and a 21% minority share in Recoletos.

**dividends ▸** The dividend payment of £187m which we are recommending in respect of 2002 represents 23.4p per share – a 5% increase on 2001. The dividend is covered 1.3 times by adjusted earnings, and 1.6 times by operating free cash flow. The company seeks to maintain a balance between the requirements of our shareholders, including our many private shareholders, for a rising stream of dividend income and the re-investment opportunities that we see across the Group. This balance has been expressed in recent years as a commitment to increase our annual dividend faster than the prevailing rate of inflation while progressively reinvesting a higher proportion of our distributable earnings in our business. While this commitment remains unchanged, we believe that the income requirements of our shareholders should take priority over reinvestment this year.





PETER JOVANOVICH ▪ CHIEF EXECUTIVE, PEARSON EDUCATION


JOAN MAZZEO ▪ PEARSON EDUCATION

## OTHER FINANCIAL ITEMS

**pensions ▸** Pearson operates a variety of pension schemes. Our UK fund is by far the largest and we also have some smaller defined benefit funds in the US and Canada. Outside the UK, most of our people operate 401K (essentially defined contribution) plans. In 2001, after a full actuarial valuation, the company resumed cash contributions to its UK Pension Fund (a £1bn fund) following a prolonged 'holiday' period. At that time, this resulted in the scheme having a small surplus of £40m. Although the next full actuarial valuation is not due until 2004, the funding level is kept under regular review by the company and the Fund trustees. After an informal indication in 2002, and taking account of current stock market conditions, the company agreed to increase contributions by £5m to £25m in 2003, ahead of the full valuation in 2004. This was designed to keep the scheme fully funded.

In this report we have included additional disclosure in respect of FRS 17 'Retirement Benefits' for pensions and other post retirement benefits. FRS 17 approaches pension cost accounting from a balance sheet perspective with the net surplus or deficit in Pearson's pension schemes being incorporated into the balance sheet. Changes in this surplus or deficit will flow through the profit and loss account and the statement of total recognised gains and losses. In this report we have disclosed the effect on the profit & loss account and balance sheet in the notes to the accounts (see note 10).

**accounting disclosures and policies ▸** As described above we have included additional disclosure in respect of FRS 17 for pensions and other post retirement benefits in accordance with that standard. The mandatory implementation of FRS 17 has been postponed and is now not required to be implemented before adoption of International Accounting Standards in 2005. FRS 19 'Deferred Tax', has been adopted in these accounts and the comparative figures have been restated. The effect of FRS 19 is discussed above and in note 21 to the accounts.

| NET TRADING ASSETS | | |
|---|---|---|
| INTANGIBLE ASSETS | £3,610m | *$5,812m* |
| TANGIBLE ASSETS | £503m | *$810m* |
| OPERATING WORKING CAPITAL | £811m | *$1,306m* |
| OTHER NET ASSETS | £5m | *$8m* |
| **TOTAL** | **£4,929m** | ***$7,936m*** |

| CAPITAL EMPLOYED | | |
|---|---|---|
| SHAREHOLDERS' FUNDS | £3,338m | *$5,374m* |
| DEFERRED TAX, PROVISIONS AND MINORITIES | £183m | *$295m* |
| NET DEBT | £1,408m | *$2,267m* |
| **TOTAL** | **£4,929m** | ***$7,936m*** |

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## MANAGING OUR FINANCIAL RISKS

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

**treasury policy ▸** The Group holds financial instruments for two principal purposes: to finance its operations and to manage the interest rate and currency risks arising from its operations and its sources of finance. The Group finances its operations by a mixture of cash flows from operations, short-term borrowings from banks and commercial paper markets, and longer-term loans from banks and capital markets. The Group borrows principally in US dollars, euros and sterling, at both floating and fixed rates of interest, using derivatives, where appropriate, to generate the desired effective currency profile and interest rate basis. The derivatives used for this purpose are principally interest rate swaps, interest rate caps and collars, currency swaps and forward foreign exchange contracts. The main risks arising from the Group's financial instruments are interest rate risk, liquidity and refinancing risk, counterparty risk and foreign currency risk. These risks are managed by the chief financial officer under policies approved by the Board which are summarised below. These policies have remained unchanged, except as disclosed, since the beginning of 2002. A treasury committee of the board receives reports on the Group's treasury activities, policies and procedures, which are reviewed periodically by a group of external professional advisers. The treasury department is not a profit centre and its activities are subject to internal audit.

| | | |
|---|---|---|
| **OPENING NET DEBT** | **£(2,379)m** | ***$(3,830)m*** |
| **CASH INFLOW** | | |
| OPERATING CASH FLOW | £455m | *$733m* |
| DISPOSALS | £930m | *$1,497m* |
| NET EQUITY | £6m | *$10m* |
| **CASH OUTFLOW** | | |
| INTEGRATION COSTS | £(44)m | *$(71)m* |
| INTEREST, TAX, DIVIDENDS AND OTHER | £(252)m | *$(406)m* |
| ACQUISITIONS | £(124)m | *$(200)m* |
| **CLOSING NET DEBT** | **£(1,408)m** | ***$(2,267)m*** |

**interest rate risk ▸** The Group's exposure to interest rate fluctuations on its borrowings is managed by borrowing on a fixed rate basis and by entering into interest rate swaps, interest rate caps and forward rate agreements. Since October 2002 the Group's policy objective has been to set a target proportion of its forecast borrowings (taken at the year end, with cash netted against floating rate debt) to be hedged (i.e. fixed or capped) over the next four years of 40% to 65%. At the end of 2002 that ratio was 56%. On that basis, a 1% change in the Group's variable rate US dollar, euro and sterling interest rates have a £6m effect on profit before tax. The disposal of Pearson's interest in RTL has resulted in a significant reduction in floating rate debt. We have cancelled a number of swap contracts in order to bring the balance of fixed and floating rate debt back within our policy parameters.

**liquidity and refinancing risk ▸** The Group's objective is to procure continuity of funding at a reasonable cost. To do this it seeks to arrange committed funding for a variety of maturities from a diversity of sources. The Group's policy objective has been that the weighted average maturity of its core gross borrowings (treating short-term advances as having the final maturity of the facilities available to refinance them) should be between three and ten years. Since January 2002, reflecting the impact of the RTL disposal, the Group's policy for non-bank sources has continued to be they should provide at least £250m of core gross borrowings, but for bank sources no such minimum is required (previously £250m). At the end of 2002 the average maturity of gross

As well as sharing technology resources and expertise for product development across the company, we're also improving all of our information systems to bring us big benefits in terms of customer service and our ability to manage our working capital.

DAVID JESKA * PEARSON TECHNOLOGY

CAROL KENNEDY * PEARSON BROADBAND
BILL GAULD * CHIEF INFORMATION OFFICER, PEARSON

JASON KINCADE * PENGUIN
JESSICA GOLDSTEIN * PEARSON EDUCATION

MICK MCGALE * PENGUIN

borrowings was 4.8 years and non-banks provided £1,790m (90%) of them (down from 5.3 years and up from 75% respectively at the beginning of the year). The proceeds of the RTL sale were used to repay debt, including part of the Group's syndicated bank facility, and to provide seasonal working capital. The Group believes that ready access to different funding markets also helps to reduce its liquidity risk, and that published credit ratings and published financial policies improve such access. The Group manages the amount of its net debt, and the level of its net interest cover, principally by the use of a target range for its interest cover ratio. All of the Group's credit ratings remained unchanged during the year. The long-term ratings are Baa1 from Moody's and BBB+ from Standard & Poor's, and the short-term ratings are P2 and A2 respectively. The Group continues to operate on the basis that the Board will take such action as is necessary to support and protect its current credit ratings. The Group also maintains undrawn committed borrowing facilities. At the end of 2002 these amounted to £1,059m, and their weighted average maturity was 2.5 years.

**counterparty risk ▸** The Group's risk of loss on deposits or derivative contracts with individual banks is managed in part through the use of counterparty limits. These limits, which take published credit limits (among other things) into account, are approved by the chief financial officer. In addition, for certain longer dated higher value derivative contracts the Group has entered into mark to market agreements whose effect is to reduce significantly the counterparty risk of the relevant transactions.

**currency risk ▸** Although the Group is based in the UK, it has a significant investment in overseas operations. The most significant currency for the Group is the US dollar, followed by the euro and sterling. The Group's policy during the year on routine transactional conversions between currencies (for example, the collection of receivables, and the settlement of payables or interest) remained that these should be effected at the relevant spot exchange rate. As in previous years, no unremitted profits were hedged with foreign exchange contracts. The Group's policy is to align approximately the currency composition of its core borrowings in US dollars, euros and sterling with the split between those currencies of its forecast operating profit. This policy aims to dampen the impact of changes in foreign exchange rates on consolidated interest cover and earnings. Long-term core borrowing is limited to these three major currencies. However, the Group still borrows small amounts in other currencies, typically for seasonal working capital needs. At the year end the split of aggregate net borrowings in its three core currencies was US dollar 72%, euro 13% and sterling 15%.

| NET BORROWINGS FIXED AND FLOATING RATE | 2002 | | 2001 | |
|---|---|---|---|---|
| FIXED RATE | £753m | *$1,212m* | £1,398m | *$2,251m* |
| FLOATING RATE | £655m | *$1,055m* | £981m | *$1,579m* |
| **TOTAL** | **£1,408m** | ***$2,267m*** | **£2,379m** | ***$3,830m*** |
| **GROSS BORROWINGS** | | | | |
| BANK DEBT | £193m | *$311m* | £694m | *$1,117m* |
| BONDS | £1,790m | *$2,882m* | £2,078m | *$3,346m* |
| **TOTAL** | **£1,983m** | ***$3,193m*** | **£2,772m** | ***$4,463m*** |
| **GROSS BORROWINGS BY CURRENCY** | | | | |
| US DOLLARS | £1,350m | *$2,174m* | £1,829m | *$2,945m* |
| STERLING | £241m | *$388m* | £520m | *$837m* |
| EURO | £380m | *$612m* | £404m | *$650m* |
| OTHER | £12m | *$19m* | £19m | *$30m* |
| **TOTAL** | **£1,983m** | ***$3,193m*** | **£2,772m** | ***$4,463m*** |

STEVE TIMEWELL * SIMON BLACKMORE * ALICE PARTRIDGE * PARVEEN BANSAL * ANTON TSAVKILOVL * FT BUSINESS, FINANCIAL TIMES

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