The Pearson goals

For the past five years, Pearson's performance measures have been central to the way we manage our business. With our portfolio transformation now largely complete, we have refined our approach.

Our six measures provide clarity, internally and externally, about the most tangible and relevant measures of our financial performance. We use our operating goals – sales growth, margins and cash conversion – to set targets for our businesses and as the basis of incentive plans across Pearson. We use our financial benchmarks – free cash flow, EBITDA and adjusted earnings per share – to align management with the interests of our shareholders. These financial benchmarks, and increasingly our share price itself, form the basis of our senior management incentive plans.

While these performance measures have served us well, with our portfolio transformation largely complete we have taken the opportunity to refine our approach. We think it's important that we continue to look at a range of measures that give a balanced view of our business, rather than an excessive focus on any single one. We also believe that our current operating goals meet our objective of being simple, measurable, stretching and consistent, and that our financial benchmarks do align our actions with the interests of our owners.

However, we are making some modest adjustments to our goals as Pearson enters this new phase in its evolution. A key objective will be to deliver returns above our cost of capital. We are therefore introducing return on invested capital as one of our financial benchmarks in place of EBITDA. (EBITDA is largely covered by our targets on cash conversion and free cash flow. For the record, EBITDA was £615m in 2002, up from £588m in 2001.)

Our operating goals already largely focus on the levers we have to improve ROIC. We will continue to measure our performance against the goals which drive operating profit: sales growth (at constant exchange rates) and operating margins. We are also retaining our cash focus and continue to aim to convert at least 80% of our operating profits into cash in any one year. We are adding a through-the-year measure of capital efficiency – an annual improvement in the average ratio of working capital to sales. We introduced this measure in 2002 at Penguin and Pearson Education, where we currently tie up an average of some £1bn in stock, debtors and creditors. The FT Group is a net contributor of working capital.

Naturally, we alter the weighting of these metrics across our company depending on the nature of the business involved and its operating environment. It is also important to note that the goals set out here do not reflect the full range of measures, both financial and non-financial, that we use to drive performance in our operating companies.

Finally, although we have always striven to communicate our financial performance openly and clearly, the radical changes in our portfolio have not made it easy to compare our performance year-on-year. Many of these complexities – which were explained in the notes to our accounts – will naturally fall away as our portfolio becomes more settled. However, we will seek to provide additional reconciliation in our accounts wherever they aid a better understanding of our business.

In 2002 we reduced the average working capital tied up in our book publishing businesses by £53m – even as we increased investment in new authors, titles and programmes – by being more efficient with our inventory.

RONA FAIRHEAD * CHIEF FINANCIAL OFFICER, PEARSON

UNDERLYING SALES GROWTH

Pearson's underlying sales grew 6% in 2002. We calculate underlying sales growth by excluding the effect of acquisitions or disposals on the one hand and currency movements on the other. As our business portfolio is now more stable, the 'underlying' impact in 2002 is primarily currency movements.

We believe that we now have a mix of companies that can deliver long-term through-the-cycle growth. However, in 2001, our book publishing businesses were unable to protect us from the downturn in our more cyclical newspaper publishing operations. In 2002 we delivered a return to growth even though sales in our newspaper and technology businesses continued to decline.

In 2003, with the outlook for our advertising-related and technology publishing businesses still difficult, we expect only modest sales growth. Looking further ahead, we expect sales growth to pick up again.

TRADING MARGIN

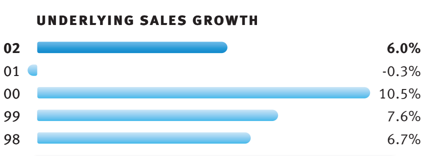
Trading margin represents our ability to turn our sales into profit. Our aim is to ensure that all our businesses generate 'best-in-class' margins, relative to their industries.

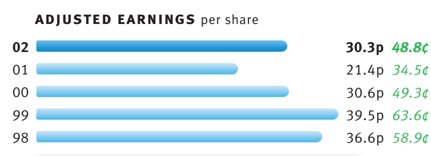
In 2002, our trading margins improved to 11.4% (from 10.5% in 2001). We benefited from lower internet losses and actions taken in 2001 to reduce our cost base. This more than offset the continued business advertising and technology publishing downturn and a change in the revenue mix at Pearson Education (where we saw a very big increase in the sales contribution from our lower-margin professional operations). Throughout 2002 we continued to take cost actions, which we expect to help improve margins in future years. These included ongoing business restructuring costs (which we expense as operating costs) and a £30m investment in back office integration and systems rationalisations.

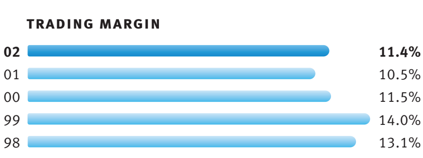
Looking ahead to 2003, we expect to reduce internet losses and the costs of our business integration investment to fall to £20m. This investment spend will disappear in 2004 and we aim to generate some £20m of annual cost savings from 2005 onwards.

ADJUSTED EARNINGS PER SHARE

We report our adjusted earnings after normal business restructuring costs, which we treat as operating expenses, but before specific non-recurring costs, primarily the integration costs relating to significant acquisitions and before







TAMMY MAN * PEARSON EDUCATION, HONG KONG
ANDREA CROZIER * PENGUIN, CANADA
JULIE GIBBS * PENGUIN, AUSTRALIA

JEFFREY ATKINSON * PENGUIN, NEW ZEALAND
SAUL MATTHEW IRELAND * PENGUIN, NEW ZEALAND
MICHAEL CAMPBELL * PEARSON EDUCATION, CANADA

We are the world's biggest book publisher and we are beginning to make that scale count in our favour. We have combined our book businesses in Australia and Canada and we are moving to share back office operations such as warehousing and distribution in the UK and New Zealand.

UDI KORE * ZEDDRICK WHITE * PEARSON

certain non-cash items – principally goodwill amortisation. Non-recurring costs were integration charges of £10m in 2002 (against £74m in 2001) and a £37m charge for the cancellation of certain swap contracts following the RTL disposal. The total goodwill charge was £340m down from £436m in 2001 with an average remaining life of goodwill of 15 years.

Our adjusted earnings per share fell back in 2001, driven by the sharp cyclical downturn in business advertising. In 2002, despite the continued advertising downturn and a weaker dollar exchange rate, we delivered earnings growth of 42%.

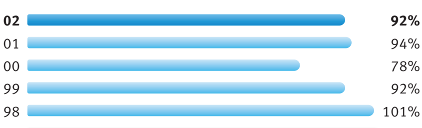
In 2003, we expect to continue to grow earnings in double-digits at constant exchange rates, as we benefit from a further steep decline in internet losses and some modest improvements from our business integrations.

Looking further out, we should benefit from our leading positions in growth markets and our ability to harness the benefits of sharing our assets and our processes. Our aim will be to deliver strong annual earnings improvement at constant exchange rates.

CASH CONVERSION

Our newspaper businesses typically convert almost all their operating profit into operating cash flow,

CASH CONVERSION

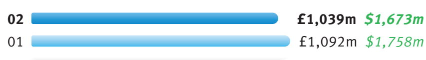


but, if they are to grow, our book publishing businesses need to absorb capital – in the form of authors' advances, pre-publication costs, inventory and receivables. We do not as a result, seek to convert 100% of our operating profit into cash, although we set ourselves a minimum target of 80% cash conversion for any year.

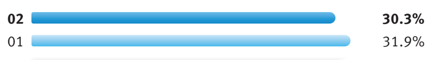
We achieved that target again last year with a strong performance in both cash collection and inventory management.

working capital ▸ Of our £1bn of working capital in 2002, 53% represents our investment in future growth – the advances that Penguin pays its authors before they deliver their manuscripts; and the new product development (or 'pre-publication costs') at Dorling Kindersley and Pearson Education.

AVERAGE WORKING CAPITAL*



AVERAGE WORKING CAPITAL/SALES RATIO*



* *Pearson Education and Penguin only*

We'll continue to make these investments, so long as we can see adequate returns. The rest of our working capital represents cash tied up in our processes, and here we see potential to become more efficient.

In our book publishing businesses we targeted and delivered a 5% improvement – some £53m – in the absolute level of average working capital, based on constant sales.

Marca, Spain's leading sports newspaper, has raised its game in the face of tough competition. A successful redesign and an aggressive marketing campaign helped *Marca* bounce back to growth.

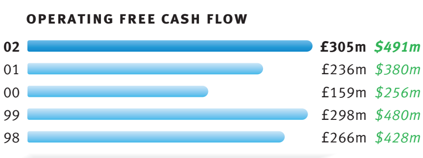
PILAR TRUCIOS * RECOLETOS

GASPAR GONZALEZ PALENZUELA * RECOLETOS
JOSE MARIA PAJARES * RECOLETOS

Improving our average working capital to sales in 2003 and 2004 will be extremely challenging as, at our education business in particular, we'll be ramping up new product investment ahead of very strong expected sales in 2005. However, we will seek to deliver continued efficiency gains and yearly progress on this measure.

FREE CASH FLOW

Free cash flow is the measure of the cash that is available from our business operations, after the payment of interest and tax, for distribution in the form of dividends or for re-investment in our business. The proceeds of disposals and the cost of acquisitions, together with any substantial integration costs associated with them, are excluded from the calculation.



Pearson's total free cash flow has been depressed in recent years by a high level of investment, particularly in the internet operations, but also in our print businesses. We believe that these investments will generate future growth, but we also need to ensure that dividends to shareholders can be paid from the cash generated by our businesses. In 2002, our focus on working capital and capital expenditure helped us to deliver a 29% improvement in free cash flow – even as we continued to invest in our businesses.

Looking ahead, we expect to deliver steady progress in cash generation, although we recognise that free cash flow in any one year may be affected by individual investment programmes. In the short term, we expect cash flow generation to be strongly positive.

RETURN ON INVESTED CAPITAL

Over the last few years, the transformation of Pearson has significantly increased the capital invested in the business (in the form of goodwill associated with the acquisitions necessary to build our market-leading businesses) and required substantial cash investment to integrate those acquisitions and to deliver an increasing proportion of our publishing and services online. With that transformation now largely complete, we are in a strong position to improve, each year, our return on invested capital.

We define ROIC as operating profit less cash tax as a percentage of our net operating assets plus total goodwill (that is, before goodwill amortisation). In 2002, our ROIC was 6%, up from 4.6% in 2001. Our cost of capital is a little lower than 8%. Our goal is to generate returns on invested capital above the cost of our capital as soon as possible.

RETURN ON INVESTED CAPITAL	2002		2001	
RETURN (OPERATING PROFIT LESS CASH TAX)	£419m	*$675m*	£394m	*$634m*
TOTAL INVESTED CAPITAL	£6,976m	*$11,231m*	£8,584m	*$13,820m*
RETURN ON INVESTED CAPITAL	6.0%		4.6%	

Going forward, we have two main levers to improve returns: increasing operating profit and reducing the level of operating assets. How quickly we can generate returns above our cost of capital will be dependent on a number of factors such as the business advertising environment.

ELISE SEE TAI * SIÂN WILLIAMS * CATHERINE GOLDSMITH * RACHAEL FOSTER * DK DESIGNS LYNN TREPICCHIO * BETSY NILES * SUZANNE KEEZER * CELIA ARGIRIOU * PEARSON EDUCATION

For the first time, children in the US, UK, Australia and Canada will learn to read from the same series of books thanks to an ambitious collaboration between Pearson Education and Dorling Kindersley. The Four Corners reading programme consists of 140 books which combine Pearson Education's mastery of content with DK's design magic.