Business Review

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

We create and manage intellectual property, which we promote and sell to our customers under well-known brand names, to inform, educate and entertain. We deliver our content in a variety of formats and through a variety of channels, including books, newspapers and online services. We increasingly offer services as well as content, from test administration and processing to teacher development and school software.

Though we operate in 60 countries around the world, today our largest markets are the US (59% of sales) and Europe (26% of sales) on a continuing basis.

Our businesses
Pearson consists of three major worldwide businesses:

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

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

— FT Publishing includes the Financial Times and FT.com, one of the world’s premier sources of business information, alongside a portfolio of financial magazines. It also includes an online financial information business Mergermarket, which provides early stage intelligence to financial institutions and corporates, as well as several joint ventures and associates including 50% of both The Economist Group and the FTSE index business.

— Interactive Data provides specialist financial data to financial institutions and retail investors. Pearson owns a 46% interest in Interactive Data, which is publicly listed on the New York Stock Exchange (NYSE:IDC).

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

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

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

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

— Content We invest steadily in unique, valuable publishing content and keep replenishing it. Over the past five years, for example, we have invested £1.7bn in new content in our education business alone.

— Technology and services We invested early and consistently in technology, believing that, in the digital world, content alone would not be enough. We now generate more than £1bn in sales from technology products and services, and our testing and assessment businesses, serving school students and professionals, make more than £1.2bn of sales, up from around £390m eight years ago.

— International markets Though we currently generate around 60% of our sales in the US, our brands, content and technology-plus-services models work around the world. All parts of Pearson are investing in selected emerging markets, where the demand for information and education is growing particularly fast.

— Efficiency We’ve invested to become a leaner, more efficient company, through savings in our individual businesses and through a strong centralised operations structure. Over the past three years, we have increased our operating profit margins from 10.8% to 15.0% and reduced average working capital as a percentage of sales in Pearson Education and Penguin from 29.4% to 25.9%, freeing up cash for further investment.

We believe this strategy can create a virtuous circle – efficiency, investment, market share gains and scale – which in turn can produce sustainable growth on our financial goals and the value of the company. This strategy helped us to achieve another set of record results in 2007.

2007 financial overview
Pearson’s three key financial measures are adjusted earnings per share, cash flow and return on invested capital. In 2007, adjusted EPS and cash flow reached record levels and we generated a further significant underlying improvement in return on invested capital.

In 2007, Pearson’s sales increased by 6% to £4.2bn and adjusted operating profit by 14% to a record £634m. Every part of Pearson contributed to this profit increase, with adjusted operating profit at Pearson Education up 9%, Penguin up 20% and the FT Group up 30%. Headline earnings per share were 46.7p, up 8% (and up 15% at constant currency).

Growth rates are stated on an underlying basis, excluding the impact of currency movements and portfolio changes. In 2007, currency movements reduced adjusted sales by £228m, adjusted operating profit by £37m and adjusted earnings per share by 2.7p, whilst portfolio changes increased adjusted sales by £146m and adjusted operating profit by £2.2m.

We also produced record cash flows. Operating cash flow increased by 19% or £1.19bn to £6.8bn and operating free cash flow by £0.9bn to £5.53bn. Cash conversion was once again very strong at 108% of operating profit. Over the past three years, the proportion of our profits converted to cash has averaged more than 100%. The ratio of average working capital to sales at Pearson Education and Penguin improved by a further 0.7% points to 26.6%. Our return on invested capital shows a headline increase of 0.2% points (to 8.2%) and a 1.0% point underlying improvement.

Statutory results show an increase of £32m in operating profit to £574m (£522m in 2006), Basic earnings per share for continuing businesses was 39.0p in 2007 against 52.7p in 2006, largely reflecting the absence of a 2006 tax credit. Net debt was £86m lower at £973m (from £1.059bn in 2006).
The board is proposing a dividend increase of 7.8% to 31.6p. Subject to shareholder approval, 2007 will be Pearson’s 16th straight year of increasing our dividend above the rate of inflation.

During the year, we announced the acquisition of Harcourt Assessment and Harcourt Education International from Reed Elsevier for $950m. The transaction closed in several stages, with the final stage completed in January 2008 following clearance by the US Department of Justice. Aside from the Harcourt deal, we also announced the acquisition of eCollege in 2007, a key provider of e-learning and enrolment services to post-secondary education.

These two transactions extend Pearson’s position as the world’s leading education company by adding new capabilities, complementary products and further international reach.

In February 2008 Pearson completed the sale of its Data Management business to M & F Worldwide Corp. for $225m.

In December 2007, we completed the sale of Les Echos to LVMH for €240m in cash. In January 2008, we announced that we had agreed to sell our 50% stake in FT Deutschland to Gruner + Jahr. The transaction increases Gruner + Jahr’s stake to 100% and is expected to complete in the first quarter of 2008.

These two transactions will allow us to focus the FT Group on the worldwide expansion of the Financial Times and our digital financial information business.

### Key Performance Indicators

**Adjusted earnings per share**

<table>
<thead>
<tr>
<th>Year</th>
<th>Earnings Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>£0.74</td>
</tr>
<tr>
<td>2006</td>
<td>£0.67</td>
</tr>
</tbody>
</table>

**Operating cash flow**

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>£164m</td>
</tr>
<tr>
<td>2006</td>
<td>£575m</td>
</tr>
</tbody>
</table>

**Savings per share generated from cost and operating efficiencies**

<table>
<thead>
<tr>
<th>Year</th>
<th>Savings Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>£0.01</td>
</tr>
<tr>
<td>2006</td>
<td>£0.03</td>
</tr>
</tbody>
</table>

**Return on invested capital**

<table>
<thead>
<tr>
<th>Year</th>
<th>Return on Invested Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>8.2%</td>
</tr>
<tr>
<td>2006</td>
<td>8.0%</td>
</tr>
</tbody>
</table>

**Profit per employee**

<table>
<thead>
<tr>
<th>Year</th>
<th>Profit Per Employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>£13K</td>
</tr>
<tr>
<td>2006</td>
<td>£17K</td>
</tr>
</tbody>
</table>

**Adjusted operating profit divided by the average number of employees**

<table>
<thead>
<tr>
<th>Year</th>
<th>Adjusted Operating Profit per Employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>£0.74</td>
</tr>
<tr>
<td>2006</td>
<td>£0.67</td>
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</tbody>
</table>

*Restated to reflect the impact of the 2007 change in tax treatment of amortisation of goodwill, 2.9p.

### Pearson Education: overview

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

In 2007 Pearson Education had sales of £2,684m or 64% of Pearson’s total. Of these, £1.9bn (70%) were generated in North America and £0.8bn (30%) in the rest of the world. Pearson Education generated 64% of Pearson’s operating profit.

Pearson Education competes with other publishers and creators of educational materials and services. These competitors include large international companies, such as McGraw-Hill and Houghton Mifflin Harcourt, alongside smaller niche players that specialise in a particular academic discipline or focus on a learning technology. Competition is based on the ability to deliver quality products and services that address the specified curriculum needs and appeal to the school boards, educators and government officials making purchasing decisions.

**Operating profit £860m / £809m +9%**

### Pearson Education: School overview

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

In the US, we publish high quality curriculum programmes for school students covering subjects such as reading, literature, maths, science and social studies. We publish under a range of well-known imprints that include Scott Foresman in the elementary school market and Prentice Hall in secondary.

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

In the US, more than 90% of school funds come from state or local government, with the remainder coming from federal sources. The major customers of our School business are state education boards and local school districts.
Continued share gains in school publishing

- Adjusted operating profit

### School: 2007 performance

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
<th>Underlying growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>£ millions</td>
<td>£ millions</td>
<td>%</td>
</tr>
<tr>
<td>1,537</td>
<td>1,453</td>
<td>6%</td>
<td>6%</td>
</tr>
</tbody>
</table>

Adjusted operating profit 203 184 10% 11%

**Continued share gains in school publishing**

- Pearson US School publishing up 3.5%, against industry growth of 2.7% (source: Association of American Publishers), as we benefit from our sustained investment in new basal programmes and innovative digital services.
- Faster underlying growth in international school publishing, with continued margin improvement.
- Pearson takes a leading share of the new US adoption market: 30% of the total market and 31% where we competed. #1 or #2 market share in reading, maths, science and social studies. Total 2007 new adoption opportunity of approximately £830m, up from £670m in 2006.
- US School new adoption market expected to remain strong over the next three years (estimated at £900m in 2008; £860m in 2009; and more than £1bn in 2010). In 2008 we are competing for around 90% of the total new adoption opportunity.
- Acquisition of Harcourt International brings leading content for school and vocational customers in many markets including the UK, South Africa, Australia and New Zealand. Transaction adds further scale to Pearson’s international education businesses and accelerates the combination of educational content and innovative technology to personalise learning. Integration of the Harcourt business is progressing well.
- Major cross company global English, maths and science projects launched, with the aim of sharing assets, expertise, investment and technology across all major international markets.
- Successful global ELT publishing franchises in every major market segment – primary, secondary, adult, business and exam preparation – drives strong growth worldwide. Sales of student editions of English Adventure, developed with Disney, top six million units in less than three years; Economist and FT branded courses also performing strongly with major launch of Penguin Readers planned for this year.
- Strong performance from school publishing businesses in South Africa and Australia; in Italy, integration of Pearson Paravia Bruno Mondadori complete, producing integration savings, margin improvement and market share gains; strong organic growth in Spanish language school publishing.

**Innovation in school technology**

- 13 product nominations in ten categories, more than any other education company, for the Software and Information Industry Association ‘Codie’ awards. The products include: PA Series, the first formative assessment product designed to measure progress and forecast student growth toward state goals or grade level expectations; Pearson Inform 4.1, a K-12 data analysis and decision support tool; PowerSchool Premier, a student information system that provides access to student information, enabling data-driven decisions that enhance student learning; and eCollege, an on-demand distance learning platform.
- Continued investment in digital programmes both for basal adoption and for special populations, including NovaNet and SuccessMaker. Pre-publication expenditure for digital programmes growing as a proportion of total pre-publication expenditure.
- enVisionMATH, our new integrated print-and-digital elementary maths programme (and the next generation of our successful California Social Studies programme), successfully launched for the 2008 adoption campaign. In 2008, maths accounts for approximately one-third of the total new adoption opportunity.

**Strong growth and share gains in school testing**

- US School testing sales up in double digits (after high single digit growth in 2006), benefiting from further contract wins, market share gains and strength in online assessment.
- 2.5 million secure online tests delivered across 13 states during the year, up from 1.4 million in 2006.
- Acquisition of Harcourt Assessment complements our existing assessment business, broadens our scale and reach in adjacent markets and creates new publishing and digital opportunities both in the US and around the world.
- In the UK, we marked a total of 9.6 million GCSE, AS and A-level exam scripts, 4.6 million of which were marked on-screen. ResultsPlus rolled out across the UK and internationally providing more than 2,250 schools with secure online access to question-level examination performance data on exam results day for the first time. More than 100,000 students access their results online on results day for the first time.
Higher Education: overview

Pearson is the largest publisher of textbooks and related course materials for colleges and universities in the US. We publish across all of the main fields of study with imprints such as Prentice Hall, Addison Wesley, Allyn & Bacon and Benjamin Cummings.

Typically, professors or other instructors select or ‘adopt’ the textbooks and online resources they recommend for their students, which students then purchase either in a bookstore or online. Today the majority of our textbooks are accompanied by online services which include homework and assessment tools, study guides and course management systems that enable professors to create online courses.

We have also introduced new formats such as downloadable audio study guides and electronic textbooks which are sold on subscription. In addition, we have a fast-growing custom publishing business which works with professors to produce textbooks and online resources specifically adapted for their particular course.

In 2007, our Higher Education business generated approximately 77% of its sales in the US. Outside the US, we adapt our textbooks and technology services for individual markets, and we have a growing local publishing programme. Our key markets outside the US include Canada, the UK, Benelux, Mexico, Germany, Hong Kong, Korea, Taiwan and Malaysia.

Higher Education: 2007 performance

<table>
<thead>
<tr>
<th>£ millions</th>
<th>2007</th>
<th>2006</th>
<th>Headline growth</th>
<th>Underlying growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>793</td>
<td>795</td>
<td>-%</td>
<td>5%</td>
</tr>
<tr>
<td>Adjusted operating profit</td>
<td>161</td>
<td>161</td>
<td>-%</td>
<td>7%</td>
</tr>
</tbody>
</table>

Rapid growth in online learning and custom publishing

- Investment in established and new author franchises, such as Campbell’s Biology, Kotler’s Marketing Management, Hubbard’s Economics and Cicarelli’s Psychology, continues to underpin the strong performance of our higher education business.

- ‘MyLab’ digital homework and assessment programmes launched in 22 new subject disciplines in 2007, increasing the total number of disciplines covered to 38. These programmes support over 2,000 textbooks and were used globally by 2.9 million students in 2007 (up more than 30% on 2006). Evaluation studies show that the use of the MyLab programmes can significantly improve student test scores and instructional productivity.

- In corporate finance, one of the largest global markets in business education, Pearson publishes the successful first edition bestseller, Berk/DeMarzo’s Corporate Finance, together with MyFinanceLab. Pearson’s market share increases from 4% to 11% in the US and from 39% to 48% in the UK. It is the most successful launch of a first edition in this discipline in more than a decade and one of Pearson’s most successful global launches ever, winning university adoptions in 22 countries. In World History, the first edition of Fernandez-Armesto’s The World: A History with MyHistoryLab increases Pearson’s market share from 25% to 35%.

- Acquisition of eCollege builds Pearson’s position as an education services provider. eCollege works with partner educational institutions to design, build and support online degree, certificate, diploma and professional development programmes. Student enrolments increase 44% in 2007 to 1.9 million. eCollege broadens Pearson’s services to academic institutions; Pearson’s scale and reach enable eCollege to access new customers in the school, post-secondary and professional/vocational markets both in the US and worldwide.

- Pearson is the largest publisher on CourseSmart.com, a joint venture of the largest US education textbook publishers with over 2,500 titles. CourseSmart.com provides cost effective e-books to students and time-efficient review of textbooks for professors.

- Continued strong double digit growth in our custom solutions business—which builds customised textbooks and online services and has become a leader in the creation of courseware and curriculum for e-learning institutions.

Good progress in international markets

- In Europe, good revenue growth and strong margin improvement as organic and acquisition investment in international education continues to bear fruit. Particular areas of strength included local language editions of our major authors and custom publishing including the successful launch of ‘local language’ science publishing in Germany.
## Professional: overview

Our Professional education business publishes educational materials and provides testing and qualifications services to adults. Our publishing imprints include Addison Wesley Professional, Prentice Hall PTR, Cisco Press (for IT professionals), Peachpit Press and New Riders Press (for graphics and design professionals), Que/Sams Publishing (for the business education market). We have a fast-growing Professional Testing business, Pearson VUE, which manages major long-term contracts to provide qualification and assessment services through its network of test centres around the world. Key customers include major technology companies, the world's Driving Standards Agency.

### Professional: 2007 performance

<table>
<thead>
<tr>
<th>Measure</th>
<th>2007</th>
<th>2006</th>
<th>Headline growth</th>
<th>Underlying growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales*</td>
<td>354</td>
<td>345</td>
<td>4%</td>
<td>9%</td>
</tr>
<tr>
<td>Adjusted operating profit</td>
<td>40</td>
<td>38</td>
<td>5%</td>
<td>11%</td>
</tr>
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</table>

*Includes Government Solutions and includes Data Management.

– With the sale of Government Solutions in 2007 and Data Management in 2008, our Professional business is focused on publishing for professionals in business and technology, and on testing and certifying adults to be professionals.
Underlying growth

Our joint ventures and associates include:

FT Publishing joint ventures and associates include:

= 50% interest in The Economist Group, publisher of the world’s leading weekly business and current affairs magazine;
= 50% interest in FTSE International, a joint venture with the London Stock Exchange, which publishes a wide range of global indices, including the FTSE index;
= 50% interest in Business Day and Financial Mail, publishers of South Africa’s leading business newspaper and magazine;
= 33% interest in Vedomosti, a leading Russian business newspaper;
= 14% interest in Business Standard, one of India’s leading business newspapers.

Interactive Data

Interactive Data is a leading global provider of financial market data, analytics and related services to financial institutions, active traders and individual investors. The company’s customers use its offerings to support their portfolio management and valuation, research and analysis, trading, sales and marketing, and client service activities.

Interactive Data’s four businesses provide a range of enterprise-wide services, including:

Pricing and Reference Data: supplying global securities pricing, evaluations and reference data for more than 3.5 million securities traded around the world, including hard-to-value instruments

Real-Time Services: providing real-time global market data and managed solutions to financial institutions, redistributors and online financial portals worldwide. Services range from a consolidated, low-latency data feed, to tools for building, managing and hosting customised applications

Fixed Income Analytics: providing fixed income portfolio analytics in North America and Europe

Desktop Solutions (eligible): through its eligible division, Interactive Data’s eligible provides global, real-time market data and decision support tools to active investors and professionals worldwide

FT Group: 2007 performance

Note: excludes Les Echos, sold in December 2007.

Great publishing, continued growth and significant margin improvement

= FT Publishing revenues up 12% (advertising revenues up 10%) with operating profit more than doubling to £56m in headline terms.
= Outstanding year at the Financial Times:
  = FT newspaper circulation up 2% to almost 440,000 (for the July-December 2007 ABC period), with a 19% increase in subscriptions;
  = Digital subscribers to the FT up 13% to 101,000; monthly unique users up 30% to 5.7 million; monthly page views up 33% to 48.2 million;
  = FT.com attracts 150,000 new registered users since launch of its innovative new access model in October 2007; strong growth continues in the early part of 2008.
  = FT named Newspaper of the Year at the 2007 What the Papers Say Awards.
  = Strong trading performance at FT Business as integration with FT Interactive Data’s four businesses provide a range of enterprise-wide services, including:

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-- FTSE, in which Pearson owns a 50% stake, achieves double digit sales growth, benefiting from a strong new business performance, a joint venture with Xinhua Finance in China and strong growth in Exchange Traded Fund (ETF) licenses.

-- Several small acquisitions of complementary subscription-based and digital businesses:
  -- Infinata, a provider of research and business information to life science and financial services companies. The company’s products, which include BioPharm Insight and HINW Insight, provide clients with comprehensive, timely information used to make strategic and tactical business decisions.
  -- Exec-Appointments, a well-established global job site that focuses on the high-earning executive sector with approximately 200,000 registered executive users.
  -- Money-Media, acquired in January 2008, a provider of must-have news and analysis via email and websites to US mutual fund managers, institutional investors, high net-worth individuals, company directors and advisers. Approximately two-thirds of Money-Media’s revenues were generated through subscriptions with close to 90% renewal rates.

-- Sale of Lex Echos to LVMH for €240m (£174m) completed in December 2007.

-- Sale of 50% stake in FT Deutschland to Gruner + Jahr announced in January 2008.

Interactive Data

Strong sales momentum

-- Underlying sales growth of 8% driven primarily by strong sales to both existing and new institutional customers and a renewal rate of approximately 95% within the Institutional Services segment.

-- Strong new sales momentum in Q4 2007 further supported activities to realign the company’s two largest institutional businesses under a single management structure.

Continued focus on high value services

-- Pricing and Reference Data continues to generate good growth in North America and Europe. The business continues to broaden its coverage of complex securities by expanding its universe of European asset-backed and mortgage-backed securities. The business also launched a new web-based offering, the Basket Calculation Service, designed to provide clients with the indicative optimised portfolio value for equity and fixed income exchange traded funds.

-- Real-Time Services continues to achieve strong growth with new institutional sales in its two core product areas of real-time data feeds and managed solutions. Highlights include: growing adoption of its PluXfeed data service for algorithmic trading applications; the introduction of DirectPlus, a new ultra low latency direct exchange data service; and excellent sales momentum for managed solutions in North America with new customers including media companies, online brokerages, stock exchanges and financial institutions.

-- Fixed Income Analytics completed 30 new BondEdge® installations during the year and made good progress in the development of its next-generation BondEdge® platform.

-- In the Active Trader Services segment, eSignal experienced modest expansion of its direct subscriber base, delivered numerous innovations across its suite of active trader services, and added new content and capabilities on its financial websites.

-- Interactive Data is listed on the New York Stock Exchange (NYSE: IDC) and Pearson owns a 62% stake. Interactive Data’s 2007 results under US GAAP are available at www.pearson.com

<table>
<thead>
<tr>
<th>FT Group Key Performance Indicators</th>
<th>FT average copy sales growth</th>
<th>Interactive Data customer retention</th>
</tr>
</thead>
<tbody>
<tr>
<td>FT Publishing advertising revenue growth**</td>
<td>10%</td>
<td>95%</td>
</tr>
<tr>
<td>FT Publishing year on year revenue growth**</td>
<td>10%</td>
<td>95%</td>
</tr>
<tr>
<td>FT.com unique user growth</td>
<td>113%</td>
<td>95%</td>
</tr>
<tr>
<td>The FT’s year on year average growth in unique users of FT.com*</td>
<td>2%</td>
<td>1%</td>
</tr>
<tr>
<td>The FT Newspaper’s year on year average growth in copy sales (ABC)</td>
<td>1%</td>
<td>2%</td>
</tr>
</tbody>
</table>

* Internal statistics.
** This KPI now reflects advertising growth of FT Publishing (FT Newspaper, FT.com, FT Business and FT Chinese).

The Penguin Group: overview

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

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

In 2007, Penguin had sales of £846m, representing 20% of Pearson’s total sales (21% in 2006) and contributed 12% of Pearson’s operating profit. Its largest market is the US, which generated around 55% of Penguin’s sales in 2007. The Penguin Group earns around 99% of its revenues from the sale of hard cover and paperback books. The balance comes primarily from audio books and e-books.
Penguin sells directly to bookshops and through wholesalers. Retail bookshops normally maintain relationships with both publishers and wholesalers and use the channel that best serves the specific requirements of an order. It also sells through online retailers such as Amazon.com, as well as Penguin’s own website.

Penguin competes with other publishers of fiction and non-fiction books. Principal competitors include Random House, HarperCollins, and Hachette Group. Publishers compete by developing a portfolio of books by established authors and by seeking out and promoting talented new writers.

### Penguin Group

<table>
<thead>
<tr>
<th>Operating profit (£m)</th>
<th>2007</th>
<th>2006</th>
<th>Underlying growth</th>
<th>Underlying growth</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>74</td>
<td>66</td>
<td>12%</td>
<td>20%</td>
</tr>
</tbody>
</table>

*Underlying growth*

### The Penguin Group: 2007 performance

- Sales: £846 million (2006: £848 million)
- Adjusted operating profit: £74 million (2006: £66 million)

**Strong competitive performance in major markets**


- Outstanding year for bestsellers in the US with titles including Elizabeth Gilbert’s *Eat, Pray, Love* (4.4 million copies shipped to date); Khaled Hosseini’s *A Thousand Splendid Suns* (2.2 million); and Ken Follett’s *World Without End* (almost 1 million).

- UK bestsellers included Marian Keyes’ *Anybody Out There?*, Jamie Oliver’s *Jamie at Home*, Jeremy Clarkson’s *Don’t Stop Me Now* and Charlie Higson’s *Double or Die*. Strong year for Brands & Licensing division driven by *The Dr Who Annual* (the second best-selling children’s book of 2007) and bestselling *In the Night Garden* titles.

- Australia: strong publishing from authors including Bryce Courtenay with *The Persimmon Tree* and Dr Manny Noakes with *CSIRO Total Wellbeing Diet Book 2*.

- DK delivered a strong global performance in traditional, custom and digital publishing, benefiting from innovative formats including *The Human Body Book*, personalised travel guides via traveldk.com and the first DK textbooks for higher education markets.

**Rapid growth in emerging markets**


- South Africa: another strong year led by John van de Ruit’s *Speak: The Madness Continues*.

**Innovation in print and online**

- Rapid growth in sales through online retail and digital channels driven by innovative digital marketing initiatives and investment in ebooks (with 5,000 Penguin titles currently available) and digital content. Strong growth in online revenues and unique visitors to Penguin and DK websites.

- Continued innovation in formats (including the pioneering US premium paperback and personalised ‘on-demand’ travel guides), genres (Portfolio business imprint in India), sales channels (bestselling ebooks via online retailers and Penguin’s own websites; audio books via iTunes and Audible; Rough Guides via Motorola, Nokia and Samsung phones) and communications channels (www.spinebreakers.com, an online community for teenagers).

- Subscribers to Penguin and DK opt-in newsletters building rapidly, up 34% year-on-year to over 150,000, allowing Penguin consumers to personalise areas of interest and strengthening relationship with Penguin brand.

**Continued focus on quality and efficiency**

- Pearson-wide renegotiation of major global paper, print and binding contracts continue to bring cost savings in 2007.

- Further improvement expected in 2008 from ongoing management of production, warehousing and distribution costs.

**Strong 2008 publishing schedule; strong start to the year**

- Strong list of new titles for 2008 from bestselling and new authors including Patricia Cornwell, Steve Coll, Michael Pollan, Jamie Oliver, Marian Keyes, Jeremy Clarkson, Thomas Friedman, Niall Ferguson and the new James Bond book from Sebastian Faulks.

- Outstanding sales performance from Eckhart Tolle’s *A New Earth*, with 4 million copies shipped since its selection for Oprah Winfrey’s book club on 30 January. First of ten online classes featuring Eckhart Tolle and Oprah Winfrey aired on 3 March.

### Penguin Key Performance Indicators

#### US Bestsellers

- 164 titles

#### UK Bestsellers

- 72 titles


- 48

#### Year end positions of Penguin books appearing in the Top Ten bestsellers lists in the UK (Bookscan Top Ten)

- 59

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Business Review continued

Pearson outlook 2008

In recent years we have significantly changed the shape of Pearson, building and diversifying our education company, shifting our financial information businesses towards recurring revenue streams and becoming more efficient through a centralised operations organisation. These moves have made Pearson a more profitable, more cash generative and more resilient company, and we expect to make further progress on our financial goals in 2008.

At this early stage, our outlook for 2008 is:

– In Education (64% of 2007 sales and operating profit), we expect another year of good profit growth, benefiting once again from the unique breadth of our education business – from pre-school to adult learning; across publishing, testing and technology; and in the US and around the world.

In our School business, integration of our recently-acquired Harcourt businesses is progressing well. In 2008, we expect School margins to be similar to 2007, after expensing integration costs relating to the acquisition. In 2009, we expect School margins to rise to around 15% as the majority of the integration costs fall away and as we realise the financial benefits of the acquisition.

Including the Harcourt contribution, we expect our School business to grow sales well into double digits in 2008 at constant currency. Excluding Harcourt, we expect underlying sales growth in the low single digits, as US market growth of 3-4% is partly offset by our lower participation in the low single digits, as US market growth of 3-4% is partly offset by our lower participation rate in new US adoptions and the conclusion of our UK Key stage testing contract.

In Higher Education, we expect our underlying sales to grow in the mid single digits, with a mix of the US and international businesses growing at 5-7% as margins are expected to be stable, as we continue to invest in expanding our adaptive learning technologies and in taking our recently-acquired eCollege platform into new verticals and geographic markets.

In Professional, we expect sales to increase in the low single digits in underlying terms with underlying margins improving once again.

– Penguin (20% of sales; 12% of operating profit) expects to improve margins further and into double digits. Penguin’s good publishing and trading performance has continued into the early part of 2008.

– The Financial Times Group (16% of sales; 24% of operating profit) expects to continue its profit growth. We have substantially increased our digital and subscription revenues and reduced our exposure to print advertising in recent years (in 2007, digital services accounted for 63% of FT Group revenues, compared with 28% in 2000; advertising accounted for 30% of FT Group revenues, down from 52% in 2000). At FT Publishing, advertising revenues have continued to grow in the early part of the year, but future advertising trends remain difficult to predict. However, as a result of our revenue diversification and cost actions we expect further profit improvement at FT Publishing this year, even without any growth in advertising revenues. Interactive Data expects to achieve revenue growth in the 7-9% range and operating profit growth in the 9-11% range (headline growth under US GAAP).

Group financial review

Operating result

On a headline basis, adjusted sales increased by £167m or 4% from £4,051m to £4,218m and total adjusted operating profit increased by £42m or 7% to £634m in 2007 from £592m in 2006.

Adjusted sales include discontinued operations held throughout the current and previous year. In 2007 the sales by our Data Management business have been included in adjusted sales. Adjusted operating profit excludes amortisation and adjustment of acquired intangibles but also includes the adjusted profits from discontinued operations.

Statutory operating profit from continuing operations increased by £52m or 10%, to £574m in 2007 from £522m in 2006. The statutory operating profit includes the effect of increased intangible amortisation but does not reflect the decreased contribution from discontinued operations.

Net finance costs

<table>
<thead>
<tr>
<th>Category</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest payable</td>
<td>(95)</td>
<td>(94)</td>
</tr>
<tr>
<td>Finance income in respect of employee benefits</td>
<td>10</td>
<td>4</td>
</tr>
<tr>
<td>Net finance costs reflected in adjusted earnings</td>
<td>(85)</td>
<td>(90)</td>
</tr>
<tr>
<td>Net foreign exchange (losses)/gains</td>
<td>(17)</td>
<td>19</td>
</tr>
<tr>
<td>Other (losses)</td>
<td>(4)</td>
<td>(3)</td>
</tr>
<tr>
<td>Net finance costs</td>
<td>(106)</td>
<td>(74)</td>
</tr>
</tbody>
</table>

Net finance costs reported in our adjusted earnings comprise net interest payable and net finance income relating to post-retirement plans. Net interest payable in 2007 was £89m, up from £84m in 2006. Although we were partly protected by our fixed rate policy, a rise in average US Dollar floating interest rates had an adverse effect. Year on year, average three month LIBOR (weighted for the Group’s borrowings in US dollars, euros and sterling at each year end) rose by 0.5% to 5.4%, reflecting a rise in interest rates and a change in the currency mix of year end debt. These two factors, together with a decrease in the Group’s average net debt of £90m, increased the Group’s average net interest rate payable by 0.3% to 7.3%. The net finance income relating to post-retirement plans rose by £6m in 2007 resulting in overall net finance cost reflected in adjusted earnings of £85m.

We expect our interest charge in 2008 to be similar to that in 2007 with the higher level of net debt following the completion of the Harcourt transaction offset by strong cash generation and the recent proceeds from the disposal of Les Echos and Data Management. We expect our pension credit will remain at a similar level to 2007, despite an upward revision of life expectancy assumptions.

Also included in the statutory definition of net finance costs are foreign exchange and other gains and losses. These are excluded from adjusted earnings as they represent short-term fluctuations in market value and are subject to significant volatility. Other gains and losses may not be realised in due course as it is normally the intention to hold the related instruments to maturity. Net foreign exchange losses of £17m in 2007 mainly relate to exchange losses on legacy Euro denominated debt held to hedge the receipt of euro proceeds from the sale of Les Echos. A corresponding gain is included in the higher proceeds realised on this sale. In 2006 euro borrowings and cross currency swaps that were not designated as net investment hedges contributed to the overall foreign exchange gains.
Taxation
In 2007 we revised our calculation of the effective tax rate on adjusted earnings to reflect the benefit of tax deductions attributable to amortisation of acquired goodwill and intangibles as this more accurately aligns the adjusted tax charge with the expected medium-term rate of cash tax payment. We have restated the 2006 comparative figure.
On this basis the effective tax rate on adjusted earnings was 26.4% in 2007 compared with 25.9% in 2006. Our overseas profits, which arise mainly in the US, remain mostly subject to tax rates which are higher than the UK corporation tax rate (which was 30% in 2007 but will fall to 28% from 1 April 2008). This factor was offset by the amortisation-related tax deductions and, as in 2006, by releases from provisions reflecting continued progress in agreeing our tax affairs with the authorities.
For 2008 we expect our effective tax rate on adjusted earnings to be in the 27% to 29% range.

The reported tax charge on a statutory basis was £131m, representing a rate of 28.8%. As we explained last year, the 2006 rate was abnormally low because of one-off adjustments related to the recognition of deferred tax assets for both capital losses and operating losses. The tax effects of the disposals during 2007, mainly Government Solutions (tax £93m) and Les Echos (tax £nil), are reflected in discontinued operations.

Tax paid in 2007 was £87m, compared with £59m in 2006. The 2007 amount included £26m paid in respect of disposals.

Discontinued operations
Discontinued operations relate to the disposal of Government Solutions (in February 2007), Les Echos (in December 2007) and the Data Management business (in February 2008). In total, we received cash proceeds of £469m for disposals in 2007.

As previously announced, we realised a loss before tax of £19m and a tax charge of £93m on the sale of Government Solutions. We realised a profit before tax of £116m with no tax payable on the sale of Les Echos. In anticipation of a loss on sale of the Data Management business, a goodwill impairment of £97m has been charged to the income statement in 2007. We received cash proceeds of £225m on the sale of Data Management on 22 February 2008.

Minority interests
Our minority interests comprise mainly the minority share in Interactive Data. Our stake in Interactive Data remained at 62% throughout 2007, leaving the minority interest unchanged at 38%.

Dividends
The dividend accounted for in our 2007 financial statements totalling £238m, represents the final dividend (18.8p) in respect of 2006 and the 2007 interim dividend of 11.1p.

We are proposing a final dividend for 2007 of 20.5p, bringing the total paid and payable in respect of 2007 to 33.6p, a 7.8% increase on 2006. This final 2007 proposed dividend was approved by the board in February 2008, is subject to shareholder approval at the forthcoming AGM and will be charged against 2008 profits. For 2007, the dividend is covered 1.5 times by adjusted earnings.

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

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

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

The income statement expense for defined benefit plans is determined using annually derived assumptions as to salary inflation, investment returns and discount rates, based on prevailing conditions at the start of the year. The assumptions for 2007 are disclosed in note 24 to our accounts, along with the year end surpluses and deficits in our defined benefit plans. We recognise actuarial gains and losses arising when assumptions diverge from reality through the statement of recognised income and expense (SORI&E).

Our charge to profit in respect of worldwide pensions and post retirement benefits amounted to £61m in 2007 (2006: £60m) of which a charge of £71m (2006: £64m) was reported in operating profit and the net finance benefit of £10m (2006: £4m) was reported against net finance costs.

Pension funding levels are kept under regular review by the company and the plan Trustee. Following the completion of the latest actuarial valuation of the UK Group pension plan as at January 2006, we made additional payments to the plan in 2007 amounting to £100m. These additional payments have contributed to the overall surplus recognised in the UK plan.

Corporate responsibility
Alongside our commitment to our financial goals, Pearson has a clear social purpose: to provide education, information and entertainment and help our customers get on in their lives. Our Corporate Responsibility programme addresses four main areas:

– Society – making communities better places to live and work;
– Our People – the issues that affect the people who work for us;
– Environment – our environmental impacts and what we do to manage them;
– Governance – our business procedures, code of conduct and supply chain management.

Pearson is a founder signatory of the UN Global Compact on labour standards, human rights, the environment and anti-corruption. We are also long-standing members of the Dow Jones Sustainability and FTSE4Good ethical indices. In 2007 Pearson was named media sector leader in the Dow Jones Sustainability Indices. Our ranking in the Business in the Community Corporate Responsibility Index again rose and we were awarded the highest, ‘platinum’ status.

We publish a detailed annual report on corporate responsibility providing details of our progress and plans in all these areas, which is available at www.pearson.com/community/csr_report2007

Society
Each one of our businesses pays great attention to the quality and accuracy of its content and services; in education, for example, we are investing in a series of long-term studies to measure the robustness of our programmes in enhancing student achievement. Beyond those basic products and services, Pearson has a proud history of corporate giving and supporting projects in our communities. Through the Pearson Foundation – and also through the efforts of our businesses and employees – we focus our charitable giving on education and literacy projects around the world.
People

The following table shows for 2007 and 2006 the average number of people employed in each of our operating divisions.

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>School</td>
<td>12,906</td>
<td>11,064</td>
</tr>
<tr>
<td>Higher Education</td>
<td>5,098</td>
<td>4,364</td>
</tr>
<tr>
<td>Professional</td>
<td>3,458</td>
<td>3,207</td>
</tr>
<tr>
<td>Penguin</td>
<td>4,683</td>
<td>3,942</td>
</tr>
<tr>
<td>FT Publishing</td>
<td>2,083</td>
<td>1,766</td>
</tr>
<tr>
<td>Interactive Data</td>
<td>2,301</td>
<td>2,206</td>
</tr>
<tr>
<td>Other</td>
<td>1,614</td>
<td>1,607</td>
</tr>
<tr>
<td>Continuing operations</td>
<td>31,622</td>
<td>28,214</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>1,070</td>
<td>6,127</td>
</tr>
<tr>
<td>Total</td>
<td>32,692</td>
<td>34,341</td>
</tr>
</tbody>
</table>

Our people are our biggest – and most important – asset. We want to be the best company to work for. We want the people who work with us to enjoy what they do, to know they are good enough to work anywhere, but to stay with us because they think we are the best.

We have a way still to go, but each year we have got closer to making this a reality. We think our benefits, incentive plans and training and management development programmes are as good as anywhere else and they all help to reinforce a strong culture which is anchored in the simple idea that as a company we want to be brave, imaginative and decent in the way we treat our customers, our suppliers and ourselves.

Training and development

Last year 220 senior managers went on Pearson-run management development and training programmes. 650 of our senior managers have now been on one or more of these programmes which cover finance, strategic planning and advanced management techniques which are taught by business school professors from both sides of the Atlantic. Each of our operating companies also run extensive training programmes of their own.

Talent management

Our goal is to make absolutely sure that we have a strong pipeline of talented people for the future and we have introduced personal development plans for many of our senior management. But we take care to identify and develop talent at all levels within the company and review this talent regularly with each operating company. We are committed to ensuring that everyone in the company has an annual appraisal. Each operating company also reviews its talent annually and the results of this process are reviewed by the CEO of Pearson, the Director for people and the CEO of each company. We focus on performance and potential. Each autumn the Pearson board has a special session devoted solely to reviewing senior talent and some of our most promising people in the company.

This ensures that we have a comprehensive succession plan for each part of our business.

International development

As we become more and more international – we are now at work in 60 countries – we have significantly expanded New Directions our programme of short term overseas assignments. In the first year of this centrally-managed programme, we moved 67 people between companies and countries and in 2008 our target is to move at least 100. In 2008, we will also launch a Senior International Leadership Programme which will help prepare senior executives to work overseas on two- to three-year assignments as part of their management development.

People for the future

Pearson has a lot of talented people at all levels and we continue to run very successful programmes to identify and develop great talent deep within the company. The cornerstone of this is our annual Forum which brings together about 100 of our newest and brightest managers from all over the world for a three-day session with the Pearson Management Committee and other senior managers. Similar forums are held within our operating companies and we also bring together our talent in functions like marketing, human resources and finance.

Diversity

Our goal is to be a company that reflects the societies in which we operate and we seek to attract the very best candidates at all levels regardless of race, gender, age, physical ability, religion or sexual orientation. We don’t set specific targets, but we do work very hard to make sure that the pool of applicants for jobs is diverse. We have made progress on several fronts in the past year, but there is still a great deal to do. We have increased the number of people we hire from minorities in the US and the UK, expanded our minority intern programmes on both sides of the Atlantic and added new titles to our African-American and Hispanic publishing lists. But we do not have enough executives at middle and senior management levels from minority backgrounds and we continue to work hard to correct this.

Health and safety

A Group level health and safety policy is in place and there are many examples of good practice relating to management initiatives and employee engagement, particularly in our distribution centres.

Share ownership

We want everyone in Pearson to own shares in the company and believe that the best way for people to profit from the success of the company is for them to become shareholders.

Employee feedback and communication

We continue to ask employees what they think about working in Pearson and each operating company also seeks and reviews its own feedback in detail. We have an internal communications programme which enables us to reach people through e-mails, employee road shows and visits from our senior managers. We try to listen as much as we talk so that we can act upon ideas, suggestions and views.

Additional detail concerning our people is found on page 31.

Suppliers

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

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

The majority of our key suppliers are located in North America and Western Europe. However, some of our suppliers, particularly those providing print and production services are based in less developed countries. Since signing the Global Compact, we have:

- Written to many thousands of our suppliers to advise them of our commitment to the Global Compact, and our code of conduct.
- Included specific contractual commitments relating to the environment, labour standards and human rights in our key contracts, particularly those that relate to paper supply, printing and distribution.
- Managed an ongoing programme of supplier visits to assess compliance with the Global Compact and our contractual commitments.
Working with the UK book publishing industry to introduce common standards on labour standards and human rights and on an industry database on the environmental characteristics of paper purchased.

Paper is our most significant area of supply and is predominantly sourced from North America and Scandinavia. Pearson was the first global publishing company to publicly disclose our environmental standards with regard to paper purchasing and we set targets relevant to our policy.

In addition to auditing suppliers against our commitments, we ensure that our commercial purchasing teams have received training on our supply chain labour standards.

Consistent with prior years, our 2007 supplier audits have not identified any material breaches of our supply chain policies.

Details of our supplier payment policy are shown on page 31 in the Directors’ Report.

Environment

Increasing consensus over the causes of climate change is emerging. Pearson does not directly operate in industries where there is a potential for serious industrial pollution. Our main products are based on intellectual property. However, our offices and distribution centres do have an impact and we are committed to playing our part in tackling climate change.

A formal environmental policy has been in place at Pearson since 1992. Our Director for people is responsible for the policy, but day-to-day implementation is with our operating companies.

Pearson has an established Environmental Management System (EMS) in place for its global operations broadly based on the requirements of the International Environmental Management System standard, ISO 14001.

Our approach has been successful. We were two years ahead of target in achieving our aim of reducing energy use by 10% compared to our 2003 baseline. However we felt we could go further, so last year, we made a commitment to become climate neutral for those operations we directly control with a view to completing the process by the end of 2009. The challenge is also to every Pearson employee to become climate aware and to identify opportunities for improvement.

We have set up an Environment Executive Committee which will have responsibility for overseeing progress against our climate neutral commitment.

Our main environmental performance indicator is our greenhouse gas emissions expressed in metric tonnes of carbon dioxide (CO2), the main greenhouse gas. Our target is to reduce these emissions from the 2006 level to zero by the end of 2009. In 2008 we will also be reviewing the environmental impact of companies acquired during 2007.

We have widened the scope of what we include within the company’s greenhouse gas inventory and carried out a review of our data collection processes. As a result, we expect the total tonnes of CO2 we report for 2007 to increase. Based on this, our initial focus is on strategies to reduce our greenhouse gas emissions. We will be outlining our plans further in our Environmental Review for 2007 which will be available in April.

In addition to our broad objectives, management in our operating companies and individual facilities are encouraged to set targets to reduce energy use, emissions and other environmental impacts.

For further information you can read about our environmental policy, practices and our progress towards our climate neutral commitment at www.pearson.com/environment

Governance and ethical standards

We are committed to complying with the standards of corporate governance in all countries in which we operate, including the governance rules contained in the Combined Code on Corporate Governance. Our Director for people has board responsibility for matters relating to Corporate Responsibility.

We also recognise the additional standards that are expected of us in terms of how we conduct our business to ensure we behave and report in an open and transparent manner. Pearson has established its own code of conduct and whistleblowing policies. These are supported by detailed policies on specific issues such as editorial standards and we adhere to external codes such as those of the Press Complaints Commission. Editors and journalists have freedom to make their own content choices within these frameworks. These codes are enforced as an integral part of editorial management and are subject to regular communication, training, and compliance audits.

Risk management

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

Government regulation

The manufacture of certain of our products in various markets is subject to governmental regulation relating to the discharge of materials into the environment. Our operations are also subject to the risks and uncertainties attendant to doing business in numerous countries. Some of the countries in which we conduct these operations maintain controls on the repartition of earnings and capital and restrict the means available to us for hedging potential currency fluctuation risks. The operations that are affected by these controls, however, are not material to us. Accordingly, these regulations have not significantly affected our international operations. Regulatory authorities may have enforcement powers that could have an impact on us. We believe, however, that we have taken and continue to take measures to comply with all applicable laws and governmental regulations in the jurisdictions where we operate so that the risk of these sanctions does not represent a material threat to us.

Principal risks and uncertainties

Our intellectual property and proprietary rights may not be adequately protected under current laws in some jurisdictions and that may adversely affect our results and our ability to grow.

Our products largely comprise intellectual property delivered through a variety of media, including newspapers, books and the internet. We rely on trademark, copyright and other intellectual property laws to establish and protect our proprietary rights in these products. We cannot be sure that our proprietary rights will not be challenged, invalidated or circumvented. Our intellectual property rights in countries such as the US and UK, jurisdictions covering the largest proportion of our operations, are well established. However, we also conduct business in other countries where the extent of effective legal protection for intellectual property rights is uncertain, and this uncertainty could affect our future growth. Moreover, despite trademark and copyright protection, third parties may copy, infringe or otherwise profit from our proprietary rights without our authorisation.

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Pearson Annual Report and Accounts 2007
These unauthorised activities may be more easily facilitated by the internet. The lack of internet-specific legislation relating to trademark and copyright protection creates an additional challenge for us in protecting our proprietary rights relating to our online business processes and other digital technology rights. The loss or diminution in value of these proprietary rights or our intellectual property could have a material adverse effect on our business and financial performance. In that regard, Penguin Group (USA) Inc. and Pearson Education have joined three other major US publishers in a suit brought under the auspices of the Association of American Publishers to challenge Google’s plans to copy the full text of all books ever published without permission from the publishers or authors. This lawsuit seeks to demarcate the extent to which search engines, other internet operators and libraries may rely on the fair-use doctrine to copy content without authorisation from the copyright proprietors, and may give publishers more control over online users of their intellectual property. If the lawsuit is unsuccessful, publishers and authors may be unable to control copying of their content for purposes of online searching, which could have an adverse impact on our business and financial performance.

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

We operate in a highly competitive environment that is subject to rapid change and we must continue to invest and adapt to remain competitive.

Our education, business information and book publishing businesses all operate in highly competitive markets, which are constantly changing in response to competition, technological innovations and other factors. A common trend facing all our businesses is the digitisation of content and proliferation of distribution channels, either over the internet, or via other electronic means, replacing traditional print formats. If we do not adapt rapidly to these changes we may lose business to ‘faster’ more ‘agile’ competitors, who increasingly are non-traditional competitors, making their identification all the more difficult.

To remain competitive we continue to invest in our authors, products, services and people to take advantage of these opportunities. There is no guarantee that these investments will generate the anticipated returns or protect us from being placed at a competitive disadvantage with respect to scale, resources and our ability to develop and exploit opportunities.

Other competitive threats we face at present include:

- Students seeking cheaper sources of content, e.g. online, used books or re-imported textbooks. To counter this trend we introduced our own digital textbook programmes and are providing students with a greater choice and customisation of our products.

- Competition from major publishers and other educational material and service providers, including not for profit organisations, in our US educational textbook and assessment businesses.

- Penguin: authors’ advances in consumer publishing. We compete with other publishing businesses to purchase the rights to author manuscripts, or that we will win this business.

- FT: we face competitive threats both from large media players as well as from smaller businesses, online portals and news redistributors operating in the digital arena and providing alternative sources of news and information.

- People: the investments we make in our employees, combined with our employment policies and practices, we believe are critical factors enabling us to recruit and retain the very best people in our business sectors.

Our US educational textbook and assessment businesses may be adversely affected by changes in state educational funding resulting from either general economic conditions, changes in government educational funding, programmes and legislation (both at the federal and state level), and/or changes in the state procurement process.

The results and growth of our US educational textbook and assessment business is dependent on the level of federal and state educational funding, which in turn is dependent on the robustness of state finances and the level of funding allocated to educational programmes. State finances could be adversely affected by a US recession and/or fallout from the sub-prime mortgage crisis reducing property values and hence state property tax receipts.

Federal and/or state legislative changes can also affect the funding available for educational expenditure, e.g. the No Child Left Behind Act.

Similarly changes in the state procurement process for textbooks, learning material and student tests, particularly in the adoptions market can also affect our markets. For example, changes in curricula, delays in the timing of adoptions and changes in the student testing process can all affect these programmes and therefore the size of our market in any given year.

There are multiple competing demands for educational funds and there is no guarantee that states will fund new textbooks or testing programmes, or that we will win this business.

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

Failure to generate anticipated revenue growth, synergies and/or cost savings from recent acquisitions leading to goodwill and intangible asset impairments.

We continually acquire and dispose of businesses to achieve our strategic objectives. We recently completed two relatively large acquisitions, i.e. the Harcourt Assessment and Harcourt Education International business for $895m and the acquisition of eCollege for $491m. If we are unable to generate the anticipated revenue growth, synergies and/or cost savings associated with these acquisitions there is a risk the goodwill and intangible assets acquired (estimated at $430m) could be impaired in future years.

We generate a substantial proportion of our revenue in foreign currencies, particularly the US dollar, and foreign exchange rate fluctuations could adversely affect our earnings and the strength of our balance sheet.

As with any international business our earnings can be materially affected by exchange rate movements. We are particularly exposed to movements in the US dollar to sterling exchange rate as approximately 60% of our revenue is generated in US dollars. We estimate that if 2006 average rates had prevailed in 2007, sales for 2007 would have been £228m or 6% higher.

This is predominantly a currency translation risk (i.e. non-cash flow item), and not a trading risk (i.e. cash flow item) as our currency trading flows are relatively limited.
These businesses are characterised by multi-million pound contracts spread over several years. As in any contracting business, there are inherent risks associated with the bidding process, start-up, operational performance and contract compliance (including penalty clauses) which could adversely affect our financial performance and/or reputation. Failure to retain contracts at the end of the contract term could adversely impact our future revenue growth.

At Edexcel, our UK examination board and testing business, any change in UK Government policy to examination marking – for example, introduction of new qualifications - could have a significant impact on our present business model. In addition to the internal business procedures and controls implemented to ensure we successfully deliver on our contractual commitments, we also seek to develop and maintain good relationships with our customers, whether they are commercial or governmental. We also look to diversify our portfolio to minimise reliance on any single contract.

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

New distribution channels, e.g. digital format, the internet, used books, combined with the concentration of retailer power pose multiple threats (and opportunities) to our traditional consumer publishing models, potentially impacting both sales volumes and pricing. Penguin’s financial performance can also be negatively affected if book return rates increase above historical average levels. Similarly, the bankruptcy of a major retail customer would disrupt short-term product supply to the market as well as result in a large debt write off.

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

We operate in markets which are dependent on information technology (IT) systems and technological change. All our businesses, to a greater or lesser extent, are dependent on technology. We either provide software and/or internet services to our customers or we use complex IT systems and products to support our business activities, particularly in business information publishing, back-office processing and infrastructure.

We face several technological risks associated with software product development and service delivery in our educational businesses, information technology security (including virus and hacker attacks), e-commerce, enterprise resource planning system implementations and upgrades. The failure to recruit and retain staff with relevant skills may constrain our ability to grow as we combine traditional publishing products with online and service offerings. We mitigate these IT risks by employing project management techniques to manage new software developments and/or system implementations and have implemented an array of security measures to protect our IT assets from attack.

Reputational damage to our brands and financial loss arising from a major data privacy breach. Across our businesses we hold increasingly large volumes of personal data including that of employees, customers and, in our assessment businesses, citizens. Failure to adequately protect personal data could lead to penalties, significant remediation costs and/or reputational damage.

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

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

Across our businesses we hold increasingly large volumes of personal data including that of employees, customers and, in our assessment businesses, citizens. Failure to adequately protect personal data could lead to penalties, significant remediation costs and/or reputational damage.

The diversification of the FT Group into other business models and revenue streams, e.g. subscription based businesses, higher proportion of digital revenues, increased business to business products, conferences and its global reach, goes some way to offsetting reliance on newspaper print advertising.

A control breakdown in our school assessment businesses could result in financial loss and reputational damage.

There are inherent risks associated with our school assessment businesses, both in the US and UK. A breakdown in our testing and assessment products and processes could lead to a mis-grading of student tests and/or late delivery of test results to students and their schools. In either event we may be subject to legal claims, penalty charges under our contracts, non-renewal of contracts and/or the suspension or withdrawal of our accreditation to conduct tests. It is also probable that such events would result in adverse publicity, which may affect our ability to retain existing contracts and/or obtain new customers.

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

Our professional services and school assessment businesses involve complex contractual relationships with both government agencies and commercial customers for the provision of various testing services. Our financial results, growth prospects and/or reputation may be adversely affected if these contracts and relationships are not properly managed.
The protection of personal data and compliance with data privacy legislation has always been a considered a business risk. We have recently re-evaluated our data security procedures and controls across all our businesses with the aim of ensuring personal data is secured and we comply with relevant legislation.

Operational disruption to our business caused by a major disaster and/or external threats restricting our ability to supply products and services to our customers.

Across all our businesses we manage complex operational and logistical arrangements including distribution centres, data centres and large office facilities as well as relationships with third party print sites. Failures, increased member life expectancy, changes in actuarial assumptions and changes in pension regulations, including accounting returns, increased member life expectancy, changes in actuarial assumptions and changes in pension regulations, including accounting returns, could all affect our business and employees, disrupting our daily business activities.

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

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

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

We draw on our experience of developing businesses outside our core markets and our existing international infrastructure to manage specific country risks, as well as expanding our financial control resources in those areas. The diversification of our international portfolio, and relative size of ‘emerging markets’ in relation to the group, further minimises the effect any one territory could have on the overall group results.

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

We operate a number of pension plans throughout the world, the principal ones being in the UK and US. The major plans are self-administered with the plans’ assets held independently of the Group. Regular valuations, conducted by independent qualified actuaries, are used to determine pension costs and funding requirements.

It is our policy to ensure that each pension plan is adequately funded, over time, to meet its ongoing and future liabilities. Our earnings and cash flows may be adversely affected by the need to provide additional funding to eliminate pension fund deficits in our defined benefit plans.

Our greatest exposure relates to our UK defined benefit pension plan. Pension fund deficits may arise because of inadequate investment returns, increased member life expectancy, changes in actuarial assumptions and changes in pension regulations, including accounting rules and minimum funding requirements.

The latest valuation of our UK defined benefit pension plan has been completed and future funding arrangements have been agreed between the company and the pension fund Trustee. Additional payments amounting to £100m were made by the company in 2007.

We review these arrangements every three years and are confident that the pension funding plans are sufficient to meet future liabilities without unduly affecting the development of the company.

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

Changes in corporate tax rates and/or other relevant tax laws in the UK and/or the US could have a material impact on our future reported tax rate and/or our future tax payable. We have internal tax professionals in the UK and US who review all significant arrangements around the world and respond to changes in tax legislation. They work closely with local management and external tax advisers.

Social, environmental and ethical risk

We consider social, environmental and ethical (SEE) risks no differently to the way we manage any other business risk. Our 2007 risk assessments did not identify any significant under-managed SEE risks, nor have any of our most important SEE risks, many concerned with reputational risk, changed year on year. These are:

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

Our risk reporting systems together with our approach to managing the key SEE risks above are described in ‘Our Business and Society’, the Pearson Corporate Responsibility Report. The web link is available at www.pearson.com/community/csr_report2007

Financial risk management

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

The main risks arising from the Group’s financial instruments are interest rate risk, liquidity and refinancing risk, counterparty risk and foreign currency risk. These risks are managed by the Chief financial officer under policies approved by the board, which are summarised below. All the treasury policies remained unchanged throughout 2007.

The audit committee and a group of external treasury advisers, receives reports on the Group’s treasury activities, policies and procedures. The treasury department is not a profit centre and its activities are subject to regular internal audit.
### Interest rate risk management

The Group’s exposure to interest rate fluctuations on its borrowings is managed by entering into rate swaps, rate caps and forward rate agreements. The Group’s policy objective has continued to be to set a target proportion of its forecast borrowings (taken at the year end, with cash netted against floating rate debt and before any adjustments for IFRS) to be hedged (i.e. fixed or capped at the year end) over the next four years, subject to a maximum of 65% and a minimum that starts at 40% and falls by 10% at each year end. At the end of 2007 the hedging ratio, on the above basis, was approximately 58%. A simultaneous 1% change on 1 January in the Group’s variable interest rates in each of US dollar, euro and sterling, taking into account forecast seasonal debt, would have a 6% effect on profit before tax.

### Liquidity and refinancing risk management

The Group’s objective is to ensure continuity of funding at a reasonable cost. To do this it seeks to arrange committed funding for a variety of maturities from a diversity of sources. The Group’s policy objective has been that the weighted average maturity of its core gross borrowings (treating short-term advances as having the final maturity of the facilities available to refinance them) should be between three and ten years. At the end of 2007 the average maturity of gross borrowings was 4.6 years of which bonds represented 72% of these borrowings (up from 4.5 years and down from 90% respectively at the beginning of the year).

The Group believes that ready access to different funding markets also helps to reduce its liquidity risk, and that published credit ratings and published financial policies improve such access. All of the Group’s credit ratings remained unchanged during the year. The long-term ratings are Ba1 from Moody’s and BBB+ from Standard & Poor’s, and the short-term ratings are P2 and A2 respectively.

The Group’s policy is to strive to maintain a rating of Ba1/BBB+ over the long term. The Group will also continue to use internally a range of ratios to monitor and manage its finances. These include interest cover, net debt to operating profit and cash flow to debt measures. The Group also maintains undrawn committed borrowing facilities. During the year the Group extended the maturity date of its main revolving credit facility to 2011. The Group also maintains undrawn committed borrowing facilities. During the year the Group extended the maturity date of its main revolving credit facility to 2011.

### Use of interest rate derivatives

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

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

### Interest rate derivative sensitivity analysis

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.

<table>
<thead>
<tr>
<th>2007 £ millions</th>
<th>Net carrying amount</th>
<th>+1% change</th>
<th>–1% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate derivatives – in a fair value hedge relationship</td>
<td>10 (24) 26</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate derivatives – not in hedge relationship</td>
<td>(1) 1 (1)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross currency rate derivatives – in a net investment hedge relationship</td>
<td>17</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>Gross currency rate derivatives – not in hedge relationship</td>
<td>9</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>35 (23) 25</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Gross borrowings by currency:

<table>
<thead>
<tr>
<th>2007 £ millions</th>
<th>£ millions</th>
<th>2006 £ millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate derivatives – in a fair value hedge relationship</td>
<td>3 (28) 31</td>
<td></td>
</tr>
<tr>
<td>Interest rate derivatives – not in hedge relationship</td>
<td>7 1 (1)</td>
<td></td>
</tr>
<tr>
<td>Gross currency rate derivatives – in a net investment hedge relationship</td>
<td>40</td>
<td>–</td>
</tr>
<tr>
<td>Gross currency rate derivatives – not in hedge relationship</td>
<td>17 (1) 1</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>67 (28) 31</td>
<td></td>
</tr>
</tbody>
</table>
Business Review continued

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

The policy above applies only to currencies that account for more than 15% of Group operating profit before depreciation and amortisation, which currently is only the US dollar. However, the Group still borrows small amounts in other currencies, typically for seasonal working capital needs. In addition, the Group currently expects to hold legacy borrowings in sterling to their maturity dates: our policy does not require existing currency debt to be terminated to match declines in that currency’s share of Group operating profit before depreciation and amortisation. Included within year end net debt, the net borrowings/(cash) in the two principal currencies above (taking into account the effect of cross currency swaps) were: US dollar £1,119m and sterling £45m.

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

Financial instruments – sensitivity analysis
The sensitivity of the Group’s financial instruments to fluctuations in interest rates and exchange rates is as follows:

<table>
<thead>
<tr>
<th>All amounts in £ millions</th>
<th>Impact of 1% increase in interest rates</th>
<th>Impact of 1% decrease in interest rates</th>
<th>Impact of 10% strengthening in sterling</th>
<th>Impact of 10% weakening in sterling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments in unlisted securities</td>
<td>52</td>
<td>–</td>
<td>(4)</td>
<td>5</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>560</td>
<td>–</td>
<td>(36)</td>
<td>44</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>40</td>
<td>–</td>
<td>(3)</td>
<td>4</td>
</tr>
<tr>
<td>Derivative financial instruments</td>
<td>35</td>
<td>(23)</td>
<td>25</td>
<td>11</td>
</tr>
<tr>
<td>Bonds</td>
<td>(1,150)</td>
<td>24</td>
<td>(26)</td>
<td>71</td>
</tr>
<tr>
<td>Other borrowings</td>
<td>(458)</td>
<td>–</td>
<td>–</td>
<td>42</td>
</tr>
<tr>
<td>Other net financial assets</td>
<td>408</td>
<td>–</td>
<td>–</td>
<td>(29)</td>
</tr>
<tr>
<td>Total financial instruments</td>
<td>(513)</td>
<td>1</td>
<td>(1)</td>
<td>52</td>
</tr>
</tbody>
</table>

The table shows the sensitivities of the fair values of each class of financial instruments to an isolated change in either interest rates or foreign exchange rates. The class ‘Other net financial assets’ comprises trade assets less trade liabilities.

The sensitivities of derivative instruments are calculated using established estimation techniques such as discounted cash flow and option valuation models.

A large proportion of the movements shown above would impact equally rather than the income statement, depending on the location and functional currency of the entity in which they arise and the availability of net investment hedge treatment.

The changes in valuations are estimates of the impact of changes in market variables and are not a prediction of future events or anticipated gains or losses.

Robin Freestone, Chief financial officer