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Burmedia Investments Ltd, company
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Pearson plc

Annual Report and Accounts 2013



80 Strand
London WC2R 0RL

Registered Number 53723 (England)

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Helping people make measurable progress in their lives through learning

ANNUAL REPORT AND ACCOUNTS 2013

OUR TRANSFORMATION

To find out more about how we are transforming our business go to page 09

EFFICACY

To find out more about our focus on efficacy go to page 14

OUR PERFORMANCE

For an in-depth analysis of our performance in 2013 go to page 19

ALWAYS LEARNING

Pearson is the world's leading learning company, with 40,000 employees in more than 80 countries working to help people of all ages to make measurable progress in their lives through learning.

We provide learning materials, technologies, assessments and services to teachers and students in order to help people everywhere aim higher and fulfil their true potential

We put the learner at the centre of everything we do

READ OUR REPORT ONLINE

Learn
more

www.pearson.com/ar2013.html

To stay up to date with Pearson throughout the year, visit our blog at blog.pearson.com and follow us on Twitter – @pearsonplc

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Financial highlights

In financial terms, Pearson's goal is to achieve sustainable growth on three key financial goals – earnings, cash and return on invested capital, and reliable cash returns to our investors through healthy and growing dividends

In 2013 trading was tough in many of our biggest and most established markets. At the same time we are now in a more intensive phase of investment, investing much more, both in building the technology and related infrastructure, and in the next generation of products and services. We also continue to finance the one-off costs of the biggest restructuring in Pearson's recent history. Headline earnings and cash were again lower than the previous year and our return on invested capital fell to 5.4% from 9.1% in 2013. We are proposing a 7% dividend increase.

	2013 £m	2012 £m	HEADLINE GROWTH	CER GROWTH	UNDERLYING GROWTH
Business performance					
Sales	5,177	5,059	2%	2%	1%
Adjusted operating profit before net restructuring charges	871	932	(7)%	(6)%	(9)%
Adjusted operating profit	736	932	(21)%	(21)%	(23)%
Adjusted earnings per share	70.1p	82.6p	(15)%		
Operating cash flow	588	788	(25)%		
Free cash flow	269	657	(59)%		
Free cash flow per share	33.3p	81.7p	(59)%		
Return on invested capital	5.4%	9.1%	–		
Net debt	1,379	918	(50)%		

Statutory results

Sales	5,069	4,959	2%
Operating profit	458	487	(6)%
Profit before tax	382	391	(2)%
Basic earnings per share	66.6p	38.7p	72%
Cash generated from operations	684	916	(25)%
Dividend per share	48.0p	45.0p	7%

Note

- a) Growth rates are stated on a constant exchange rate (CER) basis unless otherwise stated. Where quoted underlying growth rates exclude both currency movements and portfolio changes. Unless otherwise stated, sales exclude Penguin while operating profits include both Penguin and our share of Penguin Random House (PRH). Continuing operations exclude both Penguin and Mergermarket but include our share of PRH.
- b) The business performance measures are non-GAAP measures and reconciliations to the equivalent statutory heading under IFRS are included in notes 2, 7 and 8 to the financial statements.

2013 SALES

£5.2bn
+2%

2013 ADJUSTED OPERATING PROFIT

Before net restructuring charges

£871m
-6%

OUR FIVE YEAR RECORD

Average annual growth in headline terms 2008–2013

Adjusted earnings per share

+4%

Operating cash flow

-6%

Dividend

+7%

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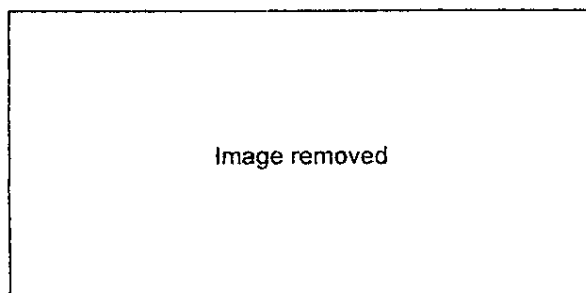
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*Exclude: Penguin/PRH (£28m)

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Chairman's introduction



Glen Moreno Chairman of Pearson

While the business environment remains challenging, the board is confident that Pearson is well placed with a clear plan to deliver future growth and create value for our shareholders.

Dear shareholders,

Pearson has always invested time and energy in producing a clear and compelling annual report, but with the new edition of the UK Corporate Governance Code now in place we have worked particularly hard to ensure that our annual report and accounts is fair, balanced and understandable. At this important time in the company's history we have focused on providing the information necessary for shareholders to fully assess the company's business model, strategy, development, performance, position and future prospects.

2013 was an extremely significant year for Pearson and the first full year under the leadership of John Fallon as chief executive. Our restructuring programme – designed to accelerate our shift towards fast-growing economies and digital and services businesses – is on track and we began 2014 under a new, integrated operating model for a single and global education company.

As a company we also made a series of unique commitments designed to measure and increase the company's impact on learning outcomes around the world, including to commit to report audited learning outcomes alongside our financial accounts, covering our whole business by 2018.

Strengthening the board and executive team

John Fallon has strengthened his executive team by promoting our best internal talent and recruiting some exceptional global leaders in their specific fields.

We have also focused on the development of the board, which I address in the Governance section of this report. With recent and planned appointments, I am confident that the board reflects the right blend of skills and experience to guide Pearson in the best interests of shareholders.

SHARE PRICE PERFORMANCE

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TOTAL SHAREHOLDER RETURN

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A challenging 2013

As CFO Robin Freestone outlines in his report (page 19), our 2013 financial performance was challenging. Market conditions continued to be strong in digital, services and emerging markets but remained more difficult in some of our largest textbook publishing markets.

These challenges were reflected in our share price performance, which underperformed our indices. While the business environment remains challenging, the board is confident that Pearson is well placed with a clear plan to deliver future growth and create value for our shareholders. Longer term, our share price and total shareholder return have reflected a 10 year track record of strong business performance. We are now focused on establishing a base for similar business growth over the next decade.

Continued transformation

As I said in last year's annual report, the basic direction of Pearson's strategy has not changed but we are accelerating the pace to shift capital and talent more quickly towards our most significant growth opportunities. The restructuring of our global education business, continued investment in technology and focus on operational efficiency are well underway.

I am confident that the global demand for affordable and effective learning will continue to grow. As the world's leading learning company we are in an increasingly strong position to take advantage of this demand and deliver products and services that measurably improve learning outcomes for our customers and learners. I am also confident that this will positively impact shareholder value.

Glen Moreno Chairman

Our business models

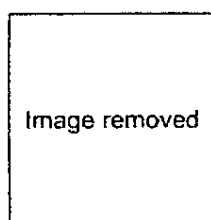
Pearson is the world's leading learning company, working to support learners and teachers in over 80 countries around the world.

Whether it's through new digital learning products in the US, developing qualifications and assessments in the UK, training school leaders in the Middle East, teaching English in China or educating professionals through content from the *Financial Times*, we're helping people make measurable progress in their lives through learning.

Our products and services may be provided and used in a standalone way but are increasingly integrated and customised to meet the needs of individual education systems, customers and learners. We have identified four major market opportunities for our products and so we create value for our customers in four different, but related ways, outlined below.

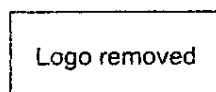
BUSINESS MODEL

Inside services



Where we provide a set of integrated services to institutions (public and private) that have an institution-wide impact on improved learning outcomes (often at lower cost)

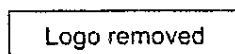
Includes



Sistema COC provides a complete solution: from digital and traditional learning to assessment tools and pedagogical support, for pre-K12 schools in Brazil, reaching 160,000 students.



Embanet is the leading provider of online learning services for the world's premier schools, colleges and universities.



We provide technology and management services to support ASU's online students. ASU is the largest public university in the US by enrolment.

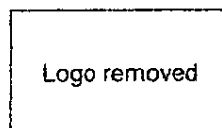
BUSINESS MODEL

Direct delivery

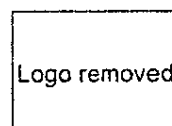


Where we own and operate the learning institution (physical, virtual and/or blended), providing an integrated learning environment direct to the learner rather than through other parties.

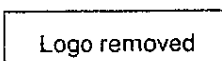
Includes



CTI is a private higher education institution in South Africa, offering full and part-time studies in Information Technology, Psychology and Counselling, Creative Arts and Graphic Design, Commerce and Law, on campuses spread throughout South Africa.



Wall Street English is among the largest providers of English language instruction for adults and corporate clients around the world, operating over 450 centres in 28 countries.



Connections Academy offers a variety of accredited virtual school options for students in grades K-12 in the US.

Underpinning the effectiveness of each of these four models, from design through to delivery, is the Efficacy Framework, a tool we have devised to help understand how our products or services can achieve the best possible outcomes or results. You can read more about our commitment to efficacy from page 14, and online at efficacy.pearson.com

Like any business, we understand that there are certain risks associated with each model. Read more about how we are managing and mitigating these on pages 41 to 45

Associates and joint ventures

We have a 47% stake in Penguin Random House, the world's first truly global trade book publisher. Penguin Random House was formed on 1 July 2013, upon the completion of an agreement between Bertelsmann and Pearson to merge their respective trade publishing companies, Random House and Penguin. Other associates and joint ventures include Vedomosti in Russia and a 50% stake in The Economist Group.

BUSINESS MODEL

Learning services



The individual elements of our products, including learning materials, that are increasingly digital in nature and operating as part of an integrated learning ecosystem

Includes



enVisionMATH is designed for students in grades K–6 and seeks to help students develop an understanding of maths concepts through problem-based instruction, small group interaction and visual learning with a focus on reasoning and modelling.

MyLab & Mastering

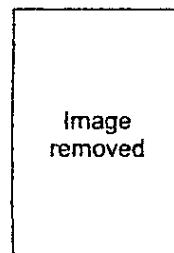
MyLab & Mastering is the world's leading collection of online homework, tutorial and assessment products. Creates personalised and continuously adaptive learning experiences.

speakout

Speakout is an award-winning English course for adults used around the world. In partnership with the BBC, it includes exercises, small group work, audio clips and video clips from well-known TV programmes.

BUSINESS MODEL

Assessment

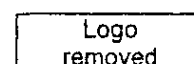


Where we provide services that enable an institution or system to measure and validate learner progress towards relevant standards or to certify competency

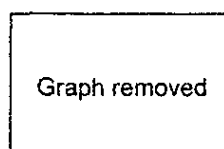
Includes

PEARSON VUE

Pearson VUE is the world's leading computer-based testing and assessment business, working with organisations of all sizes to create flexible, custom-built assessment solutions and delivering them in a secure and reliable testing environment.



BTEC vocational qualifications are recognised in more than 80 countries worldwide and in 2011/2012 over 2m learners registered for BTECs, including 650,000 school students.



We create, deliver and process state and national assessments in the US. In 2013 we administered nearly 50m online and paper tests.

We have a remarkable opportunity

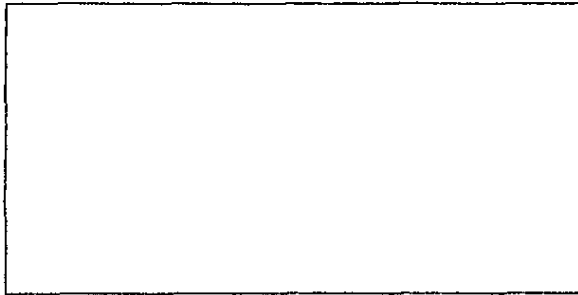
to make an impact

on some of the biggest and toughest

challenges in education

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Pearson's strategy: John Fallon, Chief executive



John Fallon Chief executive of Pearson

By accelerating the transformation of Pearson we become more confident of our ability to seize that once in a generation opportunity – to become directly accountable for helping people make progress in their lives through learning.

Dear shareholders,

Last year, in my first letter to you as Pearson's chief executive, I wrote about the establishment of a clear Pearson education strategy and its accelerated implementation. That acceleration – the transformation of the company – is now well underway. Twelve months on, I am convinced that we started it not a moment too soon, and that the changes we need to make must go deeper, and happen faster, than I originally envisaged.

The global opportunity

The long-term opportunity in global education is greater than ever. Last year, the OECD reported that poor math and literacy skills limit access to better-paying and more-rewarding jobs. People who are strong in these skills are not just wealthier and live healthier lives, they are also more actively engaged in public life. Nelson Mandela was right: education really is the most powerful weapon with which to change the world.

As rapid advances in technology continue to disrupt the world of work, the economic value of education and skills will continue to increase. Governments spend trillions of dollars per year on education and training, and, each year, the still rapidly growing middle class invests more of its own increasing wealth in the education of themselves and their children. And yet, the world fails to meet the learning needs of far too many of our fellow citizens. One in five adults in today's world still lack the written communication skills they need to progress in life, 57 million children remain out of school, and many millions more are in education, but not really learning anything very much at all.

Pearson has a unique set of advantages with which to help meet this global demand for better education and skills, in part by applying technology to help tangibly improve learning outcomes. And, by being better able to meet some of the biggest challenges in global education, we can build a stronger, more profitable and faster growing company.

Pearson's strategy John Fallon, Chief executive continued

The transformation of our company

To seize this opportunity, we need to accelerate our shift from mature to developing markets, from print to digital products and from education inputs to services with demonstrable learning outcomes. For much of the last decade, we've been implementing this strategy by reshaping the company portfolio through acquisitions and disposals – and we continued this work last year. We completed the Penguin Random House merger, securing both Penguin's commercial and creative future and the opportunity for significant economies of scale. We sold Mergermarket in February 2014, which has flourished under Pearson's ownership, but was not part of our strategy in global education. The sale proceeds helped us to finance the acquisition of Grupo Multi, the leading adult English language training company in Brazil. It fits very well with our strategy of investing more in faster growing economies and in digital and related services that can have a greater and more measurable impact on education around the world.

More urgently, the strategy now demands that we run the company in a fundamentally different way, too. Early last year, we started the biggest restructuring in the company's recent history, to tilt us towards our biggest growth opportunities, and by measuring everything we do in terms of impact in improving learning outcomes.

This is what we are doing

- 1 Redirecting more of our operating expenses, and our organic investment, more quickly to our most promising opportunities

We need fewer people, and resources, deployed in the publishing, production and manufacturing of textbooks and their physical distribution, sales and marketing. We need less print-based testing capacity, as we consolidate our operations and move more towards online testing. By spending much less on these activities as demand falls (for example, US Higher Education textbook volumes have declined by more than 20% in four years), we can invest much more in our biggest growth opportunities (for example, MyLab digital registrations and our sales in emerging markets have both doubled over the same period).

WE ARE TRANSFORMING FASTER

Our revenues in emerging markets

\$1,302m

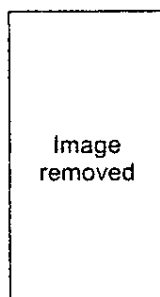
£819m

2013

\$471m

£235m

2007



Our revenues in digital products and services

\$4,727m

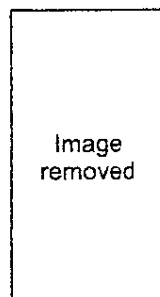
£3,020m

2013

\$2,253m

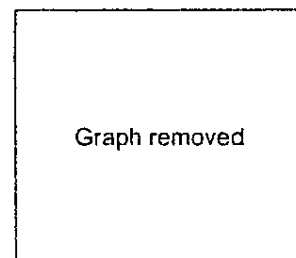
£1,125m

2007



Our revenues in print vs digital products and services

2013 revenues



Print Digital and services

2 Running Pearson as one globally connected company

Our operations are now entirely focused on our global education strategy in which we include the FT Group. We have appointed a new executive team to lead it. We'd outgrown our organisation and, as a collection of relatively stand-alone companies, we were duplicating investment and proliferating small-scale initiatives, limiting our ability to build global scale. We are now organising around a smaller number of global products and platforms, built around a single, world-class infrastructure and common systems and processes. This will help us to grow more quickly, as it frees up resources to invest in our digital transformation, and the new, more service-oriented, products that are vital to future growth.

3 Publicly committing to efficacy and improving learning outcomes

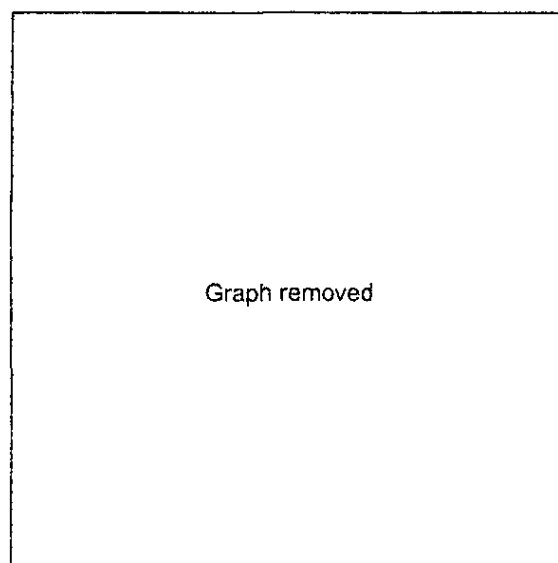
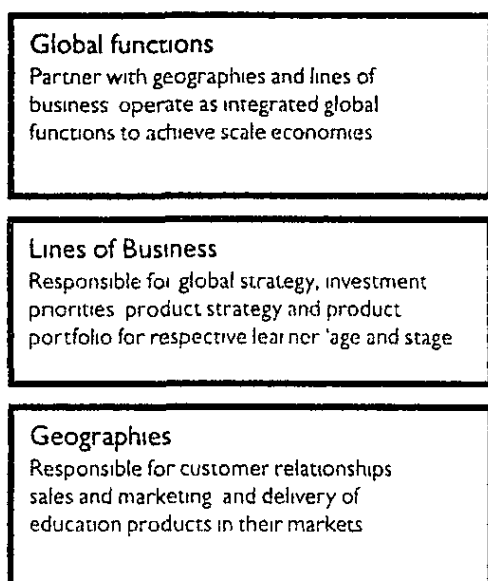
We will judge ourselves – and invite others to judge us – not by the products that we make but by their impact on learners. This changes how we decide which companies to acquire, where and how we invest, which products we get behind and which

we retire. It changes how we recruit, train and reward each and every person in this company. It will change how we develop new products, unleashing, I believe, a new wave of innovation and creativity across the company. It will be difficult to pull off, and it will take time. That's why we specifically talk about the 'path to efficacy' that we are on. And it is why we have committed to providing audited learning outcomes data for all our products and services by 2018. But, as detailed elsewhere in this report, we are making some specific, and measurable, efficacy commitments for this year.

4 We are putting the learner at the heart of everything we do

We are putting the learner at the heart of everything we do. Our commitment to efficacy recognises the fact that, whilst our customer is often a teacher, an institution, an education authority, a parent, or a company, the real beneficiary of our work – and of our customers' work – is always the learner. Our purpose as a company – and, ultimately, the true measure of our success – is whether we really do help to equip more people with the education and skills they need to progress in their lives.

WORKING AS ONE PEARSON



Pearson's strategy: John Fallon, Chief executive continued

A necessary transition

This is changing the way that every person in the company works. At times, it is proving difficult and disruptive. In the short term, it is made more painful, but all the more necessary, by the fact that we are battling against a number of cyclical, policy-related, structural and operational headwinds. These led to a sharp decline in earnings and free cash flow last year and will continue to make life difficult for us in 2014.

- › The creation of Penguin Random House is a major portfolio change, which creates economic value for Pearson, but the move to associate accounting reduces our reported operating profit in 2013 and 2014.
- › Our US college business, our biggest and most profitable activity, is highly counter-cyclical, as enrolments grow strongly during a recession, when jobs are harder to come by, and then fall back in the early years of economic recovery.
- › Our two big assessment and qualifications businesses, in the US and the UK, are seeing demand fall in the short term due to changes in government policy, which will open up new, and bigger, opportunities as these changes are implemented.

The transformation of our company is fundamental to get ahead of the significant structural changes taking place in education – chiefly the digital shift, in which Pearson is playing a leading role. It means that we are now in a much more intensive phase of investment at the same time as we are financing the one-off costs of the biggest restructuring in Pearson's recent history. We are investing much more, both in building the technology and related infrastructure, and in the next generation of products and services, that are vital to making the most of that global education opportunity.

We make this investment with confidence as we continue to grow strongly in emerging markets and with our digital and service-related products. In future years, investing in these new growth areas will be financed by cutting back in the print-led related areas I outlined earlier. But, first, we face significant one-off costs, both in 2013 and again in 2014, to achieve this.

UNIQUE MARKET POSITION

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An ever more purposeful, and faster growing, company

We have a lot of work ahead of us, but when I write again in 12 months we will have completed our second year of significant restructuring and reorganisation. We will be reaping the rewards of significant investment, and we will start to see the benefits of a more favourable trading environment as those headwinds, over time, begin to ease and the operational risks recede.

By accelerating the transformation of Pearson, we are ensuring that we shorten this transitional period – and that we get the company growing in a more profitable and sustainable manner, as quickly as we can. As we do so, we open up, for Pearson, bigger growth opportunities, a larger addressable market and a greater impact on learning outcomes.

We become more confident of our ability to seize that once-in-a-generation opportunity – to become directly accountable for helping people make progress in their lives through learning. We see the chance for Pearson to be the stand-out company in education, which is now emerging as one of the new global growth industries.

I thank all my colleagues for all their hard work and commitment, including all our former colleagues, who have served the company with such distinction. I'm sorry to see many good colleagues leave the company as a result of our restructuring and I wish them every success in their future careers. I also thank all our shareholders for their support and patience through this short, sharp transition.

I'm determined to ensure that it is rewarded, as soon as possible, by building a leaner, more cash generative and faster growing business – and one ever more equipped to tackle some of the biggest and most intractable problems in global education.

John Fallon Chief executive

Pearson's commitment to efficacy

In November 2013, Pearson announced a new commitment to report on learning outcomes across its product portfolio from 2018. This new and transparent approach to efficacy is central to our purpose to help people make progress in their lives through learning.

We want Pearson's customers to be confident that working with us will help them to achieve their long-term learning goals and enable them to make progress in their lives

In November 2013, Pearson announced a new commitment to report on learning outcomes across its product portfolio from 2018. We also published *The Incomplete Guide to Delivering Learning Outcomes*, sharing the actions we have taken over the last two years to prepare our company to meet this unique challenge and demonstrate the efficacy of our products

This new and transparent approach to efficacy is central to our purpose and also makes good business sense. We hope that by demonstrating the evidence base that supports our products we will encourage a deeper engagement with learning outcomes across the education sector and at the same time clearly demonstrate the benefits of using those products

We are now defining the practical approach that we will take to reporting publicly on learning outcomes in 2018, and how we will demonstrate and report on our progress along the 'Path to Efficacy'

Below, we summarise our work to date and share our priorities for 2014. Our approach will continue to be refined in the coming years as we work towards our goal, and we will consult upon it within and outside of Pearson through 2014 and beyond. Our vision is that by 2018, we will report on learning outcomes alongside our financial results

We welcome comments, feedback and support as we take our next steps. Please email our senior vice-president of efficacy, Saad Rizvi saad.rizvi@pearson.com with any questions or comments that you may have

Pearson's Efficacy Framework and Review Process

Pearson has developed an Efficacy Framework to support our product development and management teams to define measurable learning outcomes for Pearson products and services, and progressively to improve the likelihood of achieving them

The Framework is a tool of systematic discovery that helps us to ask key questions about our solutions, and evaluate the likelihood that they will deliver their intended learner outcomes

A standardised Efficacy Review process accompanies the Framework to ensure its wide and consistent use across the organisation. More detail on the Framework, review process and scoring system can be found at efficacy.pearson.com

THE EFFICACY FRAMEWORK

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How it works

Using this Framework we assess the potential efficacy of a product or programme against 12 criteria. By giving each criteria a rating on the four point scale (green to red) we gauge the likely overall effectiveness of a product. The Framework serves to identify specific areas which, if improved, will increase our likelihood of intended impact. Teams are able focus their activity on taking these steps before the product is assessed again.

EMBEDDING THE EFFICACY FRAMEWORK

Our progress

- › In 2012 we began using the Efficacy Framework to review all investments above \$3m in value and in 2014 all investments above \$1m will undergo a review. Products and programmes are repeatedly reviewed over time to ensure progress and improvements are being made.
- › Pearson acquisition opportunities are reviewed using the Framework to evaluate the opportunity to improve learning outcomes through Pearson ownership.
- › We will now focus on securing the consistency with which the Framework is applied by clarifying our definitions and expectations of research, efficacy and quality standards.

Key statistics at year end 2013

123

Reviews completed, including nine potential acquisitions and 14 internal functions

33%

Showed progress in repeat reviews

Our plans in 2014

- › A standardised Pearson Product Lifecycle will be introduced ensuring that the principles which support greater efficacy are embedded consistently in all new product investments.
- › We will increase the number of repeat Reviews on single products and increase the percentage of products showing an improved score between Reviews.
- › Pearson's Lines of Business and Geographies will be reviewed against Key Performance Indicators which address the implementation of Pearson's Efficacy Framework and Review processes.
- › At least 40 of our top products will have in place the detailed targets, measures and systems necessary to track learner outcomes over time.
- › All new product developments will have defined and measurable learner outcomes.
- › We will have at least three products which are already in a position to report on learning outcomes, covering the range of learner ages and stages.

Pearson's commitment to efficacy continued

Towards reporting on outcomes

The Efficacy Framework and Review process ensures that all Pearson products and programmes address the factors that could affect the learning outcomes that they are ultimately able to produce, in a consistent way

Scores on the Framework do not in themselves represent evidence of impact. Pearson's ultimate goal is to produce evidence of impact against defined learning outcomes for all of our products

Evidence will take a variety of forms depending on where a product is within its lifecycle. Efficacy evidence tends to be a longitudinal measure requiring multiple measurements over the lifecycle of a product. The standard of evidence that is available will vary by product according to the specific learning outcome targets for that product and its maturity

We anticipate therefore, that the nature of evidence will vary by product and time. We will be transparent about the standard for each of our products

TOWARDS REPORTING OUTCOMES

Our plans in 2014

- › We will investigate and consult on how best to define our evidence standards, working with an independent partner
- › We will complete and share efficacy studies that demonstrate learner outcomes for several product categories

As we move towards 2018

- › We will be able to make available increasing detail about the standard of evidence that exists for each of our products, in support of its stated intended outcome and the estimated number of learners reached by that product. Our goal is to continually improve the standard of evidence available
- › Executives will be measured on learner outcome-oriented KPIs, including the quality of evidence available across their product portfolios, along with financial returns
- › KPIs will be updated and refined to include targets which capture Pearson's aggregated impact on agreed learning outcomes. Areas addressed may include academic quality, employability, learner progression, access or affordability

Improving outcomes, in partnership

By using the Efficacy Framework and committing to high standards of evidence, we will be better able to anticipate and mitigate potential challenges to our products' efficacy, and to report back clear evidence as to their success in improving defined learning outcomes

We are acutely aware that our efficacy challenge is not one we can meet alone. We rely on guidance, support and insights of our colleagues and partners across the education community. We see a significant opportunity to work in collaboration to debate and address the broad educational research questions that will inform and improve our contribution to learning worldwide, and drive continuous improvement across education

As part of our commitment to efficacy in November we brought together experts from inside and outside of education to share their perspectives on the opportunity ahead to improve learning outcomes globally through the paper *Asking More: The Path to Efficacy*. We also began a series of public engagements on the topic of efficacy, bringing together experts in dedicated events at the National Institute of Education in Singapore, and the MIT Media Lab in Boston. We also discussed the challenges around efficacy at important global events such as the Education World Forum in London and the World Economic Forum in Davos.

PROGRESS IN 2013-14

An Avalanche is Coming

Sir Michael Barber, Saad Rizvi, Katelyn Donnelly published with think tank IPPR, this report explores the challenges and opportunities for higher education in an age of MOOCs, lifelong learning and students as consumers

www.ippr.org/publication/55/10432/an-avalanche-is-coming-higher-education-and-the-revolution-ahead

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Alive in the Swamp

Professor Michael Fullan, Katelyn Donnelly published with Nesta, this report addresses the impact of digital innovation in education

www.nesta.org.uk/publications/alive-swamp-assessing-digital-innovations-education

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Learning Metrics Task Force

Pearson co-chaired this Brookings Foundation initiative which sought input from more than 1,700 individuals in 118 countries to make a series of recommendations on improving learning opportunities and outcomes for children and young people worldwide

www.brookings.edu/research/reports/2013/09/learning-metrics-task-force-universal-learning

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Asking More: The Path to Efficacy

This pamphlet shares insights from some of the world's leading education practitioners and business people to highlight the urgent need for a global focus on outcomes in education

efficacy.pearson.com

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A Rich Seam: How New Pedagogies Find Deep Learning

Published in partnership with ITSE, MaRS Discovery District and Nesta, Professor Michael Fullan and Maria Langworthy's report asks how technology in schools is changing the student-teacher relationship

research.pearson.com

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We will continue and extend this programme of research, dialogue and engagement in 2014 and 2015, working with partners to pursue and share research outputs around eight key questions which we believe will shape the effectiveness of education in the future, through our new Global Research Function. This includes exploring educator quality and pedagogy, system reform and the future role of learning technologies and learning science in improving outcomes.

Our research is now shared at research.pearson.com

Putting the learner

at the heart

of everything we do

Image removed

Our performance: 2013 financial overview

OVERVIEW

OUR PERFORMANCE

RESPONSIBLE BUSINESS

GOVERNANCE

FINANCIAL STATEMENTS

Image removed

Robin Freestone, Chief financial officer of Pearson

In 2013, Pearson increased sales by 2% in headline terms to £5.2bn generating adjusted operating profit of £736m after net restructuring charges.

Penguin Random House was reported post-tax following completion of the transaction on 1 July 2013 and resulted in a £23m reduction in the contribution to operating income with an equal benefit to our tax charge. We expensed £135m of net restructuring charges during the year. Adjusted operating profit including the negative impact of Penguin Random House associate accounting but excluding the restructuring charges was £871m.

The headline growth rates were helped by both currency movements and acquisitions. Currency movements increased sales by £19m (with a £50m benefit primarily from a stronger dollar partly offset by a £31m reduction from non-dollar currency depreciation relative to sterling, primarily in emerging markets) but reduced operating profits by £4m (with an £8m benefit from a stronger dollar more than offset by a £12m reduction from non-dollar currency depreciation). At constant exchange rates (i.e. stripping out the impact of those currency movements), our sales and adjusted operating profit grew 2% and declined 21%, respectively.

KEY FINANCIAL GOALS

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Acquisitions contributed £119m to sales and £50m to operating profits. This includes integration costs and investments related to our newly-acquired companies, which we expense. Disposals and our exit from Pearson in Practice reduced revenues by £49m but boosted operating income by £23m. Associate accounting arising from the Penguin Random House transaction reduced operating income by £23m.

Stripping out the impact of portfolio changes, the Penguin Random House transaction, net restructuring costs and benefit and currency movements, revenues grew by 1% underlying while adjusted operating profit declined by 9%.

Our tax rate in 2013 was 14.6% compared to 23.1% in 2012 reflecting the associate accounting impact from Penguin Random House and movements in tax settlements in each year.

Adjusted earnings per share before the impact of net restructuring charges were 83.4p (2012: 82.6p). Total adjusted earnings per share after net restructuring charges were 70.1p.

Our performance 2013 financial overview continued

Cash generation

Headline operating cash flow declined by £200m reflecting restructuring and increased investment in new education programmes. Free cash flow declined by £388m to £269m, additionally reflecting higher tax payments. Our average working capital to sales ratio improved by a further 0.4 percentage points to 13.4%, helped by lower inventory levels and the absence of Penguin in the second half of the year.

Return on invested capital

Our return on average invested capital was 5.4% (2012: 9.1%). ROIC was affected by lower underlying profit, restructuring costs and higher cash taxes.

Statutory results

Our statutory results show a decrease of £29m in operating profit to £458m, from £487m in 2012, reflecting the absence in 2013 of the £113m closure-related costs for Pearson in Practice in 2012, lower underlying profits and restructuring costs. Basic earnings per share increased to 66.6p in 2013, up from 38.7p in 2012, mainly due to the Penguin Random House transaction.

Balance sheet

Our net debt increased to £1,379m (£918m in 2012) reflecting higher cash tax payments from settlements and deferred payments from 2012 due to Hurricane Sandy, lower cash conversion costs associated with disposals, restructuring costs and increased pre-publication investment. Since 2000, Pearson's net debt/EBITDA ratio has fallen from 3.9x to 1.6x and our interest cover has increased from 3.1x to 10.2x.

Dividend

The board is proposing a dividend increase of 7% to 48.0p, subject to shareholder approval. 2013 will be Pearson's 22nd straight year of increasing our dividend above the rate of inflation. Over the past 10 years we have increased our dividend at a compound annual rate of 7%, returning more than £2.9bn to shareholders. We have a progressive dividend policy: we intend to build our dividend cover to around 2.0x over the long term, increasing our dividend more in line with earnings growth from then.

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Outlook 2014

In 2014, we will continue the major restructuring and product investment programme, initiated in 2013, designed to accelerate Pearson's shift towards significant growth opportunities in digital, services and fast-growing economies. We believe this will provide Pearson with a significantly larger market opportunity, a sharper focus on the fastest-growing markets and stronger financial returns.

This restructuring coincides with continued structural, cyclical and policy-related pressures in some of our largest markets. At this early stage in the year, we expect to report adjusted earnings per share of between 62p and 67p in 2014. This guidance incorporates our expected trading environment, restructuring activity and product investment. This guidance also assumes current sterling exchange rates against the dollar and key emerging market currencies.

The major factors behind our guidance are as follows:

Portfolio changes

The sale of Mergermarket to BC Partners was completed on 4 February 2014 and will reduce 2014 adjusted operating profit before central costs by £28m. This will be partly offset by a part-year contribution from Grupo Multi, which will be diluted by integration costs and the weakness of the Real against sterling.

We expect the contribution to adjusted operating profit from Penguin Random House to be approximately £20m lower in 2014 compared to the £78m contribution in 2013. That reflects currency movements, integration charges (which will be concentrated in the first half of 2014) and an additional half-year of associate accounting.

Currency movements

Pearson generates approximately 60% of its sales in the US. A five cent move in the average £/\$ exchange rate for the full year (which in 2013 was £1/\$1.57) has an impact of approximately 1.2p on adjusted earnings per share. The move from an average £/\$ exchange rate of 1.57 in 2013 to the rate at the end of February of 1.67 will reduce operating income by approximately £30m if it continues for the full year. Similarly, when compared to 2013 average exchange rates, Sterling has significantly appreciated against a range of non-dollar currencies, primarily in emerging markets. If current exchange rates for those markets persist throughout 2014, that would reduce operating income on our 2013 base business by a further £20m.

Restructuring and investment programme

We will benefit from the absence of £176m of gross restructuring charges expensed in 2013, which we expect to generate £60m of incremental cost savings in 2014.

These benefits will be partly offset by an additional net restructuring charge of approximately £50m in 2014, primarily in North America and weighted towards the first half of the year. Our goal is to complete our restructuring programme by the end of 2014, returning to more normal annual levels of restructuring expenditure from 2015.

As previously announced, we expect additional product investment of approximately £50m in 2014 in digital, services and emerging markets to accelerate growth.

Trading conditions

We expect trading conditions to remain challenging in 2014, reflecting

In North America, our largest market, we expect college enrolments to decline again and some states to defer assessment programmes as they transition to the Common Core State Standards. Though we expect the School publishing market to show some improvement, we expect the benefits to be largely offset by higher revenue deferrals and pre-publication amortisation. We expect margins to be lower in 2014 when compared to 2013, reflecting the above organic outlook, revenue mix, launch costs for major multi-year service-based contracts, higher amortisation and new product development expenditure.

In our Core markets (which include the UK and Australia), we see tough trading conditions in the UK as curriculum change affects school, vocational publishing and assessments, market stabilisation in Australia, and a new adoption year in Italy.

In our Growth markets (which include Brazil, China, India and South Africa), we expect continued growth in China with Brazil benefitting from a better year in public sistemas and a part-year contribution from Grupo Multi. We expect a slower year in South Africa after strong gains in 2013.

Looking at our global Lines of Business, we expect School and Higher Education to remain challenging, especially in our two largest markets, North America and the UK. In Professional, we expect continued good growth in Pearson VUE and English with the *Financial Times* continuing to benefit from its digital transition.

Interest and tax

We expect our interest charge to be similar to 2013 reflecting higher floating rates broadly offset by a weaker dollar against sterling. We expect a tax rate of between 19% and 21% on our total profit before tax (which includes the post-tax contribution from Penguin Random House).

As Pearson's structure has changed to better suit our marketplace and aspirations, so must our financial reporting change. In this year's annual report, we discuss the progress made through the lens of our existing financial reporting segments (North American Education, International Education, Professional and the Financial Times Group). We will report our 2014 revenues and operating profit against new segments that better reflect the shape of our business, these will be by Geography (North America, Core and Growth) and by Line of Business (School, Higher Education and Professional).

We will make available historical 2013 half-year and full-year revenues and operating profit by Line of Business and Geography in the second quarter of 2014.

Creating personalised products and services

that meet learners' needs

and deliver measurable results

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North American Education

KEY PERFORMANCE INDICATORS

North American Education is Pearson's largest business, with 2013 sales of £2.8bn and operating profit of £406m.

Sales		Adjusted operating profit	
2013	£2,779m	2013	£406m
2012	£2,658m	2012	£536m
Headline growth	5%	Headline growth	(24)%
CER growth	3%	CER growth	(25)%
Underlying growth	0%	Underlying growth	(30)%

CASE STUDY

Online learning

We introduced adaptive learning capabilities in over 200 MyLab and Mastering products across 11 subjects. Student registrations in North America grew 9% to almost 11 million. Usage continues to grow strongly with graded submissions up 15% to almost 370 million across the globe. Evaluation studies show that the use of MyLab programmes as part of a broader course redesign,

can significantly improve student test scores and institutional efficiency (<http://bit.ly/1derVjm>). We acquired Learning Catalytics, which allows faculty to obtain real-time responses to open-ended or critical thinking questions, to determine which areas require further explanation, and enables earlier intervention to help improve retention and outcomes.

Total number of MyLab registrations

9.9m
2012

11m
2013

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North American Education continued

In 2013, we generated good growth in our digital and services businesses, where we continue to invest to build scale and volume and solid growth in our school curriculum business, which benefited from Common Core curriculum purchasing. Market conditions remained tough, with ongoing state budget pressures and the transition to the Common Core affecting our School assessment business. Lower enrolments affected Higher Education with the career college enrolments, where we have a strong market position, being particularly weak. In addition to these market pressures, our North American margins were further affected by £49m of net restructuring charges, reduced demand in our assessment business as states prepared for new Common Core testing and curriculum related investment and amortisation, the launch costs related to major multi-year service-based contracts in higher education, and increased returns provisions.

Higher Education highlights in 2013 include

- › In Higher Education, total enrolments fell 1.9%, with career enrolments in two-year public (community) and four-year for-profit declining 4.4%, affected by rising employment rates, state budget pressures and regulatory change affecting the for-profit and developmental learning sectors. The publishing market was broadly level with 2012 on a gross basis, according to the Association of American Publishers, while our higher education revenues grew 5% with an underlying decline more than offset by the contribution from Embanet.
- › We partnered with West Virginia University Parkersburg Online to redesign its Developmental Education curriculum using Competency-Based Education (CBE) modules. Our CourseConnect CBE products will enhance up to 220 existing courses and will be delivered through OpenClass where we will also provide access to eTextbooks, tutoring and media resources. Other CBE partnerships include Texas A&M University-Commerce, South Texas College, Kentucky Community & Technical College System and Northern Arizona University.

School highlights in 2013 include

- › For our School businesses, state funding pressures, the Federal sequester and the transition to Common Core assessments continued to make market conditions tough. Revenues grew modestly in 2013 with declines in state assessment contracts and learning assessments more than offset by gains in national assessment contracts for the PARCC consortium and the federal government's NAEP programme, as well as demand for Connections Education's virtual charter schools and Common Core reading/language arts and math programmes.
- › Actionable data is critical to personalising learning and boosting achievement. Our Schoolnet business aligns assessment, curriculum and other services to help individualise instruction and improve teacher effectiveness. PowerSchool helps teachers automate and manage student attendance records, gradebooks and timetables.
- › Schoolnet won significant contracts including two new Race to the Top State Instructional Improvement System contracts in New York and New Jersey, which takes the total number of state system contracts to seven, and new district contracts for Schoolnet assessment, educator development and learning management solutions in Dallas, Texas, Palm Beach, Florida, Philadelphia, Pennsylvania, and New York City. PowerSchool won new contracts in Charlotte-Mecklenburg, North Carolina, Grand Erie DSB, Ontario, and San Diego, California. Its mobile app connecting teachers, students and parents was downloaded by almost 3.4 million users. PowerSchool now supports almost 13 million students (in 70 countries), up more than 5% on 2012 while Schoolnet supports more than nine million students, up 7% on 2012.

CASE STUDY

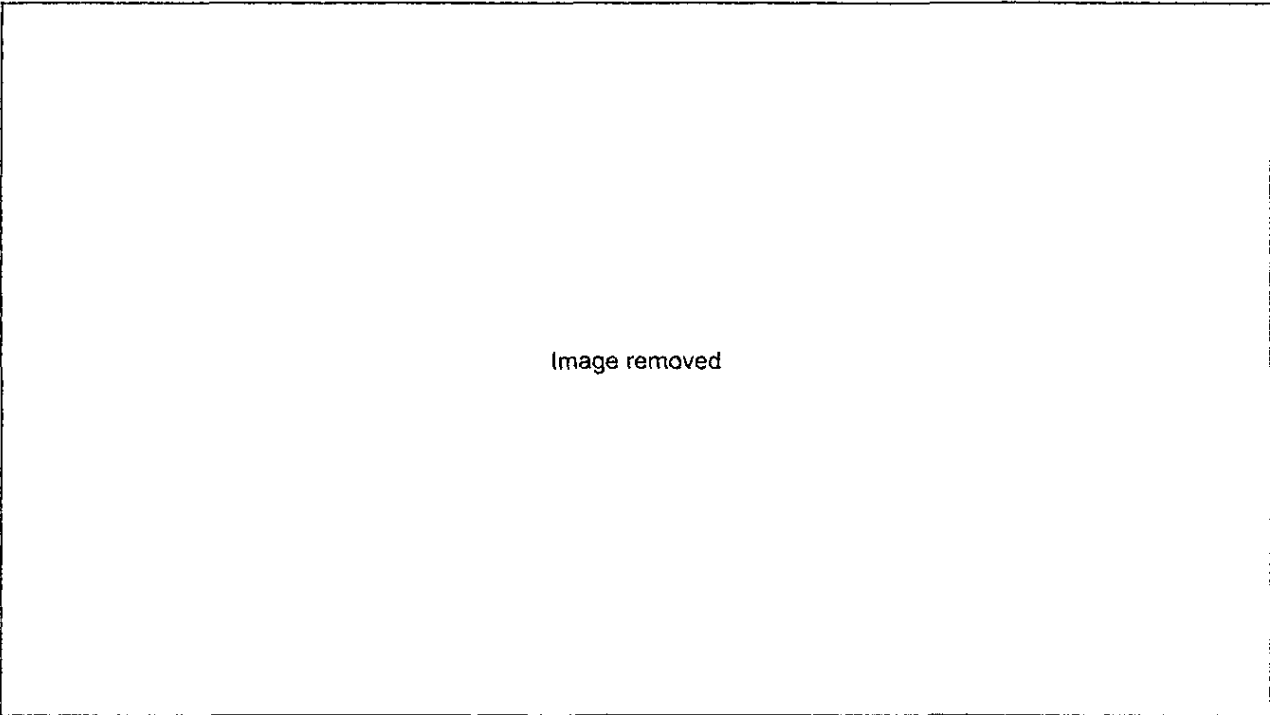


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Online learning

programmes

Enterprise-wide partnerships with Arizona State University Online, Ocean Community College, Indiana Wesleyan University and Rutgers, where we run fully online learning programmes and earn revenues based on the success of the students and the institution gained more than 64,000 student registrations, up 45% on 2012. In January 2014, we extended our partnership with the University of Florida to include both its graduate and undergraduate programmes providing technology, e-Textbooks, recruitment marketing, enrolment management, student support and retention services

Pearson Embanet increased new student enrolments by 8% to almost 12,000 and total student enrolment by 6.5% to more than 27,000, adding 16 new programmes, launching three new key academic partners with Adelphi University, Villanova University and University of Maryland, and expanding partnerships with existing customers such as Maryville and Northeastern. More than 200 colleges are working with Pearson to build online learning programmes that improve access to high quality undergraduate and graduate degree programmes

North American Education continued

- › The Partnership for Assessment of Readiness for College and Careers (PARCC), a consortium of 18 states, awarded Pearson several contracts to deliver test item tryouts, develop field tests and to provide the online delivery platform using our cloud-based, mobile-ready TestNav 8 system for new English and mathematics assessments. The assessments will be based on what students need to be ready for college and careers, and will measure and track their progress along the way. We helped Kentucky and New York deliver the first Common Core aligned state assessments, and we won new online assessment programmes in Colorado, Minnesota and Mississippi. We continued to produce strong growth in secure online testing. We delivered almost 12 million secure online tests, up 33% on 2012. Legislative changes in Texas and California reduced the scope of assessments ahead of Common Core implementation.
- › We renewed our contract with the US Department of Education to administer the National Assessment of Educational Progress (NAEP) for the 2013–2017 assessment cycles and won a number of state contract extensions in Georgia, Puerto Rico, Tennessee, Maryland, Arizona, South Dakota and Oklahoma. We were selected by the National Board of Professional Teaching Standards (NBPTS) as their partner to develop their next-generation programmes, and deliver and support NBPTS through 2025.
- › ACT Aspire, a college and career readiness assessment aligned to the Common Core State Standards, successfully launched its first field test on the new TestNav 8 assessment system. ACT Aspire is a joint venture between Pearson and ACT, Inc. Alabama is the first state to adopt the ACT Aspire system for measuring the Common Core State Standards.
- › Connections Education, which operates K-12 managed virtual public schools, managed blended public schools, and a private school, served almost 51,000 students in December 2013, up more than 20% from 2012, and now operates 33 managed public schools in 23 states and an international private virtual school. Connections Education also provides virtual and blended services to school districts and other schools seeking to incorporate virtual learning into their programmes. Connections Academy Schools have consistently high performance ratings, particularly in states focused on measuring growth in student learning.

CASE STUDY

Mental health

administration

Pearson Clinical Assessment launched Q-interactive, a portable digital tool that enables mental health professionals to automatically manage the administration of clinical assessments, digital stimuli, response recording through stylus notes and audio. It serves 1,500 users within hospitals, private practice, and schools in five countries (US, UK, Australia, Canada and Netherlands). Paid test administrations have increased ten-fold since launch.

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CASE STUDY



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Learning

Services

In Learning Services, we performed well in new adoptions, taking a market leading 33% of the total new adoption market (\$390m), with #1 positions in maths, science and social studies and a #2 position in Reading/Language Arts. We were selected by the two largest school districts in the US, Los Angeles Unified School District and New York City, to implement Common Core instructional programmes. New York City adopted our new K-5 Common Core English Language Arts programme, Ready Gen, and our middle school math offering, Connected Math. In Los Angeles Unified School District, we partnered with Apple to deliver our

innovative next generation digital learning Common Core System of Courses across K-12 Mathematics and English Language Arts, initially to 30,000 students. In both districts, we are providing professional development to thousands of teachers. Learners using our OnRamp to Algebra supplemental programme, which targets struggling maths students, significantly out-gained peers using other supplemental maths programmes, achieving 20% increase in their percentile rank while their peers increased by only 3%. In addition, students of all ability levels using OnRamp to Algebra exceeded the gains of their peers.

International Education

KEY PERFORMANCE INDICATORS

Our International Education business achieved another strong underlying performance in emerging markets, particularly in South Africa and China.

Sales		Adjusted operating profit	
2013	£1,539m	2013	£140m
2012	£1,568m	2012	£214m
Headline growth	(2)%	Headline growth	(35)%
CER growth	0%	CER growth	(29)%
Underlying growth	1%	Underlying growth	(30)%

CASE STUDY

China

In China, student enrolments at Wall Street English increased 7% to 65,000, boosted by good underlying demand. Our students rapidly acquire high-level English skills with average grade levels achieved rising by 14% during 2013. Enrolments at Global Education, our test preparation services for English language and vocational qualifications, increased 24% to more than 1.3 million, through 82 owned and 426

franchised learning centres with investment in learning centres and digital learning platforms enabling us to better meet learner demands and be a premier brand in test preparation. Around 70% of the high-end course students achieve IELTS 7.0 which demonstrates a high level of proficiency in English and a key grade when studying abroad.

Wall Street English student enrolments in China

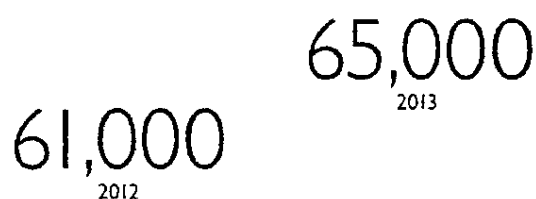


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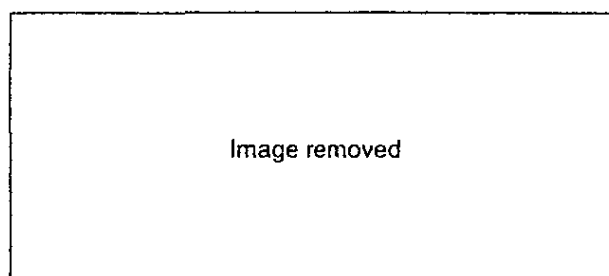
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Our International education business achieved another strong underlying performance in emerging markets, particularly in South Africa and China. This growth was offset by weak textbook sales in developed markets, currency weakness against sterling, the exit from certain publishing businesses primarily in Australia, Japan, Germany, France and the UK, increased customisation resulting from the Kirtsang ruling in the US, and policy changes affecting qualifications and textbook publishing in the UK. Although margins before restructuring charges were similar to 2012, reported margins fell due to £69m of net restructuring charges expensed during the year. More than 1.3 million students registered for our MyLab digital learning, homework and assessment programmes, an increase of 17%, with good growth in school, ELT and institutional selling in higher education.

Key highlights in 2013 include

- › Our Growth market revenues expanded strongly, boosted by curriculum change in South Africa, strong enrolment growth at CTI/MGI, and continued good growth in China, partly offset by weaker currencies against sterling, particularly in South Africa and enrolment declines in our public sistemas in Brazil.
- › In Mexico, our fully accredited online university partnership, UTEL, reached 6,000 active students in 20 undergraduate and two graduate programmes and through its services arm, Scala, signed its first three agreements to help campus-based universities make the transition to online. 5,400 students have completed short duration courses in programmes developed to address corporate and government workforce training needs.
- › In the Middle East, we won a five-year contract with the UAE's Ministry of Education to provide leadership training and professional development for 700 current and future Emirati school principals, in partnership with the UK's National College for Teaching and Leadership. We partnered with Taibah University in Saudi Arabia to implement Foundation Level MyLabsPlus across four subjects for 16,000 students, Riyadh's Princess Noura University in Saudi Arabia, the world's largest female university, to provide 12,000 new students with IT course content (through our MyLabs e-learning technology) for tablets, and Qatar University to implement MyLabsPlus for 5,000 students.

CASE STUDY



In South Africa our market leading school publishing brands Maskew Miller Longman and Heinemann, performed strongly in a year of significant curriculum reform. Student enrolments grew strongly at CTI/MGI, our universities, up 15% to 11,700 across 13 campuses.

- › Our Core market revenues declined significantly, affected by curriculum change in the UK and the exit from publishing operations in Australia, Japan and Continental Europe.
- › In the UK, revenues declined due to a softer school curriculum and vocational qualifications (BTEC) market anticipating curriculum change. This was partly offset by a strong performance in the GCSE and A/AS level qualifications market. In higher education, we partnered with Leeds Metropolitan University to develop a suite of online learning business education courses. In assessment, we marked almost six million GCSE, A/AS Level and other examinations with more than 93% using onscreen technology. We marked 2.7 million test scripts for over half a million pupils taking National Curriculum Tests at Key Stage Two in 2013 and were selected to administer the test until 2016. 2013 also saw the first delivery of the Next generation BTEC qualifications to over 100,000 students, with a further 365,000 students to date enrolled for 2014/15 delivery.

International Education continued

- › In Italy, revenues declined, with market conditions tough due to a one-year government mandated pause in new adoptions
- › In Japan, GlobalEnglish and the FT partnered with Nikkei Inc on a 'GlobalEnglish Nikkei edition', an English language learning service to serve English students in the Japanese business community. We sold our school textbook publishing business, Kiri-hara Shoten, to management
- › In Australia, market conditions were very tough, particularly in higher education where we exited the vocational publishing market. We continue to make good progress developing our digital and services business including significant sales of Secondary School Australian Curriculum ebooks. In higher education, we partnered with Monash University with an enterprise implementation of the MyLab suite of products for 6,500 students including faculty training, and to provide learning services and solutions for online graduate programmes including course development, marketing, student recruitment and retention, and faculty training
- › In English Language Learning, Wall Street English (WSE), Pearson's worldwide chain of English language centres for professionals, opened a new centre in Ho Chi Minh City in Vietnam (and is now present in 28 countries), and has 107 owned and 338 franchised centres. Our students rapidly acquire high-level English skills with average grade levels achieved rising by 8% during 2013. Student numbers grew slightly to 192,000. Registered users for ELL digital products grew 45% to 610,000 with MyEnglishLabs registrations up 51% to 400,000 and Our Discovery Island registrations, an online adventure aimed at Primary education, up almost 77% to 104,000

CASE STUDY

Brazil

In Brazil, we ended 2013 with 497,000 students (533,000 in 2012) in our public and private sistemas (or learning systems). In 2013, we added 24,000 net students in our three private sistemas, COC, Dom Bosco and Pueri Domus, up 7% on 2012. Tough market conditions for public sistemas resulted in lower enrolments in this post-election year but our NAME sistema includes the #1 performing lower secondary school in Brazil based on the 2011 IDEB (national public test) scores of 3,067 municipalities. 90% of our municipal customers tested 20% above the national standard and 70% of the municipalities that adopted NAME showed improvement in their IDEB scores. On 11 February 2014 we completed the acquisition of Grupo Multi, the largest provider of private language schools in Brazil serving over 800,000 students across more than 2,600 franchised schools.

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Professional Education

KEY PERFORMANCE INDICATORS

Our Professional Education business is focused on publishing, training, testing and certification for professionals.

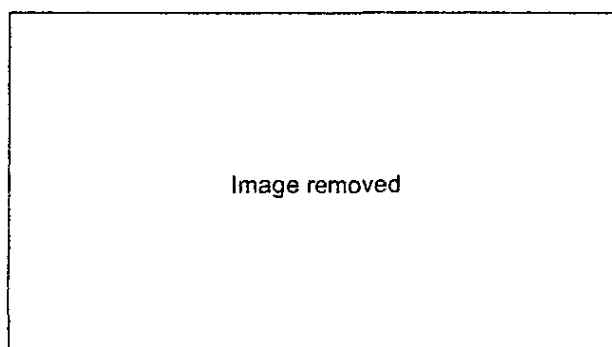
Our Professional Education business is focused on publishing, training, testing and certification for professionals. The Professional division performed well, with good revenue and profit growth in testing and training partly offset by declines in publishing.

Key highlights in 2013 include

- › Professional publishing revenues and profits declined, with good profit growth in the US, underpinned by a strong performance in our direct ecommerce sales and at Safari Books Online, our joint-venture with O'Reilly Media, offset by exiting some of our professional publishing businesses in Continental Europe
- › Professional testing continued to see good revenue and profit growth test volumes at Pearson VUE up 25% on 2012 to almost 12 million. Key contract renewals included tests for the American Board of Internal Medicine, the Association of Social Work Boards and the Pharmacy Technician Certification Board. We will continue to deliver our UK contract to administer the Driving Theory test for the DVSA until September 2016. We won a number of new contracts for computer-based testing including the Charter of Financial Analysts, Saudi Commission of Health Specialties and the Korean Productivity Centre.

Sales		Adjusted operating profit	
2013	£410m	2013	£57m
2012	£390m	2012	£37m
Headline growth	5%	Headline growth	54%
CER growth	4%	CER growth	51%
Underlying growth	8%	Underlying growth	(7)%

CASE STUDY



Vocational training in

Saudi Arabia

In Professional training, TQ grew strongly and was awarded a five-year contract by Saudi Arabia's Colleges of Excellence to develop and operate three vocational colleges in Saudi Arabia, providing high quality vocational skills and qualifications. The three colleges opened in the second half of 2013 with an expected initial intake of 1,100 students, rising to 8,000 students over time.

Financial Times Group

KEY PERFORMANCE INDICATORS

The Financial Times Group achieved profits of £55m, an underlying increase of 17% year-on-year.

Sales		Adjusted operating profit	
2013	£449m	2013	£55m
2012	£443m	2012	£47m
Headline growth	1%	Headline growth	17%
CER growth	0%	CER growth	17%
Underlying growth	0%	Underlying growth	17%

CASE STUDY

Growth in digital readership

The FT's total circulation grew 8% year-on-year to 652,000 across print and online, the highest paying readership in its 125-year history. FT.com digital subscriptions grew 31% to 415,000, more than offsetting planned reductions in print circulation. Digital subscribers now represent almost two-thirds

of the FT's total paying audience and corporate users grew nearly 60% to more than 260,000. We continue to invest to shift resources from analogue to digital and have further reduced leased printing capacity globally since 31 December 2012 from 20 to 16 sites.

Financial Times digital subscriptions

415,000
2013

316,000
2012

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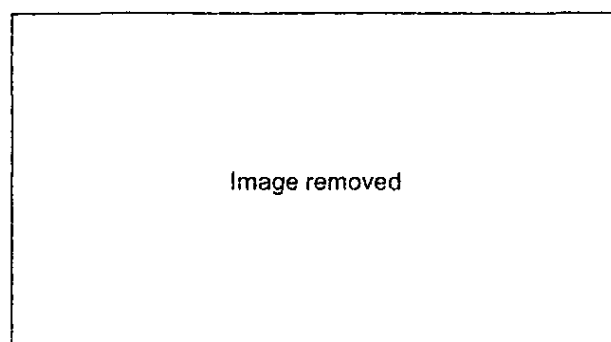
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The Financial Times Group achieved profits of £55m an underlying increase of 17% year-on-year. This was driven by strong growth in digital and content businesses and improved print circulation margins which more than offset weak advertising. Digital and services revenues accounted for 55% of FT Group revenues (31% in 2008). Content revenues comprised 63% of revenues (48% in 2008), while advertising accounted for 37% of FT Group revenues (52% in 2008).

Key highlights in 2013 include

- › Advertising continued to be short term and generally weak, but the FT increased its market share with luxury and financial sectors showing good growth in digital
- › Mobile is an increasingly important channel for the FT, driving 62% of subscriber consumption, 45% of total traffic and almost a quarter of new digital subscriptions. The FT's flagship web app now has more than 5 million users and new FT apps on Google Newsstand and Flipboard have strengthened our mobile offering. Other innovations, including launching 24-hour news service fastFT, redesigns to mobile apps and improvements to FT.com, have helped significantly increase overall digital engagement
- › The Economist Group, in which Pearson owns a 50% stake, had a record operating profit after tax, up 3% on 2012. Content revenues accounted for 60% of total revenues (44% in 2008) and digital and services revenues comprised 39% of total revenues (29% in 2010). Global print and digital circulation at *The Economist* reached a record high of 1.6 million
- › On 4 February 2014 we completed the disposal of Mergermarket to BC Partners for £382m, payable in cash. In 2013, Mergermarket contributed £108m of revenue and £28m of adjusted operating profit before central costs

CASE STUDY



Executive

education

The FT continues to expand its executive education business. FT in Education products, including annotation tool FT Newsline, are now used by almost 300 education institutions, including 37 of the world's top 50 business schools. The FT launched its Non-Executive Director (NED) Diploma in Hong Kong. More than a third of NED enrolments are now outside the UK.

Penguin Random House

The merger of Penguin and Random House was completed on 1 July 2013. Bertelsmann owns 53% and Pearson owns 47% of Penguin Random House, the first truly global consumer publishing company.

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Penguin Random House traded well in the second half of the year, with a strong bestseller performance in all major territories. Penguin Random House was reported post-tax following completion of the merger on 1 July 2013 and resulted in a £23m reduction in the contribution to our operating income with an equal benefit to our tax charge. Market share normalised, following the unprecedented success of E L James' *50 Shades of Grey* trilogy for Random House in 2012.

The integration of the two companies has commenced in each of its territories. Divisional structures are being combined, systems integration is underway, and the US business has announced a plan to consolidate distribution operations.

Key highlights in 2013 include

- › In Australia, where market conditions remain challenging, we had four out of the top five bestsellers for the year: Jeff Kinney's *Hard Luck*, *Diary of a Wimpy Kid*, Jamie Oliver's *Jamie's 15 Minute Meals* and *Save with Jamie*, and Dan Brown's *Inferno*.
- › In Brazil, Companhia das Letras (45% stake) posted strong revenue growth driven by an expanded publishing program. In a challenging market, Penguin Random House India had more than 40 titles pro forma on the 2013 Hindustan Times Nielsen top ten in combined categories. In China, our local-publishing programme continued to grow, with notable bestsellers, including *My Life* by Li Na. DK achieved significant growth through its co-edition model with Chinese publishers. In South Africa, Penguin Random House completed the purchase of the Times Media Group's majority stake in Random House Struik, cementing our market leading position, but lost a significant agency contract during the year.
- › DK performed well, boosted by the exceptional performance of Brady Games' *GTA V Strategy Guide™*, which sold over 800,000 copies, and the ongoing success of the DK LEGO® properties, which sold almost 10 million units in 2013.
- › The pro forma ebook share of Penguin Random House global revenue is 20%. Ebook growth for Penguin continued but at a slower rate, while Random House ebook sales declined significantly year-on-year due to much lower sales for the *Fifty Shades* trilogy. Digital innovations included the launch of Bookscout, a dedicated app created for and with Facebook which enables sharing personalised reading recommendations among friends and online communities.
- › Penguin Random House's authors won numerous major literary prizes around the world, including the 2013 Nobel Prize for Literature (Alice Munro), The National Book Award for Fiction in the US (James McBride's *The Good Lord Bird*), and an unprecedented four US Pulitzer Prizes.
- › In self-publishing, Author Solutions performed well, growing significantly over 2012, and continuing to launch and plan for self-publishing imprints in conjunction with Penguin in such territories as India and South Africa.
- › For 2014, Penguin Random House has a strong publishing list with major new books from authors such as Isabel Allende, Martin Amis, Lee Child, John Cleese, Harlan Coben, Steve Coogan, Lena Dunham, Janet Evanovich, Ken Follett, Stephen Fry, Robert Gates, Ina Garten, John Grisham, Deborah Harkness, Carl Hiaasen, Jan Karon, Sue Monk Kidd, Jeff Kinney, Michael Lewis, David Mitchell, Haruki Murakami, Jamie Oliver, James Patterson, Jodi Picoult, Nora Roberts, Danielle Steel, Colm Toibin, Jacqueline Wilson, and movie tie-in paperbacks of John Green's *The Fault in Our Stars*, Gillian Flynn's *Gone Girl*, and Laura Hillenbrand's *Unbroken*.

CASE STUDY

Bestsellers in 2013

In the US, on a pro forma basis, Penguin and Random House published 480 *New York Times* bestsellers, including three out of the top five Bookscan adult fiction bestsellers for the year. Dan Brown's *Inferno*, John Grisham's *Sycamore Row* and Khaled Hosseini's *And The Mountains Echoed*. Other *New York Times* bestsellers included, in adult nonfiction Sheryl Sandberg's *Lean in*, Charles Krauthammer's *Things That Matter*, and in children's fiction John Green's #1 bestselling *The Fault in Our Stars*.

In the UK, on a pro forma basis, Penguin and Random House published 102 Bookscan bestsellers including Dan Brown's *Inferno*, David Jason's *My Life*, Jamie Oliver's *Save with Jamie*, Rachel Joyce's *The Unlikely Pilgrimage of Harold Fry*, Helen Fielding's *Bridget Jones Mad About the Boy*, and a strong ongoing overall performance from Jeff Kinney's *Diary of a Wimpy Kid* series, and from its newest volume *Hard Luck*.

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More and more people want
a better education
and new ways of learning

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Other financial information

	2013 £m	2012 £m
Net finance costs		
Net interest payable	(72)	(65)
Finance income in respect of employee benefit plans	(3)	(2)
Other net finance costs	(1)	(29)
Total net finance costs	(76)	(96)

Net interest payable in 2013 was £72m, up from £65m in 2012. Although our fixed rate policy reduces the impact of changes in market interest rates, we were still able to benefit from low average US dollar and sterling interest rates during the year. Year-on-year, average three month LIBOR (weighted for the Group's net borrowings in US dollars and sterling at each year end) fell by 0.2% to 0.3%. This decrease in floating market interest rates was offset by an increase in the Group's average net debt which was the main driver behind the Group's higher interest charge. These factors combined with lower levels of cash and deposits and the impact of new notes issued in 2013 created a decrease in the Group's average net interest payable from 7.0% to 4.8%. The Group's average net debt rose by £561m, largely reflecting acquisition activity, cash costs relating to the formation of Penguin Random House (PRH) and cash paid in respect of the closure of Pearson in Practice in 2012 together with an increase in tax and dividend payments which more than offset cash generated from operations. Cash generated from operations was lower in 2013 partly as a result of restructuring activity in the year.

Net finance costs relating to post-retirement plans have been restated to reflect the adoption of IAS 19 (revised) and under the new standard was £3m in 2013 compared to £2m in 2012. Finance costs relating to retirement benefits have been excluded from our adjusted earnings as we believe the new presentation does not reflect the economic substance of the underlying assets and liabilities.

Also included in the statutory definition of net finance costs are finance costs on put options and deferred consideration associated with acquisitions, foreign exchange and other gains and losses. Finance costs for put options and deferred consideration are excluded from adjusted earnings as they relate to future earn outs and similar payments on acquisitions and therefore do not reflect cash expended. Foreign exchange and other gains and losses are

excluded from adjusted earnings as they represent short-term fluctuations in market value and are subject to significant volatility. These other gains and losses may not be realised in due course as it is normally the intention to hold the related instruments to maturity. In 2013, the total of these items excluded from adjusted earnings was a loss of £1m compared to a loss of £29m in 2012. The majority of the loss in 2012 relates to movements in the valuation of put options associated with acquisitions. In 2013 losses relating to put options were largely offset by foreign exchange gains on a proportion of unhedged US dollar assets.

Funding position and liquid resources

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. Our objective is to secure continuity of funding at a reasonable cost from diverse sources and with varying maturities. The Group does not use off-balance sheet special purpose entities as a source of liquidity or for any other financing purposes. The net debt position of the Group is set out below.

	2013 £m	2012 £m
Cash and cash equivalents	729	1,062
Marketable securities	6	6
Net derivative assets	76	178
Bonds	(2,168)	(2,200)
Bank loans and overdrafts	(47)	(55)
Finance leases	(11)	(17)
Net debt – continuing	(1,415)	(1,026)
Net cash classified as held for sale	36	108
Total net debt	(1,379)	(918)

Acquisition activity, cash costs relating to the formation of PRH and cash paid in respect of the closure of Pearson in Practice in 2012 together with an increase in tax and dividend payments and lower than expected cash generation in 2013 are the largest contributors to the increase in the Group's net debt. Reflecting the geographical and currency split of our business, a large proportion of our debt is denominated in US dollars (see note 19 for our policy). The strengthening of sterling against the US dollar during 2013 (from \$1.63 to \$1.66 £1) decreases the sterling equivalent value of our reported net debt.

Other financial information continued

The Group's credit ratings remained unchanged during the year. The long-term ratings are Baa1 from Moody's and BBB+ from Standard & Poor's, and the short-term ratings are P2 and A2 respectively. In January 2014, Moody's changed the outlook on their short-term and long-term ratings from 'Stable' to 'Negative'. In May 2013, the Group accessed the capital markets, raising \$500m through the sale of notes maturing in May 2023 and bearing interest at 3.25%. The notes were swapped to floating rate to conform with the policy described in note 19. The Group has a \$1,750m committed revolving credit facility which matures in November 2015. At 31 December 2013 this facility was undrawn. The facility is used for short-term drawings and providing refinancing capabilities, including acting as a back-up for our US commercial paper programme. This programme is primarily used to finance our US working capital requirements, in particular our US educational businesses which have a peak borrowing requirement in June. At 31 December 2013, no commercial paper was outstanding. The Group also maintains other committed and uncommitted facilities to finance short-term working capital requirements in the ordinary course of business. Further details of the Group's approach to the management of financial risks are set out in note 19 to the financial statements.

Taxation

The effective tax rate on adjusted earnings in 2013 was 14.6% as compared to an effective rate of 23.1% in 2012. The reduction in the rate is partly explained by the associate accounting treatment of our investment in PRH – tax on the profits of PRH are netted against profits in the presentation of the associate interest and is not included in the tax line. Our overseas profits, which arise mainly in the US, are largely subject to tax at higher rates than that in the UK (which had an effective statutory rate of 23.25% in 2013 and 24.5% in 2012). These higher tax rates were largely offset by amortisation-related tax deductions and by adjustments arising from settlements with tax authorities. The reported tax charge on a statutory basis was £87m (22.8%) compared to a charge of £138m (35.3%) in 2012. The decrease in the statutory rate is due to the factors affecting the adjusted rate as described above but is also exacerbated by the lack of tax relief in 2012 on the loss on closure of Pearson in Practice. Tax paid in 2013 was £246m compared to £65m in 2012. Tax paid in 2012 was unusually low as a result of the permitted deferral of US tax payments following Hurricane Sandy. These payments were subsequently made in 2013 and were accompanied

by additional payments arising from settlements with tax authorities including £55m relating to prior year disposals.

Discontinued operations

In October 2012, Pearson and Bertelsmann announced an agreement to create a new consumer publishing business by combining Penguin and Random House. The transaction completed on 1 July 2013 and resulted in a gain on the disposal of the Penguin assets of £202m. The gain arises as Pearson no longer has control of the Penguin Group of companies. The 47% interest in the new Penguin Random House (PRH) venture has been accounted for as an equity investment from 1 July 2013.

The loss of control resulted in the Penguin business being classified as held for sale on the Pearson balance sheet at 31 December 2012 and the results for both 2012 and the first six months of 2013 have been included in discontinued operations. The share of profit from associate interest in the PRH venture arising in the second half of the year has been included in operating profit in continuing operations net of tax of £23m.

Additionally on 29 November 2013 we announced the sale on the Mergermarket Group to BC Partners. The sale was completed on 4 February 2014 and the Mergermarket business has been classified as held for sale on the balance sheet at 31 December 2013. The results for both 2012 and 2013 have been included in discontinued operations.

Non-controlling interest

There are non-controlling interests in the Group's businesses in the US, South Africa and China although none of these are material to the Group numbers. Some of the minorities in South Africa and the minorities in India were bought out in the year.

Other comprehensive income

Included in other comprehensive income are the net exchange differences on translation of foreign operations. The net loss on translation of £217m in 2013 compares to a loss in 2012 of £238m and is principally due to movements in the US dollar. A significant proportion of the Group's operations is based in the US and the US dollar weakened slightly in 2013 from an opening rate of £1/\$1.63 to a closing rate at the end of 2013 of £1/\$1.66. At the end of 2012 the US dollar had also weakened in comparison to the opening rate moving from £1/\$1.55 to £1/\$1.63.

Also included in other comprehensive income in 2013 is an actuarial gain of £79m in relation to post retirement plans. This gain arises from changes in the assumptions used to value the liabilities and from returns on plan assets that are in excess of the discount rate. The gain compares to an actuarial loss for 2012 of £103m.

Dividends

The dividend accounted for in our 2013 financial statements totalling £372m represents the final dividend in respect of 2012 (30 Op) and the interim dividend for 2013 (16 Op). We are proposing a final dividend for 2013 of 32 Op, bringing the total paid and payable in respect of 2013 to 48 Op, a 7% increase on 2012. This final 2013 dividend which was approved by the board in February 2014, is subject to approval at the forthcoming AGM and will be charged against 2014 profits. For 2013, 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 and through acquisitions. The board expects to raise the dividend above inflation, more in line with earnings growth, thereby maintaining dividend cover at around two times earnings in the long term.

Pensions

Pearson operates a variety of pension plans. Our UK group plan has by far the largest defined benefit section. We have some smaller defined benefit sections in the US and Canada but, outside the UK, most of our companies operate defined contribution plans.

The charge to profit in respect of worldwide pensions and retirement benefits after restating 2012 figures for IAS 19 (revised) and including discontinued operations amounted to £104m in 2013 (2012: £114m) of which a charge of £101m (2012: £112m) was reported in adjusted operating profit and £3m (2012: £2m) was reported against other net finance costs.

The overall deficit on the UK group plan of £19m at the end of 2012 has become a surplus of £86m at the end of 2013. The movement has arisen principally due to favourable asset returns and deficit funding. In total, our worldwide deficit in respect of pensions and other post retirement benefits fell from a deficit of £172m at the end of 2012 to a net deficit of £56m at the end of 2013.

Acquisitions and disposals

During the year the Group purchased a 5% interest in NOOK Media for \$89.5m. The Nook investment was made as part of the strategy to accelerate our move into digital content and personalised learning and was made at the same time as entering into a commercial arrangement to work together on device-agnostic platforms.

Also in the year we have completed the purchase of remaining minorities interests in some of our South African and Indian businesses.

The acquisition of Grupo Multi for £492m, announced in December 2013, completed in February 2014 and has not been reflected in the financial statements at 31 December 2013.

In the first half of the year the FT Group disposed of its associate interest in BDFM, the South African Business Media Group realising a small loss and in July 2013 the International business disposed of its Japanese school and local publishing assets via a management buy-out for a nominal sum. The sale of Mergermarket will be accounted for in 2014.

Net cash consideration for all acquisitions made in the year ended 31 December 2013 was £198m including the investment in NOOK and provisional goodwill recognised was £19m. In total, acquisitions completed in the year contributed an additional £15m of sales but did not contribute a material amount to operating profit.

Return on invested capital (ROIC)

Our ROIC is calculated as total adjusted operating profit less cash tax, expressed as a percentage of average gross invested capital. ROIC fell in 2013 to 5.4% from 9.1% in 2012. Reduced profit and increased tax payments are the main reasons for the movement.

Related party transactions

Transactions with related parties are shown in note 37 of the financial statements.

Post-balance sheet events

On 4 February 2014 the Group completed the sale of Mergermarket for £382m. On 11 February 2014, we acquired 100% of Grupo Multi, the leading adult English language training company in Brazil for approximately £435m in cash plus the assumption of £57m of debt.

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Applying and working with the best

technology, innovation

and expertise

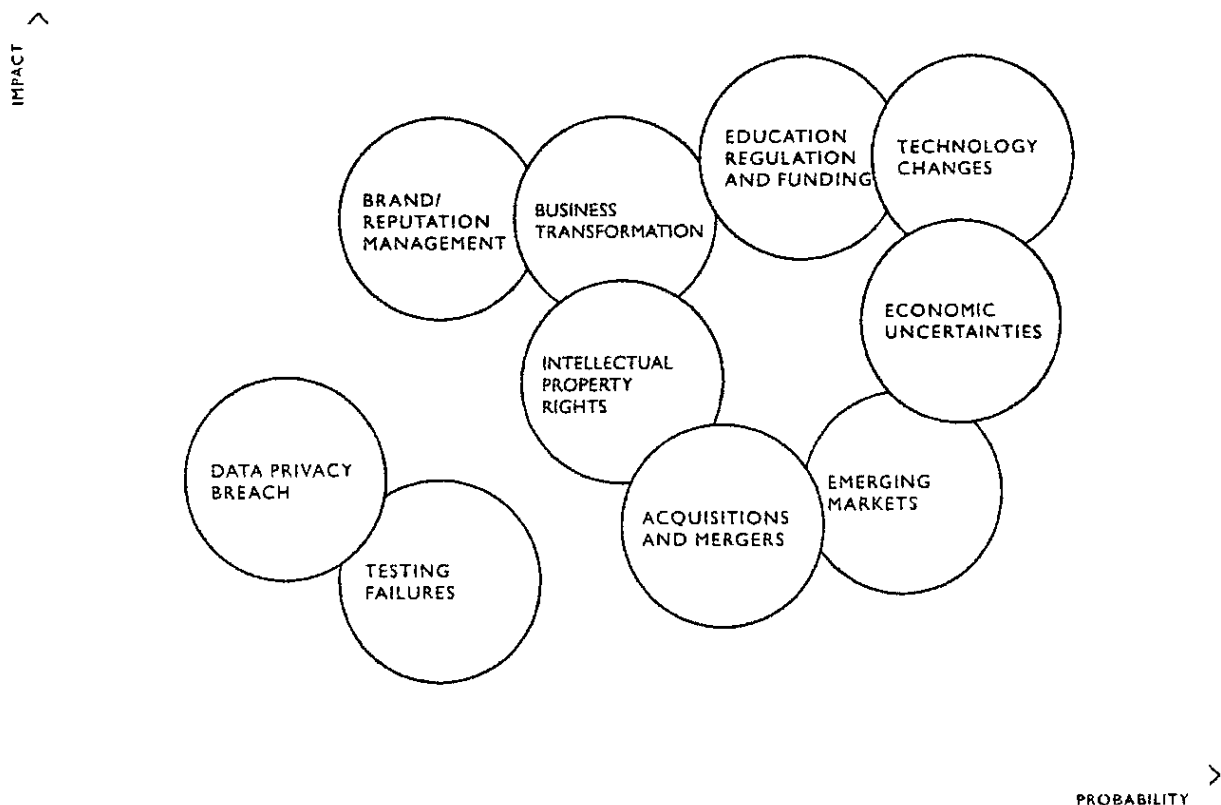
from around the world

Principal risks and uncertainties

Our principal risks and uncertainties are outlined below. These are the most significant risks that may adversely affect our business strategy, financial position or future performance. The risk assessment process evaluates the probability of the risk materialising and the financial or strategic impact of the risk. Those risks which have a higher probability and significant impact on strategy, reputation or operations or a financial impact greater than £40 million are identified as principal risks. The risk assessment and reporting criteria are designed to provide the board with a consistent, Group-wide perspective of the key risks. The reports to the board, which are submitted twice per year, include an assessment of the probability and impact of risks materialising, as well as risk mitigation initiatives and their effectiveness.

We conduct regular risk reviews to identify risk factors which may affect our business and financial performance and to assist management in prioritising their response to those risks. Our Group internal audit and compliance function facilitates risk reviews with each business, shared service operations and corporate functions, identifying measures and controls to mitigate these risks. These reviews are designed so that the different businesses are able to tailor and adapt their risk management processes to suit their specific circumstances. Management is responsible for considering and executing the appropriate action to mitigate these risks whenever 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.

PRINCIPAL RISKS – IMPACT AND PROBABILITY



Principal risks and uncertainties continued

Principal risks

TECHNOLOGY CHANGES

Our businesses will be impacted by the rate of and state of technological change, including the digital revolution and other disruptive technologies

We operate in markets which are dependent on Information Technology (IT) systems and technological change. The transition of our products and services to digital increases the potential exposure to cyber threats

EDUCATION REGULATION AND FUNDING

Our US and UK educational solutions and assessment businesses may be affected by changes in government funding resulting from either general economic conditions, changes in government educational funding, programmes, policy decisions, legislation and/or changes in the procurement processes

ECONOMIC UNCERTAINTIES

Global economic conditions may adversely impact our financial performance

A significant deterioration in Group profitability and/or cash flow caused by prolonged economic instability could reduce our liquidity and/or impair our financial ratios, and trigger a need to raise additional funds from the capital markets and/or renegotiate our banking covenants

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

Mitigating factors

Our global education strategy will drive a faster move to digital and services, recognising that this is a significant opportunity for Pearson, as well as a potential risk. We are transforming our products and services for the digital environment along with managing our print inventories. Our content is being adapted to new technologies across our businesses and is priced to drive demand. We develop new distribution channels by adapting our product offering and investing in new formats.

We seek to mitigate IT risks by establishing strong IT policies and operational controls, employing project management techniques to manage new software developments and/or systems implementations and have implemented an array of security measures to protect our IT assets from attacks or failures that could impact the confidentiality, availability or integrity of our systems.

In the US we actively monitor changes through participation in advisory boards and representation on standard setting committees. Our customer relationship teams have detailed knowledge of each state market. We are investing in new and innovative ways to expand and combine our products 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. We work through our own corporate affairs team and our industry trade associations including the Association of American Publishers. We are also monitoring municipal funding and the impact on our education receivables.

In the UK we maintain relationships with those government departments and agencies that are responsible for policy and funding. We work proactively with them to ensure our programmes meet existing and new government objectives at the right quality.

The Group's approach to funding is described on page 37 and the Group's approach to the management of financial risks is set out in note 19 to the financial statements.

Principal risks

BUSINESS TRANSFORMATION

The pace and scope of our business transformation initiatives increase the execution risk that benefits may not be fully realised, costs of these changes may increase, or that our business as usual activities do not perform in line with expectations

If we fail to attract and retain appropriately skilled employees, our business may be harmed

BRAND/REPUTATION MANAGEMENT

Our business depends on a strong brand and any failure to maintain, protect and enhance our brand would hurt our ability to retain or expand our business

Mitigating factors

A chief transformation officer was appointed in 2013, to oversee the development and implementation of a significant change programme. Some of the key mitigations for potential execution risk include change management workshops for senior leaders, additional support for people moving to new roles, and regular communication from the CEO and his leadership team in person and by online videos. To clarify decision-making authority and accountability in the new global matrix organisation, worked examples of day-to-day activities have been developed including customer-facing activities such as developing and delivering online education services.

Our trading update in January 2014 noted the importance of our transformation and our decisions on timing of changes such as deferring sales-related restructuring to avoid key selling periods.

Through the changes during 2013, we have been successful in promoting our best internal talent and recruiting individuals who are global leaders in their specific field.

Further details of how we are managing the risks associated with transformational change are set out under 'Responsible business' from page 47.

We seek to mitigate this risk through the development of comprehensive processes to enable our business units to effectively manage relationships with stakeholders, customers, communities and employees. We have an ongoing process to understand and evaluate potential brand threats and monitor and evaluate information about our brand across media sources. This process and associated governance includes the reputation and responsibility committee. The committee met during 2013 and has considered a number of topics including Pearson's non-financial targets, brand and reputation metrics and reputational risk and mitigations associated with testing failures in the US.

We take very seriously the health, safety, wellbeing and protection of our employees, learners and customers and implement appropriate policies, standards and procedures.

Principal risks and uncertainties continued

Principal risks

EMERGING MARKETS

Our investment into inherently riskier emerging markets is growing and the returns may be lower than anticipated

Mitigating factors

We draw on our experience of developing businesses internationally to manage specific country risks. We have designed and adopted an operating model for a globally-connected education company and we continue to strengthen our financial control and managerial resources in emerging markets to manage expansion. 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.

INTELLECTUAL PROPERTY RIGHTS

If we do not adequately protect our intellectual property and proprietary rights our competitive position and results may be adversely affected and limit our ability to grow.

We seek to mitigate this type of risk through general vigilance, co-operation with other publishers and trade associations, advances in technology as well as recourse to law as necessary. Digital rights management standards and monitoring programmes have been developed. We have a piracy task force to identify weaknesses and remediate breaches. We monitor activities and regulations in each market for developments in copyright/intellectual property law and enforcement and take legal action where necessary.

ACQUISITIONS AND MERGERS

Failure to generate anticipated revenue growth, synergies and/or cost savings from acquisitions, mergers and other business combinations could lead to goodwill and intangible asset impairments.

We perform pre-transaction due diligence and closely monitor actual performance to ensure we are meeting operational and financial targets. Any divergence from these plans will result in management action to improve performance and minimise the risk of any impairments. Executive management and the board receive regular reports on the status of acquisitions and mergers.

Principal risks

DATA PRIVACY BREACH

Failure to comply with data privacy regulations and standards or weakness in information security, including a failure to prevent or detect a malicious attack on our systems, could result in a major data privacy breach causing reputational damage to our brands and financial loss

TESTING FAILURES

A control breakdown or service failure in our school assessment and qualifications businesses could result in financial loss and 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 poorly managed

Mitigating factors

Through our global enterprise information security and compliance programme, we have established a governance model, security and privacy framework and policies, a global security and privacy organisational model, and standard-based information security and privacy controls and practices. We constantly test and re-evaluate 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 and contractual requirements. We pursue appropriate privacy accreditations, e.g., TRUSTe Privacy and Safe Harbor Seal. We regularly monitor regulation changes to assess the impact on existing processes and programmes. We have established a global security operations centre that provides ongoing monitoring of potential malicious attacks on our infrastructure and systems.

We seek to minimise the risk of a breakdown in our student marking with the use of robust quality assurance procedures and controls and oversight of contract performance, combined with our investment in technology, project management and skills development of our people.

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 to minimise associated risks.

We also look to diversify our portfolio to minimise reliance on any single contract.

Improving

learner outcomes

at scale, and at lower cost

Image removed

Responsible business

Our purpose as a company is to help people all over the world make progress in their lives through learning.

In 2010, we identified three key issues as the focus of the responsibility strategy for our company: raising literacy levels, improving learning outcomes and contributing to competitiveness.

Last year, we signalled that 2013 would be a year of significant change for Pearson as we developed our global educational strategy and looked forward to the creation of Penguin Random House. We also made a commitment to look at our responsibility framework using four questions to guide us:

- › Are the three key issues still the right ones for us?
- › How should we measure and report the educational impact of our products and services?
- › What commitments and targets should we set ourselves?
- › What are the big unmet educational needs that we can help tackle?

As our work on the global education strategy progressed, so a clear priority emerged – to deliver for the learner is the single most important contribution that Pearson can make to social and economic wellbeing. The tools and means by which we will deliver for the learner has become the efficacy agenda and this is central to our global education strategy.

To reflect the importance of learning outcomes, we have introduced a new efficacy section in our annual report (page 14). In that section we describe our commitments and targets on measurement and reporting as we go down the path towards efficacy. Our vision is that by 2018, we will report on learning outcomes alongside our financial results.

This section will now report on our wider responsible business agenda.

We welcome feedback on this aspect of the company as we do on any other. Please email our director of corporate responsibility at peter.hughes@pearson.com with any questions or comments you may have.

Together with sections one and two of this document, this section forms our strategic report, which was approved for issue by the board of directors on 10 March 2014 and signed on its behalf by



Robin Freestone Chief financial officer
(and board member responsible for corporate responsibility)

Responsible business continued

Overview

Helping learners to learn and progress is both the focus of our business strategy and the single most significant social contribution we can make. The section on efficacy (page 14) describes the approach we are taking to our responsibilities towards the learner.

In addition, Pearson has adopted a broad definition of responsible business reflecting priorities we share with many industry sectors and individual businesses. These include commitments across a broad range of social, community and human rights issues relevant to Pearson to:

- › Ensure that our products and services are inclusive, appropriate in content to the age and location of the learner and are safe to use and access
- › Inform, support and equip colleagues to embrace and respond to new priorities and ways of working
- › Provide a safe, healthy workplace where our employees and increasingly the learners we directly serve are able to realise their individual potential and there is respect for privacy, dignity and life outside work
- › Extend our principles on labour standards, human rights and environmental responsibility to include suppliers and business partners
- › Provide opportunities for Pearson people to be good citizens and to get involved in their local communities
- › Deliver against stakeholder expectations on a response to climate change and in making better, more efficient use of resources
- › Be open and transparent in how we share and engage with those with an interest and passion for education and learning

We consider our policies relating to these matters to be effective.

Transforming our company – supporting our people through change

Last year, we announced our plans to transform Pearson into a single company driven by a focus on helping learners make measurable progress in their lives through learning.

A priority for 2013 was to design and put in place a new organisational structure that shifted the company from being a portfolio of businesses towards a single operating model with standard systems, clear accountability and quicker decision-making.

We recognised that change can be both inspiring and empowering but can also bring operational risks. To mitigate this, we:

- › Were clear about the purpose of the change to better focus on a shared single purpose of delivering for the learner
- › Held change management workshops for senior leadership teams to prepare for the new organisational structure and operating model supported by videos, blogs, emails and interactive materials
- › Introduced the new leadership team and their priorities for 2014, both virtually and in-person
- › Explained how the new operating model would work, focusing on better use of information, improved efficiency and cohesiveness in collaborating on strategic priorities
- › Supported the people that left the organisation as a result of the restructure
- › Continually tracked morale and reaction to change to inform and shape how we communicated and supported our people

At the same time, we continued to focus on our broader responsibilities as an employer. During the year, Pearson:

- › Launched Milo, a single global platform for all our people to access learning and development resources
- › Adopted a new consistent global health and safety policy and introduced a new set of common management and reporting procedures for our businesses globally
- › Reviewed and refreshed our code of conduct including emphasising our commitment to learners of all ages and types
- › Continued to focus on how to meet our commitments to attract, recruit and retain the best people. We know that creating and sustaining an inclusive work environment is critically important, offering equal opportunity from the boardroom down regardless of race, gender, gender identity or reassignment, age, disability, religion or sexual orientation.

CASE STUDY

Gender diversity

During 2013, we continued with the development of the gender diversity strategy at Pearson. Pearson is a supporter of the 30% Club which brings together chairs and CEOs to work to encourage better gender balance across their companies. There was continued progress in advancing women and people from diverse backgrounds. An example of our work is the diversity toolkit introduced in the UK in 2012, and launched in the United States and made available globally in 2013. Designed for managers and business leaders across Pearson, it is made up of guides, tips, advice and employment law, to enable our leaders to successfully build, manage and develop their diversity management skills.

We introduced a single global data collection process based on our new operating structure to help inform people management. This includes our first global view on the gender balance within the company. More work remains, in particular to incorporate gender data from countries with recent acquisitions. The gender balance based on the introduction of our new organisational structure was:

	MEN		WOMEN	
Board of directors	7	78%	2	22%
Senior managers (excluding executive board directors)*	61	69%	28	31%
All employees**	17,190	43%	22,774	57%

* For the purposes of this report, senior managers at Pearson are defined as the senior leadership team, namely those up to and including two reporting lines from the CEO. We believe this is the most meaningful way to illustrate the senior leaders and decision-makers at Pearson.

** Data for over 2,000 employees predominantly from China and Indonesia is not included in the all employees numbers above. Employee information can be found on page 142.

- › In the United States, Pearson received a perfect score of 100% in the 2014 Corporate Equality Index (CEI), a benchmarking survey and report on corporate policies and practices related to LGBT workplace equality, administered by the Human Rights Campaign (HRC) Foundation. We were also named as one of the 100 Best Adoption Friendly Workplaces by the Dave Thomas Foundation for Adoption.

Disability forms a part of our wider commitment to equal opportunity. We work to ensure that appropriate policies, procedures, training and support are available for disabled colleagues and their managers. A recent example is a guide on how to develop corporate videos, so that all our people, including those with disabilities, can access and benefit from these films.

Partnering and investing to extend access to learning

Extending access to quality education is a big challenge, particularly in the poorest countries in the world. Meeting the challenge requires a sustained commitment to partnership – international organisations like the UN and the World Bank, national governments, donor agencies and charities, businesses such as Pearson, education providers and suppliers all working together.

We are committed to playing our part. We do this through being active in helping shape and inform the global debate around education and learning policy as well as investing in projects that explore possible solutions to the most intractable learning needs.

In 2013, we:

- › Joined the board of the Global Partnership for Education (GPE) representing the private sector and private foundations. GPE brings together representatives from nearly 60 developing countries, donor governments, charitable foundations and private businesses to work together to help developing countries strengthen their education systems. www.globalpartnership.org/
- › Championed the role of the private sector in education and learning in developing countries as a founding member of the Global Business Coalition for Education. www.gbc-education.org/
- › Made a series of commitments during the UN General Assembly including to: invest \$30m in innovative education solutions, establish a multi-year flagship partnership to help overcome barriers to learning for marginalised children, work with the GPE to develop a private sector strategy that meets the goals of its strategic focus on fragile states, and by 2018, to help 20,000 new graduates from across sub-Saharan Africa to transition into employment.

Responsible business continued

- › Continued to invest in models that provide access to affordable education through low-cost private schools. The \$15m Pearson Affordable Learning Fund has invested in projects in Ghana, Kenya and India. www.affordable-learning.com/
- › Continued to support the Education Zone on the Business Fights Poverty network. The zone is a platform for debate on the role of business in global education. www.businessfightspoverty.org/page/education-zone
- › Launched Pearson Catalyst, a new incubator programme to identify and back the most promising education start-up companies. Pearson provides mentors, seedcorn funding and access to resources and insight.

Our communities

Not-for-profit partners help us extend our reach and impact in ways that have a real impact on learning – especially for the most disadvantaged – and are complementary to our business objectives. We also believe that our stakeholders expect and value our efforts to work in partnership with charitable organisations.

We therefore partner and fund a number of charitable organisations with the Pearson Foundation being the largest of these. In 2013, our worldwide charitable giving was £11.8m or 1.5% of pre-tax profits.

Highlights this year include

- › Booktime gave its ten millionth book. Booktime sees every child starting school in England and Wales receive a book pack containing two free books to take home and keep.
- › We were the largest book donor to Book Aid International in 2013. We have given 1.2 million books to the charity to support the development of libraries in schools and communities across sub-Saharan Africa.
- › The *Financial Times* seasonal appeal raised £1.4m for World Child Cancer, a charity helping treat sick children in some of the poorest countries. Since 2006, FT appeals have raised £14m for charity partners.

For 2014, we will look more broadly at our approach to community partnerships including the metrics we use.

CASE STUDY

Pearson Foundation

The Pearson Foundation is an independent charity that aims to make a difference by promoting literacy, learning and great teaching. Its programmes in 2013 included:

- › Helping Jumpstart's Read for the Record to set a new world record for reading the same book on one day as 2,462,860 adults and children read *Otis*, by Loren Long, in classrooms, libraries, and community centres across the United States.
- › Strong Performers and Successful Reformers in Education, developed in partnership with the Organisation for Economic Co-operation and Development (OECD) helps inform what works in education globally.
- › BridgeIT has reached over one million children and their teachers using mobile technology to deliver professional development materials and educational resources to remote and underserved classrooms in ten countries around the world.

In 2011, the Pearson Foundation faced criticism on some of its programmes and the New York State Attorney General announced an investigation into the Foundation's governance, administration, and relationship with Pearson. We co-operated fully with the investigation. A settlement agreement with the Pearson Foundation and Pearson, Inc. has been concluded.

Pearson and the Foundation maintain we have always acted with the best intentions and complied with the law. However, we recognise there were times when the governance of the Foundation could have been clearer and more transparent. Over the past two years, the Foundation has taken several steps to strengthen its governance, beginning with the addition of independent directors to the board and the adoption of stronger operational systems. Under the settlement, these efforts will be further enhanced by the creation of a three-person audit committee.

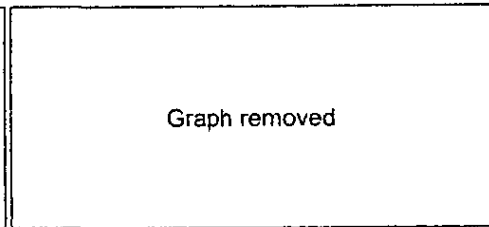
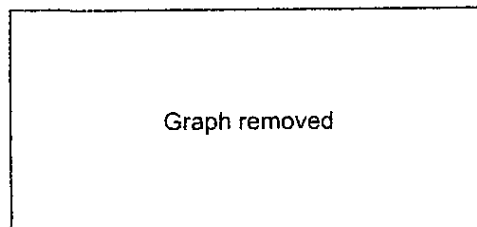
The Foundation has also agreed to pay \$7.5m into a fund managed by the Attorney General that will support the work of 100Kin10, an organisation committed to placing 100,000 science and mathematics teachers into US schools in the next ten years.

COMMUNITY

Challenges	Access to learning, literacy and great teaching	Raising literacy levels
Our commitment	To maintain our total community investment at 1% or more of operating profit	Using 2010 as our base, to expand our book gifting activities
How we measure progress	One way we extend our reach is through partnerships with literacy and learning charities. We report on our community investment spend	Number of books donated to schools, libraries and literacy charities

Community investment spend

Number of books donated



Environment: climate change and avoiding deforestation

Extreme weather events continued in 2013, most notably Typhoon Haiyan in the Philippines which was one of the worst storms on record. Pearson has around 350 people in Manila with the majority working for the FT. Although our employees are all safe and our operations were not directly affected, many had anxious moments tracking family members.

Pearson matches contributions made by Pearson employees in countries and communities where we operate. Over 1,000 Pearson people around the world contributed to a special fund set up in the wake of Haiyan, which together with matching from Pearson meant that over \$150,000 was raised for charities working in the Philippines, primarily to help children get back into school and to rebuild their lives.

Typhoon Haiyan was a stark reminder on the importance of minimising environmental impact. Pearson continues to be climate neutral, a commitment we first achieved in 2009 and have maintained ever since.

This commitment was designed to encourage the company to focus on carbon reduction. Pearson was included in the media category as a Decoupling Leader in the Natural Capital Index developed by Trucost, a research firm focusing on sustainability metrics. Trucost looked at the environmental impact of 4,600 publicly traded companies and 34 were recognised as Decoupling Leaders having successfully separated growth from resource use over a sustained period.

Our second focus area is forests. As a purchaser of paper and newsprint for our books, magazines and newspapers, security and sustainability of supply are very important to us. We have focused on sustainability sourcing and being more efficient in how we use paper. Also, as our transition towards being an educational technology and solutions provider gathers pace, so this will change our environmental footprint.

Responsible business continued

Highlights of our activities include

- › Pearson received a 2013 Green Power Leadership Award from the US Environmental Protection Agency (EPA) for its green power purchase. 100% of the electricity purchased by Pearson globally – over 215 MWh in 2013 – comes from green power
- › We have invested in renewable energy generation at four sites and have 2.3 Megawatts of wind and solar assets installed
- › Pearson was the second ever organisation to be certified globally against the Carbon Trust Standard. This recognises leadership in measuring, managing and reducing year-on-year carbon emissions
- › Facilities in the United States also seek to secure LEED, an internationally-recognised mark of excellence by the US Green Building Council. Over 800,000 square feet across six of our buildings are LEED certified. Pearson is also certified against ISO14001, the environmental management standard in the UK and Australia

Pearson invests in forest-based carbon offsets for any part of our climate footprint that we cannot reduce or avoid through other means. Since 2009, this programme has seen over 700 hectares of forest protected in Colombia, Costa Rica, the United States and the UK.

ENVIRONMENT

Challenges	Climate change
Our commitment	To maintain our commitment to climate neutrality
How we measure progress	Through carbon reduction, purchase of renewable energy, renewable energy generation at our sites and the purchase of carbon offsets

GLOBAL GHG EMISSIONS DATA FOR CALENDAR YEAR 2013

Emissions from	Metric tonnes of CO ₂ e
Combustion of fuel and operation of facilities (GHG Protocol Scope 1) natural gas, company owned/leased vehicles, refrigerant gas loss and fuel oil	30,170
Electricity, heat, steam and cooling purchased for own use (GHG Protocol Scope 2)	115,548
Total	145,718
Intensity metric (tonnes CO ₂ e/full time employee for scope 1 and 2)	3.19

We have reported on all of the emission sources required under the Companies Act 2006 (Strategic Report and Directors' Reports) Regulations 2013. These sources fall within our consolidated financial statement. We do not have responsibility for any emission sources that are not included in our consolidated statement.

The method we have used to calculate GHG emissions is the GHG Protocol Corporate Accounting and Reporting Standard (revised edition), together with the latest emission factors from recognised public sources including, but not limited to, Defra, the International Energy Agency, the US Energy Information Administration, the US Environmental Protection Agency and the Intergovernmental panel on Climate Change.

We publish a separate report providing more information on our environmental impact and this includes some corporate value chain emissions data (GHG Protocol Scope 3).

External benchmarks

One way we assess how we are doing as a responsible business is to maintain our position in key indices and benchmarks of social responsibility

	2013	2012	2011	2010
Dow Jones Sustainability Indexes*	Silver class	Gold class		Global sector leader
BITC Corporate Responsibility Index	Platinum	Platinum (retained)	Platinum	Platinum (retained)
Inclusion in FTSE4Good	Yes			

*Gold class is within 1% of the sector leader silver class is within 2% of the sector leader

Our values, principles and behaviour

Although the structure and culture of the company is changing, values are what define us. Our values to be brave, imaginative and decent in everything we do are the foundation of the company.

Our values are underpinned by our Code of Conduct that covers, among other things, individual conduct, learners, employees, community, the environment and society.

We make sure everyone is aware of and understands the code and this forms part of our induction for new employees. Once a year, everyone working for Pearson gets a copy either electronically or on paper, and is asked to read it, to confirm to the Pearson CEO that they have read it and understood it, and in doing so, to provide a check that the company complies with it. If anyone has concerns, these can be raised with a line manager or through a free, confidential telephone line/website.

Pearson has a zero tolerance policy towards bribery and corruption. Our policy introduced in 2011 sets out our standards, we carry out risk assessments and have a network of designated managers across the business responsible for compliance with our policy.

We are committed to making sure our people understand how we are doing as a company, including how world trends might affect them and the business. We provide comprehensive, relevant information in a variety of ways including regular presentations from senior executives and consulting where appropriate so that we can learn and take account of the views of our people.

We have a passion

for the life changing impact of learning

around the world

Image removed

Company Number: 53723

Board of directors

Pearson's board brings a wide range of experience, skills and backgrounds.

OVERVIEW

OUR PERFORMANCE

RESPONSIBLE BUSINESS

GOVERNANCE

FINANCIAL STATEMENTS

CHAIRMAN

Image removed

Glen Moreno Chairman
aged 70 appointed 1 October 2005

Chairman of the nomination committee and member of the remuneration committee

Glen has more than four decades of experience in business and finance and is currently deputy chairman of The Financial Reporting Council Limited in the UK and non-executive director of Fidelity International Limited. Previously Glen was deputy chairman and senior independent director at Lloyds Banking Group plc, senior independent director of Man Group plc and acting chairman of UK Financial Investments Limited, the company set up by HM Treasury to manage the government's shareholdings in UK banks.

EXECUTIVE DIRECTORS

Image removed

John Fallon Chief executive
aged 51, appointed 3 October 2012

Member of the nomination committee

John became Pearson's chief executive on 1 January 2013. Since 2008 he had been responsible for the company's education businesses outside North America and a member of the Pearson management committee. He joined Pearson in 1997 as director of communications and was appointed president of Pearson Inc. a role he combined with his communications responsibilities, in 2000. In 2003 he was appointed CEO of Pearson's educational publishing businesses for Europe, Middle East & Africa (EMA) and gradually took on a broader international education brief. Prior to joining Pearson, John was director of corporate affairs at Powergen plc, where he was also a member of the company's executive committee. Earlier in his career, John held senior public policy and communications roles in UK local government.

Image removed

Robin Freestone Chief financial officer
aged 55, appointed 12 June 2006

Robin's experience in management and accounting includes a previous role as group financial controller of Amersham plc (now part of General Electric) and senior financial positions with ICI plc, Zeneca and Henkel UK. He joined Pearson in 2004 as deputy chief financial officer and became chief financial officer in June 2006. Robin qualified as a chartered accountant with Touche Ross (now Deloitte) and is currently a non-executive director and founder shareholder of eChem Limited. Robin sits on the Advisory Group of the ICAEW's Financial Reporting Faculty and is chairman of The Hundred Group of Finance Directors. He also sits on the CBI's Economic Growth Board.

Board of directors continued

NON EXECUTIVE DIRECTORS

Image removed

David Arculus Non-executive director
aged 67, appointed 28 February 2006

Chairman of the remuneration
committee and member of the audit
and nomination committees

David has experience in banking, telecommunications and publishing in a long career in business. Currently he is chairman of Numis Corporation plc and the Advisory Board of the British Library and is a member of council of Cranfield University. David's previous roles include the chairmanship of Aldermore Bank plc, O2 plc, Severn Trent plc and IPC Group, as well as chief operating officer of United Business Media plc, group managing director of EMAP plc and a non-executive director of Telefonica SA. David served from 2002 to 2006 as chairman of the UK government's Better Regulation Task Force, which worked on reducing burdens on business.

Image removed

Vivienne Cox Senior independent director
aged 54, appointed 1 January 2012

Member of the audit, remuneration
and nomination committees

Vivienne has wide experience in energy, natural resources and business innovation. She worked for BP plc for 28 years, in Britain and Continental Europe, in posts including executive vice president and chief executive of BP's Gas, Power & Renewables business and its Alternative Energy unit. She is non-executive director of mining company Rio Tinto plc and energy company BG Group plc, and chairman of the supervisory board of Vallourec, which supplies tubular systems for the energy industry. She is also lead independent director at the UK Department for International Development. Vivienne is a commissioner of the Airports Commission, which was set up by the UK government to examine any requirements for additional UK airport capacity.

Image removed

Linda Lorimer Non-executive director
aged 61, appointed 1 July 2013

Member of the audit and
nomination committees

Linda has a deep background in education strategy, administration and public affairs. She is vice president for Global & Strategic Initiatives at Yale University in New Haven, Connecticut, where her duties include oversight of Yale's Office of International Affairs and Office of Digital Dissemination. Over a 30-year career in higher education, she has been responsible for many of Yale's administrative services including the university's public communications, alumni relations and Office of Sustainability. Previously, Linda served as president of Randolph-Macon Woman's College in Virginia, and had earlier worked at Yale in several senior roles including associate provost. She is a non-executive director of Save the Children (US) and was chair of the board of the Association of American Colleges and Universities.

Image removed

Ken Hydon Non-executive director
aged 69, appointed 28 February 2006

Chairman of the audit committee
and member of the remuneration
and nomination committees

Ken's experience in finance and business includes working in the electronics, retail, consumer products and healthcare sectors. He is a non-executive director of Reckitt Benckiser Group plc, one of the world's leading branded consumer goods companies in health, hygiene and home. He is also a non-executive director of Merlin Entertainments plc, the world's second largest visitor attraction operator. From 2004 to 2013 he was a non-executive director of Tesco plc. Previously, Ken was chief financial officer of Vodafone Group plc, the multinational telecommunications company, and financial director of subsidiaries of Racal Electronics.

Image removed

Josh Lewis Non-executive director
aged 51, appointed 1 March 2011

Member of the remuneration and
nomination committees

Josh's experience spans finance, education and the development of digital enterprises. He is the founder of Salmon River Capital LLC, a New York-based private equity/venture capital firm focused on technology-enabled businesses in education, financial services and other sectors. Over a 25-year career in active principal investing, he has been involved in a broad range of successful companies, including several pioneering enterprises in the education sector. In addition, he has long been active in the non-profit education sector with associations including New Leaders, New Classrooms, and the Bill & Melinda Gates Foundation. He is also a non-executive director of eInvestment and Axioma, both financial data/technology companies, and Parchment, an education credentials management company.

Image removed

Harish Manwani Non-executive director
aged 60, appointed 1 October 2013

Member of the nomination committee

Harish has an extensive background in emerging markets and senior experience in a successful global organisation. He is chief operating officer of consumer products company Unilever, and serves on the company's executive board. Harish joined Unilever in 1976 as a marketing management trainee in India, and has held senior management roles around the world, including North America, Latin America, Europe, Africa and Asia. He is non-executive chairman of Hindustan Unilever Limited in India, and serves on the board of Whirlpool Corporation in the US. He is also on the board of the Indian School of Business, the Economic Development Board (EDB) of Singapore, and The Human Capital Leadership Institute in Singapore.

Company Number: 53723

Chairman's letter

Dear shareholders

This year, we are reporting for the first time against the 2012 edition of the UK Corporate Governance Code (the Code)

As has been highlighted elsewhere within this report, 2013 was a period of great change in our organisation, following the appointment of John Fallon as chief executive at the start of the year. I would like to take this opportunity to share with you some insights as to how our board and governance operations have adapted throughout the year to take account of Pearson's focus on becoming one global education company.

The Pearson board consists of senior executive management alongside a strong group of non-executive directors drawn from successful international businesses and education institutions with experience of corporate strategy, education, emerging markets, technology and consumer marketing. We continually assess and refresh the board to ensure we maintain an appropriate balance and diversity of skills and experience.

2013 saw a number of changes in Pearson's boardroom, reflecting both the new strategic direction of the business and our desire to maximise the valuable external experience which non-executive directors bring to the table. Executive directors Rona Fairhead and John Makinson stepped down from the board in April and July respectively, although John remains part of the Pearson family in his new role as chairman of Penguin Random House. In August we said goodbye to Susan Fuhrman, a non-executive director for nine years and, at the end of December, Will Ethridge stepped down from his executive position on the board and from his role as CEO of Pearson North American Education, although he will remain a valued adviser to the company during 2014.

During the year we also welcomed Linda Lorimer and Harish Manwani to the board, as non-executive directors. Linda and Harish bring a wealth of experience in the areas of education, digital initiatives and emerging markets, which reflect precisely those areas on which Pearson is now focused.

With these changes the board now predominantly comprises independent non-executive directors. We believe this re-balancing enables Pearson to benefit from our board's wide range of perspectives and backgrounds, and allows the board to look at the bigger picture of the Group's strategy, performance and value, whilst allowing the executive management to focus on what it does best – driving our company forward.

May 2013 saw the announcement of the new Pearson Executive team. You will have read elsewhere in this report about the new Geographies and Lines of Business along which Pearson is now organised. The presidents of these Geographies and Lines of Business now sit on the Pearson Executive, together with colleagues leading the key enabling functions. The board and I had the pleasure of spending two days discussing strategy with the Pearson Executive in October 2013, of which a little more later in the governance report.

As a board we organise our work around four major themes where we believe we can add value: governance, strategy, business performance and people. Our board calendar and agenda provide ample time to focus on these themes and we have set out some examples of the business considered by the board, as well as the governance practices to which we adhere, on the pages that follow.

We hope this report clearly sets out how your company is run, and how we align governance and our board agenda with the strategic direction of Pearson. We always welcome questions or comments from shareholders, either via our website (www.pearson.com) or in person at our annual shareholders' meeting.

Glen Moreno Chairman

Board governance

Corporate governance

Introduction

The board believes that during 2013 the company was in full compliance with the UK Corporate Governance Code (the Code). A detailed account of the provisions of the Code can be found on the FRC's website at www.frc.org.uk and we encourage readers to view our compliance schedule on the company website at www.pearson.com/investors/shareholder-information/governance

Composition of the board

The board currently consists of the chairman, Glen Moreno, two executive directors including the chief executive, John Fallon, and six independent non-executive directors

Chairman and chief executive

There is a defined split of responsibilities between the chairman and the chief executive. The chairman is primarily responsible for the leadership of the board and ensuring its effectiveness, the chief executive is responsible for the operational management of the business and for the development and implementation of the company's strategy as agreed by the board and the Pearson Executive. The roles and responsibilities of the chairman and chief executive are clearly defined, set out in writing and reviewed and agreed by the board annually

Chairman

There were no changes to the chairman's significant commitments during the course of 2013

Senior independent director

Vivienne Cox is the company's senior independent director, having been appointed to the role on 1 January 2013

Vivienne's role includes meeting regularly with the chairman and chief executive to discuss specific issues, as well as being available to shareholders generally if they should have concerns that have not been addressed through the normal channels

Following Patrick Cescau's departure in December 2012, he was invited back in February 2013 – in his former role as senior independent director – to conduct a session with the other non-executive directors and the chief executive to appraise the performance of the chairman, including in relation to the effectiveness of the nomination committee as part of the annual board evaluation process

Vivienne, as incumbent senior independent director, has responsibility for appraising the chairman's performance during 2013 and beyond

The senior independent director would be expected to chair the nomination committee in the event that it was considering succession to the role of chairman of the board

Independence of directors

All of the non-executive directors were considered by the board to be independent for the purposes of the Code during the year ended 31 December 2013

The board reviews the independence of each of the non-executive directors annually. This includes reviewing their external appointments and any potential conflicts of interest as well as assessing their individual circumstances in order to ensure that there are no relationships or circumstances likely to affect their character or judgement. In addition to this review, each of the non-executive directors is asked annually to complete an independence questionnaire to satisfy requirements arising from Pearson's US listing

David Arculus and Ken Hydon have each now served on the board for eight years and it is their intention to retire from the board at the 2015 AGM. As chairmen of the remuneration and audit committees respectively, the nomination committee is actively considering options for their successors both in their capacity as non-executive directors and for their chairmanships

Graph removed

Company Number 53723

Conflicts of interest

Under the Companies Act 2006 (the Act), directors have a statutory duty to avoid conflicts of interest with the company. The company's Articles of Association (Articles) allow the directors to authorise conflicts of interest. The company has established a procedure to identify actual and potential conflicts of interest, including all directorships or other appointments to, or relationships with, companies which are not part of the Pearson group and which could give rise to actual or potential conflicts of interest. Once notified to the chairman or company secretary, such potential conflicts are considered for authorisation by the board at its next scheduled meeting. The relevant director cannot vote on an authorisation resolution, or be counted in the quorum, in relation to the resolution relating to his/her conflict or potential conflict. The board reviews any authorisations granted on an annual basis.

Board meetings

The board held six scheduled meetings in 2013, with some meetings taking place over two or more days. In recent years, we have developed our board meeting agenda to ensure that board discussion and debate is centred on the key strategic issues facing the company. Over the course of 2013, the board maintained a watching brief over the transformation project and received regular formal updates from the chief executive and the transformation team, headed by the director of communications. Other major items covered by the board in the year included:

BUSINESS PERFORMANCE FEBRUARY 2013, LONDON

- › 2012 report and accounts and dividend recommendation
- › 2013 operating plan
- › Risk assessment and review of mitigating actions
- › Annual review of authorised conflicts
- › Review of division of responsibilities between chairman and chief executive
- › Plans for board effectiveness review
- › Discussion of accounting exemption for UK subsidiaries

GOVERNANCE AND SHAREHOLDER MATTERS

APRIL 2013 LONDON

- › Focus on forthcoming AGM and review of shareholder issues
- › Review of investor relations strategy and share price performance
- › Review of corporate social responsibility
- › Status update on Penguin Random House transaction and ebook settlement proposal
- › Risk assessment and review of mitigating actions
- › Governance update

STRATEGY JUNE 2013 JOHANNESBURG

- › Review of Southern African education business including site visits, panel sessions and debates – see case study on page 62 for further information

BUSINESS PERFORMANCE JULY 2013 LONDON

- › Interim results and dividend approval
- › Penguin Random House – post-completion update
- › Initial review of proposed Multi acquisition
- › Consideration of Mergermarket sale

STRATEGY OCTOBER 2013 LONDON

- › Launch of efficacy strategy
- › Discussion of New York Attorney General's review of the Pearson Foundation
- › Review of standing committee terms of reference
- › Workshop with Pearson Executive – see case study on page 61 for further information

STRATEGIC PLAN DECEMBER 2013, NEW YORK

- › Preliminary view of 2014
- › Overview of changes to the 2013 year end reporting requirements
- › Risk assessment and review of mitigating actions
- › Approval of schedule of authority limits

In addition to the six scheduled meetings, the board held one further full meeting in November 2013 to approve the Mergermarket sale and Grupo Multi acquisition and undertook discussions throughout the year, both in formal meetings and as otherwise required, to consider the progress and terms of these and other corporate transactions.

Board governance continued

The following table sets out the attendance of the company's directors at scheduled board meetings during 2013

	Board meetings attended	Notes
Chairman		
Glen Moreno	6/6	
Executive directors		
John Fallon	6/6	
Will Ethridge	5/6	absent for medical reasons
Rona Fairhead	–	stood down 26 April 2013
Robin Freestone	6/6	
John Makinson	3/3	stood down 1 July 2013
Non-executive directors		
David Arculus	4/6	unable to travel due to injury
Vivienne Cox	6/6	
Susan Fuhrman	3/4	stood down 7 August 2013
Ken Hydon	6/6	
Josh Lewis	6/6	
Linda Lorimer	3/3	appointed 1 July 2013
Harish Manwani	2/2	appointed 1 October 2013

The role and business of the board

The board is deeply engaged in developing and measuring the company's long-term strategy, performance and value. We believe that it adds a valuable and diverse set of external perspectives and that robust, open debate about significant business issues brings a valuable additional discipline to major decisions.

A schedule of formal matters reserved for the board's decision and approval is available on our website, at www.pearson.com/investors/shareholder-information/governance

A standing committee of the board has been established to approve certain ordinary course of business items such as banking matters, guarantees, intra-group transactions and routine matters relating to employee share plans. The committee has written terms of reference, reviewed and approved each year, which clearly set out its authority and duties. These can be found on the company website at www.pearson.com/investors/shareholder-information/governance

The board receives timely regular and necessary financial, management and other information to fulfil its duties. Comprehensive board papers are circulated to the board and committee members at least one week in advance of each meeting and the board receives regular reports from the chief executive. In addition to meeting papers, a library of current and historic corporate information is made available to directors electronically to support the board's decision-making process. Directors can obtain independent professional advice, at the company's expense, in the performance of their duties as directors. All directors have access to the advice and services of the company secretary.

Non-executive directors meet with local senior management every time board and committee meetings are held at the locations of operating companies, such as during the board's 2013 trip to South Africa. This allows the non-executive directors to share their experience and expertise with senior managers as well as allowing them to better understand the abilities of senior management, which in turn will help them assess the company's prospects and plans for succession.

Culture and values of the board

During a time of widespread organisational and strategic change at Pearson, the board has had oversight of the plans to embed efficacy firmly into the company's culture.

Since 2012, the board has been kept abreast of the company's intentions through a number of sessions with the chief education advisor. At the most recent such session, in October 2013, the board had the opportunity to discuss building efficacy into all aspects of Pearson's operations, and noted their strong support for Pearson's involvement in the global public dialogue on efficacy and education.

Company Number 53723

Succession planning

The board considers oversight of succession planning – not only at board and executive management level but for all key positions throughout the business – as one of its prime responsibilities

2013 has seen a large scale reorganisation of both the company and the structure of its senior management team. Throughout the year, the board received regular updates from the chief executive and the transformation team on the organisational redesign project. This included oversight of the key appointments made to the Pearson Executive and that team's direct reports, the senior leadership group

CASE STUDY

Board and Pearson Executive

As part of the board's regular programme of updates on the education strategy and organisational design initiatives, a section of the October 2013 board meeting was dedicated to a workshop involving members of the Pearson Executive. Each member of the Pearson Executive discussed with the board their new roles, strategic priorities, and the challenges and opportunities facing their particular business area as they moved towards the new operating structure on 1 January 2014.

The session had benefits for all parties involved – the board was able to learn more about the recently appointed executive team, and to explore with them key issues relating to the geographies, lines of business, products and technologies, whilst demonstrating to the executive its involvement and support during a period of great change.

During the year the board also approved formal contingency plans for temporary absence of the chief executive for health or other reasons.

Board evaluation

The board's review of its effectiveness in 2012 took place during early 2013. A primary focus for the board in 2012 was chief executive succession. On review, the board concluded that the process was structured, detailed and effective.

For 2013, the board identified two key priorities:

- › To restructure and strengthen the board through a higher proportion of independent directors with experience and skills relevant to Pearson's strategy, particularly in education and emerging markets. The appointments of Linda Lorimer and Harish Manwani were in line with this objective,
- › To keep the board closely informed and involved in Pearson's strategic transformation during the year, including regular detailed briefings on strategy, planned organisational changes and key leadership appointments. The board reviewed plans and actions in considerable detail on six different occasions in 2013, including at the strategy workshop held in October with the Pearson Executive.

The board has also given consideration to the information it receives and how this is reported. As a result, an improved board information system is being designed which will enable the board to more effectively track performance and developments in the business model. As part of this review, in January 2014, we instituted a revised monthly chief executive's letter to the board.

The board also wished to give consideration as to ways in which to maximise the effectiveness of its overseas meetings. In June 2013, the board held a meeting in South Africa, more information on which is set out in the case study on page 62. Following the trip, a short questionnaire was distributed to board members. Particular learning points arising from the board's input related to:

- › Continuing to ensure site visits are representative of Pearson's operations in the region,
- › The high value placed on meeting the end users of Pearson's products – students and teachers,
- › Logistical arrangements both before and during the trip, and
- › Ensuring that board presentations are pitched to impart a sufficient level of knowledge for directors to perform their roles.

Board governance continued

It is intended that these learning points will be used to shape future overseas agendas, including potential visits by the board to the US and an emerging market territory during 2014

During the course of the year the executive directors were also evaluated on their performance against personal objectives. Up to 20% of the executives' total annual incentive opportunity for 2013 was based on functional, operational, strategic and non-financial objectives relevant to their specific area of responsibility. The chairman leads the assessment of the chief executive, and the non-executive directors, led by the senior independent director, conduct a review of the chairman's performance.

In accordance with the Code, the board anticipates undertaking an external evaluation during 2014. The board is currently discussing focus and timing for the process to gain the maximum benefit from the review.

In addition to the review of the board and individual directors, the audit and remuneration committees each undergo an annual evaluation process to review their performance and effectiveness. The process covers areas such as roles and responsibilities, quality and timeliness of meeting materials, opportunity for discussion and debate, dialogue with management and access to independent advice.

CASE STUDY

South Africa

In June 2013, the board visited South Africa for a three-day meeting to understand the economic and political environment, the education landscape and Pearson's South African business, one of the Group's most consistently successful businesses over the last decade.

The board met with a number of Pearson's senior leaders in the region and also took the opportunity to meet with the leader of Pearson's Nigeria business as it learned more about scope for growth in that country and more widely across Africa.

The board spent time visiting local schools as well as reviewing higher education initiatives on the main campus of CTI, Pearson's higher education business in South Africa.

The board also met with Cyril Ramaphosa, the recently elected deputy president of the ANC, at a session involving a range of business leaders, journalists, authors and key opinion leaders in education, exploring how Pearson could do more to tackle problems in education and training in the region.

Finally, outside of the core educational focus of the trip, the board received an update on Penguin in South Africa to learn more about how the merger with Random House is enhancing publishing opportunities.

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Directors' training and induction

Directors receive a significant bespoke induction programme and a range of information about Pearson when they join the board. This includes background information on Pearson and details of board procedures, directors' responsibilities and various governance-related issues, including procedures for dealing in Pearson shares and their legal obligations as directors. The induction also includes a series of meetings with members of the board, presentations regarding the business from senior executives and a briefing on Pearson's investor relations programme. The induction programme for Linda Lonner and Harish Manwani is ongoing and is being tailored to best introduce them to Pearson in a period of organisational change.

The directors' training is supplemented with presentations about the company's operations, by holding board meetings at the locations of operating companies and by encouraging the directors to visit operating companies and local management as and when their schedule allows. The company secretary and general counsel, in conjunction with the Group's advisers, monitor legal and governance developments and update the board on such matters as agreed with the chairman. Directors can also make use of external courses.

Directors' indemnities

In accordance with section 232 of the Act, the company grants an indemnity to all of its directors. The indemnity relates to costs incurred by them in defending any civil or criminal proceedings and in connection with an application for relief under sections 661(3) and (4) or sections 1157(1)-(3) of the Act, so long as monies are repaid not later than when the outcome becomes final if (i) they are convicted in the proceedings, (ii) judgment is given against them, or (iii) the court refuses to grant the relief sought.

The company has purchased and maintains directors' and officers' insurance cover against certain legal liabilities and costs for claims in connection with any act or omission by such directors and officers in the execution of their duties.

Shareholder engagement

Pearson has an extensive programme of communication with all of its shareholders – large and small, institutional and private.

In 2013, we continued with our shareholder outreach programme, seeing approximately 780 institutional and private investors at more than 450 different institutions in Australia, Brazil, Canada, China, Continental Europe, India, Japan, Malaysia, Singapore, South Africa, South Korea, the UK and the US.

There are five trading updates each year and the chief executive and chief financial officer present our preliminary and interim results updates. They also attend regular meetings throughout the year with investors in the UK and around the world, tailored to investor requirements, to discuss the performance of the company, the company's strategy, our restructuring programme, structural changes in our markets and risks and opportunities for the future.

The chairman meets regularly with significant shareholders to understand any issues and concerns they may have. This is in accordance with both the Code and the UK Stewardship Code. The non-executive directors meet informally with shareholders both before and after the AGM and respond to shareholder queries and requests as necessary. The chairman ensures that the board is kept informed of principal investors' and advisers' views on strategy, and corporate governance.

We also have an established programme of educational seminars for our institutional shareholders focusing on individual parts of Pearson. These seminars are available to all shareholders via webcast on www.pearson.com.

Private investors represent over 80% of the shareholders on our register and we make a concerted effort to engage with them regularly. Shareholders who cannot attend the AGM are invited to email questions to the chairman in advance at glenmoreno-agm@pearson.com.

We encourage our private shareholders to become more informed investors and have provided a wealth of information on our website about managing Pearson shareholdings, see www.pearson.com/investors/shareholder-information for further information or turn to page 210 of this report. We also encourage all shareholders, who have not already done so, to register their email addresses through our website and with our registrar. This enables them to receive email alerts when trading updates and other important announcements are added to our website.

Board governance continued

We post all company announcements on our website, www.pearson.com, as soon as they are released, and major shareholder presentations are made accessible via webcast or conference call. Our website contains a dedicated investor relations section with an extensive archive of past announcements and presentations, historical financial performance, share price data and a calendar of events. It also includes information about all of our businesses, links to their websites and details of our corporate responsibility policies and activities.

We are committed to ensuring that all our shareholders receive their dividends and encourage the use of our dividend mandate service which enables UK and many overseas shareholders to receive dividends directly into their nominated bank account.

Due to its continued popularity we again provided shareholders with smaller holdings the opportunity to use our registrar's low-cost share dealing service, giving them the chance to add to or reduce their stake in Pearson at significantly reduced dealing rates, or to donate shares to charity with ease. This service proved very popular with shareholders, and consequently we intend to offer this service again at a future date.

We believe it is important that our employees have a shared interest in the direction and achievements of Pearson and are pleased to say that a large number of our employees are shareholders in the company.

Our AGM – which will be held on 25 April this year – is an opportunity for all shareholders to meet the board and to hear presentations about Pearson's businesses and results.

Board committees

The board has established three formal committees: the nomination committee, the remuneration committee and the audit committee. The chairmen and members of these committees are appointed by the board on the recommendation (where appropriate) of the nomination committee and in consultation with each relevant committee chairman.

In addition to these board committees, two further committees operate with board input: the standing committee and the reputation and responsibility committee which primarily focuses on reputational risk. More detail on the work of this committee can be found within the principal risks and uncertainties section on pages 41 to 45.

During 2013, the balance of work considered by the board and its formal committees has shifted, so that more time is spent by the committees discussing their areas of expertise, enabling the board meetings to focus on strategy and performance. Reports to the board by each of the committee chairmen continue to form a standing item on each board agenda, ensuring a good communication flow between the bodies.

The following table shows attendance by directors at committee meetings throughout 2013.

	Audit committee meetings	Remuneration committee meetings	Nomination committee meetings
Glen Moreno	–	5/5	5/5
John Fallon	–	–	5/5
David Arculus*	4/5	5/5	3/5
Vivienne Cox	4/5	3/5	5/5
Susan Fuhrman**	3/3	–	3/4
Ken Hydon	5/5	5/5	5/5
Josh Lewis***	5/5	4/4	5/5
Linda Lorimer	–	–	2/2
Harish Manwani	–	–	1/1

* Unable to travel due to injury

** Stood down on 7 August 2013

*** Joined remuneration committee on 23 April 2013

NOMINATION COMMITTEE

Chairman Glen Moreno

Members David Arculus, Vivienne Cox, John Fallon, Ken Hydon, Josh Lewis, Linda Lorimer, Harish Manwani and Glen Moreno

The nomination committee meets at least once a year and at other times as and when required. The committee primarily monitors the composition and balance of the board and its committees, and identifies and recommends to the board the appointment of new directors and/or committee members.

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During 2013, the committee met five times with its primary focus being to consider suitable candidates for non-executive positions, culminating in the appointment of Linda Lorimer and Harish Manwani to the board. An external search consultancy, Egon Zehnder, was used during the recruitment process. Egon Zehnder does not have any other connection to Pearson apart from as a search consultancy. Pearson uses a number of leading firms in its board and executive search activities.

During the year, the committee also discussed and approved the appointments of Josh Lewis to the remuneration committee and of Linda Lorimer to the audit committee, in place of Josh Lewis who stepped down at the end of 2013. Linda Lorimer and Harish Manwani also joined the nomination committee following their appointments to the board during the year.

Although the chairman of the board chairs the nomination committee, he is not permitted to chair meetings when the appointment of his successor is being considered or during a discussion regarding his performance. At such times, the senior independent director will chair the meetings.

The committee has written terms of reference which clearly set out its authority and duties. These can be found on the company website at www.pearson.com/investors/shareholder-information/governance.

Diversity

The board embraces the Code's underlying principles with regard to board balance and diversity, including gender diversity. The nomination committee, led by the chairman, ensures that the directors of Pearson demonstrate a broad balance of skills, experience and nationality, to support Pearson's strategic development and reflect the global nature of the Group's business.

The committee and the board always take account of diversity in its broadest sense when considering board appointments whilst ensuring that appointments are made based on merit and relevant experience.

Lord Davies' review published in 2011 called for companies to target 25% female representation on boards of FTSE 100 companies by 2015. Pearson is committed to having at least 30% female directors within Lord Davies' 2015 timeframe and currently has two female directors on its board of nine (representing 22%). With the retirement of three female directors over the last year, the committee is actively seeking to recruit at least one additional female board member.

Immediately below board level, the Pearson Executive, not including the chief executive and chief financial officer who are main board directors, has four female members out of a total of 13 (representing 31%).

Pearson considers diversity as an important issue across the Group, not just at board level. One of the key aims of Pearson's diversity policy is to increase the number of leaders coming from a diverse background, including advancing more women into leadership positions. The Responsible business section of this report on pages 47 to 53 contains further information and statistics on diversity throughout the Group.

REMUNERATION COMMITTEE

Chairman David Arculus

Members David Arculus, Vivienne Cox, Ken Hydon, Josh Lewis and Glen Moreno

The remuneration committee reports to the full board and the directors' remuneration report, which has been considered and adopted by the board, is set out on pages 78 to 114.

The committee met five times during the year, and has a written charter and terms of reference which clearly set out its authority and duties. These can be found on the company website at www.pearson.com/investors/shareholder-information/governance.

Board governance continued

AUDIT COMMITTEE

Chairman Ken Hydon

Members David Aiculus, Vivienne Cox, Ken Hydon and Linda Lorimer

As a committee we welcome the new governance requirements for the financial statements, enshrined in the changes to the Code introduced in 2013, and in particular that the report and accounts need to be fair, balanced and understandable. The production, co-ordination and review of the annual report and accounts is a substantial exercise which needs to be undertaken within a relatively short timeframe, running alongside the formal audit process undertaken by our external auditors. In order to arrive at a position where the audit committee and the board are satisfied with the overall fairness, balance and clarity of the document we discussed the new requirements and agreed with management a robust process of review and approval.

The committee is aware of the recommendations of the Competition Commission and the EU on audit tender and rotation, and currently expects that the tender process will begin no later than 2017 for the 2018 financial year end. The committee reviews the auditor's independence on an annual basis and also monitors on a quarterly basis the nature and level of non-audit fees payable to them. As described later in this report, during 2013 Pearson spent a considerable amount of non-audit fees with PwC. In the main, this expenditure related to specific assurance and tax advisory services associated with the planned creation of the venture between Penguin and Random House, and both management and the audit committee believe that using PwC for these services was the most practical and economical solution for the company. We anticipate that this level of non-audit fee is unusual, and that the balance of audit to non-audit fee paid to PwC will return to more normal levels in 2014.

As I have said in previous years, a key part of the role of the committee is in providing oversight and reassurance to the board with regard to the integrity of the company's financial reporting, internal control policies, and procedures for the identification, assessment and reporting of risk. The latter two have been a particular focus for the Pearson audit committee throughout 2013 as the company embarked on such a wide ranging and significant transformational and organisational change through the launch of its global education strategy. Again, committee meetings are always attended by the chief financial officer and SVP internal audit and compliance and our external auditors and others often attend by invitation, including the chief executive and chairman.

During the year the audit committee continued to interact with local and business management, and in particular spent time with local management during their visit to South Africa, discussing the implementation of the company's anti-bribery and corruption policy, data protection, disaster recovery planning, risk registers and the Pearson code of conduct. The committee also added an additional fifth meeting to its annual calendar, both to allow an appropriate amount of time be set aside for consideration of all relevant matters, as well as to allow us to focus on a number of risk deep-dives, in particular on data security and privacy, treasury risk and anti-bribery and corruption.

In August 2013, Susan Fuhrman stood down from the board and audit committee, and at the end of 2013, Josh Lewis stood down from the committee and has been replaced by Linda Lorimer. We thank Susan and Josh for their wise counsel over the last few years and welcome Linda.

Ken Hydon

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Members

All of the audit committee members are independent non-executive directors and have financial and/or related business experience due to the senior positions they hold or have held in other listed or publicly traded companies and/or similar public organisations. Ken Hydon, chairman of the committee, is the company's designated financial expert. He is a Fellow of the Chartered Institute of Management Accountants, the Association of Chartered Certified Accountants and the Association of Corporate Treasurers. He also serves as audit committee chairman for Reckitt Benckiser Group plc and Merlin Entertainments plc, and until 2012 for Tesco plc and Royal Berkshire NHS Foundation Trust.

The qualifications and relevant experience of the other committee members are detailed on page 56.

Role and responsibilities

The committee has written terms of reference which clearly set out its authority and duties. These are reviewed annually and can be found on the company website at www.pearson.com/investors/shareholder-information/governance.

The committee has been established by the board primarily for the purpose of overseeing the accounting, financial reporting, internal control and risk management processes of the company and the audit of the financial statements of the company.

The committee is responsible for assisting the board's oversight of the quality and integrity of the company's external financial reporting and statements and the company's accounting policies and practices. The group's internal auditor has a dual reporting line to the chief financial officer and chair of the committee and external auditors have direct access to the committee to raise any matter of concern and to report on the results of work directed by the committee. The committee reports to the full board at every board meeting immediately following a committee meeting. It also reviews the independence of the external auditors, including the provision of non-audit services (further details of which can be found on page 73 and note 4 to the financial statements), and ensures that there is an appropriate audit relationship and that auditor objectivity and independence is upheld.

External audit

Based on management's recommendations, the committee reviews the proposal on the appointment of the external auditors. The committee reviewed the effectiveness and independence of the external auditors during 2013 and remains satisfied that the auditors provide effective independent challenge to management.

The review was conducted by distributing a questionnaire to key audit stakeholders including members of the audit committee, the chief executive, chief financial officer, SVP company secretarial, SVP internal audit and compliance, operating company CFOs and heads of corporate functions. In relation to specific comments received, the lead audit partner explained to the committee how PwC were monitoring and reviewing each highlighted area and confirmed that they would consider how to adapt their approach in light of feedback.

In addition, in accordance with our external auditor policy, Group internal audit performs an annual assessment of audit fees, services and independence. This review takes into account internal and external information and benchmarks and forms the basis for a recommendation by the committee to the board in respect of the appointment and compensation of our external auditor.

Recognising the importance of maintaining auditor independence and objectivity, the committee paid particular attention to this matter during 2013. PwC were appointed to provide assurance procedures over the completion balance sheet and tax advice on the Penguin Random House transaction. This decision was made only after careful consideration of the alternatives, as well as ensuring that appropriate safeguards were put in place to maintain independence. As a result of this decision, non-audit fees paid to PwC exceeded Pearson's target proportion of audit fees during the year.

Board governance continued

The committee will continue to review the performance of the external auditors on an annual basis and will consider their independence and objectivity, taking account of all appropriate guidelines. There are no contractual obligations restricting the committee's choice of external auditors. In any event, the external auditors are required to rotate the audit partner responsible for the Group audit every five years. The current lead audit partner rotated onto the Group's audit in 2013.

Pearson's last audit tender was in respect of the 1996 year end resulting in the appointment of Price Waterhouse as auditors. Given the recent rotation of lead audit partner ahead of the 2013 reporting period and giving careful consideration to the timing and other practicalities of undertaking a formal audit tendering process, the committee agreed that a tender process would commence no later than 2017 to ensure auditors have been appointed in time for the 2018 year end audit, following the end of the current lead

partner's term. The committee is also monitoring developments from the Competition Commission on audit tendering and at EU level regarding mandatory audit rotation for listed companies, and will factor any legislative requirements into its future plans for audit tender.

Significant issues

During the year, the committee discussed the planning, conduct and conclusions of the external audit as it proceeded.

At the July 2013 audit committee meeting, the committee discussed and approved the auditors' Group audit plan and reviewed the key risks of misstatement of the Group's financial statements, which were updated at the December 2013 committee meeting. The table below sets out the significant issues considered by the audit committee together with details of how these items have been addressed.

SIGNIFICANT ISSUES**Penguin Random House transaction**

A number of complex accounting and business model changes including disposal accounting, valuation of the new business and intangibles, associate accounting including harmonisation of accounting policies, changes to existing operating model of shared services, infrastructure and corporate costs such as pensions.

Revenue recognition

This is considered significant in light of a number of products and services sold by Pearson where revenue recognition practices are complex and management assumptions and estimates are necessary.

HOW ISSUES WERE ADDRESSED

The committee discussed this issue at a number of meetings including reviewing management's discussion of the significant accounting judgements and estimates and monitoring the views of the external auditors. The committee and management have visibility of Penguin Random House's accounting to ensure that all accounting policies, valuations and adjustments are considered in Pearson's accounts. The committee monitors and, where appropriate, challenges mitigating actions by management. These actions include key Sarbanes-Oxley controls over acquisition and disposal accounting including review by the technical accounting team, use of external valuation experts and use of local management to ensure that policies and operating model are communicated and adjusted as required.

The committee receives a regular presentation from management on revenue recognition and routinely monitors the views of the external auditors on this issue. The committee has visibility to internal audit findings relating to revenue recognition controls and processes, the related management action plans and timely closure of open issues. The committee monitors and, where appropriate, challenges mitigating actions by management. These actions include key Sarbanes-Oxley controls and identification of significant contracts through the 'large and unusual' process such that accounting treatment can be agreed by specialists.

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SIGNIFICANT ISSUES

US tax activity

Changes to processes, structure and strategy in 2012 and 2013, and IRS audit activity

Impairment of goodwill and intangibles

The Group carries significant goodwill and acquired intangible asset balances. There is judgement in the identification and aggregation of cash generating units (CGUs) and in the assumptions used in the annual goodwill impairment review.

HOW ISSUES WERE ADDRESSED

The committee met with the SVP Tax twice during 2013, discussed the tax strategy and held a risk deep dive into the tax process in October. Key tax accounting matters including judgements and estimates were reported to the committee by management, and the committee monitored the views of the external auditors on the company's tax accounting. The committee monitors and, where appropriate, challenges mitigating actions by management. These actions include key Sarbanes-Oxley controls in place in the US, and improved UK central oversight to ensure critical judgements are appropriately reviewed and understood.

The committee considered the results of the Group's annual goodwill impairment review and management's judgements and assumptions used in arriving at a valuation for each of the Group's CGUs. The key assumptions are cash flows derived from strategic plans, long-term growth rates and weighted average cost of capital. The committee also considered sensitivities to changes in assumptions and related disclosures as required by IAS 36 'Impairment of Assets'. The annual impairment review in 2013 showed that there was sufficient headroom in each of the Group's CGUs and based on the sensitivity analysis a reasonably possible change in any of the assumptions is unlikely to cause an impairment in any of the CGUs.

The committee discussed these issues with the auditors at the time of their review of the half year interim financial statements in July 2013 and again at the conclusion of their audit of the financial statements for the year in February 2014. All the significant issues were areas of focus for the auditors, as detailed in their report on pages 116 to 122.

In December 2013, the committee discussed with the auditors the status of their work, focusing in particular on internal controls and covering the significant issues outlined above.

As the auditors concluded their audit, they explained to the committee:

- › The work they had conducted over revenue, which included targeted procedures and testing of products and services which were considered to have more complex revenue recognition, such as multiple element arrangements (e.g. the provision of supplementary print or digital materials or training with textbooks) and certain long-term contracts in the education businesses,
- › Their evaluation of the directors' assessment of the Penguin Random House transaction and assessment of valuations of that business and associate accounting,
- › The work they had done to understand the Group's tax strategy and identify business and legislative risks, to challenge key underlying assumptions and assess the recoverability of deferred tax assets,

- › Their assessment and evaluation of returns provisions and controls in the shipment and returns processes, particularly in light of the ongoing business transition from print to digital,
- › Their evaluation of the recoverability of pre-publication assets and inventories. These are considered to be material and judgement is required to evaluate their valuation plus estimating recoverability may be more complex during the transition to digital,
- › Their focus on goodwill impairment due to the Group's significant goodwill and intangible asset balances, and the work they had done to test management's impairment analysis, underlying assumptions, calculation of discount and growth rates and integrity of the valuation model,
- › The results of their controls testing to date for Sarbanes-Oxley Act section 404 reporting purposes and in support of their financial statements audit, and
- › The review of the company's 'going concern' reports.

The auditors also reported to the committee the misstatements that they had found in the course of their work, which were insignificant, and the committee confirmed that there were no material items remaining unadjusted in these financial statements.

Board governance continued

Training

The committee receives regular technical updates as well as specific or personal training as appropriate. During 2013, the committee discussed with PwC at an audit committee meeting the new Code requirement for the annual report and accounts to be 'fair, balanced and understandable', and the disclosure committee undertook a training session on the subject.

Committee members also meet with local management on an ongoing basis in order to gain a better understanding of how Group policies are embedded in operations.

Meetings

The committee met five times during the year with the following in attendance: the chief financial officer, SVP internal audit and compliance, members of the senior management team, and the external auditors. Additionally, the chief executive and chairman periodically attended committee meetings. The committee also met regularly in private with the external auditors and the SVP internal audit and compliance.

At every meeting, the committee considered reports on the activities of the Group internal audit function, including the results of internal audits, risk reviews, project assurance reviews and fraud and whistleblowing reports. The committee also monitored the company's financial reporting, internal controls and risk management procedures, reviewed the non-audit services provided by PwC and considered any significant legal claims and regulatory issues in the context of their impact on financial reporting.

Specifically, the committee considered the following matters during the course of the year:

- › The 2012 annual report and accounts preliminary announcement, financial statements and income statement,
- › The Group accounting policies,
- › Compliance with the Code,
- › Form 20-F and related disclosures including the annual Sarbanes-Oxley Act section 404 attestation of financial reporting internal controls,
- › Receipt of the external auditors' report on the Form 20-F and on the year end audit,
- › Penguin Random House transaction – accounting matters,

- › Assessment of the effectiveness of the Group's internal control environment,
- › Reappointment, remuneration and engagement letter of the external auditors,
- › Provision of non-audit services by PwC,
- › Review of the interim financial statements and announcement,
- › Review of key findings of over 100 Group internal audits and special projects,
- › Annual reapproval of the Group internal audit mandate,
- › Compliance with SEC and NYSE requirements including Sarbanes-Oxley Act,
- › Reviews of the effectiveness of the audit committee, the external auditors and the Group internal audit function,
- › External auditor benchmarking,
- › Review of the committee's terms of reference,
- › Annual internal audit plan,
- › Review of company risk maps and mitigating actions for top risks,
- › Risk deep dives – anti-bribery and corruption, data security and privacy, and treasury risk,
- › Implementation of new health and safety strategy, policy and reporting of any significant incidents,
- › Fraud, whistleblowing and code of conduct matters
- › Review of Group tax strategy, tax risks and tax departmental structure, and
- › Annual review of treasury policy and strategy

At its December meeting, the committee considered the Group's business continuity planning, the latest internal report on which indicated that readiness to withstand significant business interruption does not currently meet Pearson's own stringent standards. It was noted that workable plans generally existed but that, in light of the scale of business transformation, these plans had not been updated or tested within the past year. The committee reported this risk to the board at its December meeting where it was noted that management had in principle accepted the level of risk on the basis that the restructured organisation would change the focus of business continuity plans which would consequently require updating.

In February 2014, the committee also considered the 2013 annual report and accounts, including the preliminary announcement, financial statements, strategic report, directors' report and corporate governance compliance statement.

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Internal control and risk management

The directors confirm they have conducted a review of the effectiveness of the Group's systems of risk management and internal controls, including strategic, financial, operational and compliance controls and risk management systems, in accordance with the Code and Turnbull guidance. These systems have been operating throughout the year and to the date of this report.

During 2013, the semi-annual reporting of top risks was reviewed by executive management as well as the board and audit committee. The principal risks are set out on pages 41 to 45, together with mitigating factors. During the year, the audit committee considered the oversight of specific selected principal risks, through a series of risk 'deep dives'. This is covered in more detail in the separate report on the audit committee.

The key elements and procedures that have been established to provide effective risk management and internal control systems are described below. We recognise that during 2014, we will need to align these existing procedures to the new organisation structure.

Control environment

The board of directors has overall responsibility for Pearson's system of internal control, which is designed to manage, and where possible mitigate, the risks facing the Group, safeguard assets and provide reasonable, but not absolute, assurance against material financial misstatement or loss.

Responsibility for monitoring financial management and reporting and risk management and internal control systems has been delegated to the audit committee by the board. At each meeting, the audit committee considers reports from management, Group internal audit and the external auditors, with the aim of reviewing the effectiveness of the internal financial and operating control environment of the Group.

The identification and mitigation of significant business risks is the responsibility of Group senior management and the management team for each business area – being the heads of the Lines of Business, Geographies and enabling functions. Each business area, including the corporate centre, maintains internal controls and procedures appropriate to its structure, business environment and risk assessment, whilst complying with Group policies, standards and guidelines.

Financial management and reporting

There is a comprehensive strategic planning, budgeting and forecasting system with an annual operating plan approved by the board of directors. Monthly financial information, including trading results, balance sheets, cash flow statements, capital expenditures and indebtedness, is reported against the corresponding figures for the plan and prior years, with corrective action outlined by the appropriate senior executive. Group senior management meet periodically with business area management to review their business and financial performance against plan and forecast. Major risks relevant to each business area as well as performance against the stated financial and strategic objectives are reviewed in these meetings.

We have an ongoing process to monitor the risks and effectiveness of controls in relation to the financial reporting and consolidation process including the related information systems. This includes up-to-date Group financial policies, formal requirements for finance functions, Group consolidation reviews and analysis of material variances, Group finance technical reviews, including the use of technical specialists, and review and sign-off by senior finance managers. These processes are subject to reviews based on Group internal audit's risk based audit programme. The Group finance function also monitors and assesses these processes, through a finance compliance function.

These controls include those over external financial reporting which are documented and tested in accordance with the requirements of section 404 of the Sarbanes-Oxley Act, which is relevant to our US listing. One key control in this area is the disclosure committee, which reports directly to the audit committee. This committee is chaired by the SVP internal audit and compliance and members include the chief financial officer, general counsel, SVP financial communications, SVP company secretarial as well as senior members of financial management. The primary responsibility of this committee is to review Pearson's public reporting and disclosures to ensure that information provided to shareholders is complete, accurate and compliant with all applicable legislation and listing regulations.

The effectiveness of key financial controls is subject to management review and self-certification and independent evaluation by Group internal audit.

Board governance continued

An enterprise risk management (ERM) framework is in place to identify, evaluate and manage risks, including key financial reporting risks. Business areas undertake semi-annual risk reviews to identify new or potentially under-managed risks. Throughout the year, risk discussions are facilitated by the risk assurance team with Group and business area management to identify the key risks the company faces in achieving its objectives, to assess the probability and impact of those risks and to document the actions being taken to manage those risks. The Pearson Executive reviews the output of these sessions, focusing on the key risks facing the business. Management has the responsibility to consider and execute appropriate action to mitigate these risks whenever possible. The results of these reviews are reported to the audit committee and the board in detail.

Group internal audit

The Group internal audit function is responsible for providing independent assurance to management and the audit committee on the design and effectiveness of internal controls to mitigate strategic, financial, operational and compliance risks. The risk-based annual internal audit plan is approved by the audit committee. Management action plans to improve internal controls and to mitigate risks, or both, are agreed with each business area after each audit. Formal follow-up procedures allow Group internal audit to monitor business areas' progress in implementing its recommendations and to resolve any control deficiencies. Group internal audit has a formal collaboration process in place with the external auditors to ensure efficient coverage of internal controls. Regular reports on the work of Group internal audit are provided to executive management and, via the audit committee, to the board.

The SVP internal audit and compliance oversees compliance with our code of conduct and works with senior legal and human resources personnel to investigate any reported incidents including ethical, corruption and fraud allegations. The Pearson anti-bribery and corruption programme provides the framework to support our compliance with various anti-bribery and corruption regulations such as the UK Bribery Act 2010 and the US Foreign Corrupt Practices Act.

Treasury management

The treasury department operates within policies approved by the board and its procedures are reviewed regularly by the audit committee. Major transactions are authorised outside the department at the requisite level, and there is an appropriate segregation of duties. Frequent reports are made to the chief financial officer and regular reports are prepared for the audit committee and the board.

Insurance

Pearson purchases comprehensive insurance coverage where this is available on a cost-effective basis. Pearson's insurance subsidiary, Spear Insurance Company Limited, is used to leverage the risk retention capability of the Group and to achieve a balance between retaining insurance risk and transferring it to external insurers.

Going concern

Having reviewed the Group's liquid resources and borrowing facilities and the Group's 2014 and 2015 cash flow forecasts, the directors believe that the Group has adequate resources to continue as a going concern. For this reason, the financial statements have, as usual, been prepared on that basis. Information regarding the Group's borrowing liabilities and financial risk management can be found in notes 18 and 19 on pages 164 to 172.

Share capital

Details of share issues are given in note 27 to the accounts on page 185. The company has a single class of shares which is divided into ordinary shares of 25p each. The ordinary shares are in registered form. As at 31 December 2013, 818,580,447 ordinary shares were in issue. At the AGM held on 26 April 2013, the company was authorised, subject to certain conditions, to acquire up to 81,746,807 ordinary shares by market purchase. Shareholders will be asked to renew this authority at the AGM on 25 April 2014.

Information provided to the company pursuant to the Financial Conduct Authority's Disclosure and Transparency Rules (DTR) is published on a Regulatory Information Service and on the company's website.

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As at 4 March 2014, being the latest practicable date before the publication of this report, the company had been notified under DTR5 of the following significant voting rights in its shares

	Number of voting rights	Percentage as at date of notification
Harbor International Fund	24,598,034	3.01%
Libyan Investment Authority	24,431,000	3.01%

Annual General Meeting (AGM)

The notice convening the AGM, to be held at 12 noon on Friday, 25 April 2014 at 8 Northumberland Avenue, London WC2N 5BY, is contained in a circular to shareholders to be dated 24 March 2014

Registered auditors

In accordance with section 489 of the Act, a resolution proposing the reappointment of PricewaterhouseCoopers LLP (PwC) as auditors to the company will be proposed at the AGM, at a level of remuneration to be agreed by the directors

Auditors' independence

In line with best practice, our relationship with PwC is governed by our external auditors policy, which is reviewed and approved annually by the audit committee. The policy establishes procedures to ensure the auditors' independence is not compromised, as well as defining those non-audit services that PwC may or may not provide to Pearson. These allowable services are in accordance with relevant UK and US legislation.

The audit committee approves all audit and non-audit services provided by PwC. Certain categories of allowable non-audit services have been pre-approved by the audit committee subject to the authorities below:

- › Pre-approved non-audit services can be authorised by the chief financial officer up to £100,000 per project, subject to a cumulative limit of £500,000 per annum
- › Acquisition or disposal transactions and due diligence up to £100,000 per project may be performed by our external auditors, in light of the need for confidentiality. Any project/transaction generating fees in excess of £100,000 must be specifically approved by the audit committee,

- › Tax compliance and related activities up to the greater of £1,000,000 per annum or 50% of the external audit fee, and

- › For forward-looking tax advisory services we use the most appropriate adviser, usually after a tender process. Where we decide to use our independent auditors, authority, up to £100,000 per project subject to a cumulative limit of £500,000 per annum, has been delegated by the audit committee to management.

Services provided by PwC above these limits and all other allowable non-audit services, irrespective of value, must be approved by the audit committee. Where appropriate, services will be tendered prior to a decision being made as to whether to award work to the auditors.

The audit committee receives regular reports summarising the amount of fees paid to the auditors. During 2013, Pearson spent a considerable amount of non-audit fees with PwC. In the main, this expenditure related to specific assurance and tax advisory services associated with the planned creation of the venture between Penguin and Random House. PwC were selected only after consideration that it was most practical and economical to utilise PwC for these services. We anticipate that this level of non-audit fee is unusual, and that the balance of audit to non-audit fee paid to PwC will return to more normal levels in 2014. Other significant non-audit work performed by PwC during 2013 was:

- › Tax compliance services related to a routine audit by the US Internal Revenue Service;
- › Assurance services on a corporate bond issued in May 2013, and
- › Other assurance services which were individually less than £100,000 per project.

In each case, PwC was selected as they were best able to provide the services we required at a reasonable fee and within the terms of our external auditors policy. To assist in ensuring that independence and objectivity is maintained for forward-looking tax advisory and due diligence work PwC assign a different partner from the one leading the external audit.

A full statement of the fees for audit and services is provided in note 4 to the accounts on page 141.

Board governance continued

Fair, balanced and understandable reporting

Pearson is mindful of the Code's revised principle C1.1 relating to fair, balanced and understandable reporting and has accordingly built in additional steps to its annual report timetable to ensure that the directors are given sufficient opportunity to review, consider and comment on the report

The disclosure committee and the board each held an additional meeting as part of their review process, and members of the disclosure committee also attended a training session provided by PwC to better understand the requirements. In addition, the audit committee is available to advise the board on certain aspects of the report, to enable the directors to fulfil their responsibility in this regard

Statement of directors' responsibilities

The directors are responsible for preparing the annual report, the report on directors' remuneration and the financial statements in accordance with applicable law and regulations

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the Group and parent company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and the Group and of the profit or loss of the Group for that period

In preparing these financial statements, the directors are required to

- › Select suitable accounting policies and then apply them consistently,
- › Make judgements and accounting estimates that are reasonable and prudent,
- › State whether applicable IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements, and
- › Prepare the financial statements on a going concern basis unless it is inappropriate to presume that the company and/or the Group will continue in business

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position

of the company and the Group and enable them to ensure that the financial statements and the report on directors' remuneration comply with the Act and, as regards the Group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities

The directors are responsible for the maintenance and integrity of the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions

Each of the directors, whose names and functions are listed on pages 55 and 56, confirm that to the best of their knowledge

- › The Group financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit of the Group and company, and
 - › The directors' report contained in the annual report includes a fair review of the development and performance of the business and the position of the company and Group, together with a description of the principal risks and uncertainties that they face
- The directors also confirm that, for all directors in office at the date of this report:

- a) so far as the directors are aware, there is no relevant audit information of which the company's auditors are unaware, and
- b) they have taken all the steps that they ought to have taken as directors in order to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information

In addition, the directors as at the date of this report consider that the annual report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy

Sections one to four of this document contain the information required to be disclosed in the directors' report and were approved by the board on 10 March 2014 and signed on its behalf by


Philip Hoffman Secretary

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Additional information for shareholders

Set out below is other statutory and regulatory information that Pearson is required to disclose in its directors' report

Amendment to Articles of Association

Any amendments to the Articles of Association of the company (the Articles) may be made in accordance with the provisions of the Companies Act 2006 (the Act) by way of a special resolution

Rights attaching to shares

The rights attaching to the ordinary shares are defined in the Articles. A shareholder whose name appears on the company's register of members can choose whether his/her shares are evidenced by share certificates (i.e. in certificated form) or held electronically (i.e. uncertificated form) in CREST (the electronic settlement system in the UK)

Subject to any restrictions below, shareholders may attend any general meeting of the company and, on a show of hands, every shareholder (or his/her representative) who is present at a general meeting has one vote on each resolution for every ordinary share of which they are the registered holder. A resolution put to the vote at a general meeting is decided on a show of hands unless before, or on the declaration of the result of, a vote on a show of hands, a poll is demanded. A poll can be demanded by the chairman of the meeting, or by at least three shareholders (or their representatives) present in person and having the right to vote, or by any shareholders (or their representatives) present in person having at least 10% of the total voting rights of all shareholders, or by any shareholders (or their representatives) present in person holding ordinary shares on which an aggregate sum has been paid up of at least 10% of the total sum paid up on all ordinary shares. At this year's AGM voting will again be conducted on a poll, consistent with best practice.

Shareholders can declare a final dividend by passing an ordinary resolution but the amount of the dividend cannot exceed the amount recommended by the board. The board can pay interim dividends on any class of shares of the amounts and on the dates and for the periods they decide. In all cases the distributable profits of the company must be sufficient to justify the payment of the relevant dividend.

The board may, if authorised by an ordinary resolution of the shareholders, offer any shareholder the right to elect to receive new ordinary shares, which will be credited as fully paid, instead of their cash dividend.

Any dividend which has not been claimed for 12 years after it became due for payment will be forfeited and will then belong to the company, unless the directors decide otherwise.

If the company is wound up, the liquidator can, with the sanction of a special resolution passed by the shareholders, divide among the shareholders all or any part of the assets of the company and he/she can value assets and determine how the division shall be carried out as between the shareholders or different classes of shareholders. The liquidator can also, with the same sanction, transfer the whole or any part of the assets to trustees upon such trusts for the benefit of the shareholders.

Voting at general meetings

Any form of proxy sent by the shareholders to the company in relation to any general meeting must be delivered to the company (via its registrars), whether in written or electronic form, not less than 48 hours before the time appointed for holding the meeting or adjourned meeting at which the person named in the appointment proposes to vote.

No shareholder is, unless the board decides otherwise, entitled to attend or vote either personally or by proxy at a general meeting or to exercise any other right conferred by being a shareholder if he/she or any person with an interest in shares has been sent a notice under section 793 of the Act (which confers upon public companies the power to require information with respect to interests in their voting shares) and he/she or any interested person failed to supply the company with the information requested within 14 days after delivery of that notice. The board may also decide, where the relevant shareholding comprises at least 0.25% of the nominal value of the issued shares of that class, that no dividend is payable in respect of those default shares and that no transfer of any default shares shall be registered.

Pearson operates two employee benefit trusts to hold shares, pending employees becoming entitled to them under the company's employee share plans.

Board governance continued

There were 9,282,365 shares so held as at 31 December 2013. Each trust has an independent trustee which has full discretion in relation to the voting of such shares. A dividend waiver operates on the shares held in these trusts.

Pearson also operates a nominee shareholding arrangement known as Sharestore which holds shares on behalf of employees. There were 4,564,039 shares so held as at 31 December 2013. The beneficial owners of shares held through Sharestore are invited to submit voting instructions online at www.shareview.co.uk. If no instructions are given by the beneficial owner, the trustees holding these shares will not exercise the voting rights.

Transfer of shares

The board may refuse to register a transfer of a certificated share which is not fully paid, provided that the refusal does not prevent dealings in shares in the company from taking place on an open and proper basis. The board may also refuse to register a transfer of a certificated share unless (i) the instrument of transfer is lodged, duly stamped (if stampable), at the registered office of the company or any other place decided by the board, and is accompanied by the certificate for the share to which it relates and such other evidence as the board may reasonably require to show the right of the transferor to make the transfer; (ii) it is in respect of only one class of shares, and (iii) it is in favour of not more than four transferees.

Transfers of uncertificated shares must be carried out using CREST and the board can refuse to register a transfer of an uncertificated share in accordance with the regulations governing the operation of CREST.

Variation of rights

If at any time the capital of the company is divided into different classes of shares, the special rights attaching to any class may be varied or revoked either

- (i) with the written consent of the holders of at least 75% in nominal value of the issued shares of the relevant class, or
- (ii) with the sanction of a special resolution passed at a separate general meeting of the holders of the shares of the relevant class.

Without prejudice to any special rights previously conferred on the holders of any existing shares or class of shares, any share may be issued with such preferred, deferred, or other special rights, or such restrictions, whether in regard to dividend, voting, return of capital or otherwise as the company may from time to time by ordinary resolution determine.

Appointment and replacement of directors

The Articles contain the following provisions in relation to directors:

Directors shall number no less than two. Directors may be appointed by the company by ordinary resolution or by the board. A director appointed by the board shall hold office only until the next AGM and shall then be eligible for reappointment, but shall not be taken into account in determining the directors or the number of directors who are to retire by rotation at that meeting. The board may from time to time appoint one or more directors to hold executive office with the company for such period (subject to the provisions of the Act) and upon such terms as the board may decide and may revoke or terminate any appointment so made.

The Articles provide that, at every AGM of the company, at least one-third of the directors shall retire by rotation (or, if their number is not a multiple of three, the number nearest to one-third). The first directors to retire by rotation shall be those who wish to retire and not offer themselves for re-election. Any further directors so to retire shall be those of the other directors subject to retirement by rotation who have been longest in office since they were last re-elected but, as between persons who became or were last re-elected on the same day, those to retire shall (unless they otherwise agree among themselves) be determined by lot. In addition, any director who would not otherwise be required to retire shall retire by rotation at the third AGM after they were last re-elected.

Notwithstanding the provisions of the Articles, the board has resolved that all directors should offer themselves for re-election annually, in accordance with the Code.

The company may by ordinary resolution remove any director before the expiration of his/her term of office. In addition, the board may terminate an agreement or arrangement with any director for the provision of his/her services to the company.

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Powers of the directors

Subject to the company's Articles, the Act and any directions given by special resolution, the business of the company will be managed by the board who may exercise all the powers of the company, including powers relating to the issue and/or buying back of shares by the company (subject to any statutory restrictions or restrictions imposed by shareholders in general meeting)

Significant agreements

The following significant agreements contain provisions entitling the counterparties to exercise termination or other rights in the event of a change of control of the company

Under the \$1,750,000,000 revolving credit facility agreement dated November 2010 which matures in November 2015 between, amongst others, the company, HSBC Bank plc (as facility agent) and the banks and financial institutions named therein as lenders (the Facility) any such bank may, upon a change of control of the company, require its outstanding advances, together with accrued interest and any other amounts payable in respect of such Facility, and its commitments, to be cancelled, each within 60 days of notification to the banks by the facility agent. For these purposes, a 'change of control' occurs if the company becomes a subsidiary of any other company or one or more persons acting either individually or in concert, obtains control (as defined in section 1124 of the Corporation Tax Act 2010) of the company

Shares acquired through the company's employee share plans rank *pari passu* with shares in issue and have no special rights. For legal and practical reasons, the rules of these plans set out the consequences of a change of control of the company

Report on directors' remuneration

Dear shareholders

I am pleased to present our report on directors' remuneration for 2013

The report and related resolutions will be put forward for your consideration and approval at the annual general meeting on 25 April 2014

I should like to start by summarising the decisions on, and the changes to, directors' remuneration made during the year and importantly the context in which those changes occurred and decisions have been taken

Pearson has a unique set of advantages with which to help meet the global demands for better education and skills. And, by being better able to meet some of the biggest challenges in global education, we can build a stronger, more profitable and faster growing company

To get there Pearson has fundamentally changed the way the company is organised. From January this year, Pearson is being run as one globally-connected education company, working to an operating model designed specifically to support a global education strategy, and a new executive team has been appointed to lead it. The new model ensures that the company will be organised around a smaller number of global products and platforms built around a single, world-class infrastructure and common systems and processes

Over time this will help Pearson to grow more quickly, as it will free up resources to invest in digital transformation, and the new, more service oriented, products that are vital to future growth. It should enable the company to increase the rate of innovation and invention, by focusing on the research and development of the next generation of global products that will have the data to demonstrate their positive impact on learning outcomes

Pearson's executive remuneration arrangements have been reviewed to align with and better support this strategy. Executive remuneration decisions have been made after careful consideration of the needs of the business, the transformation and reorganisation of the business and the impact on roles and responsibilities, the pay markets in which Pearson operates and changes in pay elsewhere within the company

This strategy also informs our remuneration philosophy and policy and complements our more traditional financial measures. In financial terms, Pearson's goal is to achieve sustainable growth on three key financial goals (earnings, cash and return on invested capital) and reliable cash returns to our investors through healthy and

growing dividends. We believe those are, in concert, good indicators that we are building the long-term value of Pearson. So those measures (or others that contribute to them) form the basis of our annual budgets and strategic plans and the basis for annual and long-term incentives

The remuneration committee is continually sensitive to the current social and economic environment surrounding executive compensation

We welcome the UK government's action to improve the clarity and transparency of remuneration disclosure. We welcome the introduction of the new executive remuneration reporting requirements including a new binding vote on policy

We hope that these changes will continue to demonstrate the link between our remuneration policy and practice and the company's strategy and performance, as well as our commitment to shareholder engagement

Performance in 2013

In 2013, trading was tough in many of our biggest and most established markets. Overall, we saw

- › sales up 2% on 2012 at constant exchange rates
- › adjusted operating profit 6% lower before net restructuring charges
- › our dividend raised 7% which was Pearson's 22nd straight year of increasing our dividend above the rate of inflation

Over the past ten years we have increased our dividend at a compound annual rate of 7%, returning £2.9bn to shareholders. Restructuring is on track to deliver benefits in 2014 and beyond.

Principles of remuneration policy

The remuneration committee believes that the purpose of its remuneration policy is to support the company's strategy and to help deliver sustained performance and consistent long-term value creation in the interests of all stakeholders

Our reward policy is aligned with the interests of all stakeholders in providing

- › competitive base salaries that reflect the market and individual roles and contribution
- › a high proportion of total remuneration being delivered in variable forms that are directly linked to the annual and long-term performance of the company
- › annual incentives that reward achievement of strategic goals

- › long-term incentives that drive long-term earnings and share price growth and encourage participants in these plans to acquire and hold Pearson shares in line with shareholders' interests

- › the opportunity for many people at Pearson to share in the company's success through cash-based annual incentives and bonuses and worldwide participation in share ownership plans, continuing practices first started in 1998

We continue to keep our remuneration policy under review in light of the prevailing economic conditions and the impact of these on the company's objectives and strategy

What we did in 2013

Looking back to some specific aspects of policy and practice in 2013

- › we reviewed and established an appropriate starting remuneration package for John Fallon comprising base salary, annual and long-term incentives, allowances and benefits
- › we reviewed and amended the service agreements for those executive directors including the CEO, who continued to serve throughout 2013. The consequence of this review was to remove any entitlement to annual incentive from the calculation of any compensation that might be payable on termination of employment by the company without notice or cause
- › we undertook a regular periodic review of base salaries for 2013 taking into account general economic and market conditions, the level of increases made across the company as a whole, the remuneration of executives in similar positions in comparable companies and individual performance
- › appointments were made to the new Pearson Executive
- › annual incentives paid to executives for 2013 were below target as they were in 2012, reflecting performance in a tough trading environment
- › there was a nil pay-out on long-term incentives based on 2013 performance reflecting below threshold performance against the company's three-year targets for earnings per share growth, return on invested capital and relative total shareholder return

What we've planned for 2014

Looking forward, for 2014

- › we have undertaken a full review of the company's executive remuneration policy and either confirmed or, where necessary, established maximum opportunities for each of the different elements of remuneration to

ensure that this policy fully supports the needs of the business

- › we have aligned executive remuneration policy with the new global education strategy and 'one Pearson' organisation
- › we have listened to, and sought to address, shareholders' concerns and wishes regarding simplicity and alignment of interests
- › we actively consulted with our major shareholders and their representative bodies on the directors' remuneration policy set out in this report

As a consequence

- › while we have established maximum opportunities for each of the different elements of remuneration, in all cases these represent maximum limits or caps to cover all likely eventualities for the life of the policy and should not be deemed to be a target or an entitlement. For example, for 2014 there will be no increase in maximum annual incentive opportunities and award levels under the long-term incentive plan will be consistent with those seen in recent years and below the policy maximum
- › starting in 2014 and onwards, the size of the global annual incentive pool and the funding of all annual incentives across the company will be linked to overall Pearson results
- › for performance-related long-term incentive awards for 2014 for members of the Pearson Executive, to emphasise the importance of earnings growth and to reward the delivery of the desired outcomes from the strategic effort, the weighting of the performance metrics within the Pearson long-term incentive plan will be changed from one-third on each measure to half on earnings per share growth, one-third (no change) on return on invested capital and one-sixth on relative total shareholder return
- › for performance-related long-term incentive awards for 2015 and onwards, the averaging period for the calculation of relative total shareholder return will be moved to the period running up to the year end and the length of the averaging period will be increased to three months. This is understood to be more in line with institutional investors' preferences
- › to promote simplicity, the previous annual bonus share matching plan has ceased to operate with the last awards made in 2013 in respect of annual bonus for 2012. We have not made any compensatory adjustments to annual or long-term incentive opportunities to take this into account

Report on directors' remuneration continued

- › for performance-related long-term incentive awards for members of the Pearson Executive, performance will continue to be tested over three years and 75% of the vested shares will continue to be released at that point. However, starting with awards for 2014, there will be a mandatory restriction on participants' ability to dispose of the 75% of the vested shares (other than to meet personal tax liabilities) for a further two years. Furthermore, participants' rights to the release of the 25% of the vested shares will be subject to continued employment over the same period.
- › we have affirmed our commitment to share ownership and increased our mandatory shareholding guidelines to 300% of salary for the CEO and 200% of salary for other executive directors (compared to 200% and 125% respectively). We will continue to set performance targets for our annual and long-term incentive arrangements that are appropriately stretching.
- › on incentive pay-outs, we have clarified our arrangements for adjusting for malus and strengthened our provisions for clawback.

We are confident that these changed remuneration arrangements will better suit the needs of Pearson going forward.

Our policy and implementation is summarised in more detail in the remainder of this report.

I look forward to the ongoing support of Pearson shareholders on both the advisory vote on the executive remuneration arrangements as they were operated in the year as well as the forward-looking remuneration policy which is the subject of the binding vote.

I am personally committed to an ongoing dialogue with shareholders regarding executive remuneration and would therefore welcome any observations or questions that individual shareholders may wish to put forward to me. I can be contacted at david.arculus@integral2.com

Finally, I would like to thank my fellow members of the committee and the people who have assisted us for their contribution over the past year.

Yours sincerely,

David Arculus
Chairman, remuneration committee

Introduction

The rest of this report on directors' remuneration comprises

- › the directors' remuneration policy report – a forward-looking statement on remuneration policy for 2014 and beyond, and
- › the annual remuneration report – a report on remuneration practice in 2013.

Together, this report was compiled in accordance with Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2008 and was approved by the board of directors on 10 March 2014.

The committee believes that the company has complied with the provisions regarding remuneration matters contained within the UK Corporate Governance Code.

Where required under current regulations, the following tables have been subject to audit:

- › single total figure of remuneration and prior year comparison (page 97)
- › remuneration paid to the chairman and non-executive directors (page 98)
- › retirement benefits (page 101)
- › details of long-term share interests including awards made in 2013 (pages 102 to 105)
- › payments to former directors (pages 105 and 106)
- › payments for loss of office (page 107)
- › interests of directors and value of shareholdings (page 108)

Directors' remuneration policy report

This report outlines the company's policy on directors' remuneration that applies to executive directors, the chairman and non-executive directors. Reference is also made to the remuneration policy for other members of the Pearson Executive (currently 13 in number) who are not directors but who fall within the committee's remit.

The policy is intended to last three years and will take effect, subject to shareholder approval, at the AGM on 25 April 2014.

The policy report is comprised of the following parts:

- › future policy table
- › selection of performance measures and target setting
- › legacy arrangements under the annual bonus share matching plan
- › remuneration policy for other employees
- › pay and performance scenario analysis
- › other policies relating to directors such as recruitment, service contracts and termination provisions, executive directors' non-executive directorships
- › considerations taken into account when determining remuneration policy for directors
- › chairman's and non-executive directors' remuneration

The committee considers that a successful remuneration policy needs to be sufficiently flexible to take account of future changes in the company's business environment and in remuneration practice. Our starting point continues to be that total remuneration should reward both short- and long-term results, delivering competitive rewards for target performance but outstanding rewards for exceptional performance.

The committee has avoided, where possible, including general discretions in the policy table. However, exceptional or genuinely unforeseen circumstances may arise in the future and in those circumstances it may be in shareholders' interests for Pearson to put in place remuneration arrangements that are outside the terms of the policy set out in this report. If this happens, the committee will be permitted to implement remuneration arrangements that it considers appropriate in the circumstances. In these circumstances, Pearson would consult in advance with major shareholders before it does so and would explain the exercise of this discretion in the following year's directors' remuneration report.

Given the long-term nature of some of Pearson's remuneration structures – including obligations under service contracts, incentive plans and pension arrangements – a number of pre-existing obligations will remain at the time that the new policy becomes effective, including obligations that are 'grandfathered' by virtue of being in force at 27 June 2012. Pearson's policy is to honour all pre-existing obligations, commitments or other entitlements that were entered into before the effective date of this policy.

Report on directors' remuneration continued

Future policy table for executive directors

Total remuneration is made up of fixed and performance-linked elements, with each element supporting different strategic objectives. Total remuneration is normally reviewed annually and benchmarked against total remuneration for similar positions in comparable companies.

Base salary

PURPOSE AND LINK TO STRATEGY

- › Helps to recruit, reward and retain
- › Reflects competitive market level, role, skills, experience and individual contribution

OPERATION

Base salaries are set to provide the appropriate rate of remuneration for the job, taking into account relevant recruitment markets, business sectors and geographic regions. Base salaries may be set in sterling or the local currency of the country in which the director is based.

Base salaries are normally reviewed annually for the following year taking into account general economic and market conditions, the level of increases made across the company as a whole, particular circumstances such as changes in role, responsibilities or organisation, the remuneration and level of increases for executives in similar positions in comparable companies, and individual performance.

For benchmarking purposes, we review remuneration by reference to different comparator groups. We look at survey data from FTSE 100 companies with significant international exposure, excluding financial services, the FTSE 20-50, excluding financial services, a broad media industry group of US companies, select UK human capital-intensive businesses, and UK and US so-called media convergence companies with a focus on media, information services and technology. These companies are of a range of sizes relative to Pearson, but the method our independent advisers Towers Watson, use to make comparisons on remuneration

takes this variation in size into account. We also look at publicly disclosed and proxy data for global media convergence comparators with a focus on media and technology. We use these companies because they represent the wider executive talent pool from which we might expect to recruit externally and the pay market to which we might be vulnerable if our remuneration was not competitive.

Base salaries are paid in cash via the regular employee payroll (monthly in the UK and every two weeks in the US) and are subject to all necessary withholdings.

No malus or clawback provisions apply to base salary.

OPPORTUNITY

Base salary increases for executive directors will not ordinarily exceed 10% per annum and will take account of the base salary increases elsewhere within the company.

The committee will retain the discretion to deliver base salary increases in excess of 10% per annum in specific individual situations including internal promotions and material changes to the business or the role.

PERFORMANCE CONDITIONS

None, although performance of both the company and the individual are taken into account when determining an appropriate level of base salary increase each year.

PERFORMANCE PERIOD

None

Allowances and benefits

PURPOSE AND LINK TO STRATEGY

- › Help to recruit and retain
- › Reflect local competitive market

OPERATION

Allowances and benefits comprise cash allowances and non-cash benefits and *inter alia* include travel-related benefits (comprising company car, car allowance and private use of a driver), health-related benefits (comprising health care, health assessment and gym subsidy), and risk benefits (comprising additional life cover and long-term disability insurance that are not covered by the company's retirement plans) Allowances may also include, where appropriate, location and market premium and housing allowance although no continuing director is in receipt of such allowances Allowances and benefits received in 2013 are set out in the annual remuneration report

Directors are also covered by the company's directors' and officers' liability insurance and an indemnity in respect of certain third-party liabilities

Other benefits may be offered on the same terms as to other employees

Allowances and benefits do not form part of pensionable earnings

No malus or clawback provisions apply to allowances and benefits

Retirement benefits

PURPOSE AND LINK TO STRATEGY

- › Help to recruit and retain
- › Recognise long-term commitment to the company

OPERATION

New employees in the UK are eligible to join the Money Purchase 2003 section of the Pearson Group Pension Plan New employees in the US are eligible to join the 401(k) plan

Under the Money Purchase 2003 section of the Pearson Group Pension Plan in the UK, normal retirement age is 62, but, subject to company consent, retirement is currently possible from age 55 or earlier in the event of ill-health During service, the company and the employee make contributions into a pension fund Account balances are used to provide benefits at retirement Pensions for a member's spouse, dependent children and/or nominated financial dependants are payable on death

OPPORTUNITY

The provision and level of cash allowances and non-cash benefits are competitive and appropriate in the context of the local market

The total value of cash allowances and non-cash benefits for executive directors will not ordinarily exceed 15% of base salary in any year The committee will retain the discretion to deliver a total value of benefits in excess of 15% of base salary in specific individual situations including changes in individual circumstances such as health status, changes in the role such as relocation, increases in the cost of current benefits that are outside company control, and changes in benefits' providers

Executive directors are also eligible to participate in savings-related share acquisition programmes in the UK, US and rest of world, which are not subject to any performance conditions, on the same terms as other employees

PERFORMANCE CONDITIONS

None

PERFORMANCE PERIOD

None

Under the 401(k) plan in the US, which is a defined contribution plan, account balances will be used to provide benefits at retirement In the event of death before retirement, the account balances will be used to provide benefits for designated beneficiaries

Depending on when they joined the company, directors may participate in the Final Pay section of the Pearson Group Pension Plan in the UK or the defined benefit Pearson Inc Pension Plan in the US, both of which are closed to new members

Under the Final Pay section of the Pearson Group Pension Plan in the UK, normal retirement age is 62, but, subject to company consent, retirement is currently possible from age 55 or earlier in the event of ill-health During service, the employee makes a contribution of 5% of pensionable salary and the pension fund builds up based on final pensionable salary and pensionable service The accrued pension is reduced on retirement prior to age 60. Pensions for a member's spouse, dependent children and/or nominated financial dependants are payable on death

Report on directors' remuneration continued

Retirement benefits continued

In the US, the defined benefit Pearson Inc Pension Plan provides a lump sum benefit that is convertible to an annuity on retirement. The lump sum benefit accrued at an age dependent percentage of capped compensation until 31 December 2001 when further benefit accruals ceased for most employees.

Employees who satisfied criteria of age and service as of 30 November 1998 continue to earn benefits under an alternative formula that provides for 1.5% of final average earnings, adjusted for US Social Security. The benefit paid to these employees is the maximum of the lump sum benefit converted to an annuity and the benefit earned under the alternative final average earnings formula.

Executive directors and other executives across the company may be entitled to additional pension benefits to take account of the cap on the amount of benefits that can be provided from the all-employee pension arrangements in the US and the UK.

Members of the Pearson Group Pension Plan who joined after May 1989 are subject to an upper limit of earnings that can be used for pension purposes, known as the earnings cap. This limit, £108,600 as at 6 April 2006, was abolished by the Finance Act 2004. However the Pearson Group Pension Plan has retained its own 'cap', which will increase annually in line with the UK Government's Index of Retail Prices (All Items). The cap was £137,400 as at 6 April 2012. As a result of the UK Government's A-Day changes effective from April 2006, UK executive directors and other members of the Pearson Group Pension Plan who are, or become, affected by the lifetime allowance or new hires who opt out of membership of the Plan may be provided with a cash supplement of normally up to 26% of salary as an alternative to further accrual of pension benefits.

No malus or clawback provisions apply to retirement benefits.

Note Effective from 6 April 2011 the annual allowance (i.e. the maximum amount of pension saving that benefits from tax relief each year) reduced from £255,000 to £50,000 and will further reduce to £40,000 from 6 April 2014. Effective 6 April 2012 the lifetime allowance (i.e. the maximum amount of pension and/or lump sum that can benefit from tax relief) reduced from £1.8m to £1.5m and will further reduce to £1.25m from 6 April 2014.

OPPORTUNITY

In the UK, company contributions for eligible employees to the Money Purchase 2003 section of the Pearson Group Pension Plan amount up to 16% of pensionable salary (double the amount of the employee contribution, which is limited according to certain age bands).

In the US, company contributions to the 401(k) plan amount to 100% of the first 3% of eligible compensation contributed by the employee and 50% of the next 3%, plus a basic annual company contribution of 1.25% of eligible compensation. Pearson Inc Pension Plan participants who were at least age 40 at 31 December 2001 can receive an additional 0.5% to 1.5% of pay.

John Fallon is a member of the Final Pay section of the Pearson Group Pension Plan. His pension accrual rate is 1/30th of pensionable salary per annum, restricted to the plan earnings cap. Until April 2006, the company also contributed to a Funded Unapproved Retirement Benefits Scheme (FURBS) on his behalf. Since April 2006, he has received a taxable and non-pensionable cash supplement in replacement of the FURBS.

Robin Freestone is a member of the Money Purchase 2003 section of the Pearson Group Pension Plan. Company contributions are 16% of pensionable salary per annum, restricted to the plan earnings cap. Until April 2006, the company also contributed to a Funded Unapproved Retirement Benefits Scheme (FURBS) on his behalf. Since April 2006, he has received a taxable and non-pensionable cash supplement in replacement of the FURBS.

The company has no ongoing financial liabilities in respect of FURBS.

No continuing director is currently a member of the defined benefit Pearson Inc Pension Plan.

PERFORMANCE CONDITIONS

None

PERFORMANCE PERIOD

None

Annual incentives

PURPOSE AND LINK TO STRATEGY

- › Motivate the achievement of annual strategic goals and personal objectives
- › Provide a focus on key financial metrics
- › Reward individual contribution to the success of the company

OPERATION

Annual incentive is delivered entirely in cash and does not form part of pensionable earnings

Measures and performance targets are set by the committee at the start of the year with payment made after year end following the committee's assessment of performance relative to targets

The plans are designed to incentivise and reward underlying performance and actual results are adjusted for the effect of foreign exchange and for portfolio changes (acquisitions and disposals) and other factors that the committee considers relevant in the performance year

Annual incentive plans are discretionary. The committee reserves the right to adjust payments up or down before they are made if it believes exceptional factors warrant doing so. The committee may in exceptional circumstances make a special award where it is satisfied that the normal operation of the annual incentive does not provide an appropriate incentive or reward to participants

The committee also reserves the right as a form of malus to adjust payments before they are made if special circumstances exist that warrant this, such as financial misstatement, individual misconduct or reputational damage to the company

The committee also reserves, in the same special circumstances, a right to reclaim or claw back payments or awards that have already been made.

OPPORTUNITY

Annual incentives will not exceed 200% of base salary

For the chief executive, the individual maximum incentive opportunity that will apply for 2014 is 180% of base salary (which is the same as applied for 2013)

For other executive directors and other members of the Pearson Executive, individual maximum incentive opportunities vary by individual but will be no more than 170% of base salary

For the chief executive, other executive directors and other members of the Pearson Executive, there is normally no pay-out for performance at threshold

No adjustment has been made to annual incentive opportunities for the cessation of the annual bonus share matching plan under which the last conditional awards were made in 2013 in respect of 2012 annual incentive

PERFORMANCE CONDITIONS

The committee has the discretion to select the performance measures, targets and relative weightings from year to year to ensure continuing alignment with strategy and to ensure targets are sufficiently stretching

The committee establishes a threshold below which no pay-out is achieved and a maximum at or above which the annual incentive pays out in full

For 2014 and onwards, the funding of annual incentives will normally be related to the performance against targets for Pearson's adjusted earnings per share (or operating profit), sales, and operating cash flow. For 2014, the weightings will be 60% on adjusted earnings per share, 20% on sales and 20% on operating cash flow

Individual annual incentive pay-outs will also take into account individual performance against personal objectives. Personal objectives are agreed with the chief executive (or, in the case of the chief executive, the chairman) and may be functional, operational, strategic and non-financial and include *inter alia* objectives relating to environmental, social and governance issues

Details of performance measures, weightings and targets will be disclosed in the annual remuneration report for the relevant financial year if and to the extent that the committee deems them to be no longer commercially sensitive

PERFORMANCE PERIOD

One year

Report on directors' remuneration continued

Long-term incentives

PURPOSE AND LINK TO STRATEGY

- › Help to recruit, reward and retain
- › Drive long-term earnings, share price growth and value creation
- › Align the interests of executives and shareholders
- › Encourage long-term shareholding and commitment to the company
- › Link management's long-term reward and wealth to corporate performance in a flexible way

OPERATION

Awards of restricted shares are made on an annual basis

Awards of restricted shares for executive directors and other members of the Pearson Executive vest on a sliding scale based on performance against stretching corporate performance targets measured at the end of the three-year performance period

For performance-related awards for members of the Pearson Executive, performance will continue to be tested over three years and 75% of the vested shares will continue to be released at that point. However, starting with awards made in 2014, there will be a mandatory restriction on participants' ability to dispose of the 75% of the vested shares (other than to meet personal tax liabilities) for a further two years. Furthermore, participants' rights to the release of the 25% of the vested shares will be subject to continued employment over the same period

Where shares vest, participants also receive additional shares representing the gross value of dividends that would have been paid on these shares during the performance period and reinvested

The plan permits awards of restricted shares to be made that are not subject to performance conditions to satisfy reward and retention objectives. However, other than in exceptional circumstances on recruitment, it is the company's normal policy not to award restricted shares to executive directors and other members of the Pearson Executive without performance conditions

The long-term incentive plan also provides for the grant of stock options. Whilst it is not the committee's intention to grant stock options in 2014 or the foreseeable future, the committee believes that it should retain the flexibility of granting stock options in addition to, or instead of, restricted stock awards in the right circumstances. Any decision by the committee to grant stock options in the future

would take account of best practice prevailing at the time. The committee would consult with shareholders before granting stock options to executive directors

An option granted under the stock option element may not generally be exercised until a time specified when the option is granted. The date on which options would become exercisable would be set by the committee. Options may not be exercised later than the tenth anniversary of grant. Any options granted to executive directors would vest only if stretching performance conditions are achieved over a three-year minimum vesting period. Any options would vest on a sliding scale based on performance over the period. There will be no re-testing

Pearson's reported financial results for the relevant periods are used to measure performance

The committee reserves the right to adjust pay-outs up or down before they are released taking into account exceptional factors that distort underlying business performance or if it believes exceptional factors warrant doing so. In making such adjustments, the committee is guided by the principle of aligning shareholder and management interests

The committee also reserves the right as a form of malus to adjust pay-outs before they are released if exceptional circumstances exist that warrant this, such as financial misstatement, individual misconduct or reputational damage to the company.

The committee also reserves, in the same special circumstances, a right to reclaim or claw back pay-outs or awards that have already been released

OPPORTUNITY

We set the level of individual awards by taking into account

- › the face value of individual awards at the time of grant, assuming that performance targets are met in full,
- › market practice for comparable companies and market assessments of total remuneration from our independent advisers,
- › individual roles and responsibilities, and
- › company and individual performance

Restricted share awards to executive directors may normally be made up to a maximum face value of 400% of base salary. Awards in excess of 400% of base salary may be made in exceptional circumstances, for example, for retention purposes or to reflect particular business situations

The reasons for any such exceptional awards will be disclosed in the annual report for the year in which they are made

The value of awards at pay-out is subject to the extent to which performance and any other conditions are met and the share price at the time of vesting. The proportion of the award that vests at threshold level of performance may vary by performance condition

Whilst it is not the committee's intention to grant stock options in 2014 or the foreseeable future, the maximum value of stock option awards would be the equivalent expected value of the maximum restricted share awards set out above, based on an independent assessment of their net present value taking into account all the conditions

For 2014, we will set the level of individual restricted share awards consistent with those seen in recent years and within the policy maximum taking into account the factors set out above

No adjustment has been made to long-term incentive opportunities for the cessation of the annual bonus share matching plan under which the last conditional awards were made in 2013 in respect of 2012 annual incentive

PERFORMANCE CONDITIONS

The committee will determine the performance measures, weightings and targets governing an award of restricted shares prior to grant to ensure continuing alignment with strategy and to ensure that targets are sufficiently stretching

The committee establishes a threshold below which no pay-out is achieved and a maximum at or above which the award pays out in full

For 2014 and onwards, awards will normally be subject to the achievement of targets for growth in earnings per share, return on invested capital and relative total shareholder return. For 2014, to emphasise the importance of earnings growth and to reward the delivery of the desired outcomes from the strategic effort, the weighting of the performance metrics within the Pearson long-term incentive plan will be changed from one-third on each measure to half on earnings per share growth, one-third on return on invested capital (no change) and one-sixth on relative total shareholder return

We will set targets for the 2014 awards that are consistent with the company's strategic objectives over the period to 2016. Full details of the performance measures, weightings and targets for 2014 and the proportion of the award payable at threshold will be set out in the annual remuneration report for 2014

As with restricted shares, the committee will determine the performance conditions that apply to any awards of stock options prior to grant. The intention would be that these conditions would be the same as apply to restricted shares

Total shareholder return (TSR) is the return to shareholders from any growth in Pearson's share price and reinvested dividends over the performance period. For long-term incentive awards, TSR is measured relative to the constituents of the FTSE World Media Index over a three-year period. Companies that drop out of the index are normally excluded i.e. only companies in the index for the entire period are counted. Share price is averaged over three months at the start and end of the performance period. Dividends are treated as reinvested on the ex-dividend date, in line with the *Datastream* methodology. The vesting of shares based on relative TSR is subject to the committee satisfying itself that the recorded TSR is a genuine reflection of the underlying financial performance of the business

Return on invested capital (ROIC) is adjusted operating profit less cash tax expressed as a percentage of gross invested capital (net operating assets plus gross goodwill)

Adjusted earnings per share (EPS) is calculated by dividing the adjusted earnings attributable to equity shareholders of the company by the weighted average number of ordinary shares in issue during the year, excluding any ordinary shares purchased by the company and held in trust (see note 8 of the financial statements for a detailed description of adjusted earnings per share). EPS growth is calculated using the point-to-point method. This method compares the adjusted EPS in the company's accounts for the financial year ended prior to the grant date with the adjusted EPS for the financial year ending three years later and calculates the implicit compound annual growth rate over the period

PERFORMANCE PERIOD

Three years

Report on directors' remuneration continued

Selection of performance measures and target setting

In the selection and weighting of performance measures for the annual and long-term incentive awards the committee takes into account Pearson's strategic objectives and short- and long-term business priorities

In the case of annual incentives the committee chose sales, earnings per share or operating profit, and operating cash flow as being relevant measures of Pearson's performance against its short-term strategic objectives and business priorities

In the case of long-term incentives, the committee chose earnings per share growth in order to reward the delivery of the desired outcomes from the strategic effort and because strong bottom-line growth is imperative if we are to improve our total shareholder return and our return on invested capital. We chose return on invested capital because, over the past few years, the transformation of Pearson has significantly increased the capital invested in the business (mostly in the form of goodwill associated with acquisitions) and required substantial cash investment to integrate those acquisitions. We chose total shareholder return relative to the constituents of the FTSE World Media Index because, in line with many of our shareholders, we felt that part of executive directors' rewards should be linked to performance relative to the company's peers

The performance ranges chosen set a careful balance between upside opportunity and downside risk and are normally based on targets in accordance with the company's operating and strategic plans

Legacy arrangements under the annual bonus share matching plan

Up to and including 2013 in respect of annual incentives for 2012, awards were made under the annual bonus share matching plan. This plan encouraged executive directors and other senior managers to acquire and hold Pearson shares and aligned the interests of executives and shareholders. Senior managers across the company were invited to invest up to 50% of their after-tax annual incentive in Pearson shares purchased in the market and hold these shares for three years, in return for the opportunity to earn additional free matching shares and dividend shares, depending on performance against a real growth in earnings per share performance condition. Where matching shares vest, participants also receive additional shares representing the gross value of dividends that would have been paid on the matching shares during the performance period and reinvested. The maximum matching award is equal to the number of shares that

could have been acquired with the amount of pre-tax annual bonus invested in Pearson shares (i.e. one matching share for every one invested share, grossed up for tax)

Remuneration policy for other employees

The approach to remuneration for the broader employee population varies by level and geography, but is broadly consistent with that of directors

- › The approach to setting base salary increases elsewhere in the company takes into account economic factors, competitive market rates, roles, skills, experience and individual performance
- › Allowances and benefits for employees reflect the local labour market in which they are based
- › As part of their overall retirement arrangements, executive directors participate in the same underlying pension arrangements that have been set up for Pearson employees in the US and the UK
- › Many employees participate in some form of cash-based annual incentive, bonus, profit-share or sales commission plan. Annual incentive plans for the Pearson Executive form the basis of the annual incentive plans below the level of the principal operating companies and establish performance measures and standards and set the ceiling for individual incentive opportunities
- › Approximately 5% of the company's employees below the Pearson Executive – selected on the basis of their role, performance and potential – currently hold time-vesting shares under the long-term incentive plan
- › All employees (including executive directors) are also eligible to participate in savings-related share acquisition programmes in the UK, US and the rest of the world, which are not subject to any performance conditions

Pay and performance scenario analysis

Consistent with its policy, the committee places considerable emphasis on the performance-linked elements i.e. annual and long-term incentives

The chart overleaf shows what each director could expect to receive in 2014 under different performance scenarios, based on the following definitions of performance

PERFORMANCE SCENARIO	ELEMENTS OF REMUNERATION AND ASSUMPTIONS
Maximum	2014 base salary, allowances, benefits, and retirement benefits at the same percentage of base salary as in 2013, maximum individual annual incentive as per policy maximum value of 2013 long-term incentive award
Target	2014 base salary, allowances, benefits, and retirement benefits at the same percentage of base salary as in 2013, target individual annual incentive as per policy, target value of 2013 long-term incentive award (Towers Watson's independent assessment of the expected value of the award i.e. the net present value taking into account all the conditions)
Minimum	2014 base salary, allowances, benefits, and retirement benefits at the same percentage of base salary as in 2013, no annual or long-term incentives

Note The value of long term incentives does not take into account dividend awards that are payable on the release of restricted shares nor any changes in share price

On this basis, the relative weighting of fixed and performance-related remuneration and the absolute size of the remuneration packages for the chief executive and the chief financial officer are as follows

Graph removed

We will continue to review the mix of fixed and performance-linked remuneration on an annual basis, consistent with our overall policy

Recruitment

The committee expects any new executive directors to be engaged on terms that are consistent with the general remuneration principles outlined in this policy. In particular, the company's policy is that regular variable remuneration would normally be awarded within the same parameters and subject to the same performance conditions as for the current executive directors outlined in the policy, save that the committee may provide that in exceptional circumstances an annual or long-term incentive award may be subject to a requirement of continued service over a specified period or some other specified requirement, rather than a corporate performance condition. The terms of any such exceptional award will be disclosed in the relevant subsequent annual remuneration report.

The committee recognises that it cannot always predict accurately the circumstances in which any new directors may be recruited. The committee may determine that it is in the interests of the company and shareholders to secure the services of a particular individual which may require the committee to take account of the terms of that individual's existing employment and/or their personal circumstances. Examples of circumstances in which the committee expects it might need to do this are

- › where an existing employee of the company is promoted to the board, in which case the company will honour all existing contractual commitments including any outstanding share awards, benefit and pension entitlements,
- › where an individual is relocating in order to take up the role in which case the company may provide certain benefits such as reasonable relocation expenses, accommodation for a short period following appointment and assistance with visa applications or other immigration issues and ongoing arrangements such as tax equalisation, annual flights home, and housing allowance,
- › where an individual would be forfeiting valuable variable remuneration in order to join the company, in which case the committee may award appropriate compensation. The committee would require reasonable evidence of the nature and value of any forfeited award and would, to the extent practicable, ensure any compensation was provided on a like-for-like basis and was no more valuable than the forfeited award.

In light of the various legacy pension arrangements enjoyed by the incumbent executive directors, in determining the pension arrangements for any new recruit, the committee expects to offer a defined contribution arrangement with company contributions not exceeding those set out on page 84 but would

Report on directors' remuneration continued

have regard to the recruit's existing arrangements, the market norms in the home country and the existing pension vehicles available within the company.

In making any decision on any aspect of the remuneration package for a new recruit, the committee would balance shareholder expectations, current best practice and the requirements of any new recruit and would strive not to pay more than is necessary to achieve the recruitment. The committee would give full details of the terms of the package of any new recruit in the next annual remuneration report.

Pearson expects any new chairman or non-executive director to be engaged on terms that are consistent with the general remuneration principles outlined in the relevant sections of this policy. However, in the case of the chairman, the committee may consider it appropriate to offer a remuneration package that differs from that of the existing incumbent if that is necessary to attract the most capable candidate or to reflect the individual's expected duties.

Service contracts and termination provisions

In accordance with long established policy, all executive directors have service agreements under which, other than by termination in accordance with the terms of these agreements, employment continues indefinitely.

There are no special provisions for notice or compensation in the event of a change of control of Pearson.

It is the company's policy that the company may terminate the chairman's and executive directors' service agreements by giving no more than 12 months' notice.

As an alternative, for executive directors the company may at its discretion pay in lieu of that notice. Payment-in-lieu of notice may be made in equal monthly instalments from the date of termination to the end of any unexpired notice period. In the case of the CEO, payment-in-lieu of notice in instalments may also be subject to mitigation and reduced taking into account earnings from alternative employment.

For executive directors, pay in lieu of notice comprises 100% of the annual salary at the date of termination and the annual cost to the company of providing pension and all other benefits. For the chairman, pay in lieu of notice comprises 100% of the annual fees at the date of termination. In limited circumstances, in addition to making a full payment in lieu of notice, the company may permit an executive director to stay employed after the announcement of his or her departure for a limited period to ensure an effective hand-over and/or allow time for a successor to be appointed.

The company may, depending on the circumstances of the termination, determine that it will not pay the director in lieu of notice and may instead terminate a director's contract in breach and make a damages payment, taking into account as appropriate the director's ability to mitigate his or her loss.

On cessation of employment, save as otherwise provided for under the rules of Pearson's discretionary share plans, executive directors' entitlements to any unvested awards lapse automatically. In the case of injury, disability, ill-health or redundancy (as determined by the committee), where a participant's employing company ceases to be part of Pearson, or any other reason if the committee so decides in its absolute discretion:

- › awards that are subject to performance conditions will stay in force as if the participant had not ceased employment and shall vest on the original vesting date,
- › awards that are not subject to a performance condition will be released as soon as practicable following cessation of employment,
- › the number of shares that are released shall be prorated for the period of the participant's service in the restricted period (although the committee may in its absolute discretion waive or vary the prorating).

In determining whether and how to exercise its discretion under Pearson's discretionary share plans the committee will have regard to all relevant circumstances distinguishing between different types of leaver, the circumstances at the time the award was originally made, the director's performance and the circumstances in which the director left employment.

On cessation of employment, executive directors, having been notified of participation in an annual incentive plan for the relevant financial year, may, at the committee's discretion, retain entitlement to a pro rata annual incentive for their period of service in the financial year prior to their leaving date. Such payment will normally be calculated in good faith on the same terms and paid at the same time as for continuing executive directors.

Eligibility for allowances and benefits including retirement benefits normally ceases on retirement or on the termination of employment for any other reason.

Details of each individual's service agreement are outlined in the table overleaf. Employment agreements for other employees are determined according to local labour law and market practice.

Individual service agreements

POSITION	DATE OF AGREEMENT	NOTICE PERIODS	COMPENSATION ON TERMINATION OF EMPLOYMENT BY THE COMPANY WITHOUT NOTICE OR CAUSE
Chairman	29 July 2005	12 months from the director, 12 months from the company	Payment-in-lieu of notice of 100% of annual fees at the date of termination
Executive directors	31 December 2012 (John Fallon) 17 December 2012 (Robin Freestone)	Six months from the director, 12 months from the company	Payment-in-lieu of notice of 100% of annual salary at the date of termination and the annual cost of pension and all other benefits

Note Under pay in lieu of notice the annual cost of pension for executive directors is normally calculated as the sum, where applicable, of an amount equal to the company's cost of providing the executive's pension under the pension plan based on the Future Service Company Contribution Rate for the relevant section of the pension plan as stated in the most recent actuarial valuation (as at the date of termination of employment) as limited by the earnings cap and any cash allowance in lieu of pension or to take account of fact that pension benefits and life assurance cover are restricted by the earnings cap

Executive directors' non-executive directorships

The committee's policy is that executive directors may, by agreement with the board, serve as non-executives of other companies and retain any fees payable for their services

Employment conditions

In accordance with the committee's charter and terms of reference, the committee's remit does not include remuneration matters below that of the chief executive, the other executive directors and other members of the Pearson Executive. However, before the remuneration packages for the Pearson Executive are set for the year ahead, the committee considers a report from the chief executive and chief human resources officer on general pay trends in the market and the level of pay increases across the company as a whole. This helps to ensure that executive remuneration packages are reviewed in the context of the wider organisation.

The company consults with various employee representative bodies – including trade unions and works councils in some jurisdictions – about the company's strategy, competitiveness and performance of the business and other matters affecting employees. The company also conducts an employee engagement survey to find out how people feel about working for Pearson, what they think about the work they do, the opportunities they have and the rewards they get (including a section on pay and benefits). The company uses all of this feedback to inform decisions on people-related activities, resources and investment, local management action plans and wider business unit and organisational strategies.

It is the company's intention to continue to engage with employees and employee representatives in this way in the future.

The committee has not consulted directly with employees on the setting of the directors' remuneration policy.

Shareholder views

The company consults regularly with shareholders on all matters affecting its strategy and business operations. As part of that process, we also engage with shareholders on matters relating to executive remuneration.

The committee continues to be aware of and respond to best practice guidelines of shareholders and their representative bodies.

The committee actively consulted with the company's major shareholders and their representative bodies on the directors' remuneration policy set out in this report. The consultation provided some valuable feedback relating to remuneration policy, company performance and business strategy. Specifically, shareholders commented on the operation of the long-term incentive plan, the use of flexibility and discretion, and the policy on recruitment. They supported the committee's proposals on deferral/holding periods for vested shares and shareholding guidelines. And, on incentive pay-outs, they requested clarification of our arrangements for adjustments for malus and the strengthening of our clawback provisions.

These matters have been addressed in this policy report.

Report on directors' remuneration continued

Future policy table for chairman's and non-executive directors' remuneration

The table below summarises policy with respect to the remuneration of the chairman and non-executive directors

PURPOSE AND LINK TO STRATEGY

To attract and retain high calibre individuals, with appropriate experience or industry relevant skills, by offering market competitive fee levels

OPERATION

The chairman is paid a single fee for all of his responsibilities

The chairman's fee is set at a level that is competitive with those of chairmen in similar positions in comparable companies. The chairman is not entitled to any annual or long-term incentive, retirement or other employee benefits

The non-executive directors are paid a basic fee. The chairmen and members of the main board committees and the senior independent director are paid an additional fee to reflect their extra responsibilities

The chairman and the non-executive directors are covered by the company's normal arrangements for directors' and officers' liability insurance and an indemnity in respect of certain third-party liabilities

The company reimburses the chairman's and non-executive directors' travel and other business expenses and any tax incurred thereon, if applicable

A minimum of 25% of the basic non-executive directors' fee is paid in Pearson shares that the non-executive directors have committed to retain for the period of their directorships. Shares are acquired quarterly at the prevailing market price with the individual after-tax fee payments

Fees for non-executive directors are determined by the full board having regard to market practice and within the restrictions contained in the company's Articles of Association. Non-executive directors receive no other pay or benefits (other than reimbursement for expenses incurred in connection with their directorship of the company) and do not participate in the company's equity-based incentive plans

Non-executive directors serve Pearson under letters of appointment which are renewed annually and do not have service contracts. For non-executive directors, there is no notice period or entitlement to compensation on the termination of their directorships

OPPORTUNITY

The chairman's fees were last reviewed in 2010 and increased with effect from 1 April 2011 with a commitment to review again in 2014. Fees for the non-executive directors were last increased with effect from 1 July 2010

The structure of non-executive directors' fees with effect from 1 May 2014 is as follows

DIRECTOR	FEE
Non-executive director	£70,000
Chairmanship of audit committee	£27,500
Chairmanship of remuneration committee	£22,000
Chairmanship of reputation and responsibility committee	£10,000
Membership of audit committee	£15,000
Membership of remuneration committee	£10,000
Membership of reputation and responsibility committee	£5,000
Senior independent director	£22,000

The maximum opportunity per director depends on individual duties or combination of duties in accordance with this structure. The total fees payable to the non-executive directors are subject to the limit set out in the Articles of Association of the company (currently £750,000) and as increased by ordinary resolution from time to time

The fees for the chairman remains unchanged at £500,000 per year

PERFORMANCE CONDITIONS

None

PERFORMANCE PERIOD

None

Annual remuneration report

The remuneration committee presents the annual remuneration report, which will be put to shareholders as an advisory (non-binding) vote at the Annual General Meeting to be held on 25 April 2014

This report comprises of a number of sections

- › The remuneration committee and its activities
- › Voting outcome at 2013 AGM
- › Single figure of total remuneration and prior year comparison
- › Detail of executive remuneration for 2013
- › Detail of long-term share interests including awards made in 2013
- › Payments to former directors
- › Payments for loss of office
- › Interests of directors and value of shareholdings
- › Executive directors' non-executive directorships
- › Historical performance and remuneration
- › Comparative information
- › Information on changes to remuneration for 2014

Report on directors' remuneration continued

The remuneration committee and its activities

Composition

David Arculus chaired the remuneration committee for the year 2013, the other members were Vivienne Cox, Ken Hydon, Joshua Lewis and Glen Moreno. David Arculus, Vivienne Cox, Ken Hydon and Joshua Lewis are independent non-executive directors. Glen Moreno, chairman of the board, is a member of the committee as permitted under the UK Corporate Governance Code.

Internal advisers to the committee

John Fallon, chief executive, Robin Freestone, chief financial officer, Robin Baliszewski, formerly director for people, Melinda Wolfe, chief human resources officer from October 2013, Robert Head, director for executive reward, and Stephen Jones, SVP company secretarial, provided material assistance to the committee during the year. They attended meetings of the committee, although none of them was involved in any decisions relating to his or her own remuneration.

External advisers to the committee

To ensure that the committee receives independent advice, Towers Watson supplies survey data and advises on market trends, long-term incentives and other general remuneration matters. Towers Watson was selected and appointed by the committee through a formal tendering process. Towers Watson also advised the company on health and welfare benefits in the US and provided consulting advice directly to certain Pearson operating companies. Towers Watson is a member of the Remuneration Consultants' Group, the body which oversees the code of conduct in relation to executive remuneration consulting in the UK. During the year, Towers Watson was paid fees for advice to the committee, which were charged on a time spent basis, of £89,129. As part of its annual review of its performance and effectiveness, the committee remains satisfied that Towers Watson's advice was objective and independent and that Towers Watson's provision of other services in no way compromises its independence.

Responsibility

The committee's principal duties are to

- › determine and regularly review the remuneration policy for the executive directors, the presidents of the principal geographic markets and lines of business and other members of the Pearson Executive who report directly to the CEO (Executive Management)

This policy includes base salary, annual and long-term incentives, pension arrangements, any other benefits and termination of employment

- › regularly review the implementation and operation of the remuneration policy for Executive Management and approve the individual remuneration and benefits packages of the executive directors

The committee's duties are also to

- › approve the design of and determine targets for, any performance-related pay plans operated by the company and approve the total payments to be made under such plans
- › review the design of the company's long-term incentive and other share plans for approval by the board and shareholders
- › advise and decide on general and specific arrangements in connection with the termination of employment of executive directors
- › review and approve corporate goals and objectives relevant to CEO remuneration and evaluate the CEO's performance in light of those goals and objectives
- › have delegated responsibility for determining the remuneration and benefits package of the chairman of the board
- › appoint and set the terms of engagement for any remuneration consultants who advise the committee and monitor the cost of such advice

The committee's full charter and terms of reference are available on the company's website.

Annually, the committee reviews its own performance, constitution and charter and terms of reference to ensure it is operating at maximum effectiveness and recommends any changes it considers necessary to the board for approval.

The committee participated in a survey to review its performance and effectiveness in July 2013, looking at areas such as the clarity of roles and responsibilities, the composition of the committee, the use of time, the quality and timeliness of meeting materials, the opportunity for discussion and debate, dialogue with management and access to independent advice.

The committee concluded that it is operating effectively and noted the challenges for the year ahead.

Meetings in 2013

The committee met five times during 2013. The matters discussed and actions taken were as follows

20 FEBRUARY 2013

- › Confirmed the leaving arrangements for Rona Fairhead
- › Noted the activity of the standing committee of the board in relation to the operation of the company's equity-based reward programmes
- › Noted company's use of equity for employee share plans
- › Noted Towers Watson's overview of the current remuneration environment
- › Reviewed and approved 2012 annual incentive plan pay-outs
- › Reviewed and approved provisional 2010 long-term incentive plan pay-outs
- › Approved vesting of 2010 annual bonus share matching awards and release of shares
- › Reviewed and approved increases in base salaries for 2013 for the Pearson management committee (now called the Pearson Executive)
- › Reviewed 2013 Pearson and operating company annual incentive plan targets
- › Reviewed and approved 2013 individual annual incentive opportunities for the Pearson management committee
- › Reviewed 2013 long-term incentive awards and associated performance conditions for the Pearson management committee
- › Reviewed and noted total remuneration for members of the Pearson management committee for 2012 and 2013
- › Reviewed and approved the 2012 report on directors' remuneration
- › Reviewed and approved the 2012 annual incentive pay-out for Marjorie Scardino
- › Reviewed and approved the 2012 annual incentive pay-out and 2013 remuneration package for John Fallon

24 APRIL 2013

- › Noted the activity of the standing committee of the board in relation to the operation of the company's equity-based reward programmes
- › Confirmed 2010 long-term incentive plan pay-outs including element relating to relative shareholder return performance and release of shares
- › Confirmed 2013 Pearson and operating company annual incentive plan targets
- › Confirmed 2013 long-term incentive awards and associated performance conditions for the Pearson management committee
- › Noted feedback on the 2012 report on directors' remuneration
- › Discussed new executive remuneration reporting requirements

24 JULY 2013

- › Reviewed the committee's charter and terms of reference
- › Discussed 2013 AGM season and shareholder voting
- › Noted remuneration packages for a number of internal appointments and one new hire to the Pearson Executive
- › Noted John Makinson's remuneration package and contract on secondment to, and appointment as chairman of, Penguin Random House
- › Noted Will Ethridge's intention to stand down from the Pearson board and the arrangements for his 2014 employment and retirement
- › Noted implications of new executive remuneration reporting requirements and commenced review of executive remuneration policy

Report on directors' remuneration continued

2 OCTOBER 2013

- › Noted the activity of the standing committee of the board in relation to the operation of the company's equity-based reward programmes
- › Reviewed the committee's charter and terms of reference
- › Reviewed the committee's performance and effectiveness
- › Reviewed the status of outstanding long-term incentive awards
- › Ratified 2013 long-term incentive awards and associated performance conditions for new appointees to the Pearson Executive
- › Considered the approach to 2013 annual incentives in light of company's restructuring plans
- › Noted the company's strategy for 2013 long-term incentive awards for executives and managers below the Pearson Executive
- › Considered the approach to annual incentives in the light of the company's global education strategy and new organisation
- › Continued the review of executive remuneration policy
- › Noted the remuneration packages for two new hires to the Pearson Executive

5 DECEMBER 2013

- › Noted the activity of the standing committee of the board in relation to the operation of the company's equity-based reward programmes
- › Reviewed and approved the committee's charter and terms of reference
- › Discussed Towers Watson's overview of the current remuneration environment and approach to executive pay benchmarking for 2013/2014
- › Reviewed the status of outstanding long-term incentive awards
- › Considered the approach to annual incentives in the light of the company's global education strategy and new organisation
- › Reviewed long-term incentive plan design and operation
- › Reviewed the programmes and policies related to equity participation of executives
- › Noted the draft format for the 2013 directors' remuneration report

Voting outcome at 2013 AGM

The following table summarises the details of votes cast in respect of the resolution to approve the directors' remuneration report at the 2013 AGM

Votes for	Votes against	Total votes cast	Votes withheld (abstentions)
523,204,046	35,545,800	558,749,846	14,082,005
93.64% of votes cast	6.36% of votes cast	68.35% of issued share capital	

While the committee was pleased with the level of support shown by shareholders in respect of this resolution consideration was given to those shareholders that did not vote in favour of the directors' remuneration report. Through consultation, the committee received feedback from three institutional shareholders who between them accounted for one-third of the votes against to understand better why these shareholders voted against the resolution. The committee subsequently discussed this at their July 2013 meeting. In the light of the feedback, the committee concluded at that time that, notwithstanding any issues arising out of its regular review of executive remuneration policy, there was nothing fundamental or structural within our existing arrangements to cause particular concern to shareholders.

As in previous years and required by law, details of the voting on all resolutions at the 2014 AGM will be announced via the RNS and posted on the Pearson website following the AGM.

http://www.pearson.com/content/dam/pearson-corporate/files/press-releases/2013/20130426_AGM_Poll_Results.pdf

Single total figure of remuneration and prior year comparison

Executive directors

The remuneration received by executive directors in respect of the financial years ending 31 December 2013 and 31 December 2012 was as follows

Executive director £000s		Base salary	Allowances and benefits	Annual incentive	Retirement benefits	Long-term incentives	Total
Current directors							
John Fallon	2013	750	43	463	330	141	1,727
	2012	146	7	63	61	221	498
Robin Freestone	2013	545	14	341	163	181	1,244
	2012	500	22	252	144	1,121	2,039
Former directors							
Will Ethridge	2013	681	7	227	247	177	1,339
	2012	658	2	293	300	1,135	2,388
Rona Fairhead (stepped down 26 April 2013)	2013	176	14	–	110	47	347
	2012	529	50	192	242	769	1,782
John Makinson (stepped down 1 July 2013)	2013	274	122	301	298	69	1,064
	2012	549	244	238	–	741	1,772
Total	2013	2,426	200	1,332	1,148	615	5,721
	2012	2,382	325	1,038	747	3,987	8,479

Note 1 John Fallon was appointed to the board on 3 October 2012. For the full year for 2012, John Fallon's remuneration reflected nine months in his role as CEO, Pearson International and three months as Pearson CEO designate and was salary/fees – £506, allowances and benefits £29, annual incentive – £259, retirement benefits – £249, long-term incentives – £909, total – £1,952 (all figures in £000s).

Note 2 In accordance with the regulations, we show a single total figure of remuneration, which includes retirement benefits and long-term incentives in addition to the other elements of remuneration that have been shown in previous reports.

Note 3 Where necessary, the figures for allowances and benefits, long-term incentives and retirement benefits for 2012 have been restated to reflect the revised requirements and valuation methodology.

Note 4 In 2012, the accrued pension over the period for John Makinson decreased because of a transfer made as a result of a pension sharing order.

Note 5 The single figure of remuneration for 2013 includes all awards that were subject to a performance condition where the performance period ended, or was substantially (but not fully) completed, at 31 December 2013 and awards where the performance condition has been satisfied but where the release of shares is subject to a further holding period. The same methodology has been applied for earlier periods and the single figure for earlier reporting periods has been restated where necessary.

Further explanatory details/notes are included in the tables that follow.

Report on directors' remuneration continued

Chairman and non-executive directors

The remuneration paid to the chairman and non-executive directors in respect of the financial years ending 31 December 2013 and 31 December 2012 was as follows

Director £000s		Salary/ basic fee	Committee chairmanship	Committee membership	Senior independent directorship	Total
Glen Moreno	2013	500	—	—	—	500
	2012	500	—	—	—	500
David Arculus	2013	65	20	10	—	95
	2012	65	20	10	—	95
Vivienne Cox	2013	65	—	15	20	100
	2012	65	—	15	—	80
Ken Hydon	2013	65	25	5	—	95
	2012	65	25	5	—	95
Josh Lewis	2013	65	—	13	—	78
	2012	65	—	10	—	75
Linda Lorimer (appointed 1 July 2013)	2013	33	—	—	—	33
	2012	—	—	—	—	—
Harish Manwani (appointed 1 October 2013)	2013	16	—	—	—	16
	2012	—	—	—	—	—
Susan Fuhrman (stepped down 7 August 2013)	2013	39	—	6	—	45
	2012	65	—	10	—	75
Total	2013	848	45	49	20	962
	2012	825	45	50	—	920

Total aggregate emoluments for executive and non-executive directors were £5.3m in 2013. These emoluments are included with total employee benefit expense in note 5 to the financial statements (page 142).

Detail of executive remuneration for 2013

In this sub-section, we summarise or provide details of each element of remuneration set out in the single figure table as required (page 97)

Base salaries

In accordance with policy, the committee considered a report from the chief executive and chief human resources officer on general pay trends in the market and the level of pay increases across the company as a whole. For 2013, the company had reiterated its starting principles that base compensation provides the appropriate rate of remuneration for the job, taking into account relevant recruitment markets, business sectors and geographic regions and that total remuneration should reward both short- and long-term results, delivering competitive rewards for target performance, but higher rewards for exceptional company performance. For the US and UK, the budget guideline issued at the end of September 2012 for adjustments to base pay for 2013 was 2% although business units were given the flexibility to take into account factors such as their own performance, where they are in the business cycle, and specific market factors. As the year closed and pay budgets for 2013 were confirmed, most businesses remained on an overall 2% salary increase pool. Local inflation rates were taken into account in particular markets.

The increases for the executive directors who served during all or part of 2013 were as follows

	John Fallon	Robin Freestone	Will Ethridge	Rona Fairhead (stepped down 26 April 2013)	John Makinson (stepped down 1 July 2013)
Base salary at 31 December 2012	£600,000	£500,000	\$1,045,500	£529,100	£548,900
Increase	£150,000 25%	£45,000 9%	\$20,900 2%	—	—
Base salary at 1 January 2013	£750,000	£545,000	\$1,066,400	£529,100	£548,900

Note John Fallon was appointed to the board on 3 October 2012 and his base salary was reviewed on his appointment to CEO on 1 January 2013

Allowances and benefits

During the year the executive directors received a number of benefits as summarised below

Allowance/benefit £	John Fallon	Robin Freestone	Will Ethridge	Rona Fairhead (stepped down 26 April 2013)	John Makinson (stepped down 1 July 2013)
Location and market premium	—	—	—	—	105,469
Travel	15,387	12,037	—	5,530	6,865
Health	2,405	1,988	5,720	663	1,132
Risk	24,765	253	1,673	8,074	8,605
Total	42,557	14,278	7,393	14,267	122,071

Note 1 Travel benefits comprise company car, car allowance and private use of a driver. Health benefits comprise healthcare, health assessment and gym subsidy. Risk benefits comprise additional life cover and long-term disability insurance.

Note 2 Allowance and benefits for Will Ethridge include US health benefits. Such benefits are self-insured and the value shown here is the fully insured equivalent. There is no employee tax on this value.

Note 3 In addition to the above benefits and allowances that are included in the single figure, the executive directors may also participate in company benefit or policy arrangements that have no taxable value.

Note 4 Additional life cover and long-term disability insurance not covered by the retirement plans were previously reported as 'other pension-related benefit costs' and included in retirement benefits in the 2012 directors' remuneration report.

Report on directors' remuneration continued

Annual incentive

For 2013, annual incentive opportunities were based on the following performance measures and performance against these measures (designated as – below threshold, < between threshold and target, > between target and maximum and + above maximum) was as follows

Name	Maximum opportunity (% of salary)	Weighting of performance measures (% of maximum opportunity)	Performance in 2013												Pay out for 2013			
			Pearson						Operating company						(€000)			
			Operating company	Personal	20%	25%	25%	10%	20%	Weighted pay-out (% of maximum)	Operating profit (pre restructuring)	Operating profit (post restructuring)	Average working capital to sales ratio	Operating cash flow	Weighted pay-out (% of maximum)			
John Fallon	180%	90%	–	10%	<	>	<	–	–	28.1%	–	–	–	–	–	61.8%	463	
Robin Freestone	170%	80%	–	20%	<	>	<	–	–	26.0%	–	–	–	–	–	62.5%	341	
Will Ethridge	175%	30%	60% Pearson North America	10%	<	>	<	–	–	26.0%	<	–	–	–	–	10.5%	33.4%	227
John Makinson (stepped down 1 July 2013)	160%	30%	60% Penguin Group	10%	<	>	<	–	–	26.0%	>	>	>	+	91.4%	109.8%	301	

Note 1 For all plans Pearson's reported financial results for the relevant period were used to measure performance. In order to incentivise and reward underlying performance, actual results are adjusted for the effect of foreign exchange and for portfolio changes (acquisitions and disposals) and other factors that the committee considers relevant in the performance year. No discretion has been exercised to adjust the resulting underlying pay-outs.

Note 2 Rona Fairhead, who left the company on 30 April 2013, was not eligible for an annual incentive in respect of her service in 2013.

Note 3 Details of performance targets and performance against those targets are not disclosed as the committee deems them to be commercially sensitive.

Retirement benefits

Details of the directors' pension entitlements and pension-related benefits during the year are as follows

Directors' pensions	Plans	Normal retirement age	Accrued pension at 31 Dec 13 £000 ⁽¹⁾	Value of defined benefit pension over the period £000 ⁽²⁾	Other pension costs to the company over the period £000 ⁽³⁾	Other allowances in lieu of pension £000 ⁽⁴⁾	Total annual value in 2013 £000 ⁽⁵⁾
John Fallon	Pearson Group Pension Plan Accrual rate of 1/30th of pensionable salary per annum Taxable and non-pensionable cash supplement	62	74.0	134.8	—	194.7	330
Robin Freestone	Money Purchase 2003 section of the Pearson Group Pension Plan Taxable and non-pensionable cash supplement	62	—	—	22.0	141.4	163
Will Ethridge	Pearson Inc. Pension Plan and the approved 401(k) plan Non-qualified Excess Plan	65	227.5	215.2	31.6	—	247
Rona Fairhead	Pearson Group Pension Plan Accrual rate of 1/30th of pensionable salary per annum Taxable and non-pensionable cash supplement	62	53.1	65.4	—	44.6	110
John Makinson	Pearson Group Pension Plan Unfunded Unapproved Retirement Benefits Scheme	62	241.1	298	—	—	298

Note 1 The accrued pension at 31 December 2013 is the deferred pension to which the member would be entitled on ceasing pensionable service on 31 December 2013. For Will Ethridge this is his pension from the US plan and the US SERP. For John Fallon and Rona Fairhead it relates to the pension payable from the UK plan. For John Makinson it relates to the pension from the UK Plan and his unapproved arrangements in aggregate. Robin Freestone does not accrue defined benefits.

Note 2 This column comprises the increase in the directors' accrued pension over the period (net of inflation) multiplied by 20 and from which the directors' contributions are deducted.

Note 3 This column comprises contributions to defined contribution arrangements for UK benefits. For US benefits, it includes company contributions to funded defined contribution plans.

Note 4 This column represents the cash allowances paid in lieu of the previous FURBS arrangements for John Fallon, Robin Freestone and Rona Fairhead. John Makinson's deferred FURBS entitlement is referred to in note 1 above.

Note 5 Total annual value is the sum of the previous three columns.

Note 6 Additional life cover and long-term disability insurance not covered by the retirement plans were previously reported as 'other pension-related benefit costs' and included in retirement benefits in the 2012 directors' remuneration report and are now included as 'allowances and benefits'.

Note 7 There are no additional benefits or special arrangements under the retirement plans for directors who retire before their normal retirement date.

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Report on directors' remuneration continued

Details of long-term share interests including awards made in 2013

Long-term incentives

Details of awards made, outstanding, held or released under the annual bonus share matching plan are as follows

Date of award	Share price on date of award	Vesting	Real compound annual EPS growth	Status of award
15/05/13	1,206 0p	15/05/16		– Outstanding subject to 2012 to 2015 performance
15/05/12	1,152 0p	15/05/15		– Outstanding subject to 2011 to 2014 performance
20/04/11	1,129 0p	20/04/14	-6.6%	Performance condition not met. Matching share award lapsed
21/04/10	1,024 1p	21/04/13	4.4%	Target met for release of 84.5% of matching share award as reported in report on directors' remuneration for 2012. Shares released on 21 April 2013

The pay-out to performance vesting scale for all awards is as follows

Performance condition	Pay-out (% of Match)
< 3% real compound annual EPS growth	Nil
3% real compound annual EPS growth	50%
3% to 5% real compound annual EPS growth	50% to 100% sliding scale
5% real compound annual EPS growth	100%
> real 5% compound annual EPS growth	100%

Note For all awards Pearson's reported financial results for the relevant period were used to measure performance and no discretion has been exercised

The following directors invested part of their after-tax annual incentive in Pearson shares and received conditional matching awards under the annual bonus share matching plan on 15 May 2013 which will vest, subject to performance, on 15 May 2016 as follows

Name	Matching shares awarded	Share price on date of award	Face value on date of award
John Fallon	6,083	1,206 0p	£73,361

Details of awards made, outstanding, vested and held or released under the long-term incentive plan are as follows

Date of award	Share price on date of award	Vesting date	Performance measures (award split equally across three measures)	Performance period	Pay-out at threshold	Pay-out at maximum	Actual performance	% of award vested	Status of award
01/05/13	1,183 Op	01/05/16	Relative TSR	2013 to 2016	30% at median	100% at upper quartile	—	—	Outstanding
			ROIC	2015	0% for ROIC of 8.5%	100% for ROIC of 10.5%	—	—	
			EPS growth	2015 compared to 2012	30% for EPS growth of 6.0%	100% for EPS growth of 12.0%	—	—	
02/05/12	1,161 Op	02/05/15	Relative TSR	2012 to 2015	30% at median	100% at upper quartile	—	—	Outstanding
			ROIC	2014	0% for ROIC of 8.5%	100% for ROIC of 10.5%	—	—	
			EPS growth	2014 compared to 2011	30% for EPS growth of 6.0%	100% for EPS growth of 12.0%	—	—	
03/05/11	1,149 Op	03/05/14	Relative TSR	2011 to 2014	30% at median	100% at upper quartile	44 th percentile	Nil	Estimated but still outstanding
			ROIC	2013	25% for ROIC of 9.0%	100% for ROIC of 10.5%	5.4%	Nil	Lapsed
			EPS growth	2013 compared to 2010	30% for EPS growth of 6.0%	100% for EPS growth of 12.0%	-3.3%	Nil	
03/03/10	962 Op	03/03/13	Relative TSR	2010 to 2013	30% at median	100% at upper quartile	48 th percentile	Nil	36.7% of shares vested
			ROIC	2012	25% for ROIC of 8.5%	100% for ROIC of 10.5%	9.1%	47.5%	Three-quarters released on 3 March 2013. If after tax number of shares are retained for a further two years, the remaining quarter will be released on 3 March 2015.
			EPS growth	2012 compared to 2009	30% for EPS growth of 6.0%	100% for EPS growth of 12.0%	8.8%	62.5%	

Note For all awards, Pearson's reported financial results for the relevant period were used to measure performance and no discretion has been exercised

The following directors received conditional restricted share awards under the long-term incentive plan on 1 May 2013 which will vest, subject to performance, on 1 May 2016 as follows

Name	Restricted shares awarded	Share price on date of award	Face value on date of award	
			£	% of 2013 base salary
John Fallon	250,000	1,183 Op	£2,957,500	394%
Robin Freestone	150,000	1,183 Op	£1,774,500	326%
Will Ethridge	150,000	1,183 Op	£1,774,500	260%

Summary of share plan interests

The following tables summarise vested, released, lapsed, held, and outstanding share interests under the share-based incentive plans for executive directors who served throughout 2013. Awards are designated as ABSMP annual bonus share matching plan, subject to performance conditions, LTIP long-term incentive plan, subject to performance conditions, Dividends where dividend-equivalent shares are added without performance conditions to vested shares under the ABSMP and LTIP and released immediately on award.

Report on directors' remuneration continued

Plan	Award date	Vesting date	Status	John Fallon	Robin Freestone	Will Ethridge
ABSMP	21/04/2010	21/04/2013	Released	6,991	26,287	6,658
ABSMP	20/04/2011	20/04/2014	Vested	0	0	0
			Value £000	£0	£0	£0
			Lapsed	4,539	29,049	4,517
			Held	0	0	0
ABSMP	15/05/2012	15/05/2015	Outstanding	8,917	17,833	4,485
ABSMP	15/05/2013	15/05/2016	Outstanding	6,083	–	–
LTIP	04/03/2008	04/03/2011	Released	24,375	30,468	36,562
LTIP	03/03/2009	03/03/2012	Held	29,887	25,617	29,887
LTIP	03/03/2010	03/03/2013	Released	41,257	34,381	41,257
			Lapsed	50,000	41,667	50,000
			Held	13,752	11,460	13,752
LTIP	03/05/2011	03/05/2014	Vested	0	0	0
			Value £000	£0	£0	£0
			Lapsed	150,000	125,000	150,000
			Held	0	0	0
LTIP	02/05/2012	02/05/2015	Outstanding	100,000	100,000	100,000
LTIP	01/05/2013	01/05/2016	Outstanding	250,000	150,000	150,000
Dividends (LTIP)	04/03/2013	04/03/2013	Released (price 1.168 0p)	6,094	7,617	9,141
			Value £000	£71	£89	£107
Dividends (LTIP)	03/04/2013	03/04/2013	Released (price 1.143 0p)	5,199	4,333	5,199
			Value £000	£59	£50	£59
Dividends (ABSMP)	21/05/2013	21/05/2013	Released (price 1.262 0p)	895	3,366	853
			Value £000	£11	£42	£11
Total			Released	84,811	106,452	99,670
			Vested	0	0	0
			Held	43,639	37,077	43,639
			Outstanding	365,000	267,833	254,485
2013 single figure of remuneration			Value £000	£141	£181	£177

Note 1 Vested means where awards are no longer subject to performance conditions. Released means where shares have been transferred to participants. Held means where awards have vested but are held pending release on the relevant anniversary of the award date. Outstanding means awards that have been granted but are still subject to the achievement of performance conditions.

Note 2 No variations to terms and conditions of plan interests were made during the year.

Note 3 Performance conditions and vesting for awards under the bonus share matching and long-term incentive plans are described on pages 102 and 103.

Note 4 The single figure of remuneration for 2013 includes all awards that were subject to a performance condition where the performance period ended or was substantially (but not fully) completed, at 31 December 2013 and awards where the performance condition has been satisfied but where the release of shares is subject to a further holding period. The same methodology has been applied for earlier periods and the single figure for earlier reporting periods has been restated where necessary.

Note 5 The value of shares included in the single figure of remuneration is the number of shares multiplied by the share price on release (or if the shares have not yet been released the average share price over the final quarter of the year which for 2013 was 1.310 45p).

Movements in directors' interests in share options

John Fallon and Robin Freestone also hold options under the worldwide save for shares plan as follows

Name	Date of grant	Options held as at 31 Dec 13	Option price	Earliest exercise date	Expiry date	Value in 2013 single figure £000
John Fallon	7/5/10	1,930	805 6p	1/8/15	1/2/16	0
Robin Freestone	4/5/12	990	909 0p	1/8/15	1/2/16	0

Note 1 No share option awards were made, vested or exercised in the year

Note 2 All share options that become exercisable during a year are included in the single figure of total remuneration for that year. The value included in the single figure of total remuneration is the number of options multiplied by the difference between the value on grant and the market value on the earliest exercise date.

Note 3 No variations to terms and conditions of share options were made during the year.

Note 4 Acquisition of shares under the worldwide save for shares plan is not subject to a performance condition.

Note 5 The market price on 31 December 2013 was 1,341 0p per share and the range during the year was 1,119 0p to 1,365 0p.

Payments to former directors

It is the committee's intention to disclose any payments to past directors, including the release of share-based awards post departure.

The number of shares retained from the number of shares originally awarded takes into account lapses due to performance, releases prior to ceasing to be a director and, where applicable, pro-rating for service in the performance period.

Marjorie Scardino

Marjorie Scardino stepped down from the Pearson board on 31 December 2012.

In accordance with her employment agreement, six months after retirement Marjorie Scardino received the distribution of the account cash and share balances of her unfunded unapproved defined contribution retirement plan.

Marjorie also retained certain entitlements on retirement and received the following share releases during 2013.

Plan	Date of award	Number of shares retained	Number of shares lapsed	Number of shares released	Date of release	Number of shares outstanding
ABSMP	21 April 2010	63,497	0	63,497	4 March 2013	0
	20 April 2011	47,630	47,630	0	--	0
LTIP	4 March 2008	97,500	0	97,500	4 March 2013	0
	3 March 2009	76,852	0	76,852	4 March 2013	0
	3 March 2010	280,024 subject to 2012 performance	133,333	146,691	3 March 2013	0
	3 May 2011	266,666 subject to 2013 performance	266,666	0	--	0
	2 May 2012	83,333 subject to 2014 performance	0	0	--	83,333
Dividends (ABSMP)	4 March 2013	--	--	6,160	4 March 2013	0
Dividends (LTIP)	4 March 2013	--	--	38,593	4 March 2013	0
	3 April 2013	--	--	18,484	3 April 2013	0

Note: In the case of the 21 April 2010 annual bonus share matching award, the number of shares retained and released comprises the total number of shares originally awarded.

Report on directors' remuneration continued

Rona Fairhead

Rona Fairhead stepped down from the Pearson board on 26 April 2013 and left the company on 30 April 2013

Rona retained certain entitlements on leaving the company and received the following share releases during 2013

Plan	Date of award	Number of shares retained	Number of shares lapsed	Number of shares released	Date of release	2013 single figure of remuneration £000	Number of shares held	Number of shares outstanding
LTIP	4 March 2008	30,468	0	30,468	4 March 2013	–	0	0
	3 March 2009	25,617	0	25,617	10 May 2013	–	0	0
	3 March 2010	87,508	41,667	34,381	3 March 2013	–	0	0
		subject to 2012 performance		11,460	10 May 2013	–	0	0
	3 May 2011	97,222	97,222	0	–	–	40,000	0
		subject to 2013 performance + 40,000 shares						
	2 May 2012	44,444	0	0	–	–	0	44,444
		subject to 2014 performance						
Dividends	4 March 2013	–	0	7,617	4 March 2013	£30	–	–
	3 April 2013	–	0	4,333	3 April 2013	£17	–	–

Note 1 In the case of the 3 May 2011 long-term incentive award, the committee agreed in December 2012 that, in recognition of the circumstances at the time the award was made, 40,000 of the 165,000 shares originally awarded should vest in full at the normal vesting date. The remaining shares would be retained on her leaving pro rata for service and be released subject to performance in the normal way.

Note 2 The value of dividends included in the 2013 single figure of remuneration is calculated pro rata for service in the year.

John Makinson

On stepping down from the board on 1 July 2013, John Makinson's then remuneration package (base salary, annual incentive, allowances and benefits and retirement benefits) continued to apply for the remainder of 2013. He did not receive a Pearson long-term incentive award for 2013.

John's participation in Pearson share plans continues and he received the following share releases during 2013

Plan	Date of award	Number of shares retained	Number of shares lapsed	Number of shares released	Date of release	2013 single figure of remuneration £000	Number of shares held	Number of shares outstanding
LTIP	4 March 2008	30,468	0	30,468	4 March 2013	–	0	0
	3 March 2009	25,617	0	–	–	–	25,617	0
	3 March 2010	87,508	41,667	34,381	3 March 2013	–	11,460	0
		subject to 2012 performance						
	3 May 2011	125,000	125,000	0	–	–	0	0
		subject to 2013 performance						
	2 May 2012	100,000	0	0	–	–	0	100,000
		subject to 2014 performance						
Dividends	4 March 2013	–	0	7,617	4 March 2013	£44	–	–
	3 April 2013	–	0	4,333	3 April 2013	£25	–	–

Note The value of dividends included in the 2013 single figure of remuneration is calculated pro rata for service in the year.

Payments for loss of office

Rona Fairhead

As announced on 27 November 2012 and set out in the report on directors' remuneration for 2012, Rona Fairhead stepped down from the board at the Annual General Meeting on 26 April 2013 and left the company on 30 April 2013. Her service agreement dated 24 January 2003 provided for notice periods of six months from the director and 12 months from the company and compensation on termination of employment by the company without notice or cause of 100% of annual salary at the date of termination, the annual cost of pension and all other benefits and 50% of potential annual incentive.

The committee and the board determined that her leaving employment was a consequence of the planned incorporation of the professional education division overseen by Rona into other parts of Pearson's education business coupled with the smaller size of the Financial Times Group owing to recent major divestments. The company therefore paid compensation amounting to £1,148,195 comprising £529,100, an amount equal to her annual salary as of her leaving date, £195,815, an amount equal to the annual cost to the company of pension and other benefits (but excluding health care to which she remained entitled for 12 months from her leaving date), and £423,280, an amount equal to half of her maximum annual incentive opportunity. The company also made a contribution toward the cost of outplacement counselling (£50,000) and paid legal fees in connection with her leaving (£6,150).

John Makinson

As first announced on 29 October 2012 and confirmed on 1 July 2013, John Makinson stepped down from the Pearson board to assume his full-time responsibilities as chairman of Penguin Random House on 1 July 2013. There was no payment for loss of office.

John's employment continues under service agreements with Pearson Inc (for the US portion of his duties) and with Pearson Management Services Limited (for his duties in the rest of the world outside the US). These Pearson entities are entering into secondment agreements with Penguin Random House, pursuant to which John's services as chairman are provided to, and paid for by, Penguin Random House. John is paid an annual base salary, but is no longer entitled to a location and market premium or an annual incentive. He will be eligible to receive a one-off performance-related cash long-term incentive award, the terms of which are being agreed by the remuneration committee of Penguin Random House. He will no longer receive awards under the Pearson long-term incentive plan. Penguin Random House is also meeting the cost of John's accrual of Pearson pension benefits while he is seconded to Penguin Random House.

Will Ethridge

As announced on 23 May 2013, Will Ethridge stepped down from the board on 31 December 2013. There was no payment for loss of office. Will's employment with Pearson Education Inc continues on the same terms and conditions as previously pending his retirement on 31 December 2014. No compensation for loss of office or severance will be payable on his retirement. On retirement, he will retain entitlement to his 2012 long-term incentive award in full and to two-thirds and one-third respectively of his 2013 and any 2014 long-term incentive awards with shares released subject to performance in 2015, 2016 and 2017.

Report on directors' remuneration continued

Interests of directors and value of shareholdings

Directors' interests

The share interests of the continuing directors and their connected persons are as follows

	Ordinary shares at 31 Dec 13	Conditional shares at 31 Dec 13	Total number of ordinary and conditional shares at 31 Dec 13	Value (x salary)	Guideline (x salary)	Guideline met
Chairman						
Glen Moreno	150,000	—	—	—	—	—
Executive directors						
John Fallon	262,569	43,639	306,208	4.5	2.00	✓
Robin Freestone	478,507	37,077	515,584	10.5	1.25	✓
Will Ethridge	397,017	43,639	440,656	7.2	1.25	✓
Non-executive directors						
David Arculus	16,301	—	—	—	—	—
Vivienne Cox	1,351	—	—	—	—	—
Ken Hydon	17,818	—	—	—	—	—
Josh Lewis	5,681	—	—	—	—	—
Linda Lonner (appointed 1 July 2013)	637	—	—	—	—	—
Harish Manwani (appointed 1 October 2013)	180	—	—	—	—	—

Note 1 Conditional shares means shares which have vested but remain held subject to continuing employment for a pre-defined holding period

Note 2 The current value of the executive directors' holdings of ordinary and conditional shares is based on the middle market value of Pearson shares of 1.113 0p on 21 February 2014 against base salaries in 2013. All executive directors comfortably exceeded the shareholding guidelines. The shareholding guidelines do not apply to the chairman and non-executive directors.

Note 3 Ordinary shares include both ordinary shares listed on the London Stock Exchange and American Depositary Receipts (ADRs) listed on the New York Stock Exchange. The figures include both shares and ADRs acquired by individuals investing part of their own after-tax annual bonus in Pearson shares under the annual bonus annual bonus share matching plan.

Note 4 The register of directors' interests (which is open to inspection during normal office hours) contains full details of directors' shareholdings and options to subscribe for shares. The market price on 31 December 2013 was 1.341 0p per share and the range during the year was 1.119 0p to 1.365 0p.

Note 5 There were no movements in ordinary shares between 1 January 2014 and a month prior to the sign-off of this report.

Note 6 Ordinary shares do not include any shares vested but held pending release under a restricted share plan.

Graph removed

Shareholding guidelines for executive directors

Executive directors are expected to build up a substantial shareholding in the company in line with the policy of encouraging widespread employee ownership and to align further the interests of executives and shareholders. With effect from 2014, target holding is 300% of salary for the chief executive and 200% of salary for the other executive directors.

Shares that count towards these guidelines include any shares held unencumbered by the executive, their spouse and/or dependent children plus any shares vested but held pending release under a restricted share plan. Executive directors have five years from the date of appointment to reach the guideline.

There are currently no mandatory share ownership guidelines below executive director level, although employees are encouraged to become shareholders in the company by retaining shares acquired through the company's discretionary and all-employee stock programmes. The shareholding guidelines do not apply to the chairman and non-executive directors.

Dilution and use of equity

We can use existing shares bought in the market, treasury shares or newly-issued shares to satisfy awards under the company's various stock plans.

For restricted stock awards under the long-term incentive plan and matching share awards under the annual bonus share matching plan, we would normally expect to use existing shares.

There are limits on the amount of new-issue equity we can use. In any rolling ten-year period, no more than 10% of Pearson equity will be issued, or be capable of being issued under all Pearson's share plans, and no more than 5% of Pearson equity will be issued, or be capable of being issued under executive or discretionary plans.

At 31 December 2013, stock awards to be satisfied by new-issue equity granted in the last ten years under all Pearson share plans amounted to 1.6% of the company's issued share capital. No stock awards granted in the last ten years under executive or discretionary share plans will be satisfied by new-issue equity.

In addition, for existing shares no more than 5% of Pearson equity may be held in trust at any time. Against this limit, shares held in trust at 31 December 2013 amounted to 1.1% of the company's issued share capital.

The headroom available for all Pearson plans, executive or discretionary plans and shares held in trust is as follows:

Headroom	2013	2012	2011
All Pearson plans	8.4%	8.3%	8.3%
Executive or discretionary plans	5.0%	5.0%	5.0%
Shares held in trust	3.9%	3.8%	3.2%

Executive directors' non-executive directorships

In accordance with policy, the following executive directors served as non-executive directors elsewhere and retained fees or other benefits for the period covered by this report as follows:

Name	Company	Fees/benefits
Rona Fairhead	HSBC Holdings plc	£83,333

Other executive directors served as non-executive directors elsewhere but either waived or did not receive fees.

Report on directors' remuneration continued

Historical performance and remuneration

Total shareholder return performance

We set out below Pearson's total shareholder return (TSR) performance relative to the FTSE All-Share index on an annual basis over the five-year period 2008 to 2013. This comparison has been chosen because the FTSE All-Share represents the broad market index within which Pearson shares are traded. TSR is the measure of the returns that a company has provided for its shareholders, reflecting share price movements and assuming reinvestment of dividends (source *DataStream*).

In accordance with the new regulations, this section also presents Pearson's TSR performance alongside the single figure of total remuneration for the CEO over the last five years and a summary of the variable pay outcomes relative to the prevailing maximum at the time. The table below summarises the total remuneration for the CEO over the last five years, and the outcomes of annual and long-term incentive plans as a proportion of maximum.

Graph removed

Financial year ending	2009	2010	2011	2012	2013
Total remuneration – John Fallon (single figure, 000s)	–	–	–	–	1,727
Total remuneration – Marjorie Scardino (single figure, 000s)	6,370	8,466	8,340	5,330	–
Annual incentive – incumbent (% of maximum)	91.3%	92.1%	75.7%	24.2%	34.3%
Long-term incentive – incumbent (% of maximum)	80.0%	97.5%	68.3%	36.7%	Nil

Note 1 Marjorie Scardino stepped down from the board on 31 December 2012 and John Fallon was appointed CEO with effect from 1 January 2013.

Note 2 The annual incentive is the actual annual incentive received by the incumbent as a percentage of maximum opportunity.

Note 3 The long-term incentive is the pay-out of performance-related restricted shares under the long-term incentive plan where the year shown is the final year of the performance period for the purposes of calculating the single total figure of remuneration.

Comparative information

The following information is intended to provide additional context regarding the total remuneration for executive directors

Relative percentage change in remuneration for CEO

The following table sets out the change between 2012 and 2013 in three elements of remuneration for the CEO, in comparison to the average for all employees

However, while the committee considers the increase in base pay for the CEO relative to the broader employee population, benefits are driven by local practices and eligibility is determined by level and individual circumstances which do not lend itself to comparison. Similarly, annual incentives are driven by different factors throughout the organisation and so are typically not compared

	Base salary	Allowances and benefits	Annual incentive	Total
CEO	-24%	-77%	7%	-22%
All employees	5%	11%	31%	8%

Note 1 The figures for the CEO are based on the remuneration of Majone Scardino for 2012 and of John Fallon for 2013

Note 2 The figures for all employees reflect average salaries and average employee numbers each year. Annual incentives include all plans including sales incentives

Relative importance of pay spend

The committee consider directors' remuneration in the context of the company's allocation and disbursement of resources to different stakeholders

In particular, we chose operating profit because this is a measure of our ability to reinvest in the company. We include dividends because these constitute an important element of our return to shareholders

£m	2013	2012	Year-on-year change	
			£m	%
Operating profit	736	932	-196	-21%
Dividends	372	346	26	+8%
Total wages and salaries	1,836	1,610	226	+14%

Note Wages and salaries include continuing operations only and include directors. 2012 is restated on the same basis. Average employee numbers for continuing operations for 2013 were 42,115 (2012: 42,135). Further details are set out in note 5 to the financial statements on page 142

Information on changes to remuneration for 2014

Executive directors' base salaries

We have undertaken a regular periodic review of base salaries for 2014 taking into account general economic and market conditions, the level of increases made across the company as a whole, the remuneration of executives in similar positions in comparable companies and individual performance

As a result of this review, the 2014 base salaries for the CEO and CFO are as follows

	John Fallon	Robin Freestone
Base salary at 31 December 2013	£750,000	£545,000
Increase	£15,000 2.0%	£11,000 2.0%
Base salary at 1 April 2014	£765,000	£556,000

Full details will be set out in the annual remuneration report and included in the single figure of total remuneration for 2014

Annual incentive

The key design principles underlying the company's approach to annual incentives for 2014 are

- › full alignment of annual incentives with the global education strategy to reinforce a 'one Pearson' focus,
- › a clear, transparent, coherent, consistent, organisation-wide approach to incentives and performance management with a common incentive framework for Lines of Business, Geographies and Enabling functions,
- › the size of the overall annual incentive pay-out will be linked to overall Pearson performance

Report on directors' remuneration continued

The principles that underlie the 'one Pearson' approach to funding are that

- › there will be a single annual incentive pool for Pearson which will vary according to the performance of the whole company;
- › for 2014, the overall Pearson performance measures and weightings will be adjusted earnings per share (60% weighting), sales (20%), cash flow (20%);
- › there will be a theoretical 'on target' size for the annual incentive pool which is the sum of all employees' annual incentive opportunities,
- › there will be scope to flex the size of the pool upwards if performance exceeds target (up to a cap) and downwards if performance falls short of target (down to a threshold below which no annual incentive would be paid) This flex will be sufficiently sensitive to demonstrate a clear link between overall performance and the annual incentive pay-out, but not so sensitive that there is significant uncertainty in the total pay-out The committee will set a range around which the annual incentive pay-out can flex,
- › the Pearson financial targets will be set each year as part of the normal operating plan process The CEO and CFO will recommend the overall Pearson incentive funding metrics (including performance measures targets and weightings) to the committee for approval in the normal way,
- › the Pearson-derived pay-out may be informed and modified (up or down) reflecting the circumstances at the time consistent with the committee's normal adjustment powers

In relation to the operation of the annual incentive framework for the executive directors and the Pearson Executive

- › there will be no change in individual annual incentive opportunities,
- › for 2014, there would be one mechanism for determining annual incentive for an individual, namely a combination of Pearson-wide performance and individual goals,

› the sum of the CEO's and the Pearson Executives' 'on target' annual incentive constitutes the incentive pool for this group which flexes up or down based on overall Pearson performance,

- › individual performance is assessed against goals set at the start of the year,
- › individual pay-outs up to individual maximum opportunities and within the total pool are recommended by the CEO (or by the chairman in the case of the CEO himself) for review and, in the case of the executive directors, approval by the committee

The committee considers the performance targets for 2014 to be commercially sensitive Details of performance measures, weightings and targets will be disclosed in the annual remuneration report for 2014 if and to the extent that the committee deems them to be no longer commercially sensitive

Long-term incentives

The committee reviewed the design and operation of the long-term incentives plan with the following changes for performance-related awards to be granted to members of the Pearson Executive in 2014

- › the weighting of the performance metrics will be 50% on earnings per share growth, 33.3% on return on invested capital and 16.7% on relative total shareholder return
- › performance will continue to be tested over three years and 75% of the vested shares will continue to be released at that point. However, there will be a mandatory restriction on participants' ability to dispose of the 75% of the vested shares (other than to meet personal tax liabilities) for a further two years. Furthermore, participants' rights to the release of the 25% of the vested shares will be subject to continued employment over the same period. We have set targets for the 2014 awards that are consistent with the company's strategic objectives over the period to 2016.

Subject to approval of the company's remuneration policy, the performance measures and targets for the 2014 long-term incentive awards to the executive directors and other members of the Pearson Executive that will be made as soon as practicable after the AGM will be as follows:

Performance measure	Weighting	Performance period	Pay-out at threshold	Pay-out progression	Pay-out at maximum
EPS growth	50%	2016 compared to 2013	30% for EPS growth of 6.0%	Straight-line	100% for EPS growth of 12.0%
ROIC	33.3%	2016	30% for ROIC of 6.5%	50% for ROIC of 7.0%	100% for ROIC of 7.5%
Relative TSR	16.7%	2014 to 2017	30% at median	Straight-line	100% at upper quartile

We will set the level of individual awards consistent with those seen in recent years and below the policy maximum taking into account:

- › the face value of individual awards at the time of grant, assuming that performance targets are met in full,
- › market practice for comparable companies and market assessments of total remuneration from our independent advisers,
- › individual roles and responsibilities, and
- › company and individual performance.

At the time of writing, the committee has yet to approve the 2014 long-term incentive awards for the executive directors and other members of the Pearson Executive.

Report on directors' remuneration continued

Full details of individual awards and of the performance measures, weightings and targets for 2014 will be set out in the annual remuneration report for 2014

For 2015 and onwards, the averaging period for the calculation of relative total shareholder return will be moved to the period running up to the year end and the length of the averaging period will be increased to three months more in line with institutional investors' preferences

Annual bonus share matching

The previous annual bonus share matching plan will cease to operate with the last awards made in 2013 in respect of annual incentive for 2012. We have not made any compensatory adjustments to annual or long-term incentive opportunities to take this into account

Fees for the chairman and non-executive directors

The chairman's and non-executive directors' fees were reviewed for 2014

As a consequence of that review, the basic non-executive directors' fee, and the fees for committee chairmanship and committee membership were increased. Fees for the chairmanship and membership of the reputation and responsibility committee were also introduced for the first time. The salary for the chairman remains unchanged

The policy and future arrangements are set out on page 92 in the directors' remuneration policy report.

Approved by the board and signed on its behalf by

David Arculus Director
10 March 2014

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Independent auditors' report to the members of Pearson plc

Report on the financial statements

Our opinion

In our opinion

- › The financial statements defined below, give a true and fair view of the state of the Group's and company's affairs as at 31 December 2013 and of the Group's profit and of the Group's and company's cash flows for the year then ended,
- › The consolidated financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union,
- › The company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006, and
- › The financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation

This opinion is to be read in the context of what we say in the remainder of this report

Separate opinion in relation to IFRSs as issued by the IASB

As explained in note 1 to the financial statements, the Group, in addition to applying IFRSs as adopted by the European Union, has also applied IFRSs as issued by the International Accounting Standards Board (IASB)

In our opinion the consolidated financial statements comply with IFRSs as issued by the IASB

What we have audited

The consolidated financial statements and company financial statements (the 'financial statements'), which are prepared by Pearson plc, comprise

- › the consolidated and company balance sheet as at 31 December 2013,
- › the consolidated income statement and statement of comprehensive income for the year then ended,
- › the consolidated and company statements of changes in equity and cash flow statements for the year then ended, and

- › the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information

The financial reporting framework that has been applied in their preparation comprises applicable law and IFRSs as adopted by the European Union and, as regards the company, as applied in accordance with the provisions of the Companies Act 2006

Certain disclosures required by the financial reporting framework have been presented elsewhere in the annual report and accounts (the 'annual report'), rather than in the notes to the financial statements. These are cross-referenced from the financial statements and are identified as audited

What an audit of financial statements involves

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) (ISAs (UK & Ireland)). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of

- › whether the accounting policies are appropriate to the Group's and company's circumstances and have been consistently applied and adequately disclosed,
- › the reasonableness of significant accounting estimates made by the directors, and
- › the overall presentation of the financial statements

In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report

Overview of our audit approach

Materiality

We set certain thresholds for materiality. These helped us to determine the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and on the financial statements as a whole.

Using our professional judgement, we determined materiality for the consolidated financial statements as a whole to be £32m. This is based on 5% of profit before tax, after adjusting for non-recurring items such as gain on disposal of subsidiaries, this being an appropriate measure of the group's underlying performance.

We agreed with the audit committee that we would report to them misstatements identified during our audit above £2m as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Overview of the scope of our audit

The Group is organised into four business segments, being North American Education, International Education, Professional and FT Group, plus the investment in associate Penguin Random House. Each segment comprises a number of reporting units. The consolidated financial statements comprise these reporting units plus the Group's centralised functions.

In establishing the overall approach to the Group audit, we determined the type of work that needed to be performed at the reporting units by us as the Group engagement team, or component auditors within PwC UK and from other PwC network firms operating under our instruction. Where the work was performed by component auditors, we determined the level of involvement we needed to have in the audit work at those reporting units to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the consolidated financial statements as a whole.

Across these segments, we identified two reporting units in the US and UK that required an audit of their complete financial information due to size alone, plus a further nine reporting units in the US, UK, Brazil, China and South Africa that required specified procedures on certain transactions and balances. We also obtained an audit opinion on the financial information of the associate Penguin Random House. Our audit work at these reporting units and at head office gave us coverage of approximately 80% of the Group's profit before tax. This, together with procedures at the consolidated Group level and at the Group's shared service centres, provided the evidence we needed for our opinion on the consolidated financial statements taken as a whole.

Areas of particular audit focus

In preparing the financial statements, the directors made a number of subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. We primarily focused our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

In our audit, we tested and examined information, using sampling and other auditing techniques, to the extent we considered necessary to provide a reasonable basis for us to draw conclusions. We obtained audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

We considered the following areas to be those that required particular focus in the current year. This is not a complete list of all risks or areas of focus identified by our audit. We discussed these areas of focus with the audit committee. Their report on those matters that they considered to be significant issues in relation to the financial statements is set out on pages 68 and 69.

Independent auditors' report to the members of Pearson plc continued

Area of focus	How the scope of our audit addressed the area of focus
<p>Risk of fraud in revenue recognition</p> <p>Auditing standards require us to consider the risk of fraud in revenue recognition</p> <p>We focused on material products and services where revenue recognition practices are particularly complex and subject to estimates, being</p> <ul style="list-style-type: none"> multiple element arrangements, such as the provision of supplementary (print or digital) materials or training with textbooks, where revenue is recognised for each element as if it were an individual contractual arrangement requiring the estimation of its fair value, and certain long-term contracts in the Education segments, where revenue is recognised using estimated percentage of completion based on costs 	<p>We evaluated the relevant systems and tested the internal controls over the accurate and complete recording of revenue</p> <p>We assessed the accounting treatment of new contracts at inception, including examination of evidence supporting key assumptions and estimates</p> <p>We assessed the profitability and percentage of completion estimates made for material long-term revenue contracts and assessed multiple-element arrangements and the related fair value allocations</p> <p>We performed substantive testing of revenue recorded during the year and evaluated any changes in estimates to determine if they were indicators of management bias</p> <p>We also tested manual journals posted to revenue to determine their appropriateness and compliance with Group revenue recognition policies</p>
<p>Risk of management override of internal controls</p> <p>Auditing standards require us to consider the risk of management override of internal controls</p>	<p>We assessed the overall control environment of the Group, including the arrangements for staff to 'whistleblow' inappropriate actions, and interviewed senior management and the Group's internal audit function</p> <p>We examined the significant accounting estimates and judgements relevant to the financial statements for evidence of bias by the directors that may represent a risk of material misstatement due to fraud</p> <p>We also tested manual journal entries, including consolidation entries, and incorporated elements of unpredictability in the nature, timing and extent of our audit procedures</p>
<p>Penguin Random House transaction</p> <p>On 1 July 2013, management announced the completion of the Penguin Random House combination which resulted in a number of complex accounting and business model changes as follows</p> <ul style="list-style-type: none"> disposal accounting, including the gain on the sale, valuation of the new business and intangible assets, and associate accounting, including alignment of accounting policies and presentation of results in the consolidated financial statements <p>We focused on this area because it was a complex transaction which required the directors to exercise a significant level of judgement</p>	<p>We evaluated the directors' assessment of this transaction as a disposal of a business segment and an acquisition</p> <p>We evaluated the valuation of the business and associated gain on disposal</p> <p>We also assessed the resulting associate accounting including the fair value acquisition adjustments such as recognition of intangible assets and alignment of accounting policies and their application</p> <p>For the valuation exercises we assessed the directors' cash flow forecasts, comparing them to board approved plans and challenged the underlying assumptions</p>

Area of focus	How the scope of our audit addressed the area of focus
<p>Provision for uncertain tax liabilities</p> <p>The Group is subject to several tax regimes due to the geographical diversity of its businesses</p> <p>The directors are required to exercise significant judgement in determining the appropriate amount to provide in respect of potential tax exposures and uncertain tax provisions. The most significant of these relate to US tax</p> <p>We focused on this area because of the inherent judgements required in estimating the amount of any provision required. Changes in assumptions can materially impact the level of provisions recorded in the financial statements</p>	<p>We obtained an understanding of the Group's tax strategy to identify tax risks relating to business and legislative developments. We recalculated the directors' valuation of tax provisions and determined whether the calculations were in line with the Group's tax policies and had been applied consistently</p> <p>We evaluated key underlying assumptions, particularly in the US and in territories with new cross border tax structures, having due regard to ongoing correspondence between the Group and local tax authorities</p>
<p>Returns provisions</p> <p>We focused on this area because there are material judgemental provisions for anticipated book returns within the Education segments particularly as the Group transitions from print to digital</p>	<p>We tested the calculation of the provisions, assessing judgements for reasonableness against historical experience and the impact on returns of the ongoing business transition from print to digital</p> <p>We also tested controls in the shipment and returns provisioning processes</p>
<p>Valuation of pre-publication assets and inventories</p> <p>We focused on this area because there are material pre-publication assets and inventories within the Education segments. Judgement is required to evaluate the valuation of these assets which may be more complex during the transition from print to digital</p>	<p>We evaluated the recoverability of the pre-publication assets and inventories held, by assessing actual experience against historical estimates and in light of business transition from print to digital</p> <p>We also tested controls in the pre-publication assets and inventories processes</p>
<p>Goodwill impairment reviews</p> <p>We focused on this area because the Group carries significant goodwill and acquired intangible asset balances. There is judgement in the identification and aggregation of cash generating units (CGUs) and in the assumptions used in the annual goodwill impairment review</p>	<p>We tested management's impairment analysis by examining their identification and aggregation of CGUs and by evaluating the underlying assumptions through assessment of forecasts, market conditions and sensitivity analysis and through assessing the historical accuracy of forecasts and budgets</p> <p>We assessed management's calculation of discount rates and perpetuity growth rates and we tested the integrity of the valuation model</p>

Independent auditors' report to the members of Pearson plc continued

Going concern

Under the Listing Rules we are required to review the directors' statement, set out on page 72, in relation to going concern. We have nothing to report having performed our review.

As noted in the directors' statement, the directors have concluded that it is appropriate to prepare the consolidated and company financial statements using the going concern basis of accounting. The going concern basis presumes that the Group and company have adequate resources to remain in operation, and that the directors intend them to do so, for at least one year from the date the financial statements were signed. As part of our audit we have concluded that the directors' use of the going concern basis is appropriate.

However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the Group's and the company's ability to continue as a going concern.

Opinions on other matters prescribed by the Companies Act 2006

In our opinion

- › the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- › the part of the directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- › we have not received all the information and explanations we require for our audit; or
- › adequate accounting records have not been kept by the company, or returns adequate for our audit have not been received from branches not visited by us; or
- › the company financial statements and the part of the directors' remuneration report to be audited are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law have not been made. We have no exceptions to report arising from this responsibility.

Corporate Governance Statement

Under the Listing Rules we are required to review the part of the Corporate Governance Statement relating to the Company's compliance with nine provisions of the UK Corporate Governance Code (the Code). We have nothing to report having performed our review.

On page 74 of the annual report, as required by the Code Provision C.1.1, the directors state that they consider the annual report taken as a whole to be fair, balanced and understandable and provides the information necessary for members to assess the Group's performance, business model and strategy. On pages 68 and 69, as required by C.3.8 of the Code, the audit committee has set out the significant issues that it considered in relation to the financial statements, and how they were addressed. Under ISAs (UK & Ireland) we are required to report to you if, in our opinion:

- › the statement given by the directors is materially inconsistent with our knowledge of the Group acquired in the course of performing our audit, or
- › the section of the annual report describing the work of the audit committee does not appropriately address matters communicated by us to the audit committee.

We have no exceptions to report arising from this responsibility.

Other information in the annual report

Under ISAs (UK & Ireland), we are required to report to you if, in our opinion, information in the annual report is:

- › materially inconsistent with the information in the audited financial statements, or
- › apparently materially incorrect based on, or materially inconsistent with our knowledge of the Group and company acquired in the course of performing our audit, or
- › is otherwise misleading.

We have no exceptions to report arising from this responsibility.

Independent auditors' report to the members of Pearson plc continued

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors
As explained more fully in the statement of directors' responsibilities set out on page 74, the directors are responsible for the preparation of the consolidated and company financial statements and for being satisfied that they give a true and fair view

Our responsibility is to audit and express an opinion on the consolidated and company financial statements in accordance with applicable law and ISAs (UK & Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Stuart Newman
Stuart Newman (Senior Statutory Auditor)

For and on behalf of PricewaterhouseCoopers LLP

Chartered Accountants and Statutory Auditors

London, United Kingdom

10 March 2014

Notes

- (a) The maintenance and integrity of the Pearson plc website is the responsibility of the directors, the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website
- (b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions

Consolidated income statement

Year ended 31 December 2013

All figures in £ millions	Notes	2013	2012 Restated
Sales	2	5,069	4,959
Cost of goods sold	4	(2,312)	(2,187)
Gross profit		2,757	2,772
Operating expenses	4	(2,353)	(2,181)
Loss on closure of subsidiary		–	(113)
Share of results of joint ventures and associates	12	54	9
Operating profit	2	458	487
Finance costs	6	(111)	(115)
Finance income	6	35	19
Profit before tax		382	391
Income tax	7	(87)	(138)
Profit for the year from continuing operations		295	253
Profit for the year from discontinued operations	1	244	61
Profit for the year		539	314
Attributable to			
Equity holders of the company		538	311
Non-controlling interest		1	3
Earnings per share for profit from continuing and discontinued operations attributable to equity holders of the company during the year (expressed in pence per share)			
– basic	8	66.6p	38.7p
– diluted	8	66.5p	38.6p
Earnings per share for profit from continuing operations attributable to equity holders of the company during the year (expressed in pence per share)			
– basic	8	36.4p	31.1p
– diluted	8	36.3p	31.0p

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Consolidated statement of comprehensive income

Year ended 31 December 2013

All figures in £ millions	Notes	2013	2012 Restated
Profit for the year		539	314
Items that may be reclassified to the income statement			
Net exchange differences on translation of foreign operations – Group		(206)	(238)
Net exchange differences on translation of foreign operations – associates		(11)	–
Currency translation adjustment disposed – Group		(18)	–
Attributable tax	7	6	1
Items that are not reclassified to the income statement			
Remeasurement of retirement benefit obligations – Group	25	79	(100)
Remeasurement of retirement benefit obligations – associates		–	(3)
Attributable tax	7	(23)	50
Other comprehensive expense for the year		(173)	(290)
Total comprehensive income for the year		366	24
Attributable to			
Equity holders of the company		369	23
Non-controlling interest		(3)	1

Consolidated balance sheet

As at 31 December 2013

All figures in £ millions	Notes	2013	2012
Assets			
Non-current assets			
Property, plant and equipment	10	342	327
Intangible assets	11	5,801	6,218
Investments in joint ventures and associates	12	1,092	15
Deferred income tax assets	13	250	229
Financial assets – Derivative financial instruments	16	111	174
Retirement benefit assets	25	86	–
Other financial assets	15	94	31
Trade and other receivables	22	70	79
		7,846	7,073
Current assets			
Intangible assets – Pre-publication	20	717	666
Inventories	21	224	261
Trade and other receivables	22	1,173	1,104
Financial assets – Derivative financial instruments	16	13	4
Financial assets – Marketable securities	14	6	6
Cash and cash equivalents (excluding overdrafts)	17	729	1,062
		2,862	3,103
Assets classified as held for sale	32	223	1,172
Total assets		10,931	11,348
Liabilities			
Non-current liabilities			
Financial liabilities – Borrowings	18	(1,693)	(2,010)
Financial liabilities – Derivative financial instruments	16	(48)	–
Deferred income tax liabilities	13	(612)	(601)
Retirement benefit obligations	25	(142)	(172)
Provisions for other liabilities and charges	23	(77)	(110)
Other liabilities	24	(257)	(282)
		(2,829)	(3,175)
Current liabilities			
Trade and other liabilities	24	(1,505)	(1,556)
Financial liabilities – Borrowings	18	(533)	(262)
Current income tax liabilities		(164)	(291)
Provisions for other liabilities and charges	23	(112)	(38)
		(2,314)	(2,147)
Liabilities directly associated with assets classified as held for sale	32	(82)	(316)
Total liabilities		(5,225)	(5,638)
Net assets		5,706	5,710

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Consolidated balance sheet continued

As at 31 December 2013

All figures in £ millions	Notes	2013	2012
Equity			
Share capital	27	205	204
Share premium	27	2,568	2,555
Treasury shares	28	(98)	(103)
Translation reserve		(103)	128
Retained earnings		3,128	2,902
Total equity attributable to equity holders of the company		5,700	5,686
Non-controlling interest		6	24
Total equity		5,706	5,710

These financial statements have been approved for issue by the board of directors on 10 March 2014 and signed on its behalf by

Robin Freestone Chief financial officer



Consolidated statement of changes in equity

Year ended 31 December 2013

All figures in £ millions	Equity attributable to equity holders of the company						Non-controlling interest	Total equity
	Share capital	Share premium	Treasury shares	Translation reserve	Retained earnings	Total		
At 1 January 2013	204	2,555	(103)	128	2,902	5,686	24	5,710
Profit for the year	–	–	–	–	538	538	1	539
Other comprehensive expense	–	–	–	(231)	62	(169)	(4)	(173)
Equity-settled transactions	–	–	–	–	37	37	–	37
Tax on equity-settled transactions	–	–	–	–	–	–	–	–
Issue of ordinary shares under share option schemes	1	13	–	–	–	14	–	14
Purchase of treasury shares	–	–	(47)	–	–	(47)	–	(47)
Release of treasury shares	–	–	52	–	(52)	–	–	–
Put options over non-controlling interest	–	–	–	–	–	–	–	–
Changes in non-controlling interest	–	–	–	–	13	13	(15)	(2)
Dividends	–	–	–	–	(372)	(372)	–	(372)
At 31 December 2013	205	2,568	(98)	(103)	3,128	5,700	6	5,706

All figures in £ millions	Equity attributable to equity holders of the company						Non-controlling interest	Total equity
	Share capital	Share premium	Treasury shares	Translation reserve	Retained earnings	Total		
At 1 January 2012	204	2,544	(149)	364	2,980	5,943	19	5,962
Profit for the year	–	–	–	–	311	311	3	314
Other comprehensive expense	–	–	–	(236)	(52)	(288)	(2)	(290)
Equity-settled transactions	–	–	–	–	32	32	–	32
Tax on equity-settled transactions	–	–	–	–	(6)	(6)	–	(6)
Issue of ordinary shares under share option schemes	–	11	–	–	–	11	–	11
Purchase of treasury shares	–	–	–	–	–	–	–	–
Release of treasury shares	–	–	46	–	(46)	–	–	–
Put options over non-controlling interest	–	–	–	–	39	39	–	39
Changes in non-controlling interest	–	–	–	–	(10)	(10)	6	(4)
Dividends	–	–	–	–	(346)	(346)	(2)	(348)
At 31 December 2012	204	2,555	(103)	128	2,902	5,686	24	5,710

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

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Consolidated cash flow statement

Year ended 31 December 2013

All figures in £ millions	Notes	2013	2012
Cash flows from operating activities			
Net cash generated from operations	34	684	916
Interest paid		(82)	(75)
Tax paid		(246)	(65)
Net cash generated from operating activities		356	776
Cash flows from investing activities			
Acquisition of subsidiaries, net of cash acquired	30	(48)	(716)
Acquisition of joint ventures and associates		(10)	(39)
Purchase of investments		(64)	(10)
Purchase of property, plant and equipment		(118)	(78)
Purchase of intangible assets		(64)	(73)
Disposal of subsidiaries, net of cash disposed	31	(132)	(11)
Proceeds from sale of associates		2	–
Proceeds from sale of investments		2	–
Proceeds from sale of property, plant and equipment	34	28	1
Proceeds from sale of intangible assets		2	3
Proceeds from sale of liquid resources		13	23
Investment in liquid resources		(14)	(19)
Interest received		9	9
Dividends received from joint ventures and associates		64	27
Net cash used in investing activities		(330)	(883)
Cash flows from financing activities			
Proceeds from issue of ordinary shares	27	14	11
Purchase of treasury shares	28	(47)	–
Proceeds from borrowings		319	327
Loans to related parties		(44)	–
Loans advanced		(5)	–
Liquid resources acquired		–	(1)
Repayment of borrowings		(225)	–
Finance lease principal payments		(8)	(8)
Dividends paid to company's shareholders	9	(372)	(346)
Dividends paid to non-controlling interest		–	(2)
Transactions with non-controlling interest	33	(76)	(4)
Net cash used in financing activities		(444)	(23)
Effects of exchange rate changes on cash and cash equivalents		21	(24)
Net decrease in cash and cash equivalents		(397)	(154)
Cash and cash equivalents at beginning of year		1,137	1,291
Cash and cash equivalents at end of year	17	740	1,137

The consolidated cash flow statement includes discontinued operations (see note 3)

Notes to the consolidated financial statements

General information

Pearson plc (the company) its subsidiaries and associates (together the Group) are international media businesses covering education, business information and consumer publishing

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

The company has its primary listing on the London Stock Exchange and is also listed on the New York Stock Exchange

These consolidated financial statements were approved for issue by the board of directors on 10 March 2014

1 Accounting policies

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

a Basis of preparation

These consolidated financial statements have been prepared on the going concern basis and in accordance with International Financial Reporting Standards (IFRS) and IFRS Interpretations Committee interpretations as adopted by the European Union (EU) and with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. In respect of the accounting standards applicable to the Group there is no difference between EU-adopted and IASB-adopted IFRS

These consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of financial assets and liabilities (including derivative financial instruments) to fair value through profit or loss

1 Interpretations and amendments to published standards effective 2013

- › The following amendments and interpretations were adopted in 2013
- › Amendments to IAS 19 'Employee Benefits (2011)', effective for annual reporting periods beginning on or after 1 January 2013. The amendments include the elimination of the corridor approach, changes to the calculation of the net interest and service cost components and changes to disclosure. The 2012 results have been restated for IAS 19 (2011) with the results as follows

Operating profit reduced by £4m

Net finance costs increased by £15m

Income tax charge reduced by £4m

The remeasurement of retirement benefit obligations charge in the statement of other comprehensive income reduced by £15m

If the results for 2013 had been prepared under IAS 19 (rev 2008) the service cost would have been £4m lower and the net interest income would have been £28m higher

- › Amendments to IAS 1 'Presentation of Financial Statements' – Presentation of Items and Other Comprehensive Income, effective for annual reporting periods beginning on or after 1 July 2012. The amendments require the grouping of items in other comprehensive income into those that may be reclassified to the income statement in subsequent periods, and those that will not. The statement of other comprehensive income has been updated to present this information
- › The IASB issued a 'package of five' new and amended standards together: IFRS 10 'Consolidated Financial Statements', IFRS 11 'Joint Arrangements' and IFRS 12 'Disclosures of Involvement with Other Entities' have been issued. IAS 27 'Separate Financial Statements' (Revised 2011) has been amended following the issuance of IFRS 10 and retains the guidance for separate financial statements. IAS 28 'Investments in Associates and Joint Ventures' (Revised 2011) has been amended following the issuance of IFRS 10 and IFRS 11. All three new standards and two amended standards are not mandatory for the Group until 1 January 2014. However, the Group has early adopted these standards and amendments as of 1 January 2013
- › IFRS 13 'Fair Value Measurement', effective for annual reporting periods beginning on or after 1 January 2013. The standard defines fair value, provides guidance on its determination, and introduces disclosure requirements on fair value measurements
- › Amendments to IFRS 7, 'Financial Instruments – Disclosures' regarding asset and liability offsetting
- › Amendments to IAS 36, 'Impairment of assets', on the recoverable amount disclosures for non-financial assets. This amendment removed certain disclosures of the recoverable amount of CGUs which had been included in IAS 36 by the issue of IFRS 13. The amendment is not mandatory for the Group until 1 January 2014. However, the Group has early adopted the amendments as of 1 January 2013

Notes to the consolidated financial statements continued

1 Accounting policies continued

a Basis of preparation continued

With the exception of IAS 19 'Employee Benefits (2011)', the adoption of these new pronouncements from 1 January 2013, does not have a material impact on the consolidated financial statements. Disclosure requirements have been updated as required.

2 *Standards, interpretations and amendments to published standards that are not yet effective*

The Group has not early adopted the following new pronouncements that are not yet effective:

- IFRS 9 'Financial Instruments', effective for annual reporting periods beginning on or after 1 January 2018. The new standard details the requirements for the classification, measurement and recognition of financial assets and liabilities. The Group is yet to assess the full impact of IFRS 9 and will do so once the remaining sections of the standard are completed.
- IFRIC 21, 'Leaves' details the accounting for an obligation to pay a levy that is not income tax. As the Group is not currently subjected to significant levies the impact on the Group is not material.

3 *Critical accounting assumptions and judgements*

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

Intangible assets: Goodwill

Intangible assets: Pre-publication assets

Taxation

Employee benefits: Pension obligations

Revenue recognition

b Consolidation

1 *Business combinations* The acquisition method of accounting is used to account for business combinations. The consideration transferred for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interest issued by the Group. The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred in the operating expenses line of the income statement.

Identifiable assets and contingent assets acquired and identifiable liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. For material acquisitions, the fair value of the acquired intangible assets is determined by an independent valuer. The excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition date fair value of any previous equity interest in the acquiree over the fair value of the identifiable net assets acquired is recorded as goodwill.

See note 1e(1) for the accounting policy on goodwill. If this is less than the fair value of the net assets of the subsidiary acquired, in the case of a bargain purchase, the difference is recognised directly in the income statement.

On an acquisition-by-acquisition basis, the Group recognises any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's net assets.

2 *Subsidiaries* Subsidiaries are entities over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date that control ceases.

3 *Transactions with non-controlling interests* Transactions with non-controlling interests that do not result in loss of control are accounted for as equity transactions, that is as transactions with the owners in their capacity as owners. Any surplus or deficit arising from disposals to a non-controlling interest is recorded in equity. For purchases from a non-controlling interest, the difference between consideration paid and the relevant share acquired of the carrying value of the subsidiary is recorded in equity.

4 *Joint ventures and associates* Joint ventures are entities in which the Group holds an interest on a long-term basis and has rights to the net assets through contractually agreed sharing of control. Associates are entities over which the Group has significant influence but not the power to control the financial and operating policies, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in joint ventures and associates are accounted for by the equity method and are initially recognised at the fair value of consideration transferred.

1 Accounting policies continued

b Consolidation continued

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

c Foreign currency translation

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

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

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

- i) assets and liabilities are translated at the closing rate at the date of the balance sheet,
- ii) income and expenses are translated at average exchange rates,
- iii) all resulting exchange differences are recognised as a separate component of equity.

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

The principal overseas currency for the Group is the US dollar. The average rate for the year against sterling was \$1.57 (2012: \$1.59) and the year end rate was \$1.66 (2012: \$1.63).

d Property, plant and equipment

Property, plant and equipment are stated at historical cost less depreciation. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for intended use. Land is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate their cost less their residual values over their estimated useful lives as follows:

Buildings (freehold)	20–50 years
Buildings (leasehold)	over the period of the lease
Plant and equipment	3–10 years

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

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

e Intangible assets

1 Goodwill For the acquisition of subsidiaries made on or after 1 January 2010 goodwill represents the excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition date fair value of any previous equity interest in the acquiree over the fair value of the identifiable net assets acquired. For the acquisition of subsidiaries made from the date of transition to IFRS to 31 December 2009 goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets acquired. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisition of associates and joint ventures represents the excess of the cost of

Notes to the consolidated financial statements continued

1 Accounting policies continued

e Intangible assets continued

an acquisition over the fair value of the Group's share of the net identifiable assets acquired. Goodwill on acquisitions of associates and joint ventures is included in investments in associates and joint ventures.

Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. An impairment loss is recognised to the extent that the carrying value of goodwill exceeds the recoverable amount. The recoverable amount is the higher of fair value less costs to sell and value in use. These calculations require the use of estimates and significant management judgement. A description of the key assumptions and sensitivities is included in note 11. Goodwill is allocated to aggregated cash-generating units for the purpose of impairment testing. The allocation is made to those aggregated cash-generating units that are expected to benefit from the business combination in which the goodwill arose.

Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

IFRS 3 'Business Combinations' has not been applied retrospectively to business combinations before the date of transition to IFRS.

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

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

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

5 Pre-publication assets Pre-publication assets represent direct costs incurred in the development of educational programmes and titles prior to their publication. These costs are recognised as current intangible assets where the title will generate probable future economic benefits and costs can be measured reliably. Pre-publication assets are amortised upon publication of the title over estimated economic lives of five years or less, being an estimate of the expected operating life cycle of the title, with a higher proportion of the amortisation taken in the earlier years.

The investment in pre-publication assets has been disclosed as part of cash generated from operations in the cash flow statement (see note 34).

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

Reviews are performed regularly to estimate recoverability of pre-publication assets. The carrying amount of pre-publication assets is set out in note 20.

f Other financial assets

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

1 Accounting policies continued

g Inventories

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

h Royalty advances

Advances of royalties to authors are included within trade and other receivables when the advance is paid less any provision required to adjust the advance to its net realisable value. The realisable value of royalty advances relies on a degree of management judgement in determining the profitability of individual author contracts. If the estimated realisable value of author contracts is overstated, this will have an adverse effect on operating profits as these excess amounts will be written off.

The recoverability of royalty advances is based upon an annual detailed management review of the age of the advance, the future sales projections for new authors and prior sales history of repeat authors. The royalty advance is expensed at the contracted or effective royalty rate as the related revenues are earned. Royalty advances which will be consumed within one year are held in current assets. Royalty advances which will be consumed after one year are held in non-current assets.

i Cash and cash equivalents

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

Short-term deposits and marketable securities with maturities of greater than three months do not qualify as cash and cash equivalents. Movements on these financial instruments are classified as cash flows from financing activities in the cash flow statement where these amounts are used to offset the borrowings of the Group or as cash flows from investing activities where these amounts are held to generate an investment return.

j. Share capital

Ordinary shares are classified as equity.

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

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

k Borrowings

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

l Derivative financial instruments

Derivatives are recognised at fair value and remeasured at each balance sheet date. The fair value of derivatives is determined by using market data and the use of established estimation techniques such as discounted cash flow and option valuation models. The Group designates certain of the derivative instruments within its portfolio to be hedges of the fair value of its bonds (fair value hedges) or hedges of net investments in foreign operations (net investment hedges).

Notes to the consolidated financial statements continued

l Accounting policies continued

l Derivative financial instruments continued

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

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

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

m Taxation

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

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

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

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

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

The Group is subject to income taxes in numerous jurisdictions. Significant judgement is required in determining the estimates in relation to the worldwide provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. The Group recognises liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made

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

n Employee benefits

l Pension obligations The retirement benefit asset and obligation recognised in the balance sheet represents the net of the present value of the defined benefit obligation and the fair value of plan assets at the balance sheet date. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting estimated future cash flows using yields on high quality corporate bonds which have terms to maturity approximating the terms of the related liability

The determination of the pension cost and defined benefit obligation of the Group's defined benefit pension schemes depends on the selection of certain assumptions, which include the discount rate, inflation rate, salary growth and longevity

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to equity in other comprehensive income in the period in which they arise

The service cost representing benefits accruing over the year, is included in the income statement as an operating cost. Net interest is calculated by applying the discount rate to the net defined benefit obligation and is presented as finance costs or finance income

1 Accounting policies continued

n Employee benefits continued

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

2 *Other post-retirement obligations* The expected costs of post-retirement healthcare and life assurance benefits are accrued over the period of employment, using a similar accounting methodology as for defined benefit pension obligations. The liabilities and costs relating to significant other post-retirement obligations are assessed annually by independent qualified actuaries

3 *Share-based payments* The fair value of options or shares granted under the Group's share and option plans is recognised as an employee expense after taking into account the Group's best estimate of the number of awards expected to vest. Fair value is measured at the date of grant and is spread over the vesting period of the option or share. The fair value of the options granted is measured using an option model that is most appropriate to the award. The fair value of shares awarded is measured using the share price at the date of grant unless another method is more appropriate. Any proceeds received are credited to share capital and share premium when the options are exercised

o Provisions

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

The Group recognises a provision for deferred consideration at fair value.

The Group recognises a provision for onerous lease contracts when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under the contract

The provision is based on the present value of future payments for surplus leased properties under non-cancellable operating leases, net of estimated sub-leasing income

p Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sale of goods and services net of sales taxes, rebates and discounts, and after eliminating sales within the Group

Revenue from the sale of books is recognised when title passes. A provision for anticipated returns is made based primarily on historical return rates. If these estimates do not reflect actual returns in future periods then revenues could be understated or overstated for a particular period

Circulation and advertising revenue is recognised when the newspaper or other publication is published. Subscription revenue is recognised on a straight-line basis over the life of the subscription

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

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

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

Notes to the consolidated financial statements continued

l Accounting policies continued**p Revenue recognition continued**

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

q Leases

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

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

r Dividends

Dividends are recorded in the Group's financial statements in the period in which they are approved by the company's shareholders.

s Assets and liabilities held for sale

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

t Trade receivables

Trade receivables are stated at fair value after provision for bad and doubtful debts and anticipated future sales returns (see also note l p).

2 Segment information

The Group is organised into the following business segments.

Continuing operations

North American Education Educational publishing, assessment and testing for the school and higher education market within the USA and Canada,

International Education Educational publishing, assessment and testing for the school and higher education market outside of North America,

Professional Business and technology publishing, training, testing and certification for professional bodies,

FT Group Publisher of the *Financial Times*, business magazines and specialist information.

In addition the Group separately discloses the results of the Penguin Random House (PRH) associate. The results of the Penguin segment to 30 June 2013 and the Mergermarket business (previously included as part of the FT Group) are shown as discontinued in both 2012 and 2013.

2 Segment information continued

For more detail on the services and products included in each business segment refer to the strategic report

									2013
All figures in £ millions	Notes	North American Education	International Education	Professional	FT Group	PRH	Corporate	Discontinued operations	Group
Continuing operations									
Sales (external)		2,779	1,539	410	341	–	–	–	5,069
Sales (inter-segment)		3	1	15	–	–	–	–	19
Adjusted operating profit		406	140	57	29	50	–	–	682
Intangible charges		(92)	(60)	(12)	(2)	(30)	–	–	(196)
Acquisition costs		(2)	(9)	–	(1)	–	–	–	(12)
Other net gains and losses		–	(16)	–	–	–	–	–	(16)
Operating profit		312	55	45	26	20	–	–	458
Finance costs	6								(111)
Finance income	6								35
Profit before tax									382
Income tax	7								(87)
Profit for the year from continuing operations									295
Segment assets									
Segment assets		5,544	2,311	609	293	–	859	223	9,839
Joint ventures	12	–	3	–	–	–	–	–	3
Associates	12	1	9	–	8	1,070	1	–	1,089
Total assets		5,545	2,323	609	301	1,070	860	223	10,931
Other segment items									
Share of results of joint ventures and associates	12	(1)	(4)	2	26	31	–	–	54
Capital expenditure	10 11	92	37	23	22	–	–	1	175
Pre-publication investment	20	288	69	7	–	–	–	–	364
Depreciation	10	43	21	8	9	–	–	1	82
Amortisation	11 20	355	141	22	15	–	–	2	535

Notes to the consolidated financial statements continued

2 Segment information continued

								2012 Restated
All figures in £ millions	Notes	North American Education	International Education	Professional	FT Group	Corporate	Discontinued operations	Group
Continuing operations								
Sales (external)		2,658	1,568	390	343	–	–	4,959
Sales (inter-segment)		5	1	12	–	–	–	18
Adjusted operating profit		536	214	37	22	–	–	809
Intangible charges		(66)	(73)	(37)	(3)	–	–	(179)
Acquisition costs		(7)	(8)	(1)	(4)	–	–	(20)
Other net gains and losses		–	–	(123)	–	–	–	(123)
Operating profit		463	133	(124)	15	–	–	487
Finance costs	6							(115)
Finance income	6							19
Profit before tax								391
Income tax	7							(138)
Profit for the year from continuing operations								253
Segment assets								
Segment assets		5,449	2,390	631	445	1,246	1,145	11,306
Joint ventures	12	–	7	–	1	–	–	8
Associates	12	1	4	–	2	–	27	34
Total assets		5,450	2,401	631	448	1,246	1,172	11,348
Other segment items								
Share of results of joint ventures and associates	12	–	(3)	(11)	23	–	–	9
Capital expenditure	10 11	66	33	16	26	–	11	152
Pre-publication investment	20	250	76	7	–	–	31	364
Depreciation	10	41	16	8	7	–	8	80
Amortisation	11 20	311	142	45	13	–	42	553

In 2013, sales from the provision of goods were £2,867m (2012: £2,946m) and sales from the provision of services were £2,202m (2012: £2,013m). Sales from the Group's educational publishing, consumer publishing and newspaper business are classified as being from the provision of goods and sales from its assessment and testing and other service businesses are classified as being from the provision of services.

Included in other net gains and losses in continuing operations in 2013 is a loss on the disposal of the Japanese school and local publishing assets and in 2012 is a loss on closure of Pearson in Practice (£113m) and an impairment loss on a joint venture (£10m).

2 Segment information continued

Corporate costs are allocated to business segments including discontinued operations on an appropriate basis depending on the nature of the cost and therefore the segment result is equal to the Group operating profit. Inter-segment pricing is determined on an arm's-length basis. Segment assets consist of property, plant and equipment, intangible assets, inventories, receivables, deferred taxation and other financial assets and exclude cash and cash equivalents and derivative assets. Corporate assets comprise cash and cash equivalents, marketable securities and derivative financial instruments. Capital expenditure comprises additions to property, plant and equipment and software (see notes 10 and 11).

Property, plant and equipment and intangible assets acquired through business combination were £202m (2012 £296m) (see note 30). Capital expenditure, depreciation and amortisation include amounts relating to discontinued operations.

The Group operates in the following main geographic areas

All figures in £ millions	Sales		Non-current assets	
	2013	2012	2013	2012
Continuing operations				
UK	649	678	1,068	803
Other European countries	366	377	200	234
USA	2,913	2,756	5,026	4,496
Canada	128	144	301	307
Asia Pacific	624	633	495	524
Other countries	389	371	215	275
Total continuing	5,069	4,959	7,305	6,639
Discontinued operations				
UK	97	187	–	–
Other European countries	49	92	–	–
USA	369	647	–	–
Canada	24	57	–	–
Asia Pacific	74	153	–	–
Other countries	8	17	–	–
Total discontinued	621	1,153	–	–
Total	5,690	6,112	7,305	6,639

Sales are allocated based on the country in which the customer is located. This does not differ materially from the location where the order is received. The geographical split of non-current assets is based on the subsidiary's country of domicile. This is not materially different to the location of the assets. Non-current assets comprise property, plant and equipment, intangible assets, investments in joint ventures and associates and trade and other receivables.

Notes to the consolidated financial statements continued

3 Discontinued operations

Discontinued operations relate to Penguin and Mergermarket

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

All figures in £ millions	2013			2012		
	Penguin	Mergermarket	Total	Penguin	Mergermarket	Total
Sales	513	108	621	1,053	100	1,153
Operating profit	28	24	52	62	24	86
Finance income	1	–	1	–	–	–
Profit before tax	29	24	53	62	24	86
Attributable tax expense	(9)	(9)	(18)	(19)	(6)	(25)
Profit after tax	20	15	35	43	18	61
Profit on disposal of Penguin before tax	202	–	202	–	–	–
Attributable tax benefit	15	–	15	–	–	–
Mergermarket transaction costs	–	(8)	(8)	–	–	–
Profit for the year from discontinued operations	237	7	244	43	18	61
Operating cash flows	36	22	58	83	26	109
Investing cash flows	(6)	(2)	(8)	(81)	(24)	(105)
Financing cash flows	(8)	(29)	(37)	10	(6)	4
Total cash flows	22	(9)	13	12	(4)	8

4 Operating expenses

All figures in £ millions	2013	2012 Restated
By function		
Cost of goods sold	2,312	2,187
Operating expenses		
Distribution costs	90	82
Selling, marketing and product development costs	1,027	925
Administrative and other expenses	1,162	1,242
Restructuring costs	176	–
Other net gains and losses	16	10
Other income	(118)	(78)
Total net operating expenses	2,353	2,181
Total	4,665	4,368

Included in other income in 2013 is service fee income from Penguin Random House of £28m

4 Operating expenses continued

All figures in £ millions	Notes	2013	2012 Restated
By nature			
Royalties expensed		256	245
Other product costs		793	865
Employee benefit expense	5	2,100	1,866
Contract labour		194	137
Employee related expense		177	168
Promotional costs		167	155
Depreciation of property, plant and equipment	10	81	72
Amortisation of software		59	49
Amortisation of intangible assets – Other		166	179
Amortisation of intangible assets – Pre-publication	20	308	283
Property and facilities		229	188
Technology and communications		104	80
Professional and outsourced services		259	253
Other general and administrative costs		61	38
Capitalised costs		(199)	(162)
Acquisition costs		12	20
Other net gains and losses		16	10
Other income		(118)	(78)
Total		4,665	4,368

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

All figures in £ millions	2013	2012
The audit of parent company and consolidated financial statements	4	4
The audit of the company's subsidiaries	2	2
Total audit fees	6	6
Other assurance services	1	1
Total assurance services	1	1
Tax compliance services	2	1
Tax advisory services	2	1
Total tax services	4	2
Total non-audit services	5	3
Total	11	9

Reconciliation between audit and non-audit service fees is shown below

All figures in £ millions	2013	2012
Group audit fees including fees for attestation under section 404 of the Sarbanes-Oxley Act	6	6
Non-audit fees	5	3
Total	11	9

Fees for attestation under section 404 of the Sarbanes-Oxley Act are allocated between fees payable for the audits of consolidated and subsidiary accounts. Non-audit fees for 2013 includes £3m for assurance and tax services related to the Penguin Random House transaction.

Notes to the consolidated financial statements continued

5 Employee information

All figures in £ millions	Notes	2013	2012 Restated
Employee benefit expense			
Wages and salaries (including termination benefits and restructuring costs)		1,836	1,610
Social security costs		136	129
Share-based payment costs	26	35	28
Retirement benefits – defined contribution plans	25	66	69
Retirement benefits – defined benefit plans	25	27	26
Other post-retirement benefits	25	–	4
Total		2,100	1,866

The details of the emoluments of the directors of Pearson plc are shown in the report on directors' remuneration

Average number employed	2013	2012
Employee numbers		
North American Education	19,670	18,552
International Education	16,113	16,751
Professional	3,357	3,706
FT Group	2,216	2,243
Other	759	883
Continuing operations	42,115	42,135

The employee benefit expense relating to discontinued operations was £168m (2012 £265m) and the average number employed was 3,592 (2012 5,387).

6 Net finance costs

All figures in £ millions	Notes	2013	2012 Restated
Interest payable		(82)	(75)
Net finance costs in respect of retirement benefits	25	(3)	(2)
Finance cost of put options, deferred consideration associated with acquisitions and other interest charges related to transactions		(9)	(27)
Net foreign exchange losses		–	(8)
Other losses on financial instruments in a hedging relationship			
– fair value hedges		–	(1)
Other losses on financial instruments not in a hedging relationship			
– derivatives		(17)	(2)
Finance costs		(111)	(115)
Interest receivable		10	10
Net foreign exchange gains		20	9
Other gains on financial instruments in a hedging relationship			
– fair value hedges		1	–
Other gains on financial instruments not in a hedging relationship			
– derivatives		4	–
Finance income		35	19
Net finance costs		(76)	(96)
Analysed as			
Net interest payable reflected in adjusted earnings		(72)	(65)
Other net finance costs		(4)	(31)
Total net finance costs		(76)	(96)

The net gain of £1m on fair value hedges in 2013 (2012 net loss of £1m) comprises a gain of £95m (2012 gain of £7m) on the underlying bonds, offset by a loss of £94m (2012 loss of £8m) on the related derivative financial instruments

Notes to the consolidated financial statements continued

7 Income tax

All figures in £ millions	Notes	2013	2012 Restated
Current tax			
Charge in respect of current year		(129)	(147)
Adjustments in respect of prior years		(7)	18
Total current tax charge		(136)	(129)
Deferred tax			
In respect of temporary differences		14	(45)
Other adjustments in respect of prior years		35	36
Total deferred tax credit/(charge)	13	49	(9)
Total tax charge		(87)	(138)

The adjustments in respect of prior years in 2013 mainly relate to changes in estimates arising from uncertain tax positions following settlements with tax authorities in the year

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

All figures in £ millions	2013	2012 Restated
Profit before tax	382	391
Tax calculated at UK rate (2013 23.25%, 2012 24.5%)	(89)	(96)
Effect of overseas tax rates	(13)	(51)
Joint venture and associate income reported net of tax	13	2
Net expense not subject to tax	(14)	(15)
Loss on sale of businesses not subject to tax	(6)	(28)
Utilisation of previously unrecognised tax losses and credits	1	2
Unutilised tax losses	(7)	(6)
Adjustments in respect of prior years	28	54
Total tax charge	(87)	(138)
UK	(13)	(14)
Overseas	(74)	(124)
Total tax charge	(87)	(138)
Tax rate reflected in earnings	22.8%	35.3%

7 Income tax continued

The tax rate reflected in adjusted earnings is calculated as follows

All figures in £ millions	2013	2012 Restated
Profit before tax	382	391
Adjustments		
Other net gains and losses	16	123
Acquisition costs	12	20
Amortisation of acquired intangibles	196	179
Other net finance costs	4	31
Adjusted profit before tax – continuing operations	610	744
Adjusted profit before tax – discontinued operations	54	123
Total adjusted profit before tax	664	867
Total tax charge	(87)	(138)
Adjustments		
Tax charge on other net gains and losses	32	–
Tax benefit on acquisition costs	(2)	(5)
Tax benefit on amortisation of acquired intangibles	(51)	(54)
Tax benefit on other net finance costs	(1)	(1)
Tax amortisation benefit on goodwill and intangibles	30	36
Adjusted income tax charge – continuing operations	(79)	(162)
Adjusted income tax charge – discontinued operations	(18)	(38)
Total adjusted income tax charge	(97)	(200)
Tax rate reflected in adjusted earnings	14.6%	23.1%

The tax (charge)/benefit recognised in other comprehensive income is as follows

All figures in £ millions	2013	2012 Restated
Remeasurement of retirement benefit obligations	(23)	50
Net exchange differences on translation of foreign operations	6	1
	(17)	51

A tax charge of £nil (2012 tax benefit £6m) relating to share-based payments has been recognised directly in equity

Notes to the consolidated financial statements continued

8 Earnings per share

Basic

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

Diluted

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

All figures in £ millions	Notes	2013	2012 Restated
Profit for the year from continuing operations		295	253
Non-controlling interest		(1)	(3)
Earnings from continuing operations		294	250
Profit for the year from discontinued operations	3	244	61
Non-controlling interest		—	—
Earnings		538	311
Weighted average number of shares (millions)		807.8	804.3
Effect of dilutive share options (millions)		1.1	1.3
Weighted average number of shares (millions) for diluted earnings		808.9	805.6
Earnings per share from continuing and discontinued operations			
Basic		66.6p	38.7p
Diluted		66.5p	38.6p
Earnings per share from continuing operations			
Basic		36.4p	31.1p
Diluted		36.3p	31.0p
Earnings per share from discontinued operations			
Basic		30.2p	7.6p
Diluted		30.2p	7.6p

Adjusted

In order to show results from operating activities on a consistent basis, an adjusted earnings per share is presented. The company's definition of adjusted earnings per share may not be comparable to other similarly titled measures reported by other companies.

Adjusted earnings includes the results from continuing and discontinued operations.

The following items are excluded from adjusted earnings:

Other net gains and losses represent profits and losses on the acquisition and disposal of subsidiaries, joint ventures, associates and other financial assets that are included within continuing or discontinued operations but which distort the performance of the Group.

Amortisation of acquired intangibles, acquisition costs and movements in contingent acquisition consideration are also excluded from adjusted earnings as these items are not considered to be fully reflective of the underlying performance of the Group.

8 Earnings per share continued

Other net finance income/costs include finance costs in respect of retirement benefits, finance costs of put options and deferred consideration and foreign exchange and other gains and losses. Finance costs relating to retirement benefits are excluded as the Group's interpretation is that the new presentation under IAS 19 (revised) does not reflect the economic substance of the underlying assets and liabilities. Finance costs of put options and deferred consideration are excluded as they relate to future earn outs and similar payments on acquisitions and do not reflect cash expended. Foreign exchange and other gains and losses are excluded 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. Other net finance costs of Group companies are included in finance costs or finance income as appropriate. Other net finance costs of joint ventures and associates are included within the share of results of joint ventures and associates within operating profit.

Tax on the above items is excluded from adjusted earnings. Where relevant the Group also excludes the benefit from recognising previously unrecognised pre-acquisition and capital losses. The Group includes the benefit of tax amortisation of goodwill and intangibles as this benefit more accurately aligns the adjusted tax charge with the expected rate of cash tax payments.

Non-controlling interest for the above items is excluded from adjusted earnings.

The following tables reconcile statutory earnings to adjusted earnings.

	2013							
All figures in £ millions	Statutory income statement	Discontinued operations	Other net gains and losses	Acquisition costs	Intangible charges	Other net finance income/costs	Tax amortisation benefit	Adjusted income statement
Operating profit	458	54	16	12	196	—	—	736
Net finance costs	(76)	—	—	—	—	4	—	(72)
Profit before tax	382	54	16	12	196	4	—	664
Income tax	(87)	(18)	32	(2)	(51)	(1)	30	(97)
Profit for the year from continuing operations	295	36	48	10	145	3	30	567
Profit for the year from discontinued operations	244	(36)	(209)	—	2	(1)	—	—
Profit for the year	539	—	(161)	10	147	2	30	567
Non-controlling interest	(1)	—	—	—	—	—	—	(1)
Earnings	538	—	(161)	10	147	2	30	566
Weighted average number of shares (millions)	807.8							807.8
Adjusted earnings per share	66.6p							70.1p

Notes to the consolidated financial statements continued

8 Earnings per share continued

								2012 Restated
All figures in £ millions	Statutory income statement	Discontinued operations	Other net gains and losses	Acquisition costs	Intangible charges	Other net finance income/ costs	Tax amortisation benefit	Adjusted income statement
Operating profit	487	123	123	20	179	–	–	932
Net finance costs	(96)	–	–	–	–	31	–	(65)
Profit before tax	391	123	123	20	179	31	–	867
Income tax	(138)	(38)	–	(5)	(54)	(1)	36	(200)
Profit for the year from continuing operations	253	85	123	15	125	30	36	667
Profit for the year from discontinued operations	61	(85)	20	1	3	–	–	–
Profit for the year	314	–	143	16	128	30	36	667
Non-controlling interest	(3)	–	–	–	–	–	–	(3)
Earnings	311	–	143	16	128	30	36	664
Weighted average number of shares (millions)	804.3							804.3
Adjusted earnings per share	38.7p							82.6p

9 Dividends

All figures in £ millions	2013	2012
Final paid in respect of prior year 30.0p (2012: 28.0p)	242	225
Interim paid in respect of current year 16.0p (2012: 15.0p)	130	121
	372	346

The directors are proposing a final dividend in respect of the financial year ended 31 December 2013 of 32.0p per share which will absorb an estimated £259m of shareholders' funds. It will be paid on 2 May 2014 to shareholders who are on the register of members on 4 April 2014. These financial statements do not reflect this dividend.

10 Property, plant and equipment

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Cost				
At 1 January 2012	363	706	12	1,081
Exchange differences	(9)	(23)	—	(32)
Additions	12	51	15	78
Disposals	(2)	(20)	—	(22)
Acquisition through business combination	4	13	—	17
Disposal through business disposal	(1)	(4)	—	(5)
Reclassifications	8	—	(8)	—
Transfer from/(to) software	9	(27)	—	(18)
Transfer from pre-publication	—	3	—	3
Transfer to assets held for sale	(32)	(102)	(1)	(135)
At 31 December 2012	352	597	18	967
Exchange differences	(5)	(14)	—	(19)
Additions	33	58	22	113
Disposals	(13)	(78)	—	(91)
Acquisition through business combination	—	3	—	3
Disposal through business disposal	(1)	(2)	—	(3)
Reclassifications	9	(1)	(8)	—
Transfer from software	—	3	—	3
Transfer from assets held for sale	—	9	—	9
Transfer to assets held for sale	—	(7)	—	(7)
At 31 December 2013	375	568	32	975

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10 Property, plant and equipment continued

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Depreciation				
At 1 January 2012	(187)	(511)	–	(698)
Exchange differences	6	17	–	23
Charge for the year	(21)	(59)	–	(80)
Disposals	2	19	–	21
Acquisition through business combination	(1)	(6)	–	(7)
Disposal through business disposal	–	2	–	2
Reclassifications	(8)	8	–	–
Transfer (from)/to software	(3)	7	–	4
Transfer to assets held for sale	17	78	–	95
At 31 December 2012	(195)	(445)	–	(640)
Exchange differences	3	13	–	16
Charge for the year	(25)	(57)	–	(82)
Disposals	7	64	–	71
Acquisition through business combination	–	(2)	–	(2)
Transfer from assets held for sale	–	(1)	–	(1)
Transfer to assets held for sale	–	5	–	5
At 31 December 2013	(210)	(423)	–	(633)
Carrying amounts				
At 1 January 2012	176	195	12	383
At 31 December 2012	157	152	18	327
At 31 December 2013	165	145	32	342

Depreciation expense of £24m (2012 £23m) has been included in the income statement in cost of goods sold and £57m (2012 £49m) in operating expenses. In 2013 £1m (2012 £8m) relates to discontinued operations.

The Group leases certain equipment under a number of finance lease agreements. The net carrying amount of leased plant and equipment included within property, plant and equipment was £11m (2012 £17m).

11 Intangible assets

All figures in £ millions	Goodwill	Software	Acquired customer lists, contracts and relationships	Acquired trade marks and brands	Acquired publishing rights	Other intangibles acquired	Total
Cost							
At 1 January 2012	5,199	428	681	253	213	356	7,130
Exchange differences	(213)	(13)	(26)	(11)	(9)	(18)	(290)
Additions – internal development	–	38	–	–	–	–	38
Additions – purchased	–	36	–	–	–	–	36
Disposals	–	(11)	–	–	–	–	(11)
Acquisition through business combination	505	12	182	27	10	56	792
Disposal through business disposal	(50)	–	(89)	(2)	–	–	(141)
Transfer from PPE	–	18	–	–	–	–	18
Transfer to assets held for sale	(364)	(42)	(19)	(9)	(7)	–	(441)
At 31 December 2012	5,077	466	729	258	207	394	7,131
Exchange differences	(122)	(6)	(25)	(8)	(12)	(11)	(184)
Additions – internal development	–	38	–	–	–	–	38
Additions – purchased	–	24	–	–	–	–	24
Disposals	–	(50)	–	–	–	–	(50)
Acquisition through business combination	(133)	–	190	–	3	7	67
Disposal through business disposal	(6)	–	–	–	–	(1)	(7)
Reclassifications	–	–	(10)	(1)	–	11	–
Transfer to PPE	–	(3)	–	–	–	–	(3)
Transfer to assets held for sale	(150)	–	(29)	(12)	–	(2)	(193)
At 31 December 2013	4,666	469	855	237	198	398	6,823

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11 Intangible assets continued

All figures in £ millions	Goodwill	Software	Acquired customer lists contracts and relationships	Acquired trademarks and brands	Acquired publishing rights	Other intangibles acquired	Total
Amortisation							
At 1 January 2012	–	(296)	(168)	(63)	(128)	(133)	(788)
Exchange differences	–	9	8	3	5	7	32
Charge for the year	–	(54)	(90)	(27)	(20)	(46)	(237)
Disposals	–	8	–	–	–	–	8
Acquisition through business combination	–	(7)	–	–	–	–	(7)
Disposal through business disposal	–	–	45	1	–	–	46
Transfer from PPE	–	(4)	–	–	–	–	(4)
Transfer to assets held for sale	–	32	1	–	4	–	37
At 31 December 2012	–	(312)	(204)	(86)	(139)	(172)	(913)
Exchange differences	–	6	10	4	6	7	33
Charge for the year	–	(59)	(78)	(21)	(15)	(54)	(227)
Disposals	–	49	–	–	–	–	49
Disposal through business disposal	–	–	–	–	–	1	1
Transfer to assets held for sale	–	–	23	10	–	2	35
At 31 December 2013	–	(316)	(249)	(93)	(148)	(216)	(1,022)
Carrying amounts							
At 1 January 2012	5,199	132	513	190	85	223	6,342
At 31 December 2012	5,077	154	525	172	68	222	6,218
At 31 December 2013	4,666	153	606	144	50	182	5,801

Goodwill

The goodwill carrying value of £4,666m relates to acquisitions completed after 1 January 1998. Prior to 1 January 1998 all goodwill was written off to reserves on the date of acquisition. For acquisitions completed between 1 January 1998 and 31 December 2002 no value was ascribed to intangibles other than goodwill and the goodwill on each acquisition was amortised over a period of up to 20 years. On adoption of IFRS on 1 January 2003, the Group chose not to restate the goodwill balance and at that date the balance was frozen (i.e. amortisation ceased). If goodwill had been restated then a significant value would have been ascribed to other intangible assets, which would be subject to amortisation, and the carrying value of goodwill would be significantly lower. For acquisitions completed after 1 January 2003 value has been ascribed to other intangible assets which are amortised.

Other intangible assets

Other intangibles acquired include content, technology and software rights.

Intangible assets are valued separately for each acquisition and the primary method of valuation used is the discounted cash flow method. The majority of acquired intangibles are amortised using the unit of production method which is based on the pattern of benefits embodied in the asset.

Amortisation of £15m (2012: £10m) is included in the income statement in cost of goods sold and £210m (2012: £218m including an impairment of £21m relating to Pearson in Practice) in operating expenses. In 2013 £2m (2012: £9m) of amortisation relates to discontinued operations.

11 Intangible assets continued

The range of useful economic lives for each major class of intangible asset (excluding goodwill and software) is shown below

	2013
Class of intangible asset	Useful economic life
Acquired customer lists, contracts and relationships	3–20 years
Acquired trademarks and brands	2–20 years
Acquired publishing rights	5–20 years
Other intangibles acquired	2–20 years

The expected amortisation profile of acquired intangible assets is shown below

	2013			
All figures in £ millions	One to five years	Six to ten years	More than ten years	Total
Class of intangible asset				
Acquired customer lists, contracts and relationships	357	166	83	606
Acquired trademarks and brands	78	41	25	144
Acquired publishing rights	46	4	—	50
Other intangibles acquired	148	33	1	182

Impairment tests for cash-generating units containing goodwill

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

Goodwill is allocated to, and monitored at the level of, nine aggregated cash-generating units (CGUs) within the business segments as follows:

All figures in £ millions	2013	2012
US Education Publishing	2,225	2,384
US School Assessment and Information	750	773
Canada	173	188
International – Emerging Markets	423	463
International – UK	444	450
International – Rest of World	253	267
Professional Publishing	14	15
Professional Assessment and Training	334	334
Pearson Education total	4,616	4,874
Financial Times	50	51
Continuing operations	4,666	4,925
Mergermarket	—	152
Discontinued operations	—	152
Total	4,666	5,077

Notes to the consolidated financial statements continued

11 Intangible assets continued

Impairment tests for cash-generating units containing goodwill continued

The recoverable amount of each CGU is based on value in use calculations. Goodwill is tested for impairment annually. Other than goodwill there are no intangible assets with indefinite lives. The goodwill is generally denominated in the currency of the relevant cash flows and therefore the impairment review is not materially sensitive to exchange rate fluctuations.

Key assumptions

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

Discount rates The discount rate is based on the risk-free rate for government bonds, adjusted for a risk premium to reflect the increased risk in investing in equities. The risk premium adjustment is assessed for each specific CGU. The average pre-tax discount rates used are in the range of 10.7% to 13.8% for the Pearson Education businesses (2012: 9.8% to 12.7%) and 11.3% for the Financial Times (2012: 11.5%).

Perpetuity growth rates A perpetuity growth rate of 2.0% was used for cash flows subsequent to the approved budget period for all CGUs in 2013 (2012: 2.0%). This perpetuity growth rate is a conservative rate and is considered to be lower than the long-term historic growth rates of the underlying territories in which the CGU operates and the long-term growth rate prospects of the sectors in which the CGU operates.

Cash flow growth rates The cash flow growth rates are derived from management's latest forecast of sales taking into consideration experience of operating margins achieved in the CGU. Historically, such forecasts have been reasonably accurate.

Sensitivities

The Group's impairment review is sensitive to a change in assumptions used, most notably the discount rates, the perpetuity growth rates and expected future cash flows. Based on the Group's sensitivity analysis, a reasonably possible change in any of these assumptions is unlikely to cause an impairment in any of the CGUs.

12 Investments in joint ventures and associates

The amounts recognised in the balance sheet are as follows:

All figures in £ millions	2013	2012
Associates	1,089	7
Joint ventures	3	8
Total	1,092	15

The amounts recognised in the income statement are as follows:

All figures in £ millions	2013	2012
Associates	56	23
Joint ventures	(2)	(14)
Total	54	9

12 Investments in joint ventures and associates continued

Investment in associates

The Group has the following material associates

	Principal place of business	% Ownership interest	Nature of relationship	Measurement method
Penguin Random House	Global	47	Note 1	Equity ³
The Economist Newspaper Ltd	UK	50	Note 2	Equity ⁴

³Neither associate has a quoted market price

Note 1 – On 1 July 2013 Penguin Random House was formed, upon the completion of an agreement between Pearson and Bertelsmann to merge their respective trade publishing companies, Penguin and Random House, with the parent companies owning 47% and 53% of the combined business respectively. The shareholder agreement includes protection rights for Pearson as the minority shareholder including rights to dividends.

Note 2 – The Group has a 50% interest in The Economist Newspaper Ltd, publisher of one of the world's leading weekly business and current affairs magazines.

The summarised financial information of the material associates is detailed below

	2013		2012
All figures in £ millions	Penguin Random House	Economist	Economist
Assets			
Current assets	1,210	103	120
Non-current assets	1,361	163	160
Liabilities			
Current liabilities	(905)	(190)	(202)
Non-current liabilities	(455)	(60)	(78)
Net assets	1,211	16	–
Sales	1,315	340	348
Profit from continuing operations	66	52	46
Other comprehensive (expense)/income	(34)	9	(6)
Total comprehensive income	32	61	40
Dividends received from associate	43	21	21

The information above reflects the amounts presented in the financial statements of the associates, adjusted for fair value and similar adjustments.

Notes to the consolidated financial statements continued

12 Investments in joint ventures and associates continued

Investment in associates continued

A reconciliation of the summarised financial information to the carrying value of the material associates is shown below

All figures in £ millions	2013		2012
	Penguin Random House	Economist	Economist
Opening net assets	--	--	--
Exchange differences	(68)	--	(1)
Profit for the period	66	52	46
Other comprehensive income	(34)	9	(6)
Dividends	(91)	(41)	(41)
Additions	1,338	--	--
Distribution from associate in excess of carrying value	--	--	2
Reversal of distribution from associate in excess of carrying value	--	(4)	--
Closing net assets	1,211	16	--
Share of net assets	569	8	--
Goodwill	501	--	--
Carrying value of associate	1,070	8	--

Information on other individually immaterial associates is detailed below

All figures in £ millions	2013	2012
Loss from continuing operations	(1)	--
Other comprehensive income	--	--
Total comprehensive expense	(1)	--

Transactions with material associates

The Group has loans to Penguin Random House which are unsecured and interest is calculated based on market rates. The amount outstanding at 31 December 2013 was £44m.

The Group also has a current asset receivable of £14m from Penguin Random House arising from the provision of services. Included in other income (note 4) is £28m of service fees.

Investment in joint ventures

Information on joint ventures, all of which are individually immaterial, is detailed below

All figures in £ millions	2013	2012
Loss from continuing operations	(2)	(14)
Other comprehensive income	--	--
Total comprehensive expense	(2)	(14)

13 Deferred income tax

All figures in £ millions	2013	2012
Deferred income tax assets	250	229
Deferred income tax liabilities	(612)	(601)
Net deferred income tax	(362)	(372)

Substantially all of the deferred tax assets are expected to be recovered after more than one year

Deferred income tax assets and liabilities may be offset when there is a legally enforceable right to offset current income tax assets against current income tax liabilities and when the deferred income taxes relate to the same fiscal authority. At 31 December 2013 the Group has unrecognised deferred income tax assets of £4m (2012 £13m) in respect of UK losses, £11m (2012 £14m) in respect of US losses and approximately £36m (2012 £30m) in respect of losses in other territories. None of the unrecognised UK losses have expiry dates associated with them. The US losses relate to state taxes and therefore have expiry periods of between 5 and 20 years.

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

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

All figures in £ millions	Notes	2013	2012 Restated
At beginning of year		(372)	(333)
Exchange differences		9	14
Income statement benefit/(charge)	7	47	(13)
Acquisition through business combination	30	(37)	(67)
Disposal through business disposal	31	—	11
Tax charge to other comprehensive income or equity		(35)	34
Transfer to current tax		25	—
Transfer to assets held for sale		1	(18)
At end of year		(362)	(372)

Included in the income statement above for 2013 is a £2m charge (2012 £4m charge) relating to discontinued operations.

Notes to the consolidated financial statements continued

13 Deferred income tax continued

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

All figures in £ millions	Trading losses	Goodwill and intangibles	Returns provisions	Retirement benefit obligations	Other	Total Restated
Deferred income tax assets						
At 1 January 2012	14	–	89	19	165	287
Exchange differences	–	–	(3)	(1)	(5)	(9)
Acquisition through business combination	19	–	–	–	–	19
Income statement charge	(13)	–	(16)	(1)	(33)	(63)
Tax benefit/(charge) to other comprehensive income or equity	–	–	–	39	(6)	33
Transfer to assets held for sale	(2)	–	(25)	(9)	(2)	(38)
At 31 December 2012	18	–	45	47	119	229
Exchange differences	–	–	(1)	(1)	(4)	(6)
Acquisition through business combination	21	–	–	–	–	21
Income statement (charge)/benefit	(24)	–	(5)	25	22	18
Tax charge to other comprehensive income or equity	–	–	–	(36)	–	(36)
Transfer to current tax	–	–	–	–	25	25
Transfer from assets held for sale	–	–	–	7	(7)	–
Transfer to assets held for sale	–	–	–	–	(1)	(1)
At 31 December 2013	15	–	39	42	154	250

Other deferred income tax assets include temporary differences on share-based payments, inventory and other provisions

All figures in £ millions	Goodwill and intangibles	Other	Total
Deferred income tax liabilities			
At 1 January 2012	(464)	(156)	(620)
Exchange differences	18	5	23
Acquisition through business combination	(65)	(21)	(86)
Disposal through business disposal	11	–	11
Income statement benefit	15	35	50
Tax benefit to other comprehensive income or equity	–	1	1
Transfer to assets held for sale	10	10	20
At 31 December 2012	(475)	(126)	(601)
Exchange differences	13	2	15
Acquisition through business combination	(61)	3	(58)
Income statement (charge)/benefit	(61)	90	29
Tax benefit to other comprehensive income or equity	–	1	1
Transfer to assets held for sale	–	2	2
At 31 December 2013	(584)	(28)	(612)

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

14 Classification of financial instruments

The accounting classification of each class of the Group's financial assets and financial liabilities, together with their fair values, is as follows

									2013

Notes to the consolidated financial statements continued

14 Classification of financial instruments continued

									2012
All figures in £ millions	Notes	Fair value				Amortised cost		Total carrying value	Total market value
		Available for sale	Derivatives deemed held for trading	Derivatives in hedging relationships	Other liabilities	Loans and receivables	Other liabilities		
Investments in unlisted securities – continuing operations	15	31	–	–	–	–	–	31	31
Investments in unlisted securities classified within assets held for sale	32	1	–	–	–	–	–	1	1
Cash and cash equivalents – continuing operations	17	–	–	–	–	1,062	–	1,062	1,062
Cash and cash equivalents classified within assets held for sale	32	–	–	–	–	115	–	115	115
Marketable securities		6	–	–	–	–	–	6	6
Derivative financial instruments	16	–	1	177	–	–	–	178	178
Trade receivables – continuing operations	22	–	–	–	–	883	–	883	883
Trade receivables classified within assets held for sale		–	–	–	–	249	–	249	249
Total financial assets		38	1	177	–	2,309	–	2,525	2,525
Trade payables – continuing operations	24	–	–	–	–	–	(337)	(337)	(337)
Trade payables classified within liabilities held for sale		–	–	–	–	–	(148)	(148)	(148)
Other financial liabilities – put options over non-controlling interest	24	–	–	–	(68)	–	–	(68)	(68)
Bank loans and overdrafts – continuing operations	18	–	–	–	–	–	(55)	(55)	(55)
Bank loans and overdrafts classified within liabilities held for sale	32	–	–	–	–	–	(7)	(7)	(7)
Borrowings due within one year	18	–	–	–	–	–	(229)	(229)	(228)
Borrowings due after more than one year	18	–	–	–	–	–	(1,988)	(1,988)	(2,043)
Total financial liabilities		–	–	–	(68)	–	(2,764)	(2,832)	(2,886)

14 Classification of financial instruments continued

Certain of the Group's derivative financial instruments are classified as held for trading either as they do not meet the hedge accounting criteria specified in IAS 39 'Financial Instruments: Recognition and Measurement' or the Group has chosen not to seek hedge accounting for these instruments. None of these derivatives are held for speculative trading purposes. Transactions in derivative financial instruments are only undertaken to manage risks arising from underlying business activity, in accordance with the Group's treasury policy as described in note 19.

The Group designates certain qualifying derivative financial instruments as hedges of the fair value of its bonds (fair value hedges). Changes in the fair value of these derivative financial instruments are recorded in the income statement, together with any change in the fair value of the hedged liability attributable to the hedged risk.

The Group also designates certain of its borrowings and derivative financial instruments as hedges of its investments in foreign operations (net investment hedges). Movements in the fair value of these financial instruments (to the extent they are effective) are recognised in other comprehensive income.

None of the Group's financial assets or liabilities are designated at fair value through the income statement upon initial recognition.

More detail on the Group's accounting for financial instruments is included in the Group's accounting policies. The Group's approach to managing risks in relation to financial instruments is described in note 19.

15 Other financial assets

All figures in £ millions	2013	2012
At beginning of year	31	26
Exchange differences	–	(2)
Acquisition of investments	63	10
Disposal of investments	–	(2)
Transfer to assets held for sale	–	(1)
At end of year	94	31

Other financial assets comprise non-current unlisted securities.

16 Derivative financial instruments

The Group's approach to the management of financial risks is set out in note 19. The Group's outstanding derivative financial instruments are as follows:

All figures in £ millions	2013			2012		
	Gross notional amounts	Assets	Liabilities	Gross notional amounts	Assets	Liabilities
Interest rate derivatives – in a fair value hedge relationship	1,439	81	(32)	1,465	143	–
Interest rate derivatives – not in a hedge relationship	634	4	(16)	61	1	–
Cross-currency rate derivatives – in a net investment hedge relationship	220	39	–	220	34	–
Total	2,293	124	(48)	1,746	178	–
Analysed as expiring						
In less than one year	312	13	–	215	4	–
Later than one year and not later than five years	1,377	111	–	701	69	–
Later than five years	604	–	(48)	830	105	–
Total	2,293	124	(48)	1,746	178	–

Notes to the consolidated financial statements continued

16 Derivative financial instruments continued

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

At the end of 2013, the currency split of the mark-to-market values of rate derivatives, including the exchange of principal on cross-currency rate derivatives, was US dollar £(151)m, sterling £243m and South African rand £(16)m (2012 US dollar £(59)m, sterling £257m and South African rand £(20)m).

The fixed interest rates on outstanding rate derivative contracts at the end of 2013 range from 1.10% to 9.28% (2012 3.65% to 9.28%) and the floating rates are based on LIBOR in US dollar and sterling.

The Group's portfolio of rate derivatives is diversified by maturity, counterparty and type. Natural offsets between transactions within the portfolio and the designation of certain derivatives as hedges significantly reduce the risk of income statement volatility. The sensitivity of the portfolio to changes in market rates is set out in note 19.

Derivative financial assets and liabilities subject to offsetting arrangements are as follows:

	2013			2012		
	Gross derivative assets £m	Gross derivative liabilities £m	Net derivative assets/liabilities £m	Gross derivative assets £m	Gross derivative liabilities £m	Net derivative assets/liabilities £m
All figures in £ millions						
Counterparties in an asset position	122	(12)	110	178	—	178
Counterparties in a liability position	2	(36)	(34)	—	—	—
Total as presented in the balance sheet	124	(48)	76	178	—	178

All of the Group's derivative financial instruments are subject to enforceable netting arrangements with individual counterparties, allowing net settlement in the event of default of either party. Offset arrangements in respect of cash balances are shown in note 17.

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

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

17 Cash and cash equivalents (excluding overdrafts)

All figures in £ millions	2013	2012
Cash at bank and in hand	521	372
Short-term bank deposits	208	690
Continuing operations	729	1,062
Cash at bank and in hand classified within assets held for sale	36	115
	765	1,177

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

At the end of 2013 the currency split of cash and cash equivalents was US dollar 28% (2012 47%), sterling 18% (2012 25%), euro 5% (2012 3%) and other 49% (2012 25%)

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

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

All figures in £ millions	2013	2012
Cash and cash equivalents – continuing operations	729	1,062
Cash at bank and in hand classified within assets held for sale	36	115
Bank overdrafts – continuing operations	(25)	(33)
Bank overdrafts classified within liabilities held for sale	–	(7)
	740	1,137

The Group has the following cash pooling arrangements in US dollars, sterling and euro, where both the company and the bank have a legal right of offset.

All figures in £ millions	2013			2012		
	Offset asset	Offset liability	Net offset asset/liability	Offset asset	Offset liability	Net offset asset/liability
US dollars	298	(299)	(1)	39	(37)	2
Sterling	1,018	(1,027)	(9)	982	(1,057)	(75)
Euro	6	(5)	1	11	(11)	–
Total for continuing operations as presented in the balance sheet			(9)			(73)

In addition to the above, the Group had offset US dollar, sterling and euro asset balances of £1m, £16m and £nil respectively in respect of discontinued operations at the end of 2013. At the end of 2012, the Group had a sterling offset asset of £74m in respect of discontinued operations

Offset arrangements in respect of derivatives are shown in note 16

Notes to the consolidated financial statements continued

18 Financial liabilities – Borrowings

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

All figures in £ millions	2013	2012
Non-current		
5 7% US Dollar Bonds 2014 (nominal amount \$400m)	--	264
7 0% Sterling Bonds 2014 (nominal amount £250m)	--	256
6 0% Sterling Bonds 2015 (nominal amount £300m)	299	298
4 0% US Dollar Notes 2016 (nominal amount \$350m)	221	229
6 25% Global Dollar Bonds 2018 (nominal amount \$550m)	375	402
4 625% US Dollar Notes 2018 (nominal amount \$300m)	202	217
3 75% US Dollar Notes 2022 (nominal amount \$500m)	283	315
3 25% US Dollar Notes 2023 (nominal amount \$500m)	286	--
Bank loans and overdrafts	22	22
Finance lease liabilities	5	7
	1 693	2 010
Current		
Due within one year or on-demand		
5 5% Global Dollar Bonds 2013 (nominal amount \$350m)	--	219
5 7% US Dollar Bonds 2014 (nominal amount \$400m)	248	--
7 0% Sterling Bonds 2014 (nominal amount £250m)	254	--
Bank loans and overdrafts	25	33
Finance lease liabilities	6	10
	533	262
Total borrowings – continuing operations	2 226	2 272
Bank overdrafts classified within liabilities held for sale	--	7
Total borrowings	2 226	2 279

Included in the non-current borrowings above is £9m of accrued interest (2012 £11m). Included in the current borrowings above is £4m of accrued interest (2012 £2m)

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

All figures in £ millions	2013	2012
Between one and two years	303	524
Between two and five years	821	552
Over five years	569	934
	1 693	2 010

18 Financial liabilities – Borrowings continued

The carrying amounts and market values of borrowings are as follows

All figures in £ millions	Effective interest rate	Carrying value	2013		2012
			Market value	Carrying value	Market value
Bank loans and overdrafts	n/a	47	47	55	55
5.5% Global Dollar Bonds 2013	5.76%	–	–	219	218
5.7% US Dollar Bonds 2014	5.88%	248	246	264	260
7.0% Sterling Bonds 2014	7.20%	254	262	256	274
6.0% Sterling Bonds 2015	6.27%	299	325	298	337
4.0% US Dollar Notes 2016	4.26%	221	223	229	233
6.25% Global Dollar Bonds 2018	6.46%	375	376	402	410
4.625% US Dollar Notes 2018	4.69%	202	195	217	209
3.75% US Dollar Notes 2022	3.94%	283	286	315	313
3.25% US Dollar Notes 2023	3.36%	286	273	–	–
Finance lease liabilities	n/a	11	11	17	17
Continuing operations		2,226	2,244	2,272	2,326
Bank overdrafts classified within liabilities held for sale	n/a	–	–	7	7
		2,226	2,244	2,279	2,333

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

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

All figures in £ millions	2013	2012
US dollar	1,645	1,684
Sterling	559	573
Other	22	22
	2,226	2,279

The Group has the following undrawn capacity on its committed borrowing facilities as at 31 December

All figures in £ millions	2013	2012
Floating rate		
– expiring within one year	–	–
– expiring beyond one year	1,057	1,077
	1,057	1,077

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

All of the Group's borrowings are unsecured. In respect of finance lease obligations, the rights to the leased asset revert to the lessor in the event of default.

Notes to the consolidated financial statements continued

18 Financial liabilities – Borrowings continued

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

All figures in £ millions	2013	2012
Finance lease liabilities – minimum lease payments		
Not later than one year	6	10
Later than one year and not later than two years	4	4
Later than two years and not later than three years	1	3
Later than three years and not later than four years	–	–
Later than four years and not later than five years	–	–
Later than five years	–	–
Future finance charges on finance leases	–	–
Present value of finance lease liabilities	11	17

The present value of finance lease liabilities is as follows

All figures in £ millions	2013	2012
Not later than one year	6	10
Later than one year and not later than five years	5	7
Later than five years	–	–
	11	17

The carrying amounts of the Group's lease obligations approximate their fair value

19 Financial risk management

The Group's approach to the management of financial risks together with sensitivity analyses of its financial instruments is set out below

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 overleaf. All the treasury policies remained unchanged throughout, except for revisions to the Group's bank counterparty risk limits and related approval processes and a change to permitted investment instruments for some operating companies.

The audit committee 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.

19 Financial risk management continued

Interest rate risk management

The Group's exposure to interest rate fluctuations on its borrowings is managed by borrowing on a fixed rate basis and 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 certain adjustments for IAS 39 'Financial Instruments: Recognition and Measurement') 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 2013 the fixed to floating hedging ratio, on the above basis, was approximately 45% 55%. A simultaneous 1% change on 1 January 2014 in the Group's variable interest rates in US dollar and sterling, taking into account forecast seasonal debt, would have a £11m effect on profit before tax.

Use of interest rate derivatives

The policy described 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 predominantly 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 portfolio 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.

Liquidity and refinancing risk management

The Group's objective is to secure 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 2013 the average maturity of gross borrowings was 4.2 years (2012: 3.9 years) of which bonds represented 97% (2012: 97%) of these borrowings.

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 Baa1 from Moody's and BBB+ from Standard & Poor's, and the short-term ratings are P2 and A2 respectively. In January 2014 Moody's changed the outlook on their short-term and long-term ratings from 'Stable' to 'Negative'. The Group's policy is to strive to maintain a rating of Baa1/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. At the end of 2013 the committed facilities amounted to £1,057m and their weighted average maturity was 1.9 years.

Notes to the consolidated financial statements continued

19 Financial risk management continued

Analysis of Group debt, including the impact of derivatives

The following tables analyse the Group's sources of funding and the impact of derivatives on the Group's debt instruments

The Group's net debt position is set out below

All figures in £ millions	2013	2012
Cash and cash equivalents	729	1,062
Marketable securities	6	6
Derivative financial instruments	76	178
Bank loans, overdrafts and loan notes	(47)	(55)
Bonds	(2,168)	(2,200)
Finance lease liabilities	(11)	(17)
Continuing operations	(1,415)	(1,026)
Cash and cash equivalents classified within assets held for sale	36	115
Bank loans, overdrafts and loan notes classified within liabilities held for sale	—	(7)
Net debt	(1,379)	(918)

The split of net debt between fixed and floating rate, stated after the impact of rate derivatives, is as follows

All figures in £ millions	2013	2012
Fixed rate	612	499
Floating rate	767	419
Total	1,379	918

Gross borrowings, after the impact of cross-currency rate derivatives, analysed by currency are as follows

All figures in £ millions	2013	2012
US dollar	1,849	1,883
Sterling	339	353
Other	38	43
Total	2,226	2,279

As at 31 December 2013 the exposure of the borrowings of the Group to interest rate changes when the borrowings re-price is as follows

All figures in £ millions	Less than one year	One to five years	More than five years	Total
Re-pricing profile of borrowings	533	1,124	569	2,226
Effect of rate derivatives	1,026	(422)	(604)	—
Total	1,559	702	(35)	2,226

19 Financial risk management continued

The maturity of contracted cash flows associated with the Group's financial liabilities are as follows

All figures in £ millions	2013			
	USD	GBP	Other	Total
Not later than one year	434	316	113	863
Later than one year and not later than five years	1,000	106	—	1,106
Later than five years	648	—	—	648
Total	2,082	422	113	2,617
Analysed as				
Bonds	1,918	604	—	2,522
Rate derivatives – inflows	(350)	(248)	—	(598)
Rate derivatives – outflows	359	1	16	376
Trade payables	155	65	97	317
Total	2,082	422	113	2,617

All figures in £ millions	2012			
	USD	GBP	Other	Total
Not later than one year	489	126	142	757
Later than one year and not later than five years	726	357	21	1,104
Later than five years	863	—	—	863
Total	2,078	483	163	2,724
Analysed as				
Bonds	1,837	639	—	2,476
Rate derivatives – inflows	(326)	(264)	—	(590)
Rate derivatives – outflows	328	3	22	353
Trade payables	239	105	141	485
Total	2,078	483	163	2,724

All cash flow projections shown above are on an undiscounted basis. Any cash flows based on a floating rate are calculated using interest rates as set at the date of the last rate reset. Where this is not possible, floating rates are based on interest rates prevailing at 31 December in the relevant year. All derivative amounts are shown gross, although the Group net settles these amounts wherever possible.

Any amounts drawn under revolving credit facilities and commercial paper are assumed to mature at the maturity date of the relevant facility with interest calculated as payable in each calendar year up to and including the date of maturity of the facility.

Financial counterparty risk management

Counterparty credit limits, which take published credit rating and other factors into account, are set to cover our total aggregate exposure to a single financial institution. The limits applicable to published credit ratings bands are approved by the chief financial officer within guidelines approved by the board. Exposures and limits applicable to each financial institution are reviewed on a regular basis.

Notes to the consolidated financial statements continued

19 Financial risk management 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 the Group's operations are domestic within their country of operation. No unremitted 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 (after the impact of cross-currency rate derivatives) with its forecast operating profit before depreciation and amortisation. This policy aims to soften 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. The Group still borrows small amounts in other currencies, typically for seasonal working capital needs. 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. In addition currencies that account for less than 15% of Group operating profit before depreciation and amortisation can be included in the above hedging process at the request of the chief financial officer.

Included within year end net debt, the net borrowings/(cash) in the hedging currencies above (taking into account the effect of cross-currency swaps) were US dollar £1.631m, sterling £202m and South African rand £(21)m.

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 – fair value measurement

The following table provides an analysis of those financial instruments that are measured subsequent to initial recognition at fair value, grouped into levels 1 to 3, based on the degree to which the fair value is observable.

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 fair value measurements are those derived from inputs, other than quoted prices included within level 1, that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices), and

Level 3 fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

19 Financial risk management continued

Financial instruments – fair value measurement continued

All figures in £ millions	2013				2012			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Financial assets at fair value								
Derivative financial assets	–	124	–	124	–	178	–	178
Marketable securities	–	6	–	6	–	6	–	6
Available for sale financial assets								
Investments in unlisted securities – continuing operations	–	–	94	94	–	–	30	30
Investments in unlisted securities classified within assets held for sale	–	–	–	–	–	–	1	1
Financial liabilities at fair value								
Derivative financial liabilities	–	(48)	–	(48)	–	–	–	–
Other financial liabilities – put options over non-controlling interest	–	–	–	–	–	–	(68)	(68)
Total	–	82	94	176	–	184	(37)	147

The following table analyses the movements in level 3 fair value measurements

All figures in £ millions	2013		2012	
	Investments in unlisted securities	Other financial liabilities	Investments in unlisted securities	Other financial liabilities
At beginning of year	31	(68)	26	(86)
Exchange differences	–	9	(2)	5
Additions	63	–	10	–
Fair value movements	–	(8)	–	(25)
Transfer to assets classified as held for sale	–	–	(1)	–
Disposals	–	67	(2)	38
At end of year	94	–	31	(68)

The fair value of the investments in unlisted securities is determined by reference to the financial performance of the underlying asset and amounts realised on the sale of similar assets. In 2012, the fair value of other financial liabilities represents the present value of the estimated future liability.

Notes to the consolidated financial statements continued

19 Financial risk management continued

Financial instruments – sensitivity analysis

As at 31 December 2013 the sensitivity of the carrying value of the Group's financial instruments to fluctuations in interest rates and exchange rates is as follows

All figures in £ millions	Carrying value	Impact of 1% increase in interest rates	Impact of 1% decrease in interest rates	Impact of 10% strengthening in sterling	Impact of 10% weakening in sterling
Investments in unlisted securities – continuing operations	94	–	–	(9)	10
Cash and cash equivalents – continuing operations	729	–	–	(56)	68
Cash and cash equivalents classified within assets held for sale	36	–	–	(2)	2
Marketable securities	6	–	–	–	–
Derivative financial instruments	76	(54)	59	15	(18)
Bonds	(2 168)	58	(62)	147	(179)
Other borrowings – continuing operations	(58)	–	–	5	(5)
Other net financial assets – continuing operations	566	–	–	(43)	53
Other net financial assets classified within assets and liabilities held for sale	24	–	–	(1)	1
Total financial instruments	(695)	4	(3)	56	(68)

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. Where modelling an interest rate decrease of 1% led to negative interest rates, these points on the yield curve were adjusted to 0%. A large proportion of the movements shown above would impact equity rather than the income statement, due to the location and functional currency of the entities 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.

20 Intangible assets – Pre-publication

All figures in £ millions	2013	2012
Cost		
At beginning of year	1,876	1,965
Exchange differences	(46)	(74)
Additions	364	364
Disposal through business disposal	(29)	–
Disposals	(234)	(188)
Acquisition through business combination	2	14
Transfer to property, plant and equipment	–	(3)
Transfer to assets classified as held for sale	–	(202)
At end of year	1,933	1,876
Amortisation		
At beginning of year	(1,210)	(1,315)
Exchange differences	46	55
Charge for the year	(308)	(316)
Disposal through business disposal	23	–
Disposals	234	188
Acquisition through business combination	(1)	(8)
Transfer to assets classified as held for sale	–	186
At end of year	(1,216)	(1,210)
Carrying amounts		
At end of year	717	666

Included in the above are pre-publication assets amounting to £480m (2012 £431m) which will be realised in more than one year

Amortisation is included in the income statement in cost of goods sold. In 2013 £nil (2012 £33m) relates to discontinued operations

21 Inventories

All figures in £ millions	2013	2012
Raw materials	15	13
Work in progress	13	11
Finished goods	196	237
	224	261

The cost of inventories relating to continuing operations recognised as an expense and included in the income statement in cost of goods sold amounted to £472m (2012 £512m). In 2013 £53m (2012 £71m) of inventory provisions was charged in the income statement. None of the inventory is pledged as security.

Notes to the consolidated financial statements continued

22 Trade and other receivables

All figures in £ millions	2013	2012
Current		
Trade receivables	863	868
Royalty advances	23	16
Prepayments and accrued income	101	81
Other receivables	186	139
	1,173	1,104
Non-current		
Trade receivables	19	15
Royalty advances	8	13
Prepayments and accrued income	33	33
Other receivables	10	18
	70	79

Trade receivables are stated at fair value, net of provisions for bad and doubtful debts and anticipated future sales returns. The movements on the provision for bad and doubtful debts are as follows:

All figures in £ millions	2013	2012
At beginning of year	(55)	(102)
Exchange differences	5	4
Income statement movements	(27)	(21)
Utilised	18	53
Acquisition through business combination	–	(1)
Transfer to assets classified as held for sale	1	12
At end of year	(58)	(55)

Concentrations of credit risk with respect to trade receivables are limited due to the Group's large number of customers, who are internationally dispersed.

The ageing of the Group's trade receivables is as follows:

All figures in £ millions	2013	2012
Within due date	783	774
Up to three months past due date	194	231
Three to six months past due date	36	43
Six to nine months past due date	22	10
Nine to 12 months past due date	9	7
More than 12 months past due date	1	5
Total trade receivables	1,045	1,070
Less: provision for sales returns	(163)	(187)
Net trade receivables	882	883

The Group reviews its bad debt provision at least twice a year following a detailed review of receivable balances and historic payment profiles. Management believe all the remaining receivable balances are fully recoverable.

23 Provisions for other liabilities and charges

All figures in £ millions	Deferred consideration	Property	Disposals and closures	Legal and other	Total
At 1 January 2013	64	26	15	43	148
Exchange differences	(1)	—	—	(1)	(2)
Charged to income statement	—	6	67	55	128
Released to income statement	—	(4)	—	(1)	(5)
Deferred consideration on acquisition	2	—	—	—	2
Utilised	(4)	(17)	(15)	(66)	(102)
Transfer from liabilities held for sale	—	—	—	24	24
Transfer to liabilities held for sale	(3)	—	—	(1)	(4)
At 31 December 2013	58	11	67	53	189

Analysis of provisions

2013					
All figures in £ millions	Deferred consideration	Property	Disposals and closures	Legal and other	Total
Current	5	10	67	30	112
Non-current	53	1	—	23	77
	58	11	67	53	189
2012					
Current	6	12	15	5	38
Non-current	58	14	—	38	110
	64	26	15	43	148

Deferred consideration primarily relates to the formation of a venture in the US Professional business in 2011. Disposals and closures include retirement benefit obligations and other liabilities related to the disposal of Penguin. Legal and other includes litigation in relation to ebooks which was settled in full during 2013, as well as other provisions in relation to legal claims, contract disputes and potential contract losses.

24 Trade and other liabilities

All figures in £ millions	2013	2012
Trade payables	316	337
Social security and other taxes	23	30
Accruals	478	440
Deferred income	698	714
Interest payable	22	21
Put options over non-controlling interest	—	68
Other liabilities	225	228
	1,762	1,838
Less non-current portion		
Accruals	25	18
Deferred income	155	147
Interest payable	21	13
Put options over non-controlling interest	—	25
Other liabilities	56	79
	257	282
Current portion	1,505	1,556

Notes to the consolidated financial statements continued

24 Trade and other liabilities continued

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

The deferred income balance comprises principally multi year obligations to deliver workbooks to adoption customers in school businesses, advance payments in assessment, testing and training businesses, subscription income in school, college and newspaper businesses, and obligations to deliver digital content in future years

The put options over non-controlling interest in 2012 are the fair value of options held by the non-controlling interests in the Group's Southern African and Indian businesses

25 Retirement benefit and other post-retirement obligations**Background**

The Group operates a number of defined benefit and defined contribution retirement plans throughout the world

The largest plan is the Pearson Group Pension Plan (UK Group plan) in the UK, which is sectionalised to provide both defined benefit and defined contribution pension benefits. The defined benefit section was closed to new members from 1 November 2006. The defined contributions section, opened in 2003, is open to new and existing employees. Finally, there is a separate section within the UK Group plan set up for auto-enrolment. The defined benefit section of the UK Group plan is a final salary pension plan which provides benefits to members in the form of a guaranteed level of pension payable for life. The level of benefits depends on the length of service and final pensionable pay. The UK Group plan is funded with benefit payments from trustee administered funds. The UK Group plan is administered in accordance with the Trust Deed and Rules in the interests of its beneficiaries by Pearson Group Pension Trustee Limited.

At 31 December 2013 the UK Group plan has approximately 26,500 members, analysed in the following table

%	Active	Deferred	Pensioners	Total
Defined benefit	3	25	32	60
Defined contribution	17	23	–	40
Total	20	48	32	100

The other major defined benefit plans are based in the US. These are also final salary pension plans which provide benefits to members in the form of a guaranteed pension payable for life, with the level of benefits dependent on length of service and final pensionable pay. The majority of the US plans are funded.

The Group also has several post-retirement medical benefit plans (PRMBs), principally in the US. PRMBs are unfunded but are accounted for and valued similarly to defined benefit pension plans.

The defined benefit schemes expose the Group to actuarial risks such as life expectancy, inflation risks, and investment risk including asset volatility and changes in bond yields. The Group is not exposed to any unusual entity specific or plan specific risks.

25 Retirement benefit and other post-retirement obligations continued

Assumptions

The principal assumptions used for the UK Group plan and the US PRMB are shown below. Weighted average assumptions have been shown for the other plans, which primarily relate to US pension plans.

	2013			2012		
	UK Group plan	Other plans	PRMB	UK Group plan	Other plans	PRMB
%						
Inflation	3.4	2.5	2.5	3.0	2.5	2.5
Rate used to discount plan liabilities	4.4	4.4	4.4	4.4	3.6	3.6
Expected rate of increase in salaries	3.9	3.9	4.0	3.5	3.9	—
Expected rate of increase for pensions in payment and deferred pensions	2.3 to 5.1	—	—	2.3 to 5.1	—	—
Initial rate of increase in healthcare rate	—	—	7.5	—	—	8.0
Ultimate rate of increase in healthcare rate	—	—	5.0	—	—	5.0

The UK discount rate is based on corporate bond yields adjusted to reflect the duration of liabilities. The US discount rate is set by reference to a US bond portfolio matching model.

The inflation rate for the UK Group plan of 3.4% reflects the RPI rate. In line with changes to legislation in 2010, certain benefits have been calculated with reference to CPI as the inflationary measure and in these instances a rate of 2.6% has been used.

The expected rate of increase in salaries has been set at 3.9% for 2013 with a short-term assumption of 3.0% for three years.

For the UK plan, the mortality base table assumptions have been derived from the SAPS 'all pensioners' tables for males and the SAPS 'normal health pensioners' tables for females, adjusted to reflect the observed experience of the plan, with CMI model improvement factors. A 1.5% long term rate improvement on the CMI model is applied for males, and 1.25% for females.

For the US plans, the RP2000 table projected to 2020 is used, reflecting the mortality assumption most prevalent in the US.

Using the above tables, the remaining average life expectancy in years of a pensioner retiring at age 65 on the balance sheet date for the UK Group plan and US plans is as follows:

	UK		US	
	2013	2012	2013	2012
Male	24.3	23.0	19.2	19.2
Female	24.4	24.2	21.1	21.1

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

	UK		US	
	2013	2012	2013	2012
Male	25.9	25.1	19.2	19.2
Female	25.9	26.1	21.1	21.1

Notes to the consolidated financial statements continued

25 Retirement benefit and other post-retirement obligations continued

Financial statement information

The amounts recognised in the income statement are as follows

						2013
All figures in £ millions	UK Group plan	Defined benefit other	Sub-total	Defined contribution	PRMB	Total
Current service cost	22	3	25	72	4	101
Curtailments	–	–	–	–	(4)	(4)
Administration expenses	4	–	4	–	–	4
Total operating expense	26	3	29	72	–	101
Interest on plan assets	(95)	(6)	(101)	–	–	(101)
Interest on plan liabilities	94	7	101	–	3	104
Net finance (income)/expense	(1)	1	–	–	3	3
Net income statement charge	25	4	29	72	3	104

						2012 Restated
All figures in £ millions	UK Group plan	Defined benefit other	Sub-total	Defined contribution	PRMB	Total
Current service cost	23	3	26	78	4	108
Administration expenses	4	–	4	–	–	4
Total operating expense	27	3	30	78	4	112
Interest on plan assets	(98)	(6)	(104)	–	–	(104)
Interest on plan liabilities	96	7	103	–	3	106
Net finance (income)/expense	(2)	1	(1)	–	3	2
Net income statement charge	25	4	29	78	7	114

Included within the 2013 results are discontinued operations consisting of a £2m charge (2012 £4m charge) relating to defined benefit schemes and a £6m charge (2012 £9m charge) relating to defined contribution schemes

The amounts recognised in the balance sheet are as follows

				2013			2012	
All figures in £ millions	UK Group plan	Other funded plans	Other unfunded plans	Total	UK Group plan	Other funded plans	Other unfunded plans	Total
Fair value of plan assets	2,353	156	–	2,509	2,162	165	–	2,327
Present value of defined benefit obligation	(2,267)	(171)	(20)	(2,458)	(2,181)	(196)	(24)	(2,401)
Net pension asset/(liability)	86	(15)	(20)	51	(19)	(31)	(24)	(74)
Other post-retirement medical benefit obligation				(77)				(89)
Other pension accruals				(30)				(35)
Net retirement benefit obligations				(56)				(198)
Analysed as								
Retirement benefit assets				86				–
Retirement benefit obligations				(142)				(198)

25 Retirement benefit and other post-retirement obligations continued

Included within the 2012 retirement benefit obligation is a liability of £26m which relates to Penguin and is classified as held for sale. During 2013 this was transferred back from held for sale to pension liabilities.

The following gains/(losses) have been recognised in other comprehensive income:

All figures in £ millions	2013	2012 Restated
Amounts recognised for defined benefit plans	70	(95)
Amounts recognised for post-retirement medical benefit plans	9	(5)
Total recognised in year	79	(100)

The fair value of plan assets comprises the following

	2013			2012		
	UK Group plan	Other funded plans	Total	UK Group plan	Other funded plans	Total
%						
Equities	28	2	30	32	2	34
Bonds	40	3	43	38	3	41
Property	9	—	9	9	1	10
Other	17	1	18	14	1	15

The plan assets do not include any of the Group's own financial instruments, or any property occupied by the Group.

The table below further disaggregates the UK Group plan assets into additional categories and those assets which have a quoted market price in an active market and those that do not.

	2013		2012	
	Quoted market price	No quoted market price	Quoted market price	No quoted market price
%				
UK equities	6	1	6	1
Non-UK equities	20	3	25	3
Fixed-interest securities	19	—	21	—
Index-linked securities	24	—	19	—
Property	—	9	—	10
Other	—	18	1	14
Total	69	31	72	28

The liquidity profile of the UK Group plan assets is as follows

	2013	2012
%		
Liquid – call < 1 month	72	73
Less liquid – call 1–3 months	2	2
Illiquid – call > 3 months	26	25

Notes to the consolidated financial statements continued

25 Retirement benefit and other post-retirement obligations continued

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

All figures in £ millions	2013			2012 Restated		
	UK Group plan	Other plans	Total	UK Group plan	Other plans	Total
Fair value of plan assets						
Opening fair value of plan assets	2,162	165	2,327	2,008	149	2,157
Exchange differences	–	(2)	(2)	–	(5)	(5)
Interest on plan assets	95	6	101	98	6	104
Return on plan assets excluding interest	103	6	109	48	9	57
Contributions by employer	77	5	82	72	2	74
Contributions by employee	2	–	2	2	–	2
Benefits paid	(86)	(24)	(110)	(78)	(11)	(89)
Acquisition through business combination	–	–	–	12	15	27
Closing fair value of plan assets	2,353	156	2,509	2,162	165	2,327
Present value of defined benefit obligation						
Opening defined benefit obligation	(2,181)	(220)	(2,401)	(1,983)	(197)	(2,180)
Exchange differences	–	4	4	–	7	7
Current service cost	(22)	(3)	(25)	(23)	(3)	(26)
Administration expenses	(4)	–	(4)	(4)	–	(4)
Interest cost	(94)	(7)	(101)	(96)	(7)	(103)
Actuarial gains/(losses) – experience	5	1	6	44	2	46
Actuarial gains/(losses) – demographic	–	1	1	(14)	–	(14)
Actuarial gains/(losses) – financial	(55)	9	(46)	(170)	(14)	(184)
Contributions by employee	(2)	–	(2)	(2)	–	(2)
Benefits paid	86	24	110	78	11	89
Acquisition through business combination	–	–	–	(11)	(19)	(30)
Closing defined benefit obligation	(2,267)	(191)	(2,458)	(2,181)	(220)	(2,401)

The weighted average duration of the defined benefit obligation is 15.8 years for the UK and 9.4 years for the US.

25 Retirement benefit and other post-retirement obligations continued

Changes in the value of the US PRMB are as follows

All figures in £ millions	2013	2012
Opening defined benefit obligation	(89)	(85)
Exchange differences	1	4
Current service cost	(4)	(4)
Curtailments	4	–
Interest cost	(3)	(3)
Actuarial gains/(losses) – experience	–	2
Actuarial gains/(losses) – financial	9	(7)
Benefits paid	5	4
Closing defined benefit obligation	(77)	(89)

Funding

The UK Group plan is self-administered with the plan's assets being held independently of the Group in trust. The trustee of the plan is required to act in the best interest of the plan's beneficiaries. Assets of the plan are divided into two elements, matching assets, which are assets that produce cashflows that can be expected to match the cashflows for a proportion of the membership, and include UK and overseas bonds, inflation linked property and infrastructure, return seeking assets which are assets invested with a longer term horizon to generate the returns needed to provide the remaining expected cashflows for the beneficiaries, and include equities, property and alternative asset classes. The benchmark allocation is 60% matching and 40% return seeking assets.

The most recent triennial actuarial valuation for funding purposes was completed as at 1 January 2012 and this valuation revealed a funding shortfall. The Group has agreed that the funding shortfall will be eliminated by June 2017. In 2013 the Group contributed £56m (2012: £48m) towards the funding shortfall. Following the completion of the triennial funding valuation the Group has agreed to contribute £41m per annum until 2017 in excess of regular contributions. In addition, a mechanism has been agreed for the Group to make supplementary payments up to a maximum of £15m per annum if certain conditions are met. If such payments are made they are expected to accelerate the end date for extinguishing the deficit. Regular contributions to the plan in respect of the defined benefit sections are estimated to be £18m for 2014.

The Group expects to contribute \$12m in 2014 and \$12m in 2015 to its US defined benefit pension plans.

Notes to the consolidated financial statements continued

25 Retirement benefit and other post-retirement obligations continued

Sensitivities

The effect of a one percentage point increase and decrease in the discount rate on the defined benefit obligation and the total pension expense is as follows

All figures in £ millions	2013	
	1% increase	1% decrease
Effect		
(Decrease)/increase in defined benefit obligation -- UK Group plan	(316.0)	390.5
(Decrease)/increase in defined benefit obligation -- US plan	(16.1)	20.0

The effect of members living one year more or one year less on the defined benefit obligation is as follows

All figures in £ millions	2013	
	1 year increase	1 year decrease
Effect		
Increase/(decrease) in defined benefit obligation -- UK Group plan	79.2	(76.2)
Increase/(decrease) in defined benefit obligation -- US plan	4.2	(4.8)

The effect of a half percentage point increase and decrease in the inflation rate is as follows

All figures in £ millions	2013	
	0.5% increase	0.5% decrease
Effect		
Increase/(decrease) in defined benefit obligation -- UK Group plan	106.1	(99.5)
Increase/(decrease) in defined benefit obligation -- US plan	0.2	(0.3)

The above sensitivity analyses are based on a change in an assumption while holding all other assumptions constant, although in practice this is unlikely to occur and changes in some assumptions may be correlated. When calculating these sensitivities the same method has been applied to calculate the defined benefit obligation as has been applied when calculating the liability recognised in the balance sheet. This methodology is the same as prior periods.

26 Share-based payments

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

All figures in £ millions	2013	2012
Pearson plans	35	28

Share-based payment charges included in discontinued operations amounted to £2m (2012: £4m)

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

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

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

Long-Term Incentive Plan This plan was first introduced in 2001, renewed in 2006 and again in 2011. The plan consists of restricted shares.

The vesting of restricted shares is normally dependent on continuing service over a three to five-year period, and in the case of senior management upon the satisfaction of corporate performance targets over a three-year period. These targets may be based on market and/or non-market performance criteria. Restricted shares awarded to senior management in May and October 2013, and May 2012 vest dependent on relative total shareholder return, return on invested capital and earnings per share growth. The award was split equally across all three measures. Other restricted shares awarded in 2013 and 2012 vest depending on continuing service over a three-year period.

Annual Bonus Share Matching Plan This plan permits executive directors and senior executives around the Group to invest up to 50% of any after tax annual bonus in Pearson shares. If these shares are held and the Group meets an earnings per share growth target, the company will match them on a gross basis of up to one matching share for every invested share, i.e. the maximum number of matching shares is equal to the number of shares that could have been acquired with the amount of the pre-tax annual bonus taken in invested shares.

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

	2013		2012	
	Number of share options '000s	Weighted average exercise price £	Number of share options '000s	Weighted average exercise price £
Outstanding at beginning of year	3,373	8.24	3,203	7.15
Granted during the year	763	9.14	1,321	9.09
Exercised during the year	(820)	7.12	(840)	5.59
Forfeited during the year	(516)	8.75	(294)	7.84
Expired during the year	(8)	5.75	(17)	5.60
Outstanding at end of year	2,792	8.73	3,373	8.24
Options exercisable at end of year	35	6.95	106	5.58

Notes to the consolidated financial statements continued

26 Share-based payments continued

Options were exercised regularly throughout the year. The weighted average share price during the year was £12.42 (2012: £12.01). Early exercises arising from redundancy, retirement or death are treated as an acceleration of vesting and the Group therefore recognises in the income statement the amount that otherwise would have been recognised for services received over the remainder of the original vesting period.

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

Range of exercise prices £	2013		2012	
	Number of share options 000s	Weighted average contractual life Years	Number of share options 000s	Weighted average contractual life Years
0 – 5	—	—	—	—
5 – 10	2,792	2.31	3,373	2.56
>10	—	—	—	—
	2,792	2.31	3,373	2.56

In 2013 and 2012 options were granted under the Worldwide Save for Shares Plan. The weighted average estimated fair value for the options granted was calculated using a Black-Scholes option pricing model.

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

	2013 Weighted average	2012 Weighted average
Fair value	£2.27	£2.38
Weighted average share price	£11.71	£11.51
Weighted average exercise price	£9.14	£9.09
Expected volatility	22.05%	23.62%
Expected life	3.8 years	3.8 years
Risk free rate	0.53%	0.74%
Expected dividend yield	3.84%	3.65%
Forfeiture rate	3.3%	3.3%

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

The following shares were granted under restricted share arrangements:

	2013		2012	
	Number of shares 000s	Weighted average fair value £	Number of shares 000s	Weighted average fair value £
Long-Term Incentive Plan	3,482	11.52	4,503	11.56
Annual Bonus Share Matching Plan	99	12.06	237	11.52

The fair value of shares granted under the Long-Term Incentive Plan that vest unconditionally is determined using the share price at the date of grant. The number of shares expected to vest is adjusted, based on historical experience, to account for potential forfeitures. Restricted shares granted under the Annual Bonus Share Matching Plan are valued using the share price at the date of grant. Participants under both plans are entitled to dividends during the vesting period and therefore the share price is not discounted.

26 Share-based payments continued

Restricted shares with a market performance condition were valued by an independent actuary using a Monte Carlo model. Restricted shares with a non-market performance condition were fair valued based on the share price at the date of grant. Non-market performance conditions are taken into consideration by adjusting the number of shares expected to vest based on the most likely outcome of the relevant performance criteria.

27 Share capital and share premium

	Number of shares 000s	Ordinary shares £m	Share premium £m
At 1 January 2012	815,626	204	2,544
Issue of ordinary shares – share option schemes	1,417	–	11
At 31 December 2012	817,043	204	2,555
Issue of ordinary shares – share option schemes	1,537	1	13
At 31 December 2013	818,580	205	2,568

The ordinary shares have a par value of 25p per share (2012 25p per share). All issued shares are fully paid. All shares have the same rights.

The Group manages its capital to ensure that entities in the Group will be able to continue as a going concern while maximising the return to shareholders through the optimisation of the debt and equity balance.

The capital structure of the Group consists of debt (see note 18), cash and cash equivalents (see note 17) and equity attributable to equity holders of the parent, comprising issued capital, reserves and retained earnings.

The Group reviews its capital structure on a regular basis and will balance its overall capital structure through payments of dividends, new share issues as well as the issue of new debt or the redemption of existing debt in line with the financial risk policies outlined in note 19.

28 Treasury shares

	Pearson plc	
	Number of shares 000s	£m
At 1 January 2012	14,665	149
Purchase of treasury shares	–	–
Release of treasury shares	(4,563)	(46)
At 31 December 2012	10,102	103
Purchase of treasury shares	4,111	47
Release of treasury shares	(4,931)	(52)
At 31 December 2013	9,282	98

The Group holds Pearson plc shares in trust to satisfy its obligations under its restricted share plans (see note 26). These shares, representing 1.1% (2012 1.2%) of called-up share capital, are treated as treasury shares for accounting purposes and have a par value of 25p per share.

The nominal value of Pearson plc treasury shares amounts to £2.3m (2012 £2.5m).

At 31 December 2013 the market value of Pearson plc treasury shares was £124.4m (2012 £120.0m).

Notes to the consolidated financial statements continued

29 Other comprehensive income

	2013				
	Attributable to equity holders of the company				
All figures in £ millions	Translation reserve	Retained earnings	Total	Non-controlling interest	Total
Items that may be reclassified to the income statement					
Net exchange differences on translation of foreign operations – Group	(202)	–	(202)	(4)	(206)
Net exchange differences on translation of foreign operations – associate	(11)	–	(11)	–	(11)
Currency translation adjustment disposed – subsidiaries	(18)	–	(18)	–	(18)
Attributable tax	–	6	6	–	6
Items that are not reclassified to the income statement					
Remeasurement of retirement benefit obligations – Group	–	79	79	–	79
Remeasurement of retirement benefit obligations – associate	–	–	–	–	–
Attributable tax	–	(23)	(23)	–	(23)
Other comprehensive expense for the year	(231)	62	(169)	(4)	(173)

	2012 Restated				
	Attributable to equity holders of the company				
All figures in £ millions	Translation reserve	Retained earnings	Total	Non controlling interest	Total
Items that may be reclassified to the income statement					
Net exchange differences on translation of foreign operations – Group	(236)	–	(236)	(2)	(238)
Attributable tax	–	1	1	–	1
Items that are not reclassified to the income statement					
Remeasurement of retirement benefit obligations – Group	–	(100)	(100)	–	(100)
Remeasurement of retirement benefit obligations – associate	–	(3)	(3)	–	(3)
Attributable tax	–	50	50	–	50
Other comprehensive expense for the year	(236)	(52)	(288)	(2)	(290)

30 Business combinations

There were no significant acquisitions in 2013. Adjustments have been made in respect of prior year acquisitions in 2013 and include the recognition of intangibles of £185m on the EmbanetCompass acquisition. The acquisition was made in late 2012 and was provisionally accounted for as at 31 December 2012.

30 Business combinations continued

Provisional values for the assets and liabilities arising from acquisitions completed in the year together with adjustments to prior year acquisitions are as follows

All figures in £ millions	Notes			2013	2012
		Current year	Prior year	Total fair value	Total fair value
Property, plant and equipment	10	1	–	1	10
Intangible assets	11	7	193	200	280
Intangible assets – Pre-publication	20	1	–	1	6
Inventories		–	1	1	1
Trade and other receivables		8	1	9	34
Cash and cash equivalents (excluding overdrafts)		2	–	2	34
Net deferred income tax assets/(liabilities)	13	2	(39)	(37)	(67)
Retirement benefit obligations		–	–	–	(2)
Provisions for other liabilities and charges		–	–	–	(1)
Trade and other liabilities		(6)	(1)	(7)	(111)
Current income tax liabilities		–	–	–	(1)
Net assets acquired at fair value		15	155	170	183
Goodwill	11	19	(152)	(133)	505
Fair value of previously held interest arising on stepped acquisition		(7)	–	(7)	–
Total		27	3	30	688
Satisfied by					
Cash		(25)	(6)	(31)	(682)
Deferred consideration		(2)	–	(2)	(6)
Net prior year adjustments		–	3	3	–
Total consideration		(27)	(3)	(30)	(688)

The goodwill arising on these acquisitions results from cost and revenue synergies and from benefits that cannot be separately recognised

A provisional value of £6m of goodwill arising on 2013 acquisitions is expected to be deductible for tax purposes (2012 £nil)

Intangible assets acquired in 2012 and recognised in 2013 have the following useful economic lives

EmbanetCompass customer lists, contracts and relationships 3–17 years, trademarks and brands two years

Intangible assets acquired in 2013 are classified as other intangible assets and have useful lives of 3–10 years

Notes to the consolidated financial statements continued

30 Business combinations continued

All figures in £ millions	2013	2012
Cash flow on acquisitions		
Cash – Current year acquisitions	(25)	(682)
Deferred payments for prior year acquisitions and other items	(6)	(31)
Cash and cash equivalents acquired	2	34
Acquisition costs and other acquisition liabilities paid	(19)	(37)
Net cash outflow	(48)	(716)

In total, acquisitions of subsidiaries completed in the year contributed an additional £15m of sales but did not contribute a material amount to operating profit. There would not have been a material difference to either sales or profits had these acquisitions completed on 1 January 2013.

31 Disposals including business closures

All figures in £ millions	Penguin	Other	2013 Total	2012
Disposal of subsidiaries				
Property, plant and equipment	(39)	(3)	(42)	(3)
Intangible assets	(43)	–	(43)	(45)
Investment in joint ventures and associates	(22)	–	(22)	–
Other financial assets	(1)	–	(1)	–
Intangible assets – Pre-publication	(20)	(6)	(26)	–
Inventories	(91)	(3)	(94)	–
Trade and other receivables	(447)	(6)	(453)	–
Cash and cash equivalents (excluding overdrafts)	(34)	(3)	(37)	–
Net deferred income tax (assets)/liabilities	(22)	–	(22)	11
Retirement benefit obligations	–	4	4	–
Provisions for other liabilities and charges	7	–	7	–
Trade and other liabilities	224	10	234	–
Non-controlling interest	3	–	3	–
Attributable goodwill	(370)	(6)	(376)	(50)
Cumulative translation adjustment	18	–	18	–
Net assets disposed	(837)	(13)	(850)	(87)
Cash received	–	3	3	–
Fair value of associate acquired	1,160	–	1,160	–
Costs	(121)	(14)	(135)	(26)
Gain/(loss) on disposal	202	(24)	178	(113)

The gain on disposal of Penguin arises from the measurement at fair value of the associate investment acquired in Penguin Random House.

31 Disposals including business closures continued

All figures in £ millions	2013	2012
Cash flow from disposals		
Cash – current year disposals	3	–
Cash and cash equivalents disposed	(37)	–
Costs and other disposal liabilities paid	(98)	(11)
Net cash outflow	(132)	(11)

The disposal in 2012 includes the write down of assets resulting from the closure of Pearson in Practice

32 Held for sale

Assets classified as held for sale in 2012 relate to Penguin and in 2013 to Mergermarket

All figures in £ millions	Notes	2013	2012
Property, plant and equipment	10	2	40
Intangible assets	11	158	404
Investments in joint ventures and associates		–	27
Deferred income tax assets	13	1	38
Other financial assets	15	–	1
Trade and other receivables		26	451
Intangible assets – Pre-publication	20	–	16
Inventories		–	80
Cash and cash equivalents (excluding overdrafts)	17	36	115
Assets classified as held for sale		223	1,172
Financial liabilities – Borrowings	18	–	(7)
Deferred income tax liabilities	13	(2)	(20)
Retirement benefit obligations	25	–	(26)
Provisions for other liabilities and charges	23	(4)	(29)
Trade and other liabilities		(71)	(234)
Current income tax liabilities		(5)	–
Liabilities directly associated with assets classified as held for sale		(82)	(316)
Net assets classified as held for sale		141	856

33 Transactions with non-controlling interest

In 2013 the Group purchased non-controlling interests in the Southern African business for £65m, and in the Indian business for £11m. In 2012 the Group increased its investments in its subsidiaries in China at a cost of £4m

Notes to the consolidated financial statements continued

34 Cash generated from operations

All figures in £ millions	Notes	2013	2012
Profit		539	314
Adjustments for			
Income tax		90	163
Depreciation	10	82	80
Intangible charges	11	168	183
Amortisation of other intangible assets	11	59	54
Net finance costs		75	96
Share of results of joint ventures and associates	12	(54)	(9)
(Profit)/loss on disposals		(187)	113
Acquisition costs		12	21
Costs on formation of Penguin Random House		–	32
Net foreign exchange adjustment from transactions		(40)	(21)
Share-based payment costs	26	37	32
Pre-publication		(77)	(55)
Inventories		18	49
Trade and other receivables		(50)	(94)
Trade and other liabilities		72	–
Retirement benefit obligations		(57)	(37)
Provisions for other liabilities and charges		(3)	(5)
Net cash generated from operations		684	916
Dividends from joint ventures and associates		64	27
Purchase of property, plant and equipment		(118)	(78)
Purchase of intangible assets		(64)	(73)
Proceeds from sale of property, plant and equipment		28	1
Proceeds from sale of intangible assets		2	3
Finance lease principal payments		(8)	(8)
Operating cash flow		588	788
Operating tax paid		(191)	(65)
Net operating finance costs paid		(73)	(66)
Operating free cash flow		324	657
Non-operating tax paid		(55)	–
Free cash flow		269	657
Dividends paid (including to non-controlling interests)		(372)	(348)
Net movement of funds from operations		(103)	309
Acquisitions and disposals (net of tax)		(326)	(780)
Loans advanced (including to related parties)		(49)	–
Purchase of treasury shares		(47)	–
New equity		14	11
Other movements on financial instruments		(9)	–
Net movement of funds		(520)	(460)
Exchange movements on net debt		59	41
Total movement in net debt		(461)	(419)

34 Cash generated from operations continued

Net cash generated from operations is translated at an exchange rate approximating to the rate at the date of cash flow. The difference between this rate and the average rate used to translate profit gives rise to a currency adjustment in the reconciliation between net profit and net cash generated from operations. This adjustment reflects the timing difference between recognition of profit and the related cash receipts or payments.

Operating cash flow, operating free cash flow and total free cash flow are non-GAAP measures and have been disclosed as they are part of Pearson's corporate and operating measures.

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

All figures in £ millions	2013	2012
Net book amount	19	1
Profit on sale of property, plant and equipment	9	—
Proceeds from sale of property, plant and equipment	28	1

35 Contingencies

There are contingent Group liabilities that arise in the normal course of business in respect of indemnities, warranties and guarantees in relation to former subsidiaries and in respect of guarantees in relation to subsidiaries, joint ventures and associates. In addition there are contingent liabilities of the Group in respect of legal claims, contract disputes, royalties, copyright fees, permissions and other rights. None of these claims are expected to result in a material gain or loss to the Group.

36 Commitments

There were no commitments for capital expenditure contracted for at the balance sheet date but not yet incurred.

The Group leases various offices and warehouses under non-cancellable operating lease agreements. The leases have varying terms and renewal rights. The Group also leases various plant and equipment under operating lease agreements, also with varying terms. Lease expenditure charged to the income statement was £183m (2012: £169m).

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

All figures in £ millions	2013	2012
Not later than one year	161	186
Later than one year and not later than two years	149	174
Later than two years and not later than three years	133	158
Later than three years and not later than four years	118	137
Later than four years and not later than five years	105	124
Later than five years	737	899
	1,403	1,678

Notes to the consolidated financial statements continued

37 Related party transactions

Joint ventures and associates

Amounts advanced to joint ventures and associates during the year and at the balance sheet date are set out in note 12. Apart from transactions with the Group's joint ventures and associates, there were no other material related party transactions.

Key management personnel

Key management personnel are deemed to be the members of the board of directors of Pearson plc. It is this board which had responsibility for planning, directing and controlling the activities of the Group in 2013. Key management personnel compensation is disclosed in the directors' remuneration report.

There were no other material related party transactions.

No guarantees have been provided to related parties.

38 Events after the balance sheet date

On 4 February 2014, the Group completed the sale of Mergermarket for £382m. On 11 February 2014, the Group acquired 100% of Grupo Multi, the leading English Language Training company in Brazil, for approximately £435m in cash plus the assumption of £57m of debt.

39 Accounts and audit exemptions

The Pearson plc subsidiary companies listed below are exempt from the requirements of the Companies Act 2006 relating to the audit of individual accounts by virtue of section 479A

	Company number		Company number
Aldwych Finance Ltd	04720439	Pearson Education Ltd	00872828
ASET Ltd	04231636	Pearson Funding Four plc	07970304
ASET Group Ltd	03964551	Pearson Funding One plc	02911143
ASET Management Ltd	03139404	Pearson Funding Two plc	07210654
ASET Solutions Ltd	03849880	Pearson Heinemann Ltd	03099304
Blue Wharf Ltd	04344573	Pearson in Practice ATA Ltd	07679091
Burmedia Investments Ltd	03060487	Pearson in Practice Holdings Ltd	06337129
Edexcel Ltd	04496750	Pearson in Practice Skills Based Learning Ltd	03755464
Education Development International plc	03914767	Pearson in Practice Technology Ltd	03786989
Embankment Finance Ltd	04460625	Pearson International Finance Ltd	02496206
eNVQ Ltd	03985948	Pearson Loan Finance No 2 Unltd	05632021
EQL Assessment Ltd	05224778	Pearson Loan Finance No 3 Ltd	05052661
Escape Studios Ltd	04399042	Pearson Loan Finance No 4 Ltd	02635107
Financial Times (ASC) Ltd	00519261	Pearson Loan Finance Unltd	05144467
Financial Times Group Ltd	00879531	Pearson Management Services Ltd	00096263
Fronter UK Ltd	05737591	Pearson Overseas Holdings Ltd	00145205
FT Business Information Ltd	00758738	Pearson PRH Holdings Ltd	08561316
FT Labs Ltd	04701650	Pearson Professional Holdings Ltd	00149375
FT Personal Finance Ltd	03855520	Pearson Services Ltd	01341060
Goal Ltd	03566588	Pearson Shared Services Ltd	04623186
Green Wharf Ltd	07009228	Peter Honey Publications Ltd	03754757
Icodeon Ltd	05068195	Sector Training Ltd	05342448
Joint Examining Board Ltd	03278422	St Clements Press (1988) Ltd	02174119
Longman Group (Overseas Holdings) Ltd	00690236	Testchange Ltd	02496240
Midlands Educational Technology Ltd	01448842	The Coaching Space Ltd	05333023
Pearson Affordable Learning Fund Ltd	08038068	The Financial Times (Benelux) Ltd	01613899
Pearson Amsterdam Finance Ltd	03041245	The Financial Times (France) Ltd	00867316
Pearson Australia Finance Unltd	05578463	The Financial Times (Japan) Ltd	01613900
Pearson Books Ltd	02512075	The Financial Times (M-M UK) Ltd	01398449
Pearson Canada Finance Unltd	05578491	The Financial Times (Spain) Ltd	01214411
Pearson College Ltd	07967446	The Financial Times Ltd	00227590
Pearson Dollar Finance plc	05111013	TQ Catalis Ltd	07307943
Pearson Dollar Finance Two plc	06507766	TQ Clapham Ltd	07307925
Pearson Education Holdings Ltd	00210859	TQ Global Ltd	07802458
Pearson Education Investments Ltd	08444933	TQ Holdings Ltd	06294307

Notes to the consolidated financial statements continued

39 Accounts and audit exemptions continued

The Pearson plc subsidiary companies listed below are exempt from the requirements of the Companies Act 2006 to prepare individual accounts by virtue of section 394A

	Company number		Company number
Exec-Appointments Ltd	04010964	Medley Global Advisors Ltd	00931507
FDI Intelligence Ltd	N1040129	The Financial News Ltd	00607228
Financial Times Business Ltd	00202281	The Financial Times (Switzerland) Ltd	01613901
Financial Times Electronic Publishing Ltd	02749250	The Financial Times (Zhongwen) Ltd	01900030
Financial Times Investor Ltd	04005565	Throgmorton Publications Ltd	00905696
Mandatewire Ltd	03855296		

Company balance sheet

As at 31 December 2013

All figures in £ millions	Notes	2013	2012
Assets			
Non-current assets			
Investments in subsidiaries	2	8 537	9,108
Amounts due from subsidiaries		2,009	2,021
Financial assets – Derivative financial instruments	6	111	174
		10,657	11 303
Current assets			
Amounts due from subsidiaries		380	578
Amounts due from related parties		44	–
Prepayments		–	4
Current income tax assets		24	–
Financial assets – Derivative financial instruments	6	13	4
Cash and cash equivalents (excluding overdrafts)	4	394	643
		855	1,229
Total assets		11,512	12,532
Liabilities			
Non-current liabilities			
Amounts due to subsidiaries		(3,553)	(4 227)
Financial liabilities – Borrowings	5	(202)	(473)
Financial liabilities – Derivative financial instruments	6	(48)	–
		(3,803)	(4,700)
Current liabilities			
Amounts due to subsidiaries		(1,256)	(1,953)
Current income tax liabilities		–	(13)
Financial liabilities – Borrowings	5	(766)	(618)
Provisions for other liabilities and charges	7	(42)	–
		(2,064)	(2 584)
Total liabilities		(5 867)	(7 284)
Net assets		5,645	5 248
Equity			
Share capital	8	205	204
Share premium	8	2,568	2,555
Treasury shares	c	(22)	(27)
Special reserve		447	447
Retained earnings		2,447	2,069
Total equity attributable to equity holders of the company		5 645	5,248

These financial statements have been approved for issue by the board of directors on 10 March 2014 and signed on its behalf by

Robin Freestone Chief financial officer
10 March 2014



Company statement of changes in equity

Year ended 31 December 2013

All figures in £ millions	Equity attributable to equity holders of the company					
	Share capital	Share premium	Treasury shares	Special reserve	Retained earnings	Total
At 1 January 2013	204	2,555	(27)	447	2,069	5,248
Profit for the year	—	—	—	—	802	802
Issue of ordinary shares under share option schemes*	1	13	—	—	—	14
Purchase of treasury shares	—	—	(47)	—	—	(47)
Release of treasury shares	—	—	52	—	(52)	—
Dividends	—	—	—	—	(372)	(372)
At 31 December 2013	205	2,568	(22)	447	2,447	5,645

All figures in £ millions	Equity attributable to equity holders of the company					
	Share capital	Share premium	Treasury shares	Special reserve	Retained earnings	Total
At 1 January 2012	204	2,544	(94)	447	1,450	4,551
Profit for the year	—	—	—	—	1,011	1,011
Issue of ordinary shares under share option schemes*	—	11	—	—	—	11
Contributions from subsidiaries for treasury shares	—	—	21	—	—	21
Release of treasury shares	—	—	46	—	(46)	—
Dividends	—	—	—	—	(346)	(346)
At 31 December 2012	204	2,555	(27)	447	2,069	5,248

The special reserve represents the cumulative effect of cancellation of the company's share premium account

Included within retained earnings is an amount of £131m (2012: £131m) relating to profit on intra-group disposals that is not distributable

*Full details of the share-based payment plans are disclosed in note 26 to the consolidated financial statements

Company cash flow statement

Year ended 31 December 2013

All figures in £ millions	Notes	2013	2012
Cash flows from operating activities			
Net profit		802	1,011
Adjustments for			
Income tax		(51)	(39)
Net finance costs		167	103
Amounts due to subsidiaries		(1,053)	(427)
Net cash (used in)/generated from operations		(135)	648
Interest paid		(82)	(93)
Tax received		14	43
Net cash (used in)/generated from operating activities		(203)	598
Cash flows from investing activities			
Disposal of subsidiaries, net of cash disposed		482	–
Interest received		10	1
Net cash received from investing activities		492	1
Cash flows from financing activities			
Proceeds from issue of ordinary shares	8	14	11
Net purchase of treasury shares		(48)	–
Loans to related parties		(44)	–
Repayment of borrowings		–	(1)
Dividends paid to company's shareholders		(372)	(346)
Net cash used in financing activities		(450)	(336)
Effects of exchange rate changes on cash and cash equivalents		18	(4)
Net (decrease)/increase in cash and cash equivalents		(143)	259
Cash and cash equivalents at beginning of year		25	(234)
Cash and cash equivalents at end of year	4	(118)	25

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Notes to the company financial statements

1 Accounting policies

The financial statements on pages 195 to 203 comprise the separate financial statements of Pearson plc. As permitted by section 408 of the Companies Act 2006, only the consolidated income statement and statement of comprehensive income has been presented.

The company has no employees.

The accounting policies applied in the preparation of these company financial statements are the same as those set out in note 1 to the consolidated financial statements with the addition of the following:

Investments

Investments in subsidiaries are stated at cost less provision for impairment, with the exception of certain hedged investments that are held in a foreign currency and revalued at each balance sheet date.

2 Investments in subsidiaries

All figures in £ millions	2013	2012
At beginning of year	9,108	9,056
Subscription for share capital in subsidiaries	424	110
Disposals/liquidations	(985)	–
Currency revaluations	(10)	(58)
At end of year	8,537	9,108

3 Financial risk management

The company's financial instruments comprise amounts due to/from subsidiary undertakings, cash and cash equivalents, derivative financial instruments and current and non-current borrowings. Derivative financial instruments are held at fair value, with all other financial instruments held at amortised cost. The company's approach to the management of financial risks is consistent with the Group's treasury policy, as discussed in note 19 to the consolidated financial statements. The company believes the value of its financial assets to be fully recoverable.

The company designates certain of its qualifying derivative financial instruments as hedges of the fair value of its bonds (fair value hedges). Changes in the fair value of these derivative financial instruments are recorded in the income statement, together with any change in the fair value of the hedged liability attributable to the hedged risk.

The carrying value of the company's financial instruments is exposed to movements in interest rates and foreign currency exchange rates (primarily US dollars). The company estimates that a 1% increase in interest rates would result in a £47m decrease in the carrying value of its financial instruments, with a 1% decrease in interest rates resulting in a £50m increase in their carrying value. The company also estimates that a 10% strengthening in sterling would decrease the carrying value of its financial instruments by £126m, while a 10% decrease in the value of sterling would increase the carrying value by £129m. These increases and decreases in carrying value would be recorded through the income statement. Sensitivities are calculated using estimation techniques such as discounted cash flow and option valuation models. Where modelling an interest rate decrease of 1% led to negative interest rates, these points on the yield curve were adjusted to 0%.

3 Financial risk management continued

The maturity of contracted cash flows on the company's borrowings and all of its derivative financial instruments are as follows

				2013
All figures in £ millions	USD	GBP	Other	Total
Not later than one year	(20)	233	16	229
Later than one year and not later than five years	287	(212)	—	75
Later than five years	(39)	—	—	(39)
Total	228	21	16	265
Analysed as				
Bonds	219	268	—	487
Rate derivatives – inflows	(350)	(248)	—	(598)
Rate derivatives – outflows	359	1	16	376
Total	228	21	16	265

				2012
All figures in £ millions	USD	GBP	Other	Total
Not later than one year	(26)	3	1	(22)
Later than one year and not later than five years	105	21	21	147
Later than five years	155	—	—	155
Total	234	24	22	280
Analysed as				
Bonds	232	285	—	517
Rate derivatives – inflows	(326)	(264)	—	(590)
Rate derivatives – outflows	328	3	22	353
Total	234	24	22	280

All cash flow projections shown above are on an undiscounted basis. Any cash flows based on a floating rate are calculated using interest rates as set at the date of the last rate reset. Where this is not possible, floating rates are based on interest rates prevailing at 31 December in the relevant year. All derivative amounts are shown gross, although the company net settles these amounts wherever possible.

Any amounts drawn under revolving credit facilities and commercial paper are assumed to mature at the maturity date of the relevant facility, with interest calculated as payable in each calendar year up to and including the date of maturity of the facility.

Notes to the company financial statements continued

4 Cash and cash equivalents (excluding overdrafts)

All figures in £ millions	2013	2012
Cash at bank and in hand	269	1
Short-term bank deposits	125	642
	394	643

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

At the end of 2013 the currency split of cash and cash equivalents was US dollar 76% (2012 63%) and sterling 24% (2012 37%)

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

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

All figures in £ millions	2013	2012
Cash and cash equivalents	394	643
Bank overdrafts	(512)	(618)
	(118)	25

5 Financial liabilities – Borrowings

All figures in £ millions	2013	2012
Non-current		
7.0% Sterling Bonds 2014 (nominal amount £250m)	—	256
4.625% US Dollar Notes 2018 (nominal amount \$300m)	202	217
	202	473
Current		
Due within one year or on-demand		
7.0% Sterling Bonds 2014 (nominal amount £250m)	254	—
Bank loans and overdrafts	512	618
	766	618
Total borrowings	968	1,091

Included in non-current borrowings above is £nil of accrued interest (2012 £3m) Included in current borrowings above is £3m of accrued interest (2012 £nil)

5 Financial liabilities – Borrowings continued

The maturity of the company's non-current borrowings is as follows

All figures in £ millions	2013	2012
Between one and two years	—	256
Between two and five years	202	—
Over five years	—	217
	202	473

As at 31 December 2013 the exposure to interest rate changes of the borrowings and amounts due to subsidiaries when the borrowings re-price is as follows

All figures in £ millions	Less than one year	One to five years	More than five years	Total
Re-pricing profile of borrowings	766	202	—	968
Amounts due to subsidiaries	1,256	2,731	822	4,809
Effect of rate derivatives	1,026	(422)	(604)	—
	3,048	2,511	218	5,777

The carrying amounts and market values of borrowings are as follows

All figures in £ millions	Effective interest rate	2013		2012	
		Carrying amount	Market value	Carrying amount	Market value
Bank loans and overdrafts	n/a	512	512	618	618
7.0% Sterling Bonds 2014	7.20%	254	262	256	274
4.625% US dollar Notes 2018	4.69%	202	195	217	209
		968	969	1,091	1,101

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

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

All figures in £ millions	2013	2012
US dollar	202	255
Sterling	762	826
Euro	4	10
	968	1,091

Notes to the company financial statements continued

6 Derivative financial instruments

The company's outstanding derivative financial instruments are as follows

All figures in £ millions	2013			2012		
	Gross notional amounts	Assets	Liabilities	Gross notional amounts	Assets	Liabilities
Interest rate derivatives – in a fair value hedge relationship	231	22	–	234	35	–
Interest rate derivatives – not in a hedge relationship	1,842	63	(48)	1,292	109	–
Cross-currency derivatives	220	39	–	220	34	–
Total	2,293	124	(48)	1,746	178	–
Analysed as expiring						
In less than one year	312	13	–	215	4	–
Later than one year and not later than five years	1,377	111	–	701	69	–
Later than five years	604	–	(48)	830	105	–
Total	2,293	124	(48)	1,746	178	–

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

7 Provisions for other liabilities and charges

Provisions in the year comprise liabilities assumed on the closure of the business of a group subsidiary. It is anticipated that the provision will be utilised in less than one year.

8 Share capital and share premium

	Number of shares 000s	Ordinary shares £m	Share premium £m
At 1 January 2012	815,626	204	2,544
Issue of ordinary shares – share option schemes	1,417	–	11
At 31 December 2012	817,043	204	2,555
Issue of ordinary shares – share option schemes	1,537	1	13
At 31 December 2013	818,580	205	2,568

The ordinary shares have a par value of 25p per share (2012 25p per share). All issued shares are fully paid. All shares have the same rights.

9 Treasury shares

	Number of shares 000s	£m
At 1 January 2012	14,665	94
Purchase of treasury shares	—	—
Contribution from subsidiaries	—	(21)
Release of treasury shares	(4,563)	(46)
At 31 December 2012	10,102	27
Purchase of treasury shares	4,111	47
Release of treasury shares	(4,931)	(52)
At 31 December 2013	9,282	22

The company holds its own shares in trust to satisfy its obligations under its restricted share plans. These shares are treated as treasury shares for accounting purposes and have a par value of 25p per share. The nominal value of the company's treasury shares amounts to £2.3m (2012: £2.5m). At 31 December 2013 the market value of the company's treasury shares was £124.4m (2012: £120.0m).

10 Contingencies

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

11 Audit fees

Statutory audit fees relating to the company were £35,000 (2012: £35,000).

12 Related party transactions

Subsidiaries

The company transacts and has outstanding balances with its subsidiaries. Amounts due from subsidiaries and amounts due to subsidiaries are disclosed on the face of the company balance sheet.

These loans are generally unsecured and interest is calculated based on market rates. The company has interest payable to subsidiaries for the year of £144m (2012: £171m) and interest receivable from subsidiaries for the year of £59m (2012: £64m). Management fees payable to subsidiaries in respect of centrally provided services amounted to £55m (2012: £47m). Dividends received from subsidiaries were £1,363m (2012: £1,124m).

Associates

Amounts due from related parties, disclosed on the face of the company balance sheet, relate to loans to Penguin Random House, an associate of the Group. These loans are unsecured and interest is calculated based on market rates.

Key management personnel

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

There were no other material related party transactions.

Principal subsidiaries

The principal operating subsidiaries at 31 December 2013 are listed below. They operate mainly in the countries of incorporation or registration. The investments are in equity share capital and they are all 100% owned.

	Country of incorporation or registration
Pearson Education	
Pearson Education Inc	US
Pearson Education Ltd	England
NCS Pearson Inc	US
FT Group	
The Financial Times Ltd	England

The company has taken advantage of the exemption under Section 410(2) of the Companies Act 2006 by providing information only in relation to subsidiary undertakings whose results or financial position, in the opinion of the directors, principally affected the financial statements. A complete list of subsidiary and associated undertakings will be included in the next Pearson plc annual return filed with the Registrar of Companies.

Five-year summary

All figures in £ millions	2009	2010	2011 Restated	2012 Restated	2013
Sales					
North American Education	2,470	2,640	2,584	2,658	2,779
International Education	1,035	1,234	1,424	1,568	1,539
Professional	275	333	382	390	410
Education	3,780	4,207	4,390	4,616	4,728
FT Group	288	325	338	343	341
Continuing	4,068	4,532	4,728	4,959	5,069
Discontinued	1,556	1,427	1,134	1,153	621
Total sales	5,624	5,959	5,862	6,112	5,690
Adjusted operating profit					
North American Education	403	469	493	536	406
International Education	141	171	194	214	140
Professional	43	51	66	37	57
Education	587	691	753	787	603
FT Group	19	41	53	22	29
Penguin Random House	—	—	—	—	50
Continuing	606	732	806	809	682
Discontinued	252	206	132	123	54
Total adjusted operating profit	858	938	938	932	736
Operating margin – continuing	14.9%	16.2%	17.0%	16.3%	13.5%
Adjusted earnings					
Total adjusted operating profit	858	938	938	932	736
Net finance costs	(97)	(85)	(55)	(65)	(72)
Income tax	(194)	(215)	(196)	(200)	(97)
Non-controlling interest	(44)	(17)	1	(3)	(1)
Adjusted earnings	523	621	688	664	566
Weighted average number of shares (millions)	799.3	801.2	800.2	804.3	807.8
Adjusted earnings per share	65.4p	77.5p	86.0p	82.6p	70.1p

2011 and 2012 have been restated to reflect the adoption of IAS 19 revised. Prior periods have not been restated.

Five-year summary continued

All figures in £ millions	2009	2010	2011 Restated	2012 Restated	2013
Cash flow					
Operating cash flow	913	1,057	983	788	588
Operating cash conversion	106%	113%	105%	85%	80%
Operating free cash flow	723	904	772	657	324
Operating free cash flow per share	90.5p	112.8p	96.5p	81.7p	40.1p
Total free cash flow	723	904	772	657	269
Total free cash flow per share	90.5p	112.8p	96.5p	81.7p	33.3p
 Net assets	 4,636	 5,605	 5,962	 5,710	 5,706
 Net debt	 1,092	 430	 499	 918	 1,379
 Return on invested capital (gross basis)					
Total adjusted operating profit	858	938	938	932	736
Cash tax paid	(103)	(85)	(151)	(65)	(191)
Return	755	853	787	867	545
Average invested capital	8,504	8,315	8,731	9,578	10,130
Return on invested capital	8.9%	10.3%	9.0%	9.1%	5.4%
 Dividend per share	 35.5p	 38.7p	 42.0p	 45.0p	 48.0p

Corporate and operating measures

Pearson's corporate and operating measures include the results of Mergermarket throughout 2013 as the business was wholly-owned during that period

Sales – underlying and constant exchange rate movement

Sales movement excluding Penguin and excluding the impact of acquisitions and disposals and movements in exchange rates

All figures in £ millions	2013
Underlying increase	29
Portfolio changes	70
Exchange differences	19
Total sales increase	118
Underlying increase	1%
Constant exchange rate increase	2%

Adjusted income statement

Reconciliation of the consolidated income statement to the adjusted numbers presented as non-GAAP measures in the financial statements

	2013							
All figures in £ millions	Statutory income statement	Discontinued operations	Other net gains and losses	Acquisition costs	Intangible charges	Other net finance income/ costs	Tax amortisation benefit	Adjusted income statement
Operating profit	458	54	16	12	196	—	—	736
Net finance costs	(76)	—	—	—	—	4	—	(72)
Profit before tax	382	54	16	12	196	4	—	664
Income tax	(87)	(18)	32	(2)	(51)	(1)	30	(97)
Profit for the year from continuing operations	295	36	48	10	145	3	30	567
Profit for the year from discontinued operations	244	(36)	(209)	—	2	(1)	—	—
Profit for the year	539	—	(161)	10	147	2	30	567
Non-controlling interest	(1)	—	—	—	—	—	—	(1)
Earnings	538	—	(161)	10	147	2	30	566

Corporate and operating measures continued

Adjusted income statement continued

								2012
All figures in £ millions	Statutory income statement	Discontinued operations	Other net gains and losses	Acquisition costs	Intangible charges	Other net finance income/costs	Tax amortisation benefit	Adjusted income statement
Operating profit	487	123	123	20	179	—	—	932
Net finance costs	(96)	—	—	—	—	31	—	(65)
Profit before tax	391	123	123	20	179	31	—	867
Income tax	(138)	(38)	—	(5)	(54)	(1)	36	(200)
Profit for the year from continuing operations	253	85	123	15	125	30	36	667
Profit for the year from discontinued operations	61	(85)	20	1	3	—	—	—
Profit for the year	314	—	143	16	128	30	36	667
Non-controlling interest	(3)	—	—	—	—	—	—	(3)
Earnings	311	—	143	16	128	30	36	664

Adjusted operating profit – underlying and constant exchange rate movement

Operating profit movement excluding the impact of acquisitions, disposals and movements in exchange rates

All figures in £ millions	2013
Underlying decrease	(222)
Portfolio changes	30
Exchange differences	(4)
Total adjusted operating profit decrease	(196)
Underlying decrease	(23)%
Constant exchange rate decrease	(21)%

The underlying and constant exchange rate decreases above primarily reflect the impact of restructuring charges booked during 2013. Excluding the impact of these restructuring charges, underlying and constant exchange rate operating profits have decreased 9% and 6% respectively.

Free cash flow per share

Operating cash flow for continuing and discontinued operations before tax and finance charges, divided by the weighted average number of shares in issue

All figures in £ millions	2013	2012
Adjusted operating profit	736	932
Cash conversion	80%	85%
Operating cash flow	588	788
Operating tax paid	(191)	(65)
Net operating finance costs paid	(73)	(66)
Total operating free cash flow	324	657
Non-operating tax paid	(55)	—
Total free cash flow	269	657
Weighted average number of shares in issue (millions)	807.8	804.3
Operating free cash flow per share	40.1p	81.7p
Total free cash flow per share	33.3p	81.7p

Return on invested capital

All figures in £ millions	Invested capital	
	2013	2012
Total adjusted operating profit	736	932
Operating tax paid	(191)	(65)
Return	545	867
Average goodwill and other intangibles	8,903	8,550
Average net operating assets	1,227	1,028
Average invested capital	10,130	9,578
Return on invested capital	5.4%	9.1%

Return on invested capital is calculated as total adjusted operating profit less operating cash tax paid expressed as a percentage of average invested capital. Invested capital includes the original unamortised goodwill and intangibles.

Shareholder information

Pearson ordinary shares are listed on the London Stock Exchange and on the New York Stock Exchange in the form of American Depositary Receipts

Corporate website

The investors' section of our corporate website www.pearson.com/investors provides a wealth of information for shareholders. It is also possible to sign up to receive email alerts for reports and press releases relating to Pearson at www.pearson.com/investors/announcements/email-alerts

Shareholder information online

Shareholder information can be found on our website www.pearson.com/investors/shareholder-information

Our registrar, Equiniti also provides a range of shareholder information online. You can check your holding and find practical help on transferring shares or updating your details at www.shareview.co.uk. For more information, please contact our registrar, Equiniti, Aspect House, Spencer Road, Lancing, West Sussex BN99 6DA. Telephone 0871 384 2233* or, for those shareholders with hearing difficulties, textphone number 0871 384 2255*

Information about the Pearson share price

The company's share price can be found on our website at www.pearson.com. It also appears in the financial columns of the national press.

2013 Dividends

	Payment date	Amount per share
Interim	13 September 2013	16 pence
Final	2 May 2014	32 pence

Payment of dividends to mandated accounts

Should you elect to have your dividends paid through BACS, this can be done directly into a bank or building society account, with the tax voucher sent to the shareholder's registered address. Equiniti can be contacted for information on 0871 384 2043*

Dividend reinvestment plan (DRIP)

The DRIP gives shareholders the right to buy the company's shares on the London stock market with their cash dividend. For further information, please contact Equiniti on 0871 384 2268*

Individual Savings Accounts (ISAs)

Equiniti offers ISAs in Pearson shares. For more information, please go to www.shareview.co.uk/dealing or call customer services on 0845 300 0430*

Share dealing facilities

Equiniti offers telephone and internet services for dealing in Pearson shares. For further information, please contact their telephone dealing helpline on 08456 037 037 (weekdays only) or, for online dealing, log on to www.shareview.co.uk/dealing. You will need your shareholder reference number as shown on your share certificate.

A weekly postal dealing service is also available through Equiniti. Please telephone 0871 384 2248* for details or log on to www.shareview.co.uk to download a form.

ShareGift

Shareholders with small holdings of shares, whose value makes them uneconomic to sell, may wish to donate them to ShareGift, the share donation charity (registered charity number 1052686). Further information about ShareGift and the charities it has supported may be obtained from their website, www.ShareGift.org or by contacting them at ShareGift, PO Box 72253, London, SW1P 9LQ.

American Depositary Receipts (ADRs)

Pearson's ADRs are listed on the New York Stock Exchange and traded under the symbol PSO. Each ADR represents one ordinary share. For enquiries regarding registered ADR holder accounts and dividends, please contact The Bank of New York Mellon, PO Box 43006, Providence, RI 02940-3006, telephone 1 (866) 259 2289 (toll free within the US) or 001 201 680 6825 (outside the US). Alternatively you may email shrrelations@bnymellon.com, or log on to www.bnymellon.com/shareowner. Voting rights for registered ADR holders can be exercised through The Bank of New York Mellon, and for beneficial ADR holders (and/or nominee accounts) through your US brokerage institution. Pearson will file with the Securities and Exchange Commission a Form 20-F.

*Calls to these numbers are charged at 8p per minute plus network extras. Lines open 8.30am to 5.30pm Monday to Friday.

Share register fraud protecting your investment

Pearson does not contact its shareholders directly to provide recommendation advice and neither does it appoint third parties to do so. As required by law, our shareholder register is available for public inspection but we cannot control the use of information obtained by persons inspecting the register. Please treat any approaches purporting to originate from Pearson with caution.

For more information, please log on to our website at www.pearson.com/investors/shareholder-information/managing-your-shares and www.pearson.com/shareholderfaqs

Tips on protecting your shares

- › Keep any documentation that contains your shareholder reference number in a safe place and shred any unwanted documentation
- › Inform our registrar, Equiniti promptly when you change address

- › Be aware of dividend payment dates and contact the registrar if you do not receive your dividend cheque or better still, make arrangements to have the dividend paid directly into your bank account
- › Consider holding your shares electronically in a CREST account via a nominee

2014 Financial calendar

Ex-dividend date	2 April
Record date	4 April
Last date for dividend reinvestment election	9 April
Annual General Meeting	25 April
Payment date for dividend and share purchase date for dividend reinvestment	2 May
Interim results	25 July
Payment date for interim dividend	12 September

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Reliance on this document

Our Strategic report on pages 02 to 53 has been prepared in accordance with section 414 ('Duty to prepare a strategic report') of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013. It also incorporates much of the guidance set out in the Accounting Standards Board's Reporting Statement on the Operating and Financial Review.

The intention of this document is to provide information to shareholders and is not designed to be relied upon by any other party or for any other purpose.

Forward-looking statements

This document contains forward-looking statements which are made by the directors in good faith based on information available to them at the time of approval of this report. In particular, all statements that express forecasts, expectations and projections with respect to future matters, including trends in results of operations, margins, growth rates, overall market trends, the impact of interest or exchange rates, the availability of financing, anticipated costs savings and synergies and the execution of Pearson's strategy, are forward-looking statements.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that will occur in the future. There are a number of factors which could cause actual results and developments to differ materially from those expressed or implied by these forward-looking statements, including a number of factors outside Pearson's control. Any forward-looking statements speak only as of the date they are made, and Pearson gives no undertaking to update forward-looking statements to reflect any changes in its expectations with regard thereto or any changes to events, conditions or circumstances on which any such statement is based.

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Pearson has supported the planting of 400 square metres of new native woodland with the Woodland Trust, helping to remove 16 tonnes of carbon dioxide emissions generated by the production of this report.

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