Consolidated income statement

Year ended 31 December 2011

All figures in £ millions	Notes	2011	2010
Sales	2	5,862	5,663
Cost of goods sold	4	(2,624)	(2,588)
Gross profit		3,238	3,075
Operating expenses	4	(2,457)	(2,373)
Profit on sale of associate	12	412	–
Share of results of joint ventures and associates	12	33	41
Operating profit	2	1,226	743
Finance costs	6	(97)	(109)
Finance income	6	26	36
Profit before tax		1,155	670
Income tax	7	(199)	(146)
Profit for the year from continuing operations		956	524
Profit for the year from discontinued operations	3	–	776
Profit for the year		956	1,300
Attributable to:			
Equity holders of the company		957	1,297
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	119.6p	161.9p
– diluted	8	119.3p	161.5p
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	119.6p	66.0p
– diluted	8	119.3p	65.9p

Consolidated statement of comprehensive income

Year ended 31 December 2011

All figures in £ millions	Notes	2011	2010
Profit for the year		956	1,300
Net exchange differences on translation of foreign operations		(44)	173
Currency translation adjustment disposed – subsidiaries		–	13
Actuarial (losses)/gains on retirement benefit obligations – Group	25	(56)	70
Actuarial (losses)/gains on retirement benefit obligations – associate	12	(8)	1
Tax on items recognised in other comprehensive income	7	3	(41)
Other comprehensive (expense)/income for the year		(105)	216
Total comprehensive income for the year		851	1,516
Attributable to:			
Equity holders of the company		858	1,502
Non-controlling interest		(7)	14

Consolidated balance sheet
As at 31 December 2011

All figures in £ millions	Notes	2011	2010
Assets			
Non-current assets			
Property, plant and equipment	10	383	366
Intangible assets	11	6,342	5,467
Investments in joint ventures and associates	12	32	71
Deferred income tax assets	13	287	276
Financial assets – Derivative financial instruments	16	177	134
Retirement benefit assets	25	25	–
Other financial assets	15	26	58
Trade and other receivables	22	151	129
		7,423	6,501
Current assets			
Intangible assets – Pre-publication	20	650	647
Inventories	21	407	429
Trade and other receivables	22	1,386	1,337
Financial assets – Derivative financial instruments	16	–	6
Financial assets – Marketable securities	14	9	12
Cash and cash equivalents (excluding overdrafts)	17	1,369	1,736
		3,821	4,167
Total assets		11,244	10,668
Liabilities			
Non-current liabilities			
Financial liabilities – Borrowings	18	(1,964)	(1,908)
Financial liabilities – Derivative financial instruments	16	(2)	(6)
Deferred income tax liabilities	13	(620)	(471)
Retirement benefit obligations	25	(166)	(148)
Provisions for other liabilities and charges	23	(115)	(42)
Other liabilities	24	(325)	(246)
		(3,192)	(2,821)
Current liabilities			
Trade and other liabilities	24	(1,741)	(1,605)
Financial liabilities – Borrowings	18	(87)	(404)
Financial liabilities – Derivative financial instruments	16	(1)	–
Current income tax liabilities		(213)	(215)
Provisions for other liabilities and charges	23	(48)	(18)
		(2,090)	(2,242)
Total liabilities		(5,282)	(5,063)
Net assets		5,962	5,605

All figures in £ millions	Notes	2011	2010
Equity			
Share capital	27	204	203
Share premium	27	2,544	2,524
Treasury shares	28	(149)	(137)
Translation reserve		364	402
Retained earnings		2,980	2,546
Total equity attributable to equity holders of the company		5,943	5,538
Non-controlling interest		19	67
Total equity		5,962	5,605

These financial statements have been approved for issue by the board of directors on 7 March 2012 and signed on its behalf by

Robin Freestone Chief financial officer

Consolidated statement of changes in equity

Year ended 31 December 2011

	Equity attributable to equity holders of the company							
All figures in £ millions	Share capital	Share premium	Treasury shares	Translation reserve	Retained earnings	Total	Non-controlling interest	Total equity
At 1 January 2011	203	2,524	(137)	402	2,546	5,538	67	5,605
Profit for the year	–	–	–	–	957	957	(1)	956
Other comprehensive expense	–	–	–	(38)	(61)	(99)	(6)	(105)
Equity-settled transactions	–	–	–	–	40	40	–	40
Tax on equity-settled transactions	–	–	–	–	3	3	–	3
Issue of ordinary shares under share option schemes	1	20	–	–	–	21	–	21
Purchase of treasury shares	–	–	(60)	–	–	(60)	–	(60)
Release of treasury shares	–	–	48	–	(48)	–	–	–
Put options over non-controlling interest	–	–	–	–	(63)	(63)	–	(63)
Changes in non-controlling interest	–	–	–	–	(76)	(76)	(40)	(116)
Dividends	–	–	–	–	(318)	(318)	(1)	(319)
At 31 December 2011	204	2,544	(149)	364	2,980	5,943	19	5,962

	Equity attributable to equity holders of the company							
All figures in £ millions	Share capital	Share premium	Treasury shares	Translation reserve	Retained earnings	Total	Non-controlling interest	Total equity
At 1 January 2010	203	2,512	(226)	227	1,629	4,345	291	4,636
Profit for the year	–	–	–	–	1,297	1,297	3	1,300
Other comprehensive income	–	–	–	175	30	205	11	216
Equity-settled transactions	–	–	–	–	50	50	–	50
Tax on equity-settled transactions	–	–	–	–	4	4	–	4
Issue of ordinary shares under share option schemes	–	12	–	–	–	12	–	12
Purchase of treasury shares	–	–	(77)	–	–	(77)	–	(77)
Release/cancellation of treasury shares	–	–	166	–	(166)	–	–	–
Changes in non-controlling interest	–	–	–	–	(6)	(6)	(231)	(237)
Dividends	–	–	–	–	(292)	(292)	(7)	(299)
At 31 December 2010	203	2,524	(137)	402	2,546	5,538	67	5,605

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.

Consolidated cash flow statement

Year ended 31 December 2011

All figures in £ millions	Notes	2011	2010
Cash flows from operating activities			
Net cash generated from operations	33	1,093	1,169
Interest paid		(70)	(78)
Tax paid		(151)	(85)
Net cash generated from operating activities		872	1,006
Cash flows from investing activities			
Acquisition of subsidiaries, net of cash acquired	30	(779)	(535)
Acquisition of joint ventures and associates		(9)	(22)
Purchase of investments		(12)	(7)
Purchase of property, plant and equipment		(67)	(76)
Purchase of intangible assets		(77)	(56)
Disposal of subsidiaries, net of cash disposed	31	(6)	984
Proceeds from sale of associates	12	428	–
Proceeds from sale of investments		75	–
Proceeds from sale of property, plant & equipment	33	9	–
Proceeds from sale of intangible assets		3	–
Tax paid on disposal of subsidiaries		–	(250)
Interest received		10	10
Dividends received from joint ventures and associates		30	23
Net cash (used in)/received from investing activities		(395)	71
Cash flows from financing activities			
Proceeds from issue of ordinary shares	27	21	12
Purchase of treasury shares	28	(60)	(77)
Proceeds from borrowings		–	241
Liquid resources sold		2	53
Repayment of borrowings		(318)	(13)
Finance lease principal payments		(8)	(3)
Dividends paid to company's shareholders	9	(318)	(292)
Dividends paid to non-controlling interest		(1)	(6)
Transactions with non-controlling interest	32	(108)	(7)
Net cash used in financing activities		(790)	(92)
Effects of exchange rate changes on cash and cash equivalents		(60)	(1)
Net (decrease)/increase in cash and cash equivalents		(373)	984
Cash and cash equivalents at beginning of year		1,664	680
Cash and cash equivalents at end of year	17	1,291	1,664

The consolidated cash flow statement includes discontinued operations (see note 3).

Independent auditors' report to the members of Pearson plc

We have audited the consolidated and company financial statements (together the 'financial statements') of Pearson plc for the year ended 31 December 2011. The consolidated financial statements comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated balance sheet, the consolidated statement of changes in equity, the consolidated cash flow statement and the related notes to the consolidated financial statements. The company financial statements comprise the company balance sheet, the company statement of changes in equity, the company cash flow statement and the related notes to the company financial statements. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Respective responsibilities of directors and auditors

As explained more fully in the statement of directors' responsibilities set out in the Governance section of the directors' report, the directors are responsible for the preparation of the 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 financial statements in accordance with applicable law and International Standards on Auditing (UK and 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.

Scope of the audit of the financial statements

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 the 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 and accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion:

- The financial statements give a true and fair view of the state of the Group's and of the company's affairs as at 31 December 2011 and of the Group's profit and Group's and company's cash flows for the year then ended;
- The consolidated financial statements have been properly prepared in accordance with 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.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- The part of the report on directors' remuneration to be audited has been properly prepared in accordance with the Companies Act 2006; and
- The information given in the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- 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 report on directors' remuneration to be audited are not in agreement with the accounting records and returns; or
- Certain disclosures of directors' remuneration specified by law are not made; or
- We have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- The directors' statement set out in the Governance section of the directors' report in relation to going concern;
- The parts of the corporate governance statement relating to the company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review; and
- Certain elements of the report to shareholders by the board on directors' remuneration.

Ranjan Sriskandan (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
7 March 2012

Notes to the consolidated financial statements

General information

Pearson plc (the company) and its subsidiaries (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 7 March 2012.

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 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.

1. Interpretations and amendments to published standards effective in 2011

The following amendments and interpretations were adopted in 2011 and have not had an impact on the Group financial statements:

- Amendments to IAS 24 'Related Parties'.
- Amendments to IAS 32 'Financial Instruments: Presentation' – Classification of Rights.
- IFRIC 19 'Extinguishing Financial Liabilities with Equity Instruments'.
- Amendments to IFRIC 14 'Prepayments of a Minimum Funding Requirement'.
- 'Improvements to IFRSs – 2010'.

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 and are evaluating the effect on the financial statements:

- IFRS 9 'Financial Instruments', effective for annual reporting periods beginning on or after 1 January 2015. The new standard details the requirements for the classification and measurement of financial assets and liabilities.
- 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 effective for annual reporting periods beginning on or after 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 and provides guidance on its determination, and introduces disclosure requirements on fair value measurements.
- 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 profit or loss in subsequent periods, and those that will not.

1. Accounting policies continued

a. Basis of preparation continued

2. Standards, interpretations and amendments to published standards that are not yet effective – continued

- 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 component and changes to disclosure.

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
Royalty advances
Taxation
Employee benefits: Pension obligations
Revenue recognition

b. Consolidation

1. Business combinations The acquisition method of accounting is used to account for business combinations of the Group with an acquisition date on or after 1 January 2010. 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.

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 external, 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 the power to govern the financial and operating policies, generally accompanying a shareholding of more than one half of the voting rights. Subsidiaries are fully consolidated from the date on which control is transferred to the Group and are de-consolidated from the date that control ceases.

3. Transactions with non-controlling interests Transactions with non-controlling interests are treated as transactions with shareholders. 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 which are jointly controlled, with one or more other venturers, under a contractual arrangement. 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 cost.

Notes to the consolidated financial statements continued

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 $1.60 (2010: $1.54) and the year end rate was $1.55 (2010: $1.57).

d. Property, plant and equipment

Property, plant and equipment are stated at historical cost less depreciation. 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.

1. Accounting policies continued

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 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 cash-generating units for the purpose of impairment testing. The allocation is made to those 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 33).

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.

Notes to the consolidated financial statements continued

1. Accounting policies continued

e. Intangible assets continued

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.

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. Newspaper development costs

Investment in the development of newspaper titles consists of measures to increase the volume and geographical spread of circulation. The measures include additional and enhanced editorial content, extended distribution and remote printing. These costs are expensed as incurred as they do not meet the criteria under IAS 38 'Intangible Assets' to be capitalised as intangible assets.

j. 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 as these amounts are used to offset the borrowings of the Group.

k. 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.

1. Accounting policies continued

l. 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.

m. Derivative financial instruments
Derivatives are recognised at fair value and re-measured 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).

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.

n. 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.

Notes to the consolidated financial statements continued

1. Accounting policies continued

o. Employee benefits

1. 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, longevity and expected return on scheme assets.

Actuarial gains and losses arising from differences between actual and expected returns on plan assets, experience adjustments on liabilities and changes in actuarial assumptions are recognised immediately in other comprehensive income.

The service cost, representing benefits accruing over the year, is included in the income statement as an operating cost. The unwinding of the discount rate on the scheme liabilities and the expected return on scheme assets are presented as finance costs or finance income.

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.

p. 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.

q. 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.

1. Accounting policies continued

q. Revenue recognition continued

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.

Income from recharges of freight and other activities which are incidental to the normal revenue generating activities is included in other income.

r. 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.

s. Dividends

Dividends are recorded in the Group's financial statements in the period in which they are approved by the company's shareholders. Interim dividends are recorded in the period in which they are approved and paid.

t. Non-current 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.

u. Trade receivables

Trade receivables are stated at fair value after provision for bad and doubtful debts and anticipated future sales returns (see also note 1q).

Notes to the consolidated financial statements continued

2. Segment information

The Group is organised into five business segments:

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;

Penguin Publisher with brand imprints such as Penguin, Putnam, Berkley, Viking and Dorling Kindersley.

For more detail on the services and products included in each business segment refer to the business review.

The results of the Interactive Data segment are shown as discontinued for the period until its disposal on 29 July 2010.

									2011
All figures in £ millions	Notes	North American Education	International Education	Professional	FT Group	Penguin	Corporate	Discontinued operations	Group
Continuing operations									
Sales (external)		2,584	1,424	382	427	1,045	–	–	5,862
Sales (inter-segment)		3	–	9	–	2	–	–	14
Adjusted operating profit		493	196	66	76	111	–	–	942
Amortisation of acquired intangibles		(57)	(60)	(11)	(8)	(3)	–	–	(139)
Acquisition costs		(2)	(9)	–	(1)	–	–	–	(12)
Other net gains and losses		29	(6)	–	412	–	–	–	435
Operating profit		463	121	55	479	108	–	–	1,226
Finance costs	6								(97)
Finance income	6								26
Profit before tax									1,155
Income tax	7								(199)
Profit for the year from continuing operations									956
Segment assets		5,198	2,388	626	424	1,021	1,555	–	11,212
Joint ventures	12	–	16	–	1	1	–	–	18
Associates	12	1	8	–	4	1	–	–	14
Total assets		5,199	2,412	626	429	1,023	1,555	–	11,244
Other segment items									
Share of results of joint ventures and associates	12	–	(2)	1	34	–	–	–	33
Capital expenditure	10, 11	75	33	17	19	12	–	–	156
Pre-publication investment	20	237	60	2	–	32	–	–	331
Depreciation	10	36	14	8	4	8	–	–	70
Amortisation	11, 20	309	128	16	20	45	–	–	518

2. Segment information continued

All figures in £ millions	Notes	North American Education	International Education	Professional	FT Group	Penguin	Corporate	Discontinued operations	Group
									2010
Continuing operations									
Sales (external)		2,640	1,234	333	403	1,053	–	–	5,663
Sales (inter-segment)		–	–	5	–	3	–	–	8
Adjusted operating profit		469	171	51	60	106	–	–	857
Amortisation of acquired intangibles		(53)	(35)	(7)	(9)	(1)	–	–	(105)
Acquisition costs		(1)	(7)	(2)	(1)	–	–	–	(11)
Other net gains and losses		–	(10)	–	12	–	–	–	2
Operating profit		415	119	42	62	105	–	–	743
Finance costs	6								(109)
Finance income	6								36
Profit before tax									670
Income tax	7								(146)
Profit for the year from continuing operations									524
Segment assets		4,401	2,122	601	447	1,138	1,888	–	10,597
Joint ventures	12	15	–	1	1	1	–	–	18
Associates	12	24	6	–	23	–	–	–	53
Total assets		4,440	2,128	602	471	1,139	1,888	–	10,668
Other segment items									
Share of results of joint ventures and associates	12	(3)	1	1	42	–	–	–	41
Capital expenditure	10, 11	45	27	16	17	18	–	21	144
Pre-publication investment	20	215	61	7	–	36	–	–	319
Depreciation	10	23	19	9	5	13	–	13	82
Amortisation	11, 20	307	111	18	23	43	–	12	514

In 2011, sales from the provision of goods were £4,054m (2010: £4,200m) and sales from the provision of services were £1,808m (2010: £1,463m). 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.

Notes to the consolidated financial statements continued

2. Segment information continued

Corporate costs are allocated to business segments 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 £404m (2010: £311m) (see note 30). Capital expenditure, depreciation and amortisation include amounts relating to discontinued operations.

The Group operates in the following main geographic areas:

	Sales		Non-current assets	
All figures in £ millions	2011	2010	2011	2010
Continuing operations				
UK	865	790	1,237	1,031
Other European countries	471	415	225	237
USA	3,313	3,361	4,325	3,790
Canada	209	228	226	235
Asia Pacific	646	577	570	364
Other countries	358	292	325	376
Total continuing	5,862	5,663	6,908	6,033
Discontinued operations				
UK	–	31	–	–
Other European countries	–	48	–	–
USA	–	196	–	–
Canada	–	2	–	–
Asia Pacific	–	18	–	–
Other countries	–	1	–	–
Total discontinued	–	296	–	–
Total	5,862	5,959	6,908	6,033

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.

3. Discontinued operations

Discontinued operations in 2010 relate to the Group's interest in Interactive Data (sold on 29 July 2010).

There were no discontinued operations in 2011.

An analysis of the results and cash flows of discontinued operations is as follows:

All figures in £ millions	2011 Interactive Data	2010 Interactive Data
Sales	–	296
Operating profit	–	73
Finance income	–	–
Profit before tax	–	73
Attributable tax expense	–	(28)
Profit after tax	–	45
Profit on disposal of discontinued operations before tax	–	1,037
Attributable tax expense	–	(306)
Profit for the year from discontinued operations	–	776
Operating cash flows	–	85
Investing cash flows	–	(35)
Financing cash flows	–	49
Total cash flows	–	99

4. Operating expenses

All figures in £ millions	2011	2010
By function:		
Cost of goods sold	2,624	2,588
Operating expenses		
Distribution costs	273	298
Administrative and other expenses	2,342	2,190
Other income	(158)	(115)
Total net operating expenses	2,457	2,373
Total	5,081	4,961

Included in other income in 2011 is a profit of £29m on the sale of an investment and a gain of £8m on a stepped acquisition. Both these items are excluded from adjusted earnings.

Notes to the consolidated financial statements continued

4. Operating expenses continued

All figures in £ millions	Notes	2011	2010
By nature:			
Utilisation of inventory	21	829	836
Depreciation of property, plant and equipment	10	70	69
Amortisation of intangible assets – Pre-publication	20	331	350
Amortisation of intangible assets – Other	11	187	152
Employee benefit expense	5	1,983	1,849
Operating lease rentals		185	166
Other property costs		50	50
Royalties expensed		500	524
Advertising, promotion and marketing		280	250
Information technology costs		77	78
Other costs		747	752
Other income		(158)	(115)
Total		5,081	4,961

During the year the Group obtained the following services from the Group's auditors:

All figures in £ millions	2011	2010
Fees payable to the company's auditors for the audit of parent company and consolidated financial statements	4	4
The audit of the company's subsidiaries pursuant to legislation	2	2
Tax services	2	2
Other services	1	2
Total	9	10

Reconciliation between audit and non-audit service fees is shown below:

All figures in £ millions	2011	2010
Group audit fees including fees for attestation under section 404 of the Sarbanes-Oxley Act	6	6
Non-audit fees	3	4
Total	9	10

Fees for attestation under section 404 of the Sarbanes-Oxley Act are allocated between fees payable for the audits of consolidated and subsidiary accounts.

Tax services include services related to tax planning and various other tax advisory matters. Other services mainly relate to due diligence on acquisitions.

5. Employee information

All figures in £ millions	Notes	2011	2010
Employee benefit expense			
Wages and salaries (including termination benefits and restructuring costs)		1,711	1,603
Social security costs		136	121
Share-based payment costs	26	40	35
Retirement benefits – defined contribution plans	25	69	66
Retirement benefits – defined benefit plans	25	24	22
Other post-retirement benefits	25	3	2
Total		1,983	1,849

The details of the emoluments of the directors of Pearson plc are shown in the report on directors' remuneration.

Average number employed	2011	2010
Employee numbers		
North American Education	16,133	14,828
International Education	13,646	10,713
Professional	4,561	3,721
FT Group	2,765	2,557
Penguin	3,557	3,470
Other	859	1,028
Continuing operations	41,521	36,317

Notes to the consolidated financial statements continued

6. Net finance costs

All figures in £ millions	Notes	2011	2010
Interest payable		(66)	(82)
Net finance costs in respect of retirement benefits	25	–	(12)
Finance cost of put options and deferred consideration associated with acquisitions		(4)	–
Net foreign exchange losses		(22)	(9)
Other losses on financial instruments in a hedging relationship:			
– fair value hedges		–	–
Other losses on financial instruments not in a hedging relationship:			
– derivatives		(5)	(6)
Finance costs		(97)	(109)
Interest receivable		11	9
Net finance income in respect of retirement benefits	25	3	–
Net foreign exchange gains		11	18
Other gains on financial instruments in a hedging relationship:			
– fair value hedges		–	–
Other gains on financial instruments not in a hedging relationship:			
– amortisation of transitional adjustment on bonds		1	2
– derivatives		–	7
Finance income		26	36
Net finance costs		(71)	(73)
Analysed as:			
Net interest payable		(55)	(73)
Net finance income/(costs) in respect of retirement benefits	25	3	(12)
Net finance costs reflected in adjusted earnings – continuing operations		(52)	(85)
Other net finance (costs)/income		(19)	12
Total net finance costs		(71)	(73)

The net movement on fair value hedges of nil in both 2011 and 2010 comprises a £39m loss (2010: £40m loss) on the underlying bonds offset by a £39m gain (2010: £40m gain) on the related derivative financial instruments.

7. Income tax

All figures in £ millions	Notes	2011	2010
Current tax			
Charge in respect of current year		(205)	(82)
Adjustments in respect of prior years		43	13
Total current tax charge		(162)	(69)
Deferred tax			
In respect of temporary differences		(35)	(77)
Other adjustments in respect of prior years		(2)	–
Total deferred tax charge	13	(37)	(77)
Total tax charge		(199)	(146)

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	2011	2010
Profit before tax	1,155	670
Tax calculated at UK rate (2011: 26.5%, 2010: 28%)	(306)	(188)
Effect of overseas tax rates	(35)	(40)
Joint venture and associate income reported net of tax	9	11
Net income not subject to tax	6	8
Gain on sale of businesses not subject to tax	88	–
Utilisation of previously unrecognised tax losses and credits	1	56
Unutilised tax losses	(3)	(6)
Adjustments in respect of prior years	41	13
Total tax charge	(199)	(146)
UK	(15)	(28)
Overseas	(184)	(118)
Total tax charge	(199)	(146)
Tax rate reflected in earnings	17.2%	21.8%

A number of changes to the UK corporation tax system were announced in the June 2010 Budget Statement. The Finance (No.2) Act 2010 was enacted in July 2010 and reduced the main rate of corporation tax from 28% to 27% from 1 April 2011. The March 2011 Budget further reduced the rate of corporation tax from 1 April 2011 to 26% and this was substantially enacted at the end of March 2011. The Finance (No. 3) Act 2011 was enacted in July 2011 and reduces the main rate of corporation tax to 25% from 1 April 2012. The reduction in the rate of corporation tax to 25% did not result in a significant movement in the net deferred tax asset owing to the size of the net deferred tax asset in the UK.

Notes to the consolidated financial statements continued

7. Income tax continued

The tax rate reflected in adjusted earnings is calculated as follows:

All figures in £ millions	2011	2010
Profit before tax	1,155	670
Adjustments:		
Other net gains	(435)	(2)
Acquisition costs	12	11
Amortisation of acquired intangibles	139	105
Other net finance costs/(income)	19	(12)
Adjusted profit before tax – continuing operations	890	772
Adjusted profit before tax – discontinued operations	–	81
Total adjusted profit before tax	890	853
Total tax charge	(199)	(146)
Adjustments:		
Tax charge/(benefit) on other net gains	19	(1)
Tax benefit on acquisition costs	(4)	(4)
Tax benefit on amortisation of acquired intangibles	(44)	(35)
Tax (benefit)/charge on other net finance income	(5)	3
Tax amortisation benefit on goodwill and intangibles	34	36
Recognition of pre-acquisition tax losses and capital losses	–	(37)
Adjusted income tax charge – continuing operations	(199)	(184)
Adjusted income tax charge – discontinued operations	–	(31)
Total adjusted income tax charge	(199)	(215)
Tax rate reflected in adjusted earnings	22.4%	25.2%

The tax benefit/(charge) recognised in other comprehensive income is as follows:

All figures in £ millions	2011	2010
Pension contributions and actuarial gains and losses	7	(42)
Net investment hedges and other foreign exchange gains and losses	(4)	1
	3	(41)

A tax benefit of £3m (2010: tax benefit £4m) relating to share-based payments has been recognised directly in equity.

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	2011	2010
Profit for the year from continuing operations		956	524
Non-controlling interest		1	5
Earnings from continuing operations		957	529
Profit for the year from discontinued operations	3	–	776
Non-controlling interest		–	(8)
Earnings		957	1,297
Weighted average number of shares (millions)		800.2	801.2
Effect of dilutive share options (millions)		1.7	1.8
Weighted average number of shares (millions) for diluted earnings		801.9	803.0
Earnings per share from continuing and discontinued operations			
Basic		119.6p	161.9p
Diluted		119.3p	161.5p
Earnings per share from continuing operations			
Basic		119.6p	66.0p
Diluted		119.3p	65.9p
Earnings per share from discontinued operations			
Basic		–	95.9p

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.

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.

Notes to the consolidated financial statements continued

8. Earnings per share continued

Other net finance income/costs include the finance costs of put options and deferred consideration that relate to future earn outs and similar payments on acquisition, foreign exchange and other gains and losses that represent short-term fluctuations in market value and foreign exchange movements on transactions and balances that are no longer in a hedge relationship. In the case of acquisition related items these are excluded as they do not reflect cash expended and foreign exchange and other gains and losses are subject to significant volatility and may not be realised in due course as it is normally the intention to hold these 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 adds the benefit of tax amortisation of goodwill and intangibles as this benefit more accurately aligns the adjusted tax charge with the expected medium-term 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.

									2011
All figures in £ millions	Statutory income statement	Discontinued operations	Other net gains and losses	Acquisition costs	Amortisation of acquired intangibles	Other net finance income/ costs	Tax amortisation benefit	Tax loss recognition	Adjusted income statement
Operating profit	1,226	–	(435)	12	139	–	–	–	942
Net finance costs	(71)	–	–	–	–	19	–	–	(52)
Profit before tax	1,155	–	(435)	12	139	19	–	–	890
Income tax	(199)	–	19	(4)	(44)	(5)	34	–	(199)
Profit for the year	956	–	(416)	8	95	14	34	–	691
Non-controlling interest	1	–	–	–	–	–	–	–	1
Earnings	957	–	(416)	8	95	14	34	–	692
Weighted average number of shares (millions)	800.2								800.2
Adjusted earnings per share	119.6p								86.5p

8. Earnings per share continued

All figures in £ millions	Statutory income statement	Discontinued operations	Other net gains and losses	Acquisition costs	Amortisation of acquired intangibles	Other net finance income/costs	Tax amortisation benefit	Tax loss recognition	Adjusted income statement
									2010
Operating profit	743	81	(2)	11	105	–	–	–	938
Net finance costs	(73)	–	–	–	–	(12)	–	–	(85)
Profit before tax	670	81	(2)	11	105	(12)	–	–	853
Income tax	(146)	(31)	(1)	(4)	(35)	3	36	(37)	(215)
Profit for the year from continuing operations	524	50	(3)	7	70	(9)	36	(37)	638
Profit for the year from discontinued operations	776	(50)	(731)	–	5	–	–	–	–
Profit for the year	1,300	–	(734)	7	75	(9)	36	(37)	638
Non-controlling interest	(3)	–	(12)	–	(2)	–	–	–	(17)
Earnings	1,297	–	(746)	7	73	(9)	36	(37)	621
Weighted average number of shares (millions)	801.2								801.2
Adjusted earnings per share	161.9p								77.5p

9. Dividends

All figures in £ millions	2011	2010
Final paid in respect of prior year 25.7p (2010: 23.3p)	206	187
Interim paid in respect of current year 14.0p (2010: 13.0p)	112	105
	318	292

The directors are proposing a final dividend in respect of the financial year ended 31 December 2011 of 28.0p per share which will absorb an estimated £225m of shareholders' funds. It will be paid on 4 May 2012 to shareholders who are on the register of members on 10 April 2012. These financial statements do not reflect this dividend.

Notes to the consolidated financial statements continued

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 2010	348	815	7	1,170
Exchange differences	8	28	–	36
Additions	21	55	12	88
Disposals	(4)	(58)	–	(62)
Acquisition through business combination	8	25	–	33
Disposal through business disposal	(48)	(201)	–	(249)
Reclassifications	3	5	(8)	–
At 31 December 2010	336	669	11	1,016
Exchange differences	2	(2)	–	–
Additions	15	51	13	79
Disposals	(13)	(31)	–	(44)
Acquisition through business combination	11	21	–	32
Disposal through business disposal	–	(2)	–	(2)
Reclassifications	12	–	(12)	–
At 31 December 2011	363	706	12	1,081

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Depreciation				
At 1 January 2010	(174)	(608)	–	(782)
Exchange differences	(4)	(19)	–	(23)
Charge for the year	(16)	(66)	–	(82)
Disposals	3	58	–	61
Acquisition through business combination	(3)	(13)	–	(16)
Disposal through business disposal	28	164	–	192
At 31 December 2010	(166)	(484)	–	(650)
Exchange differences	(1)	1	–	–
Charge for the year	(16)	(54)	–	(70)
Disposals	2	29	–	31
Acquisition through business combination	(1)	(10)	–	(11)
Disposal through business disposal	–	2	–	2
Reclassifications	(5)	5	–	–
At 31 December 2011	(187)	(511)	–	(698)
Carrying amounts				
At 1 January 2010	174	207	7	388
At 31 December 2010	170	185	11	366
At 31 December 2011	176	195	12	383

10. Property, plant and equipment continued

Depreciation expense of £15m (2010: £10m) has been included in the income statement in cost of goods sold, £10m (2010: £7m) in distribution expenses and £45m (2010: £52m) in administrative and other expenses. In 2011 £nil (2010: £13m) 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 £18m (2010: £12m).

11. Intangible assets

All figures in £ millions	Goodwill	Software	Acquired customer lists and relationships	Acquired trademarks and brands	Acquired publishing rights	Other intangibles acquired	Total
Cost							
At 1 January 2010	4,346	339	347	143	215	261	5,651
Exchange differences	140	9	10	4	9	10	182
Additions – internal development	–	41	–	–	–	–	41
Additions – purchased	–	15	–	–	–	–	15
Disposals	(11)	(18)	–	–	–	–	(29)
Acquisition through business combination	288	9	159	40	6	76	578
Disposal through business disposal	(195)	(43)	(85)	(1)	–	(41)	(365)
At 31 December 2010	4,568	352	431	186	230	306	6,073
Exchange differences	15	(1)	1	(1)	(12)	(1)	1
Additions – internal development	–	49	–	–	–	–	49
Additions – purchased	–	28	–	–	–	–	28
Disposals	–	(9)	–	–	–	–	(9)
Acquisition through business combination	620	9	200	68	–	100	997
Disposal through business disposal	(4)	–	–	–	(5)	–	(9)
At 31 December 2011	5,199	428	632	253	213	405	7,130

Notes to the consolidated financial statements continued

11. Intangible assets continued

All figures in £ millions	Goodwill	Software	Acquired customer lists and relationships	Acquired trademarks and brands	Acquired publishing rights	Other intangibles acquired	Total
Amortisation							
At 1 January 2010		(224)	(96)	(27)	(85)	(90)	(522)
Exchange differences	–	(5)	(3)	(2)	(2)	(1)	(13)
Charge for the year	–	(51)	(39)	(12)	(24)	(38)	(164)
Disposals	–	16	–	–	–	–	16
Acquisition through business combination	–	(5)	–	–	–	–	(5)
Disposal through business disposal	–	19	35	–	–	28	82
At 31 December 2010	–	(250)	(103)	(41)	(111)	(101)	(606)
Exchange differences	–	(2)	1	–	4	(3)	–
Charge for the year	–	(48)	(55)	(22)	(22)	(40)	(187)
Disposals	–	6	–	–	–	–	6
Acquisition through business combination	–	(2)	–	–	–	–	(2)
Disposal through business disposal	–	–	–	–	1	–	1
At 31 December 2011	–	(296)	(157)	(63)	(128)	(144)	(788)
Carrying amounts							
At 1 January 2010	4,346	115	251	116	130	171	5,129
At 31 December 2010	4,568	102	328	145	119	205	5,467
At 31 December 2011	5,199	132	475	190	85	261	6,342

Goodwill

The goodwill carrying value of £5,199m 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. £3,138m of the carrying value relates to acquisitions completed between 1 January 1998 and 31 December 2002 and £2,061m relates to acquisitions completed after 1 January 2003 (the date of transition to IFRS).

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, contracts and software rights.

Amortisation of £10m (2010: £3m) is included in the income statement in cost of goods sold and £177m (2010: £149m) in administrative and other expenses. In 2011 £nil (2010: £12m) of amortisation relates to discontinued operations.

11. Intangible assets continued

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 in respect of continuing operations is allocated to 13 cash-generating units (CGUs) within the business segments as follows:

All figures in £ millions	2011	2010
US Education Publishing	2,127	1,976
US School Assessment and Information	792	683
Canada	192	197
International – Emerging Markets	508	310
International – UK	460	398
International – Rest Of World	228	205
Professional Publishing	13	13
Professional Assessment and Training	377	287
Pearson Education total	4,697	4,069
Financial Times	49	48
Mergermarket	138	136
FT Group total	187	184
Penguin US	198	196
Penguin UK	102	103
Penguin Asia Pacific & International	15	16
Penguin total	315	315
Total goodwill	5,199	4,568

Following a reorganisation within the International Education business the CGUs have been re-analysed into Emerging Markets, UK and Rest Of World to align with the management and reporting structure. The goodwill has been reallocated accordingly.

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 rate 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 13.3% for the Pearson Education businesses (2010: 11.2% to 12.1%), 11.6% to 17.9% for the FT Group businesses (2010: 12.9% to 20.0%) and 10.7% to 12.5% for the Penguin businesses (2010: 10.5% to 13.0%).

Notes to the consolidated financial statements continued

11. Intangible assets continued

Impairment tests for cash-generating units containing goodwill continued

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 2011 (2010: 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

Joint ventures

All figures in £ millions	2011	2010
At beginning of year	18	18
Exchange differences	(3)	–
Share of loss after tax	(2)	(1)
Dividends	(2)	(3)
Additions and further investment	7	4
At end of year	18	18

Investments in joint ventures are accounted for using the equity method of accounting and are initially recognised at cost. The total goodwill recorded on acquisition of joint ventures at 31 December 2011 was £11m (2010: £12m).

12. Investments in joint ventures and associates continued

The aggregate of the Group's share of its joint ventures' assets (including goodwill) and liabilities, none of which are individually significant, are as follows:

All figures in £ millions	2011	2010
Assets		
Non-current assets	15	15
Current assets	17	14
Liabilities		
Non-current liabilities	(1)	–
Current liabilities	(13)	(11)
Net assets	18	18
Income	22	17
Expenses	(24)	(18)
Loss after tax	(2)	(1)

Associates

All figures in £ millions	2011	2010
At beginning of year	53	12
Exchange differences	(3)	(1)
Share of profit after tax	35	42
Dividends	(30)	(20)
Additions	2	17
Disposals	(15)	–
Reversal of distribution from associate in excess of carrying value	–	(7)
Actuarial (losses)/gains on retirement benefit obligations	(8)	1
Transfer from other financial assets	–	9
Transfer to subsidiary	(20)	–
At end of year	14	53

In addition to the amounts disclosed above, FTSE International Ltd paid royalties of £13m (2010: £11m) to the FT Group during the year. This royalty payment ceased upon the disposal of FTSE International Ltd.

Included in the share of profit after tax in 2010 is a gain in fair value of £12m arising on a stepped acquisition by FTSE International Ltd.

Investments in associates are accounted for using the equity method of accounting and are initially recognised at cost. The total goodwill recorded on acquisition of associates at 31 December 2011 was £nil (2010: £21m).

The Group's interests in its principal associates, all of which are unlisted, are as follows:

	2011					
All figures in £ millions	Country of incorporation	% interest held	Assets	Liabilities	Revenues	Profit
The Economist Newspaper Ltd	England	50	140	(140)	179	27
FTSE International Ltd *	England	50	–	–	31	7
Other			16	(2)	15	1
Total			156	(142)	225	35

* FTSE International Ltd included to date of disposal

Notes to the consolidated financial statements continued

12. Investments in joint ventures and associates continued

All figures in £ millions	Country of incorporation	% interest held	Assets	Liabilities	Revenues	Profit
						2010
The Economist Newspaper Ltd	England	50	129	(129)	169	25
FTSE International Ltd	England	50	62	(44)	45	17
Other			41	(6)	9	–
Total			232	(179)	223	42

The interests held in associates are equivalent to voting rights.

On 16 December 2011 the Group sold its 50% interest in FTSE International Ltd.

Gain on sale of FTSE International Ltd

All figures in £ millions	2011
Proceeds	428
Disposal costs	(1)
Net assets disposed	(15)
Gain on sale	412

13. Deferred income tax

All figures in £ millions	2011	2010
Deferred income tax assets	287	276
Deferred income tax liabilities	(620)	(471)
Net deferred income tax	(333)	(195)

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. The Group has unrecognised deferred income tax assets of £13m at 31 December 2011(2010: £14m) in respect of UK losses, and approximately £15m (2010: £16m) in respect of losses in other territories. None of the unrecognised UK losses have expiry dates associated with them.

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	2011	2010
At beginning of year		(195)	(86)
Exchange differences		(5)	(4)
Income statement charge	7	(37)	(72)
Acquisition through business combination	30	(96)	(37)
Disposal through business disposal	31	1	47
Tax charge to other comprehensive income or equity		(1)	(43)
At end of year		(333)	(195)

Included in the income statement charge above for 2010 is a £5m credit relating to discontinued operations.

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
Deferred income tax assets						
At 1 January 2010	22	11	92	68	194	387
Exchange differences	1	–	3	–	5	9
Acquisition through business combination	–	–	–	–	4	4
Disposal through business disposal	–	–	–	–	(7)	(7)
Income statement (charge)/benefit	(18)	(7)	1	(9)	(35)	(68)
Tax (charge)/benefit to other comprehensive income or equity	–	–	–	(53)	4	(49)
At 31 December 2010	5	4	96	6	165	276
Exchange differences	–	–	1	–	2	3
Acquisition through business combination	8	–	–	–	1	9
Income statement benefit/ (charge)	1	(4)	(8)	19	(6)	2
Tax (charge)/benefit to other comprehensive income or equity	–	–	–	(6)	3	(3)
At 31 December 2011	14	–	89	19	165	287

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 2010	(319)	(154)	(473)
Exchange differences	(9)	(4)	(13)
Acquisition through business combination	(41)	–	(41)
Disposal through business disposal	25	29	54
Income statement benefit/(charge)	10	(14)	(4)
Tax benefit to other comprehensive income or equity	–	6	6
At 31 December 2010	(334)	(137)	(471)
Exchange differences	(6)	(2)	(8)
Acquisition through business combination	(102)	(3)	(105)
Disposal through business disposal	–	1	1
Income statement charge	(22)	(17)	(39)
Tax benefit to other comprehensive income or equity	–	2	2
At 31 December 2011	(464)	(156)	(620)

Other deferred income tax liabilities include temporary differences in respect of depreciation and royalty advances.

Notes to the consolidated financial statements continued

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:

									2011
					Fair value	Amortised cost			
All figures in £ millions	Notes	Available for sale	Derivatives deemed held for trading	Derivatives in hedging relationships	Other liabilities	Loans and receivables	Other liabilities	Total carrying value	Total market value
Investments in unlisted securities	15	26	–	–	–	–	–	26	26
Cash and cash equivalents	17	–	–	–	–	1,369	–	1,369	1,369
Marketable securities		9	–	–	–	–	–	9	9
Derivative financial instruments	16	–	3	174	–	–	–	177	177
Trade receivables	22	–	–	–	–	1,061	–	1,061	1,061
Total financial assets		35	3	174	–	2,430	–	2,642	2,642
Derivative financial instruments	16	–	(1)	(2)	–	–	–	(3)	(3)
Trade payables	24	–	–	–	–	–	(483)	(483)	(483)
Other financial liabilities – put options over non-controlling interest	24	–	–	–	(86)	–	–	(86)	(86)
Bank loans and overdrafts	18	–	–	–	–	–	(78)	(78)	(78)
Borrowings due within one year	18	–	–	–	–	–	(9)	(9)	(9)
Borrowings due after more than one year	18	–	–	–	–	–	(1,964)	(1,964)	(2,000)
Total financial liabilities		–	(1)	(2)	(86)	–	(2,534)	(2,623)	(2,659)

14. Classification of financial instruments continued

All figures in £ millions	Notes	Available for sale	Derivatives deemed held for trading	Derivatives in hedging relationships	Other liabilities	Loans and receivables	Other liabilities	Total carrying value	Total market value
									2010
			Fair value			Amortised cost			
Investments in unlisted securities	15	58	–	–	–	–	–	58	58
Cash and cash equivalents	17	–	–	–	–	1,736	–	1,736	1,736
Marketable securities		12	–	–	–	–	–	12	12
Derivative financial instruments	16	–	8	132	–	–	–	140	140
Trade receivables	22	–	–	–	–	1,031	–	1,031	1,031
Total financial assets		70	8	132	–	2,767	–	2,977	2,977
Derivative financial instruments	16	–	–	(6)	–	–	–	(6)	(6)
Trade payables	24	–	–	–	–	–	(470)	(470)	(470)
Other financial liabilities – put option over non-controlling interest	24	–	–	–	(25)	–	–	(25)	(25)
Bank loans and overdrafts	18	–	–	–	–	–	(73)	(73)	(73)
Borrowings due within one year	18	–	–	–	–	–	(331)	(331)	(333)
Borrowings due after more than one year	18	–	–	–	–	–	(1,908)	(1,908)	(1,939)
Total financial liabilities		–	–	(6)	(25)	–	(2,782)	(2,813)	(2,846)

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.

Notes to the consolidated financial statements continued

15. Other financial assets

All figures in £ millions	2011	2010
At beginning of year	58	62
Exchange differences	–	1
Acquisition of investments	12	7
Transfers to associates	–	(9)
Disposal of investments	(44)	(3)
At end of year	26	58

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:

	2011			2010		
All figures in £ millions	Gross notional amounts	Assets	Liabilities	Gross notional amounts	Assets	Liabilities
Interest rate derivatives – in a fair value hedge relationship	1,208	151	–	1,327	112	–
Interest rate derivatives – not in a hedge relationship	65	3	(1)	256	8	–
Cross currency rate derivatives – in a net investment hedge relationship	220	23	(2)	220	20	(6)
Total	1,493	177	(3)	1,803	140	(6)
Analysed as expiring:						
In less than one year	–	–	(1)	319	6	–
Later than one year and not later than five years	946	81	(2)	749	74	(6)
Later than five years	547	96	–	735	60	–
Total	1,493	177	(3)	1,803	140	(6)

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 2011, 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 £(66)m, sterling £263m and South African rand £(23)m (2010: US dollar £(97)m, sterling £259m and South African rand £(28)m).

The fixed interest rates on outstanding rate derivative contracts at the end of 2011 range from 3.65% to 9.28% (2010: 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.

16. Derivative financial instruments continued

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	2011	2010
Cash at bank and in hand	864	763
Short-term bank deposits	505	973
	1,369	1,736

Short-term bank deposits are invested with banks and earn interest at the prevailing short-term deposit rates.

At the end of 2011 the currency split of cash and cash equivalents was US dollar 31% (2010: 73%), sterling 38% (2010: 9%), euro 8% (2010: 6%) and other 23% (2010: 12%).

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	2011	2010
Cash and cash equivalents	1,369	1,736
Bank overdrafts	(78)	(72)
	1,291	1,664

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	2011	2010
Non-current		
5.5% Global Dollar Bonds 2013 (nominal amount $350m)	233	236
5.7% US Dollar Bonds 2014 (nominal amount $400m)	286	288
7.0% Sterling Bonds 2014 (nominal amount £250m)	257	256
6.0% Sterling Bonds 2015 (nominal amount £300m)	298	297
4.0% US Dollar Notes 2016 (nominal amount $350m)	238	227
6.25% Global Dollar Bonds 2018 (nominal amount $550m)	419	389
4.625% US Dollar Notes 2018 (nominal amount $300m)	224	208
Finance lease liabilities	9	7
	1,964	1,908
Current		
Due within one year or on demand:		
Bank loans and overdrafts	78	73
7.0% Global Dollar Bonds 2011 (nominal amount $500m)	–	325
Finance lease liabilities	9	6
	87	404
Total borrowings	2,051	2,312

Included in the non-current borrowings above is £12m of accrued interest (2010: £12m). Included in the current borrowings above is £nil of accrued interest (2010: £1m).

The maturity of the Group's non-current borrowing is as follows:

All figures in £ millions	2011	2010
Between one and two years	241	4
Between two and five years	1,080	1,080
Over five years	643	824
	1,964	1,908

18. Financial liabilities – Borrowings continued

The carrying amounts and market values of borrowings are as follows:

All figures in £ millions	2011 Effective interest rate	2011 Carrying value	2011 Market value	2010 Carrying value	2010 Market value
Bank loans and overdrafts	n/a	78	78	73	73
7.0% Global Dollar Bonds 2011	n/a	–	–	325	327
5.5% Global Dollar Bonds 2013	5.76%	233	237	236	241
5.7% US Dollar Bonds 2014	5.88%	286	280	288	277
7.0% Sterling Bonds 2014	7.20%	257	282	256	282
6.0% Sterling Bonds 2015	6.27%	298	340	297	329
4.0% US Dollar Notes 2016	4.26%	238	237	227	226
6.25% Global Dollar Bonds 2018	6.46%	419	409	389	385
4.625% US Dollar Notes 2018	4.69%	224	206	208	192
Finance lease liabilities	n/a	18	18	13	13
		2,051	2,087	2,312	2,345

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	2011	2010
US dollar	1,488	1,759
Sterling	563	553
Euro	–	–
	2,051	2,312

The Group has the following undrawn capacity on its committed borrowing facilities as at 31 December:

All figures in £ millions	2011	2010
Floating rate		
– expiring within one year	–	–
– expiring beyond one year	1,126	1,118
	1,126	1,118

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	2011	2010
Finance lease liabilities – minimum lease payments		
Not later than one year	9	6
Later than one year and not later than two years	8	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	18	13

The present value of finance lease liabilities is as follows:

All figures in £ millions	2011	2010
Not later than one year	9	6
Later than one year and not later than five years	9	7
Later than five years	–	–
	18	13

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 below. All the treasury policies remained unchanged throughout, except for a revision to the Group's bank counterparty limits.

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 2011 the fixed to floating hedging ratio, on the above basis, was approximately 104%. This above-policy level reflects the receipt of the proceeds from the divestment of FTSE International Ltd in December 2011, combined with strong cash collections, resulting in lower than typical net debt and hence a higher hedging ratio. Our policy does not require us to cancel derivative contracts and we expect to return to compliance with this policy during 2012. A simultaneous 1% change on 1 January 2012 in the Group's variable interest rates in US dollar and sterling, taking into account forecast seasonal debt, would have a £1m 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 2011 the average maturity of gross borrowings was 4.0 years (2010: 4.4 years) of which bonds represented 95% (2010: 96%) 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. 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 2011 the committed facilities amounted to £1,126m and their weighted average maturity was 3.9 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	2011	2010
Cash and cash equivalents	1,369	1,736
Marketable securities	9	12
Derivative financial instruments	174	134
Bank loans, overdrafts and loan notes	(78)	(73)
Bonds	(1,955)	(2,226)
Finance lease liabilities	(18)	(13)
Net debt	(499)	(430)

The split of net debt between fixed and floating rate, stated after the impact of rate derivatives, is as follows:

All figures in £ millions	2011	2010
Fixed rate	510	577
Floating rate	(11)	(147)
Total	499	430

Gross borrowings, after the impact of cross-currency rate derivatives, analysed by currency are as follows:

All figures in £ millions	2011	2010
US dollar	1,687	1,954
Sterling	343	333
Other	21	25
Total	2,051	2,312

As at 31 December 2011 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	87	1,321	643	2,051
Effect of rate derivatives	1,273	(726)	(547)	–
Total	1,360	595	96	2,051

19. Financial risk management continued

The maturity of contracted cash flows associated with the Group's financial liabilities are as follows:

				2011
All figures in £ millions	USD	GBP	Other	Total
Not later than one year	261	124	156	541
Later than one year and not later than five years	984	378	25	1,387
Later than five years	563	–	–	563
Total	1,808	502	181	2,491
Analysed as:				
Bonds	1,553	675	–	2,228
Rate derivatives – inflows	(292)	(281)	–	(573)
Rate derivatives – outflows	321	5	27	353
Trade creditors	226	103	154	483
Total	1,808	502	181	2,491

				2010
All figures in £ millions	USD	GBP	Other	Total
Not later than one year	571	117	160	848
Later than one year and not later than five years	767	399	32	1,198
Later than five years	792	–	–	792
Total	2,130	516	192	2,838
Analysed as:				
Bonds	1,938	710	–	2,648
Rate derivatives – inflows	(364)	(297)	–	(661)
Rate derivatives – outflows	340	7	34	381
Trade creditors	216	96	158	470
Total	2,130	516	192	2,838

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 £1,266m, sterling £(185)m and South African rand £(1)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	2011 Level 1	2011 Level 2	2011 Level 3	2011 Total	2010 Level 1	2010 Level 2	2010 Level 3	2010 Total
Financial assets at fair value								
Derivative financial assets	–	177	–	177	–	140	–	140
Marketable securities	–	9	–	9	–	12	–	12
Available for sale financial assets								
Investments in unlisted securities	–	–	26	26	–	–	58	58
Financial liabilities at fair value								
Derivative financial liabilities	–	(3)	–	(3)	–	(6)	–	(6)
Other financial liabilities – put options over non-controlling interest	–	–	(86)	(86)	–	–	(25)	(25)
Total	–	183	(60)	123	–	146	33	179

The following table analyses the movements in level 3 fair value measurements:

All figures in £ millions	2011 Investments in unlisted securities	2011 Other financial liabilities	2010 Investments in unlisted securities	2010 Other financial liabilities
At beginning of year	58	(25)	62	(23)
Exchange differences	–	3	1	–
Additions	13	(63)	7	(2)
Fair value movements	–	(1)	–	–
Disposals	(45)	–	(12)	–
At end of year	26	(86)	58	(25)

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. The fair value of other financial liabilities represents the present value of the estimated future liability.

Financial instruments – sensitivity analysis

As at 31 December 2011 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	26	–	–	1	(1)
Cash and cash equivalents	1,369	–	–	(78)	96
Marketable securities	9	–	–	–	–
Derivative financial instruments	174	(53)	56	8	(10)
Bonds	(1,955)	52	(53)	127	(156)
Other borrowings	(96)	–	–	8	(10)
Put options over non-controlling interest	(86)	–	–	8	(10)
Other net financial assets	578	–	–	(43)	53
Total financial instruments	19	(1)	3	31	(38)

Notes to the consolidated financial statements continued

19. Financial risk management continued

Financial instruments – sensitivity analysis continued

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, depending on the location and functional currency of the entity in which they arise and the availability of net investment hedge treatment. The changes in valuations are estimates of the impact of changes in market variables and are not a prediction of future events or anticipated gains or losses.

20. Intangible assets – Pre-publication

All figures in £ millions	2011	2010
Cost		
At beginning of year	1,863	1,727
Exchange differences	6	52
Additions	331	319
Disposals	(249)	(248)
Acquisition through business combination	14	13
At end of year	1,965	1,863
Amortisation		
At beginning of year	(1,216)	(1,077)
Exchange differences	(11)	(33)
Charge for the year	(331)	(350)
Disposals	249	248
Acquisition through business combination	(6)	(4)
At end of year	(1,315)	(1,216)
Carrying amounts		
At end of year	650	647

Included in the above are pre-publication assets amounting to £413m (2010: £399m) which will be realised in more than one year.

Amortisation is included in the income statement in cost of goods sold.

21. Inventories

All figures in £ millions	2011	2010
Raw materials	24	34
Work in progress	20	19
Finished goods	363	376
	407	429

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 £829m (2010: £836m). In 2011 £74m (2010: £87m) of inventory provisions was charged in the income statement. None of the inventory is pledged as security.

22. Trade and other receivables

All figures in £ millions	2011	2010
Current		
Trade receivables	1,048	1,028
Royalty advances	107	111
Prepayments and accrued income	90	77
Other receivables	141	121
	1,386	1,337
Non-current		
Trade receivables	13	3
Royalty advances	88	89
Prepayments and accrued income	34	28
Other receivables	16	9
	151	129

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	2011	2010
At beginning of year	(83)	(76)
Exchange differences	1	(2)
Income statement movements	(31)	(33)
Utilised	17	26
Acquisition through business combination	(8)	(3)
Disposal through business disposal	2	5
At end of year	(102)	(83)

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	2011	2010
Within due date	1,097	1,180
Up to three months past due date	297	234
Three to six months past due date	46	39
Six to nine months past due date	10	6
Nine to 12 months past due date	14	13
More than 12 months past due date	50	21
Total trade receivables	1,514	1,493
Less: provision for bad and doubtful debts	(102)	(83)
Less: provision for sales returns	(351)	(379)
Net trade receivables	1,061	1,031

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.

Notes to the consolidated financial statements continued

23. Provisions for other liabilities and charges

All figures in £ millions	Deferred consideration	Property	Legal and other	Total
At 1 January 2011	29	20	11	60
Exchange differences	–	–	1	1
Charged to income statement	1	2	32	35
Released to income statement	–	(3)	–	(3)
Acquisition through business combination – current year	69	–	9	78
Utilised	(2)	(2)	(4)	(8)
At 31 December 2011	97	17	49	163

All figures in £ millions	2011	2010
Analysis of provisions		
Non-current	115	42
Current	48	18
	163	60

Deferred consideration primarily relates to the acquisition of Fronter in 2009 and the formation of a venture in the US Professional business in 2011 for which deferred consideration of £66m is recognised.

Legal and other includes provisions in relation to legal claims, contract disputes and potential contract losses.

24. Trade and other liabilities

All figures in £ millions	2011	2010
Trade payables	483	470
Social security and other taxes	25	22
Accruals	544	559
Deferred income	678	559
Interest payable	18	12
Put options over non-controlling interest	86	25
Other liabilities	232	204
	2,066	1,851
Less: non-current portion		
Accruals	25	26
Deferred income	147	120
Put options over non-controlling interest	62	25
Interest payable	6	–
Other liabilities	85	75
	325	246
Current portion	1,741	1,605

The carrying value of the Group’s trade and other liabilities approximates its fair value.

24. Trade and other liabilities continued

The deferred income balance comprises principally: multi-year obligations to deliver workbooks to adoption customers in school businesses; advance payments in assessment and testing businesses; subscription income in school and newspaper businesses; and obligations to deliver digital content in future periods.

The put options over non-controlling interest are the fair value of options held by the non-controlling interests in the Group's Southern African, Indian and Mexican 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. For the defined benefit plans, benefits are based on employees' length of service and final pensionable pay. Defined contribution benefits are based on the amount of contributions paid in respect of an individual member, the investment returns earned and the amount of pension this money will buy when a member retires.

The largest plan is the Pearson Group Pension Plan ('UK Group plan') with both defined benefit and defined contribution sections. From 1 November 2006, all sections of the UK Group plan were closed to new members with the exception of a defined contribution section that was opened in 2003. This section is available to all new employees of participating companies. The other major defined benefit plans are based in the US.

Other defined contribution plans are operated principally overseas with the largest plan being in the US. The specific features of these plans vary in accordance with the regulations of the country in which employees are located.

Pearson 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.

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.

			2011			2010
%	UK Group plan	Other plans	PRMB	UK Group plan	Other plans	PRMB
Inflation	3.0	2.5	2.5	3.5	2.5	2.5
Rate used to discount plan liabilities	4.9	4.2	4.2	5.5	5.1	5.1
Expected return on assets	5.7	6.4	–	6.0	6.6	–
Expected rate of increase in salaries	4.0	4.0	–	4.7	4.0	–
Expected rate of increase for pensions in payment and deferred pensions	2.4 to 4.3	–	–	2.6 to 4.4	–	–
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 the annualised yield on the iBoxx over 15-year AA-rated corporate bond index, 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 3.0% 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 2.0% has been used. The change from RPI to CPI for deferred revaluation and Post 88 GMP pension increases in payment for 2010 has been included in the prior year results, resulting in a gain of £23m, taken as an actuarial gain on the obligation.

Notes to the consolidated financial statements continued

25. Retirement benefit and other post-retirement obligations continued

The expected rates of return on categories of plan assets are determined by reference to relevant indices. The overall expected rate of return is calculated by weighting the individual rates in accordance with the anticipated balance in the plan's investment portfolio, plus a diversification premium.

The expected rate of increase in salaries has been set at 4.0% for 2011 with a short-term assumption of 3.3% 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 medium cohort improvement factors. A 1.5% improvement floor on the medium cohort is applied for males, and 1.25% for females, with tapering.

For the US plans the RP2000 table is used, reflecting the mortality assumption most prevalent in the US. In 2010 a 10 year projection was added.

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	
	2011	2010	2011	2010
Male	22.6	22.8	19.2	18.4
Female	23.5	23.6	21.1	20.6

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	
	2011	2010	2011	2010
Male	25.2	25.4	19.2	18.4
Female	25.6	25.7	21.1	20.6

Financial statement information

The amounts recognised in the income statement are as follows:

						2011
All figures in £ millions	UK Group plan	Defined benefit other	Sub-total	Defined contribution	PRMB	Total
Current service cost	21	3	24	69	3	96
Total operating expense	21	3	24	69	3	96
Expected return on plan assets	(107)	(7)	(114)	–	–	(114)
Interest on plan liabilities	100	8	108	–	3	111
Net finance (income)/expense	(7)	1	(6)	–	3	(3)
Net income statement charge	14	4	18	69	6	93
Actual return on plan assets	161	5	166	–	–	166

25. Retirement benefit and other post-retirement obligations continued

All figures in £ millions	UK Group plan	Defined benefit other	Sub-total	Defined contribution	PRMB	Total
						2010
Current service cost	21	2	23	68	2	93
Curtailments	(5)	–	(5)	–	–	(5)
Total operating expense	16	2	18	68	2	88
Expected return on plan assets	(93)	(7)	(100)	–	–	(100)
Interest on plan liabilities	100	9	109	–	3	112
Net finance expense	7	2	9	–	3	12
Net income statement charge	23	4	27	68	5	100
Actual return on plan assets	177	13	190	–	–	190

There are no amounts in the 2011 results relating to discontinued operations.

Included within the 2010 results are discontinued operations of £5m relating to the curtailment credit, a £1m charge relating to defined benefit schemes and a £2m charge relating to defined contribution schemes.

The amounts recognised in the balance sheet are as follows:

All figures in £ millions	UK Group plan	Other funded plans	Other unfunded plans	Total	UK Group plan	Other funded plans	Other unfunded plans	Total
				2011				2010
Fair value of plan assets	2,008	149	–	2,157	1,847	135	–	1,982
Present value of defined benefit obligation	(1,983)	(173)	(24)	(2,180)	(1,852)	(158)	(20)	(2,030)
Net pension asset/(liability)	25	(24)	(24)	(23)	(5)	(23)	(20)	(48)
Other post-retirement medical benefit obligation				(85)				(72)
Other pension accruals				(33)				(28)
Net retirement benefit obligations				(141)				(148)
Analysed as:								
Retirement benefit assets				25				–
Retirement benefit obligations				(166)				(148)

The following (losses)/gains have been recognised in other comprehensive income:

All figures in £ millions	2011	2010
Amounts recognised for defined benefit plans	(47)	75
Amounts recognised for post-retirement medical benefit plans	(9)	(5)
Total recognised in year	(56)	70
Cumulative amounts recognised	(232)	(176)

Notes to the consolidated financial statements continued

25. Retirement benefit and other post-retirement obligations continued

The fair value of plan assets comprises the following:

	2011			2010		
%	UK Group plan	Other funded plans	Total	UK Group plan	Other funded plans	Total
Equities	31.6	2.7	34.3	27.0	3.3	30.3
Bonds	44.7	3.4	48.1	49.3	2.7	52.0
Properties	11.1	0.1	11.2	11.2	0.1	11.3
Other	5.6	0.8	6.4	5.6	0.8	6.4

The plan assets do not include any of the Group's own financial instruments, or any property occupied by the Group.

Changes in the values of plan assets and liabilities of the retirement benefit plans are as follows:

	2011			2010		
All figures in £ millions	UK Group plan	Other plans	Total	UK Group plan	Other plans	Total
Fair value of plan assets						
Opening fair value of plan assets	1,847	135	1,982	1,609	118	1,727
Exchange differences	–	1	1	–	4	4
Expected return on plan assets	107	7	114	93	7	100
Actuarial gains/(losses)	54	(2)	52	84	6	90
Contributions by employer	71	18	89	132	13	145
Contributions by employee	3	–	3	3	–	3
Benefits paid	(74)	(10)	(84)	(74)	(13)	(87)
Closing fair value of plan assets	2,008	149	2,157	1,847	135	1,982
Present value of defined benefit obligation						
Opening defined benefit obligation	(1,852)	(178)	(2,030)	(1,798)	(169)	(1,967)
Exchange differences	–	–	–	–	(5)	(5)
Current service cost	(21)	(3)	(24)	(21)	(2)	(23)
Curtailment	–	–	–	5	–	5
Interest cost	(100)	(8)	(108)	(100)	(9)	(109)
Actuarial losses	(81)	(18)	(99)	(9)	(6)	(15)
Contributions by employee	(3)	–	(3)	(3)	–	(3)
Benefits paid	74	10	84	74	13	87
Closing defined benefit obligation	(1,983)	(197)	(2,180)	(1,852)	(178)	(2,030)

25. Retirement benefit and other post-retirement obligations continued

Changes in the value of the US PRMB are as follows:

All figures in £ millions	2011	2010
Opening defined benefit obligation	(72)	(65)
Exchange differences	(2)	(2)
Current service cost	(3)	(2)
Interest cost	(3)	(3)
Actuarial losses	(9)	(5)
Benefits paid	4	5
Closing defined benefit obligation	(85)	(72)

The history of the defined benefit plans is as follows:

All figures in £ millions	2011	2010	2009	2008	2007
Fair value of plan assets	2,157	1,982	1,727	1,578	1,853
Present value of defined benefit obligation	(2,180)	(2,030)	(1,967)	(1,594)	(1,811)
Net pension (liability)/asset	(23)	(48)	(240)	(16)	42
Experience adjustments on plan assets	52	90	56	(268)	29
Experience adjustments on plan liabilities	(99)	(15)	(351)	194	50

Funding

The UK Group plan is self-administered with the plan's assets being held independently of the Group. The trustees of the plan are required to act in the best interest of the plan's beneficiaries. The most recent triennial actuarial valuation for funding purposes was completed as at 1 January 2009 and this valuation revealed a funding shortfall. The Group has agreed that the funding shortfall will be eliminated by 31 December 2020. In 2011 the Group contributed £48m (2010: £41m) towards the funding shortfall and has agreed to contribute a similar amount per annum until 2020 in excess of regular contributions. Regular contributions to the plan are estimated to be £22m for 2012.

Under UK law (section 75 debt) a company that participates in a multi-employer defined benefit plan is liable, on withdrawal from that pension plan, for its share of the total deficit in the plan calculated on a 'solvency' or 'buy out' basis. The Interactive Data sale and the termination of Interactive Data Corporation (Europe) Ltd's participation in the UK Group plan triggered this 'section 75' liability. £68m was contributed to the plan in respect of this liability in 2010.

The Group expects to contribute $83m in 2012 and $86m in 2013 to its US pension plans.

Future benefit payments

The following table shows the expected benefit payments from the defined benefit plans over the next 10 years. These use actuarial assumptions as at 31 December 2011. These represent payments from the pension funds to pensioners and others entitled to benefits, and are not an indication of payments from the company. For company funding requirements refer to the prior section.

Notes to the consolidated financial statements continued

25. Retirement benefit and other post-retirement obligations continued

All figures in £ millions	UK Group plan	Defined benefit other	Total
Expected future benefit payments:			
2012	74	24	98
2013	76	23	99
2014	79	24	103
2015	82	21	103
2016	86	18	104
2017 to 2021 combined	479	80	559

Sensitivities

The net retirement benefit obligations are calculated using a number of assumptions, the most significant being the discount rate used to calculate the defined benefit obligation. 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	2011	
	1% increase	1% decrease
Effect on:		
(Decrease)/increase in defined benefit obligation – UK Group plan	(282.0)	348.5
Decrease of aggregate of service cost and interest cost – UK Group plan	(0.7)	(1.2)
(Decrease)/increase in defined benefit obligation – US plan	(11.7)	14.0

The effect of members living one year more or one year less on the defined benefit obligation is as follows:

All figures in £ millions	2011	
	1 year increase	1 year decrease
Effect on:		
Increase/(decrease) in defined benefit obligation – UK Group plan	53.6	(52.1)
Increase/(decrease) in defined benefit obligation – US plan	1.9	(2.0)

The effect of a one percentage point increase and decrease in the assumed medical cost trend rates is as follows:

All figures in £ millions	2011	
	1% increase	1% decrease
Effect on:		
Increase/(decrease) in post-retirement medical benefit obligation	3.2	(2.8)
Increase/(decrease) of aggregate of service cost and interest cost	0.1	(0.1)

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	2011	2010
Pearson plans	40	35

Share-based payments included in discontinued operations amounted to £nil (2010: £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 two parts: share options and/or restricted shares.

Options were last granted under this plan in 2001 based on a pre-grant earnings per share growth test and were not subject to further performance conditions on exercise. The options became exercisable in tranches and lapsed if they remained unexercised at the tenth anniversary of the date of grant. Any outstanding options remaining lapsed during 2011.

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 March 2010 and May 2011 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 2010 and 2011 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.

In addition to the above, share options under Executive Share Option, Reward and Special Share Option Plans, legacy plans which were replaced with the introduction of the Long-Term Incentive Plan in 2001, lapsed during 2011.

Notes to the consolidated financial statements continued

26. Share-based payments continued

The number and weighted average exercise prices of share options granted under the Group's plans are as follows:

	2011		2010	
	Number of share options 000s	Weighted average exercise price £	Number of share options 000s	Weighted average exercise price £
Outstanding at beginning of year	8,878	10.20	12,487	12.78
Granted during the year	1,157	8.92	628	8.06
Exercised during the year	(2,323)	7.27	(1,154)	7.12
Forfeited during the year	(457)	8.54	(457)	9.08
Expired during the year	(4,052)	14.12	(2,626)	23.47
Outstanding at end of year	3,203	7.15	8,878	10.20
Options exercisable at end of year	64	5.54	5,825	12.40

Options were exercised regularly throughout the year. The weighted average share price during the year was £11.14 (2010: £9.63). 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:

	2011		2010	
Range of exercise prices £	Number of share options 000s	Weighted average contractual life Years	Number of share options 000s	Weighted average contractual life Years
0 – 5	–	–	38	0.65
5 – 10	3,203	2.51	4,757	1.86
10 – 15	–	–	4,083	0.36
15 – 20	–	–	–	–
20 – 25	–	–	–	–
>25	–	–	–	–
	3,203	2.51	8,878	1.17

In 2011 and 2010 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.

26. Share-based payments continued

The weighted average estimated fair values and the inputs into the Black-Scholes model are as follows:

	2011 Weighted average	2010 Weighted average
Fair value	£2.97	£2.14
Weighted average share price	£11.47	£9.48
Weighted average exercise price	£8.92	£8.06
Expected volatility	27.50%	28.28%
Expected life	4.0 years	4.0 years
Risk free rate	1.91%	2.24%
Expected dividend yield	3.37%	3.75%
Forfeiture rate	3.5%	3.5%

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:

	2011		2010	
	Number of shares 000s	Weighted average fair value £	Number of shares 000s	Weighted average fair value £
Long-Term Incentive Plan	4,854	10.44	4,742	9.45
Annual Bonus Share Matching Plan	285	11.29	266	10.25

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.

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.

Notes to the consolidated financial statements continued

27. Share capital and share premium

	Number of shares 000s	Ordinary shares £m	Share premium £m
At 1 January 2010	810,799	203	2,512
Issue of ordinary shares – share option schemes	1,878	–	12
At 31 December 2010	812,677	203	2,524
Issue of ordinary shares – share option schemes	2,949	1	20
At 31 December 2011	815,626	204	2,544

The ordinary shares have a par value of 25p per share (2010: 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		Interactive Data		Total
	Number of shares 000s	£m	Number of shares 000s	£m	£m
At 1 January 2010	9,665	96	10,485	130	226
Purchase of treasury shares	8,000	77	–	–	77
Release/cancellation of treasury shares	(3,656)	(36)	(10,485)	(130)	(166)
At 31 December 2010	14,009	137	–	–	137
Purchase of treasury shares	5,387	60	–	–	60
Release of treasury shares	(4,731)	(48)	–	–	(48)
At 31 December 2011	14,665	149	–	–	149

The Group holds Pearson plc shares in trust to satisfy its obligations under its restricted share plans (see note 26). These shares, representing 1.8% (2010: 1.7%) 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 £3.7m (2010: £3.5m).

At 31 December 2011 the market value of Pearson plc treasury shares was £177.4m (2010: £141.2m).

29. Other comprehensive income

All figures in £ millions	Translation reserve	Retained earnings	Total	Non-controlling interest	Total
	2011				
	Attributable to equity holders of the Company				
Net exchange differences on translation of foreign operations	(38)	–	(38)	(6)	(44)
Actuarial losses on retirement benefit obligations – Group	–	(56)	(56)	–	(56)
Actuarial losses on retirement benefit obligations – associate	–	(8)	(8)		(8)
Tax on items recognised in other comprehensive income		3	3	–	3
Total other comprehensive expense for the year	(38)	(61)	(99)	(6)	(105)

All figures in £ millions	Translation reserve	Retained earnings	Total	Non-controlling interest	Total
	2010				
	Attributable to equity holders of the Company				
Net exchange differences on translation of foreign operations	162	–	162	11	173
Currency translation adjustment disposed – subsidiaries	13	–	13	–	13
Actuarial gains on retirement benefit obligations – Group	–	70	70	–	70
Actuarial gains on retirement benefit obligations – associate	–	1	1	–	1
Tax on items recognised in other comprehensive income	–	(41)	(41)	–	(41)
Total other comprehensive income for the year	175	30	205	11	216

30. Business combinations

On 31 May 2011 the North American Education business acquired Schoolnet, a leading provider of data-driven education software for students and teachers. On 10 June 2011, the International Education business completed the acquisition of EDI plc, a UK listed education services company operating primarily in the work based learning sector. On 1 November 2011 the North American Education business acquired Connections Education, a company that operates online or virtual public schools in the US and on 19 December 2011 the International Education business acquired Global Education and Technology Group, a leading provider of test preparation services for students in China who are learning English. The Group acquired a 100% interest in all the investments noted above.

Also in the year to 31 December 2011, the Group completed the acquisitions of CTI Education in South Africa, Tutorvista in India, Stark Holding in Germany, TQ in the UK and various other smaller acquisitions.

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Notes to the consolidated financial statements continued

30. Business combinations continued

Provisional values for the assets and liabilities arising from these and other acquisitions completed in the year together with adjustments to prior year acquisitions are as follows:

							2011	2010
All figures in £ millions	Notes	Schoolnet fair value	EDI fair value	Connections fair value	Global Education fair value	Other fair value	Total fair value	Total fair value
Property, plant and equipment	10	1	4	4	9	3	21	17
Intangible assets	11	56	57	141	1	120	375	285
Intangible assets – Pre-publication	20	–	–	9	–	(1)	8	9
Inventories		–	–	–	–	2	2	2
Trade and other receivables		4	14	22	4	14	58	41
Cash and cash equivalents		2	10	8	90	41	151	26
Financial liabilities – Borrowings		–	–	–	–	(9)	(9)	(13)
Net deferred income tax liabilities	13	(15)	(13)	(51)	–	(17)	(96)	(37)
Retirement benefit obligations		–	(1)	–	–	(3)	(4)	(1)
Provisions for other liabilities and charges	23	–	–	–	–	(78)	(78)	(10)
Trade and other liabilities		(8)	(16)	(13)	(21)	(57)	(115)	(37)
Current income tax liabilities		–	–	–	–	(2)	(2)	(3)
Non-controlling interest		–	–	–	–	(1)	(1)	(39)
Net assets acquired at fair value		40	55	120	83	12	310	240
Goodwill	11	102	60	130	103	225	620	288
Fair value of previously held interest arising on stepped acquisition		–	–	–	–	(15)	(15)	–
Total		142	115	250	186	222	915	528
Satisfied by:								
Cash		(142)	(115)	(250)	(186)	(220)	(913)	(530)
Deferred consideration		–	–	–	–	–	–	(8)
Net prior year adjustments		–	–	–	–	(2)	(2)	10
Total consideration		(142)	(115)	(250)	(186)	(222)	(915)	(528)

The goodwill arising on these acquisitions results from substantial cost and revenue synergies and from benefits that cannot be separately recognised, such as the assembled workforce.

The fair value of trade and other receivables is £58m and includes trade receivables with a fair value of £47m. The gross contractual amount for trade receivables due is £55m of which £8m is expected to be uncollectable.

A provisional value of £1m of goodwill arising on 2011 acquisitions is expected to be deductible for tax purposes (2010: £12m).

30. Business combinations continued

All figures in £ millions	2011	2010
Cash flow on acquisitions		
Cash – Current year acquisitions	(913)	(530)
Deferred payments for prior year acquisitions and other items	(5)	(20)
Cash and cash equivalents acquired	151	26
Acquisition costs paid	(12)	(11)
Net cash outflow	(779)	(535)

Acquisitions in 2011 contributed £129m to sales and £9m to operating profit before acquisition costs and amortisation of acquired intangibles from the date of acquisition to the balance sheet date. Of these amounts, Schoolnet contributed £15m of sales and a loss of £2m, EDI contributed £17m of sales and £5m of profit and Connections contributed £24m of sales and £6m of profit. As Global Education was acquired late in December 2011 it did not contribute a significant amount of sales or profit in 2011.

If the acquisitions had completed on 1 January 2011, the Group estimates that sales for the period would have been £6,042m and profit before tax would have been £1,163m.

Notes to the consolidated financial statements continued

31. Disposals

All figures in £ millions	Notes	2011 Total	2010 Total
Disposal of subsidiaries			
Property, plant and equipment	10	–	(57)
Intangible assets	11	(4)	(88)
Other financial assets		–	(3)
Inventories		(7)	–
Trade and other receivables		(5)	(103)
Cash and cash equivalents		(6)	(165)
Net deferred income tax liabilities	13	1	47
Retirement benefit obligations		1	8
Trade and other liabilities		2	132
Current income tax liabilities		1	12
Non-controlling interest		7	271
Attributable goodwill	11	(4)	(195)
Cumulative translation adjustment		–	(13)
Net assets disposed		(14)	(154)
Cash received		–	1,234
Costs		–	(43)
(Loss)/profit on sale		(14)	1,037

All figures in £ millions	2011	2010
Cash flow from disposals		
Cash – Current year disposals	–	1,234
Cash and cash equivalents disposed	(6)	(165)
Costs paid	–	(32)
Pension contribution paid on disposal	–	(53)
Net cash (outflow)/inflow	(6)	984

The disposal in 2011 relates to Longman Nigeria and in 2010 to Interactive Data. Further details of the Interactive Data disposal are shown in note 3.

32. Transactions with non-controlling interest

In 2011 the remaining non-controlling interest in Sistema Educacional Brasileiro was acquired for £108m. In 2010 the transactions with non-controlling interests (£7m) comprise the acquisition of the remaining non-controlling interest in our Italian Education business and the receipt of proceeds from shares issued to employees of Interactive Data.

33. Cash generated from operations

All figures in £ millions	Notes	2011	2010
Profit		956	1,300
Adjustments for:			
Income tax		199	480
Depreciation	10	70	82
Amortisation of acquired intangible assets	11	139	113
Amortisation of other intangible assets	11	48	51
Loss on sale of property, plant and equipment		–	3
Net finance costs	6	71	73
Share of results of joint ventures and associates	12	(33)	(41)
Profit on disposal of discontinued operations	3	–	(1,037)
(Profit)/loss on disposals		(435)	10
Acquisition costs		12	11
Net foreign exchange adjustment from transactions		24	(3)
Share-based payment costs	26	40	39
Pre-publication		2	29
Inventories		15	37
Trade and other receivables		(9)	(82)
Trade and other liabilities		31	165
Retirement benefit obligations		(65)	(64)
Provisions for other liabilities and charges		28	3
Net cash generated from operations		1,093	1,169
Dividends from joint ventures and associates		30	23
Purchase of property, plant and equipment		(67)	(76)
Purchase of intangible assets		(77)	(56)
Proceeds from sale of property, plant and equipment		9	–
Proceeds from sale of intangible assets		3	–
Finance lease principal payments		(8)	(3)
Operating cash flow		983	1,057
Operating tax paid		(151)	(85)
Net operating finance costs paid		(60)	(68)
Free cash flow		772	904
Dividends paid (including to non-controlling interests)		(319)	(298)
Net movement of funds from operations		453	606
Acquisitions and disposals (net of tax)		(420)	150
Purchase of treasury shares		(60)	(77)
New equity		21	12
Other movements on financial instruments		(8)	2
Net movement of funds		(14)	693
Exchange movements on net debt		(55)	(31)
Total movement in net debt		(69)	662

Notes to the consolidated financial statements continued

33. 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	2011	2010
Net book amount	9	3
Loss on sale of property, plant and equipment	–	(3)
Proceeds from sale of property, plant and equipment	9	–

The principal other non-cash transactions are movements in finance lease obligations of £10m (2010: £2m).

34. 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.

During the year various government bodies in the US and Europe have been in the process of investigating Penguin and other major publishers over the agency arrangements for selling e-books. These investigations are ongoing and Penguin is cooperating fully with these inquiries. At the same time beginning in August 2011, Penguin and various other book publishers and book retailers have been sued in a number of private consumer class action law suits in the US which allege violation of the anti-trust and unfair competition laws by the defendants in connection with the adoption of the agency selling model for e-books. The complaints in those suits generally seek treble damages, injunctive relief and attorneys' fees. Penguin is defending itself in those actions and believes that it was fully compliant with all applicable laws.

35. 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. The lease expenditure charged to the income statement during the year is disclosed in note 4.

The future aggregate minimum lease payments in respect of operating leases are as follows:

All figures in £ millions	2011	2010
Not later than one year	179	164
Later than one year and not later than two years	164	151
Later than two years and not later than three years	149	130
Later than three years and not later than four years	134	112
Later than four years and not later than five years	119	95
Later than five years	980	785
	1,725	1,437

36. 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. There are no material amounts falling due from joint ventures and associates. In December 2011, the Group disposed of its 50% interest in FTSE International Ltd and details of this transaction are also shown in note 12.

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 has responsibility for planning, directing and controlling the activities of the Group. 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.

37. Events after the balance sheet date

There were no significant post balance sheet events.

Company balance sheet
As at 31 December 2011

All figures in £ millions	Notes	2011	2010
Assets			
Non-current assets			
Investments in subsidiaries	2	9,056	9,180
Amounts due from subsidiaries		318	323
Financial assets – Derivative financial instruments	6	177	134
		9,551	9,637
Current assets			
Amounts due from subsidiaries		2,944	1,602
Prepayments		4	8
Financial assets – Derivative financial instruments	6	–	6
Current income tax assets		–	9
Cash and cash equivalents (excluding overdrafts)	4	469	944
		3,417	2,569
Total assets		12,968	12,206
Liabilities			
Non-current liabilities			
Amounts due to subsidiaries		(1,370)	(2,752)
Financial liabilities – Borrowings	5	(481)	(464)
Financial liabilities – Derivative financial instruments	6	(2)	(6)
		(1,853)	(3,222)
Current liabilities			
Amounts due to subsidiaries		(5,850)	(4,306)
Current income tax liabilities		(10)	–
Financial liabilities – Borrowings	5	(703)	(859)
Financial liabilities – Derivative financial instruments	6	(1)	–
		(6,564)	(5,165)
Total liabilities		(8,417)	(8,387)
Net assets		4,551	3,819
Equity			
Share capital	7	204	203
Share premium	7	2,544	2,524
Treasury shares	8	(94)	(82)
Special reserve		447	447
Retained earnings		1,450	727
Total equity attributable to equity holders of the company		4,551	3,819

These financial statements have been approved for issue by the board of directors on 7 March 2012 and signed on its behalf by

Robin Freestone Chief financial officer
7 March 2012

Company statement of changes in equity

Year ended 31 December 2011

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 2011	203	2,524	(82)	447	727	3,819
Profit for the year	–	–	–	–	1,089	1,089
Issue of ordinary shares under share option schemes	1	20	–	–	–	21
Purchase of treasury shares	–	–	(60)	–	–	(60)
Release of treasury shares	–	–	48	–	(48)	–
Dividends	–	–	–	–	(318)	(318)
At 31 December 2011	204	2,544	(94)	447	1,450	4,551

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 2010	203	2,512	(47)	447	766	3,881
Profit for the year	–	–	–	–	289	289
Issue of ordinary shares under share option schemes	–	12	–	–	–	12
Net purchase of treasury shares	–	–	(71)	–	–	(71)
Release of treasury shares	–	–	36	–	(36)	–
Dividends	–	–	–	–	(292)	(292)
At 31 December 2010	203	2,524	(82)	447	727	3,819

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 (2010: £131m) relating to profit on intra-group disposals that is not distributable.

Company cash flow statement

Year ended 31 December 2011

All figures in £ millions	Notes	2011	2010
Cash flows from operating activities			
Net profit		1,089	289
Adjustments for:			
Income tax		(39)	(40)
Net finance costs		85	115
Amounts due (to)/from subsidiaries		(917)	873
Net cash generated from operations		218	1,237
Interest paid		(112)	(156)
Tax received		57	50
Net cash generated from operating activities		163	1,131
Cash flows from investing activities			
Acquisition of subsidiaries, net of cash acquired		(114)	(93)
Interest received		–	1
Net cash used in investing activities		(114)	(92)
Cash flows from financing activities			
Proceeds from issue of ordinary shares	7	21	12
Net purchase of treasury shares		(60)	(71)
Repayment of borrowings		(307)	–
Dividends paid to company's shareholders		(318)	(292)
Net cash used in financing activities		(664)	(351)
Effects of exchange rate changes on cash and cash equivalents		(29)	17
Net (decrease)/increase in cash and cash equivalents		(644)	705
Cash and cash equivalents at beginning of year		410	(295)
Cash and cash equivalents at end of year	4	(234)	410

Notes to the company financial statements

1. Accounting policies

The financial statements on pages 158 to 166 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	2011	2010
At beginning of year	9,180	8,547
Subscription for share capital in subsidiaries	279	1,884
Disposals/liquidations	(413)	(1,291)
Currency revaluations	10	40
At end of year	9,056	9,180

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 £40m decrease in the carrying value of its financial instruments, with a 1% decrease in interest rates resulting in a £41m 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 £122m, while a 10% decrease in the value of sterling would increase the carrying value by £149m. 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%.

Notes to the company financial statements continued

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:

All figures in £ millions				2011
	USD	GBP	Other	Total
Not later than one year	(24)	3	2	(19)
Later than one year and not later than five years	128	24	25	177
Later than five years	176	–	–	176
Total	280	27	27	334
Analysed as:				
Bonds	251	303	–	554
Rate derivatives – inflows	(292)	(281)	–	(573)
Rate derivatives – outflows	321	5	27	353
Total	280	27	27	334

All figures in £ millions				2010
	USD	GBP	Other	Total
Not later than one year	297	3	3	303
Later than one year and not later than five years	109	27	32	168
Later than five years	158	–	–	158
Total	564	30	35	629
Analysed as:				
Bonds	589	320	–	909
Rate derivatives – inflows	(364)	(297)	–	(661)
Rate derivatives – outflows	339	7	35	381
Total	564	30	35	629

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.

4. Cash and cash equivalents (excluding overdrafts)

All figures in £ millions	2011	2010
Cash at bank and in hand	–	2
Short-term bank deposits	469	942
	469	944

Short-term bank deposits are invested with banks and earn interest at the prevailing short-term deposit rates.

At the end of 2011 the currency split of cash and cash equivalents was US dollar 2% (2010: 86%), sterling 98% (2010: 13%) and Hong Kong dollar 0% (2010: 1%).

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	2011	2010
Cash and cash equivalents	469	944
Bank overdrafts	(703)	(534)
	(234)	410

5. Financial liabilities – Borrowings

All figures in £ millions	2011	2010
Non-current		
7.0% Sterling Bonds 2014 (nominal amount £250m)	257	256
4.625% US Dollar notes 2018 (nominal amount $300m)	224	208
	481	464
Current		
Due within one year or on demand:		
Bank loans and overdrafts	703	534
7.0% Global Dollar Bonds 2011 (nominal amount $500m)	–	325
	703	859
Total borrowings	1,184	1,323

Included in the non-current borrowings above is £4m of accrued interest (2010: £4m).

Included in the current borrowings above is £nil of accrued interest (2010: £1m).

Notes to the company financial statements continued

5. Financial liabilities – Borrowings continued

The maturity of the company's non-current borrowings is as follows:

All figures in £ millions	2011	2010
Between one and two years	–	–
Between two and five years	257	256
Over five years	224	208
	481	464

As at 31 December 2011 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	One year	One to five years	More than five years	Total
Re-pricing profile of borrowings	703	257	224	1,184
Amounts due to subsidiaries	5,850	825	545	7,220
Effect of rate derivatives	1,273	(726)	(547)	–
	7,826	356	222	8,404

The carrying amounts and market values of borrowings are as follows:

		2011		2010	
All figures in £ millions	Effective interest rate	Carrying amount	Market value	Carrying amount	Market value
Bank loans and overdrafts	n/a	703	703	534	534
7.0% Global Dollar Bonds 2011	n/a	–	–	325	327
7.0% Sterling Bonds 2014	7.20%	257	282	256	282
4.625% US Dollar notes 2018	4.69%	224	206	208	192
		1,184	1,191	1,323	1,335

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	2011	2010
US dollar	373	579
Sterling	802	736
Euro	9	8
	1,184	1,323

6. Derivative financial instruments

The company's outstanding derivative financial instruments are as follows:

All figures in £ millions	2011 Gross notional amounts	2011 Assets	2011 Liabilities	2010 Gross notional amounts	2010 Assets	2010 Liabilities
Interest rate derivatives – in a fair value hedge relationship	243	35	–	369	24	–
Interest rate derivatives – not in a hedge relationship	1,030	119	–	1,214	96	–
Cross currency derivatives	220	23	(3)	220	20	(6)
Total	1,493	177	(3)	1,803	140	(6)
Analysed as expiring:						
In less than one year	–	–	(1)	319	6	–
Later than one year and not later than five years	946	81	(2)	749	74	(6)
Later than five years	547	96	–	735	60	–
Total	1,493	177	(3)	1,803	140	(6)

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. Share capital and share premium

	Number of shares 000s	Ordinary shares £m	Share premium £m
At 1 January 2010	810,799	203	2,512
Issue of shares – share option schemes	1,878	–	12
At 31 December 2010	812,677	203	2,524
Issue of shares – share option schemes	2,949	1	20
At 31 December 2011	815,626	204	2,544

The ordinary shares have a par value of 25p per share (2010: 25p per share). All issued shares are fully paid. All shares have the same rights.

Notes to the company financial statements continued

8. Treasury shares

	Number of shares 000s	£m
At 1 January 2010	9,665	47
Purchase of treasury shares	8,000	77
Contribution from subsidiaries	–	(6)
Release of treasury shares	(3,656)	(36)
At 31 December 2010	14,009	82
Purchase of treasury shares	5,387	60
Contribution from subsidiaries	–	–
Release of treasury shares	(4,731)	(48)
At 31 December 2011	14,665	94

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 £3.7m (2010: £3.5m). At 31 December 2011 the market value of the company's treasury shares was £177.4m (2010: £141.2m).

9. 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.

10. Audit fees

Statutory audit fees relating to the company were £35,000 (2010: £35,000).

11. 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 £176m (2010: £209m) and interest receivable from subsidiaries for the year of £54m (2010: £56m). Management fees payable to subsidiaries in respect of centrally provided services amounted to £17m (2010: £33m). Dividends received from subsidiaries were £1,471m (2010: £1,695m).

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.