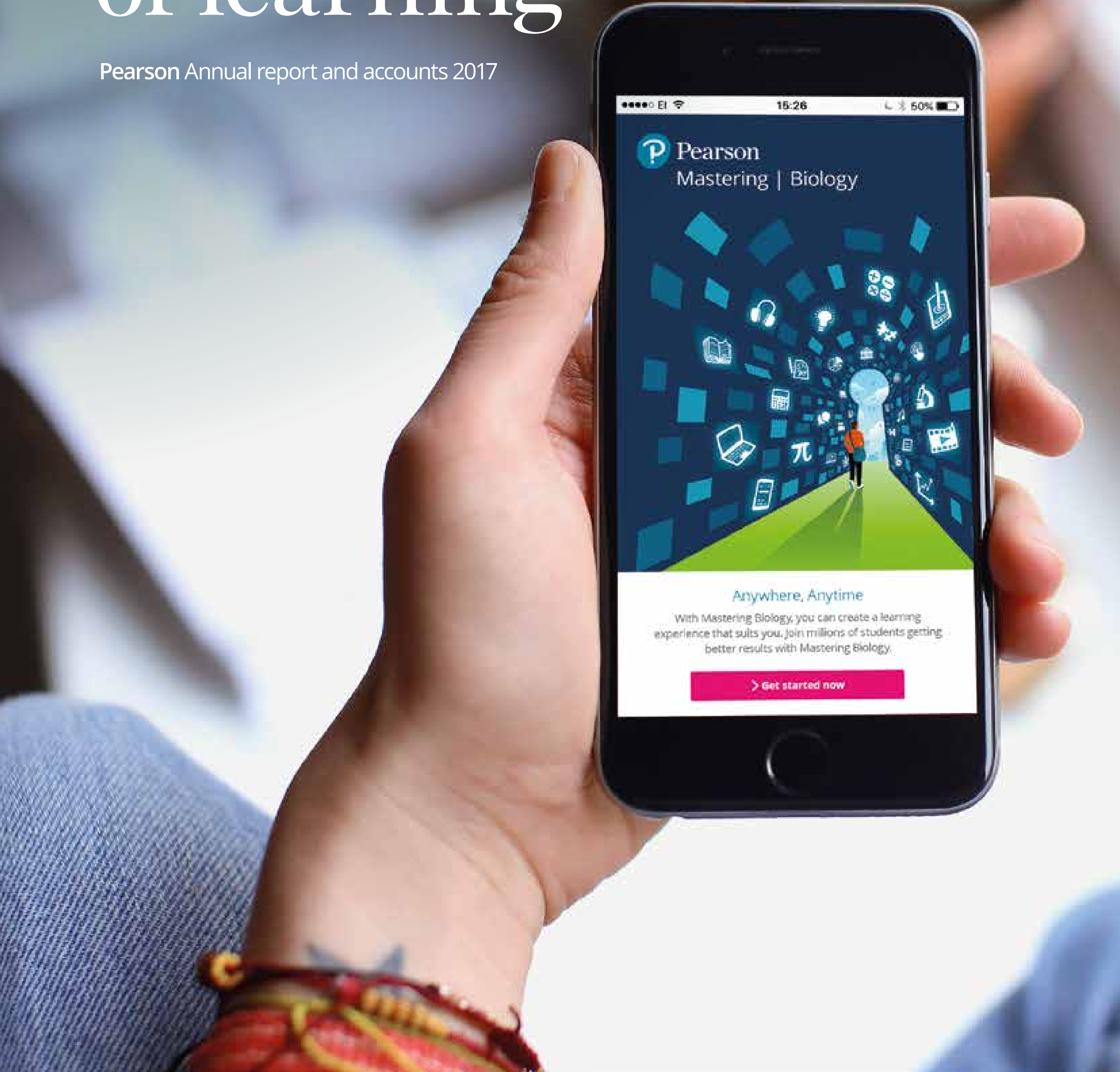
Pearson

The future of learning

Pearson Annual report and accounts 2017



In this report

Strategic report

Governance

Financial statements

Helping create the future of learning

In this report we have included employee interviews from around our business to showcase how Pearson's people are helping create the future of learning.

Strategy and performance reporting The strategic report up to and including p60 is formed of three sections: 'Overview', 'Our strategy in action' and 'Our performance', and was approved for issue by the Board on 14 March 2018 and signed on its behalf by:

Coram Williams Chief Financial Officer

At Pearson we have a clear mission: to help people make *progress* in their lives through *learning*.

We are focusing on the changing needs of the world's education markets, and our strategy is to combine content and assessment, powered by services and technology, leading to more effective teaching and personalised learning at scale.

That is at the heart of what we do and is reflected through our three strategic priorities: We are growing market share through our digital transformation, focusing on structural growth markets and becoming a simpler and more efficient business. See *Our strategy*, p13

This will enable us to drive innovation by providing more authentic learning and assessment experiences, helping more learners around the globe build their skills and be better prepared for the future world of work.

Pearson products provide:

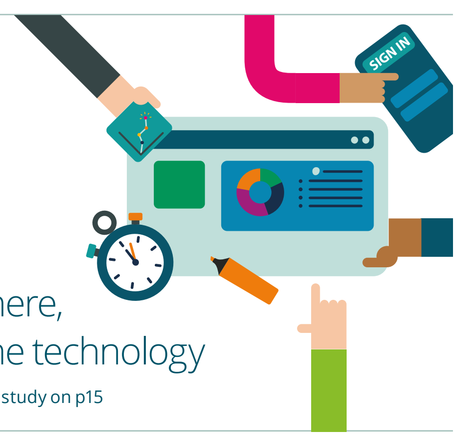
1 Better learning

“I can't imagine *a better way to learn.*

“The digital experience that students get can really shape their understanding of the subject – it gives them a real world feel, with first class pedagogy and assessment built in.”

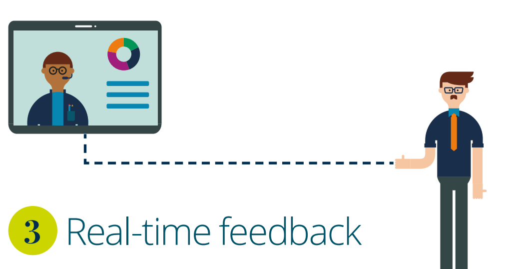
Pearson author Glenn Hubbard on why he and partner Anthony P O'Brien are transforming their classic textbook from print format into a digital education experience.

See case study on p43



2 Anywhere, anytime technology

See case study on p15



3 Real-time feedback

See case study on p15

Our KPIs

We measure our progress against three broad categories of KPIs: financial, business and non-financial measures.

These two pages summarise performance against all of these KPIs. More details on the performance, trends and factors influencing select KPIs are described within the relevant sections throughout this report.

R See how we link strategy to how management is rewarded on p90.

Financial measures

Maintain long-term growth

Indicator	2017	Underlying change	Reference
Sales R	£4,513m	-2%	p35
Adjusted operating profit R	£576m[1]	-9%	p35
Operating profit	£451m[2]	n/a	

Deliver sustainable returns

Indicator	2017	Headline change	Reference
Adjusted earnings per share R	54.1p[1]	-8%	p36
Basic earnings per share	49.9p[2]	n/a	
Return on invested capital (gross basis) R	4.3%	-0.7 percentage points	p36
One year total shareholder return R	-4.5%[3]		
Dividend per share	17p	-67%	p7

Manage our cash and balance sheet

Indicator	2017	Headline change	Reference
Operating cash flow R	£669m[1]	+1%	p37
Net cash generated from operations	£462m[2]	-11%	
Net debt	£432m	+60%	p37

1 See p36–38 for an explanation of these alternative performance measures and p192–195 for full reconciliation of the numbers to the equivalent statutory measure and definitions of headline and underlying variances.
2 Equivalent statutory measure.
3 Source: Datastream.

Our KPIs

Business measures

1 Grow market share through digital transformation of our courseware & assessment businesses R

Indicator	Performance	Reference
2017 Digital revenues[4] Digital: 32% Digitally enabled: 27% Non-digital: 41%		p14
US higher education courseware	Market position: #1	p14
US assessment	Market position: #1	p14
UK assessment[5]	Market position: #1	p14

4 Excluding GEDU, WSE and US K-12 courseware.
5 Includes both vocational and general qualifications.

2 Invest in structural growth markets

Indicator	Performance	Reference
Virtual schools (Connections)	Market position: #2	p16
Global online program management	Market position: #1	p16
Global professional testing (Pearson VUE)	Market position: #1	p16
English	Market position (courseware): #2 Market position (testing): #3	p16

3 Become simpler & more efficient R

Indicator	Performance	Reference
Expected cost savings 2017-2020 programme[6]	c.£300m	p18
Restructuring costs in 2017	£79m	
Planned headcount reduction 2017-2020 programme	c.3,000	p18

6 Phased plan first presented on August 4 2017, based on December 2016 FX rates. Note: A significant part of these costs and savings are in US Dollar and other non-Sterling currencies and so subject to FX movements over the implementation timeframe.

Non-financial measures

Talent & employee engagement

Indicator	Performance	Reference
Executive team's achievement of quarterly employee engagement milestones	100%	p27
% of Senior Leadership Group with development goals	89%	p27
Employees taking at least one course on Pearson's internal training programme, PearsonU	83%	p27

Strengthen brand & reputation

Indicator	Performance	Change	Reference
Awareness of Pearson among teachers, learners and parents	59%	+2 percentage points	
Favourability of those aware of Pearson	89%	+1 percentage points	

Deliver gender diversity

Indicator	Performance	Change	Reference
Female Board members	30%	no change	p29
Female senior managers[7]	30%	-2%	p29
Female employees	61%	+1%	p29

7 Two reporting lines from the Chief Executive.

Reduce our carbon footprint

Indicator	Performance	Change	Reference
Global greenhouse gas emissions (Metric Tonnes of CO_2e)	104,384	-17%	p29

Maintain investment in communities & social innovation

Indicator	Performance	Change	Reference
Target 1% or more of adjusted pre-tax profits	£7.2m	+1.4%	p31

About Pearson

Pearson is the world's learning company, providing a range of products and services to help people across different learning stages make measurable progress in their lives.

Where we operate

We operate in 70 markets worldwide, with a focus on those below. We report by geography because this is how we deliver learning: through providing a range of educational products and services to institutions, governments, professional bodies and individual learners in our key markets around the world, helping people everywhere aim higher and fulfil their true potential.

Sales by geography

North America

Sales

£2,929m

Our largest market including all 50 US states and Canada.

Core markets

Sales

£815m

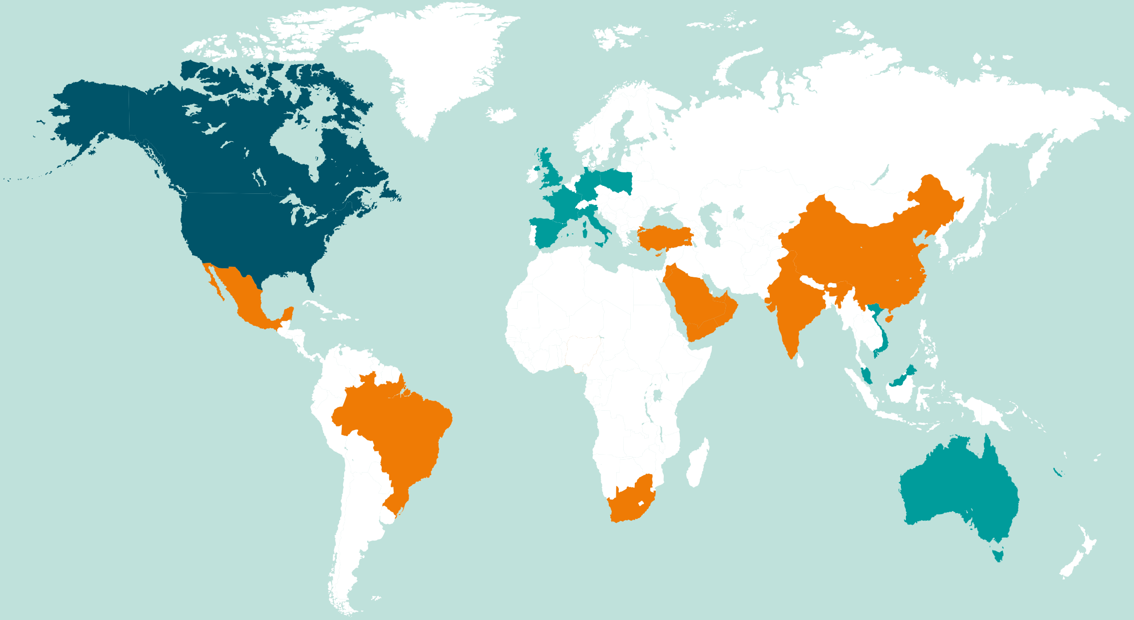
Our international business in established and mature education markets including the UK, Australia, Italy, France, Germany, Spain, Poland, Singapore, Malaysia and Vietnam.

Growth markets

Sales

£769m

Our growth markets in emerging and developing economies, with investment priorities in Brazil, India, South Africa, Mexico, Hong Kong & China, and the Middle East.



What we offer

We provide content, assessment and digital services to schools, colleges and universities, as well as professional and vocational education to learners to help increase their skills and employability prospects. Increasingly, we do this through partnership models where we bring investment, expertise and scale to help deliver better learning outcomes.

Sales by products and services

Courseware
Sales
49%

We provide world-leading educational content for use in both traditional and digital learning.

Assessment
Sales
30%

We provide assessment services to measure and validate learner progress, and to certify competency.

Services
Sales
21%

We provide integrated services that help educational institutions improve learner outcomes.

Courseware

Higher Education

Our personalised course content and digital resources help educators build knowledge and unlock learners' potential. We increasingly sell direct to consumers and to educational institutions so students can come to class completely prepared from day one. This helps drive better learning experiences and outcomes.

See case study, p15

Schools

Our content business for schools in the US, UK and globally provides educational instructional resources, curriculum materials, digital learning tools and assessments to help to educate children across the world. Going forward, we are focusing our school content business on markets outside the US.

English

Pearson English language teaching develops courses, qualifications and learning tools to make teaching English easier.

Assessment

Schools

We partner with US educators and districts to develop new, personalised ways of learning through effective, scalable assessments that measure 21st century skills and inform instruction for all learners. In the UK, Pearson is a market-leading, award winning organisation offering academic and vocational qualifications. We're leading the adoption of AI (Artificial Intelligence) in assessment to support better learning.

See case study, p45

Professional certification

We help organisations measure and make improvements to ensure the success of employees and learners. Test owners and test takers across the world choose us to help develop, manage, deliver and grow their computer-based testing programmes. With the industry's most secure testing environments, we're the leader in computer-based testing.

See case study, p42

Clinical assessment

We provide assessment solutions to help professionals through the identification and management of barriers to learning and functioning in daily life. Our wide range of assessment and intervention products are used by psychologists, speech language pathologists, occupational therapists, counselors, human resources and talent management professionals.

English

Our fast-growing test, Pearson Test of English Academic, is the world's leading computer-based test of English for study abroad and immigration.

Services

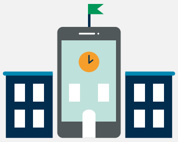
Online Program Management

Pearson helps higher education institutions launch or expand online degree programs enabling them to increase enrolments, support online learning, boost graduation rates and deliver on employability.

Virtual schools

Connections Education is an accredited provider of high-quality, highly accountable virtual education solutions for students in grade K–12, including online schools, online courses, instructional tools and more.

See case study, p17



Fully integrated programmes

Our sistemas businesses offers a complete package of products and services for private and public K-12 schools in Brazil. We provide courseware, educational assistance, professional development, management consulting and marketing support, as well as digital content. In India we offer similar whole-school academic partnerships called MyPedia.

See interview on p47

English

Leading the English learning market in Brazil, we offer a diverse methodology in a franchising based model to help learners improve their lives by learning a second language.

Link to strategic priorities 1 Grow share through digital transformation 2 Invest in structural growth markets See *Our strategy*, p13–21

Chairman's introduction

"2018 is a pivotal year for Pearson – it is the first in several when Pearson is expected to return to underlying profit growth."

Sidney Taurel
Chairman

Dear shareholders,

This has been an important year in the company's transformation and significant progress has been made in 2017. On an operational level, the company has stabilised and, for the first time in several years, Pearson has met both internal and external expectations. We are still in the midst of a transformation and the environment in our largest business, US higher education courseware, remains challenging. However, we continue to take action and have a good handle on these challenges, as well as on the growth opportunities in other parts of our business, leaving us well placed to meet our long-term aspiration to be the leader in digital learning.

From a Board perspective, management is faithfully executing on our strategy, as seen through the actions taken to simplify the company, focus our portfolio, invest in our digital capabilities and invest in growth opportunities that will drive the future of Pearson. 2017 performance provides a solid foundation from which to build, with Pearson aiming to return to underlying profit growth in 2018.

Overseeing our strategic progress

The Pearson strategy must meet the evolving demands of learners while delivering sustainable returns to shareholders. Pearson meets those demands by combining world-class content and assessment, powered by services and technology, to support more effective teaching and personalised learning at scale. To deliver on the strategy, Pearson is focused on three priorities:

1. Grow share through the digital transformation of our courseware and assessment businesses
2. Invest in the biggest structural growth markets
3. Simplify the company, becoming more efficient and delivering better customer experiences.

A key tenet of the strategy is investment in content and technology to ensure Pearson has the skills and platforms to keep its products relevant, to become more agile in its digital capabilities, and to provide a robust infrastructure to deliver efficiencies. In turn, these will help Pearson win market share with products that deliver better outcomes, provide better customer experiences and deliver sustainable long-term growth, driving greater value for shareholders. You can read more about these priorities on p13–21.

Our simplification journey

Pearson enters 2018 in a strong financial position because of tight management of costs, actions to simplify the portfolio and a sharper focus on the biggest opportunities – areas that are consistent with our previously announced simplification strategy. In July 2017, the Board sanctioned the sale of a 22% stake in the Penguin Random House venture to Pearson's joint venture partner Bertelsmann, and the recapitalisation of its remaining 25% stake in the business.

In the latter part of the year, Pearson also agreed the sale of two of its direct delivery businesses – GEDU and Wall Street English. Pearson has raised £2.4bn from strategic disposals since 2015, which has helped Pearson greatly strengthen its balance sheet, reinvest back into the business and return excess capital to shareholders. In October 2017, Pearson commenced a share buyback programme, completed on 16 February 2018, repurchasing a total of 42.8m shares at an average price of 700p.

Shareholder returns

It is my job to ensure that capital is allocated appropriately on behalf of our shareholders. I know that shareholders are disappointed about the reduction of the dividend in 2017. This was not a decision the Board took lightly and it reflects a continued focus on maintaining a strong balance sheet, investing in Pearson's digital transformation and sustaining a solid investment-grade credit rating.

Governance at Pearson

Leadership and effectiveness

Board members challenge and debate strategy, performance, responsibility and accountability to ensure that the decisions we make are robust. Board activity and performance are assessed annually.

Accountability

Detailed risk assessment and management information shapes all strategic and operational decisions, with clearly defined Board and management responsibilities and processes.

Engagement

Building strong relationships with our diverse stakeholders is crucial to our sustainable success. We aim to engage through many forums, and channels, to build trust.

See our Governance report on p61–110

Remuneration

Our remuneration policy aligns with strategy and adapts to market conditions and performance.

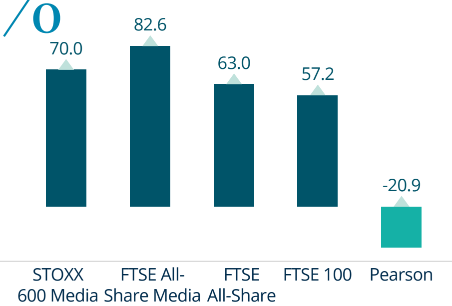
See our Remuneration report on p90–105

Chairman's introduction

Key performance indicators *Deliver sustainable returns*

Total shareholder return (Five years % change)

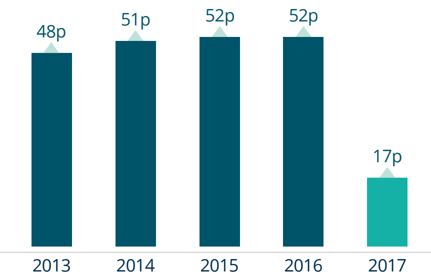
–20.9%



Five-year TSR in 2017 was -20.9% which compares with a 57.2% return on the FTSE 100 Index of large UK listed companies. Our recent share price performance has been disappointing but we are confident that the plans and strategy laid out in this report will continue to make Pearson a simpler, stronger company, and that they set the company up for a sustained period of growth and value creation.

Dividend per share in fiscal year (pence)

17p



We cut our dividend in 2017 to reflect portfolio changes, increased product investment and challenging market conditions in our largest business. Our intention is to pay a sustainable and progressive dividend that is comfortably covered by the earnings of our ongoing business, excluding any contribution from our stake in Penguin Random House.

Our stated objective in the long term is to rebuild our payment to shareholders, reflecting the Board's long-standing confidence in the strong future cash generation of Pearson. At this stage, we are focused on striking the right balance between short-term shareholder reward and investing in the long-term success of the business. As a result, the proposed final dividend payment for 2017 is 12p per share, taking the full year dividend to 17p per share.

Board engagement with our investors and company stakeholders

The 2017 financial year has been one of significant engagement with our shareholders. I have enjoyed spending time throughout the year with many of you to ensure that we maintain an open, transparent dialogue, keep you updated on our strategy and receive your inputs.

Since May 2017, Elizabeth Corley, who chairs the Pearson Remuneration Committee, has led our work to engage with investors in connection with Pearson's remuneration policy and to listen to your concerns. It is clear that shareholders and other stakeholders would like our approach to remuneration to be simple and transparent, closely linked to our strategy and the company's performance.

We have worked hard to develop an approach that the majority of our shareholders can support. Elizabeth explains our approach in more detail in the remuneration section of this report on p90–105, and I would like to thank those who helped us refine our proposals.

More broadly, our Board members have been engaging with educators, learners, community and thought leaders, and other stakeholders in a variety of ways. This remains an ongoing area of focus for us – you can read more about our engagement in the governance section on p61–110.

Investing in world-class talent

A company that is moving to a digital-first model needs to have the best and brightest talent to help guide it through the transition. I am pleased that in 2017 we made a number of significant hires – at Board and Executive level, as well as across the entire company.

Over the last few years we have further strengthened the composition of our Board through the addition of more technology knowledge, more international experience and greater depth regarding transformation. For example, Michael Lynton joined us as an Independent Non-Executive Director on 1 February 2018. Michael was formerly Chairman and CEO of Sony Entertainment, and CEO of Sony Pictures Entertainment before that. He is currently Chairman of Snap Inc., the owner of messaging start-up Snapchat, and brings a wealth of experience and expertise.

I believe we have a strong and experienced Board, fully engaged with the business and focused on helping guide Pearson back to growth. All across Pearson, there is a focus on developing necessary skills and capabilities to ensure Pearson has the right talent, building a market-leading, digital-first business.

Looking ahead

Pearson has an important role to play in supporting customers across the globe to make progress in their lives through learning. This encapsulates our work to build a more digital and sustainable business.

2018 is a pivotal year for Pearson – it is the first in several when Pearson is expected to return to underlying profit growth. The Board is confident management has a good plan to deliver on this guidance and that the strategy is working. Longer term, we are excited about the significant growth opportunities globally and about delivering sustainable long-term growth to drive shareholder value.

Thank you for your ongoing support of Pearson.

Sidney Taurel Chairman

CEO's strategic overview

"We are optimistic about what the future holds and expect to make further progress in 2018."

John Fallon
Chief Executive

Dear shareholders,

In 2017, in a challenging trading environment, we made an adjusted operating profit of £576m – at the top end of our guidance range – and we reported adjusted earnings per share of 54.1p. We continued to invest in the digital transformation and simplification of the company. We have further strengthened our balance sheet, ending the financial year with net debt of £432m. We expect to make further progress in 2018, and over the next three years, we will start growing again, in a sustainable way.

Returns to shareholders

As a result of our strong cash flow generation and proceeds from the further simplification of our portfolio, we launched a £300m share buyback during 2017, which was completed on 16 February 2018, repurchasing a total of 42.8m shares at an average price of 700p. This was accompanied by a significant cut in the dividend. While difficult, this ensures that we can continue to invest in the business to drive long-term growth and a sustainable and progressive dividend going forward. This will enable us to deliver value for our shareholders.

The global opportunity

Globally, there continues to be a tremendous opportunity in education. The estimated global spend is £3.6tn* per year. Currently only 2%* of that spend is on digital but we expect that to grow. But what does digital, look like in effective practice? It means moving to a world of better learning – anywhere, anytime, with real time feedback – driving better outcomes and more meaningful learning experiences.

It means better understanding not just what works, but how it works and in what context. That is what our commitment to efficacy – and reporting on the impact of the use our products on learning outcomes – is about. We made that commitment in 2013 and, as promised, this year we release audited efficacy reports. We are listening to the challenges and opportunities faced by teachers and students, and designing and developing products based on learning and data science – all with a focus on helping them achieve the outcomes that matter most. Technology has changed how, when and where learning takes place. With our scale and resources, brand and commitment to digital, we are in a unique position to make a significant mark on the future of learning.

Put simply, we need to give flexibility to students, arming them with the opportunities to learn in modern, innovative ways, so they have the foundational knowledge and the 21st century skills to not only adapt but succeed.

Our diverse global customer base shares common values of wanting to have more control of their futures in an increasingly uncertain world. We can enable them to do that by helping drive better engagement and by helping learners realise the true economic value of education – and how it helps them make progress. Our focus is on giving the next generation of learners the confidence to be successful no matter what they do. Read more on our approach to creating value for all our stakeholders on p20–21.

It is with this in mind that Pearson is accelerating its move to digital. We are creating products and services to help people teach, learn and grow in new and powerful ways, while fostering a culture of continuous innovation that will ensure we stay relevant over time. Through this transformation, our products will deliver:

- Better learning. Our technology inspires more personalised, flexible and engaging learning that delivers better outcomes
- Anywhere, anytime technology. Our technology gives people the freedom and flexibility they crave, giving them the control over when, where and how they learn
- Real-time feedback. Our innovative online products and services provide real-time personalised feedback so that teachers and faculty can see where they might need to adjust their lessons, and learners can focus where they need to.

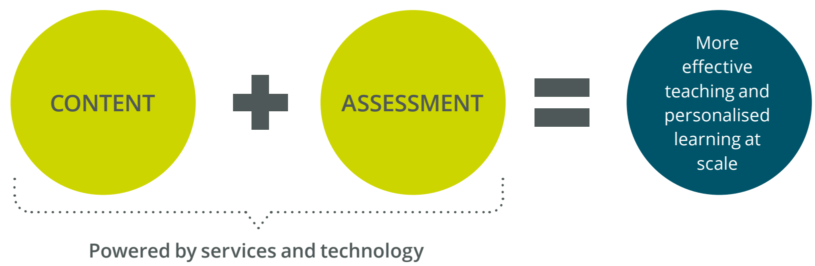
This focus on understanding the evolving needs of learners and on innovating to anticipate and meet those needs drives everything we do.

* Source: Citi GPS: Global Perspectives & Solutions, July 2017.

CEO's strategic overview

Our strategy

Our business



Our strategic priorities

1. Grow market share through digital transformation
2. Invest in structural growth markets
3. Become simpler and more efficient

See *Our strategy*, p13

Our strategy and priorities

Our mission at Pearson is to help people make progress in their lives through learning. To deliver our purpose, we have a vision to be the trusted gateway to lifelong learning.

In order to deliver on this vision, there are three areas of focus:

1. We will grow share through the digital transformation of our courseware and assessment businesses
2. We will invest to build our businesses in structurally growing markets more quickly
3. We will simplify our company to be more efficient and to deliver a much better experience to our customers.

We need to leverage our core strengths in content and assessment powered by services and technology to bring more effective teaching and personalised learning at scale.

Gain share through our digital transformation

This will help us satisfy changing learner consumption preferences and transition our assessment businesses to deliver fewer, smarter tests.

The single biggest opportunity to gain share through our digital transformation is in US higher education courseware, which makes up 28% of product contribution. These profits have declined over the last few years due to the challenges we face in this business, which will continue for the next couple of years.

However, we are making good progress in shifting the business from ownership to 'pay for use', which is a much more viable and sustainable model. We are doing this by ensuring the business is significantly more digital, prioritising access to content over ownership and transacting more product directly to consumers and institutions. Last January, we lowered the price on thousands of eBook rentals, and we also launched a new print rental programme. Our 'Inclusive Access' model gives convenience and better value to students and is a direct-to-institution model that allows students to have materials for their course on day one.

We are building a Global Learning Platform, which is a single, cloud-based platform that's highly scalable and more reliable, and allows us to innovate faster and support a lifelong learning ecosystem for hundreds of millions of learners.

We also know that getting to market more quickly and improving our agility will help us win. To that end, we are making a record level of investment in our business each year – over £700m annually – to drive and scale innovation at Pearson. Some recent examples include:

› Fostering complex skills: using machine learning to improve and accelerate essay grading and student feedback in US higher education courseware

› Personalised pathways: providing adaptive practice and learning in maths and the sciences in US higher education courseware

› Intelligent tutoring: partnering with IBM Watson to embed tutoring dialogue into our courseware products to help students when they need it most

› Natural Language Processing: partnering with Microsoft Research Asia to integrate AI capabilities into English language learning curriculum in China.

CEO's strategic overview

Invest in structural growth markets

Our second strategic priority is to invest in structural market opportunities. That means investing and growing share in our fastest-growing businesses across Pearson, such as:

Professional Certifications (Pearson VUE), which helps more than 450 credential owners across the globe develop, manage, deliver and grow their assessment programmes.

Virtual Schools (Connections Academy), which provides high-quality online education for c.78,000 K-12 students in the US.

English language learning curriculum, instruction and assessment, including our fast-growing Pearson Test of English Academic, the only fully digital test which offers a convenient way for people to demonstrate their English language proficiency as a gateway for other opportunities.

Online Program Management, which helps colleges and universities take their programmes online and improves access for learners who cannot attend a brick-and-mortar school.

Become a simpler and more efficient company

Our third strategic priority is to become a simpler and more efficient company, phasing out dated technologies and systems, eliminating duplication and streamlining operations.

As many of you know, we removed more than £650m in cost between 2013 to 2016. In 2017, we announced our plans to deliver another £300m in cost savings over a three-year period by further simplifying our technology, increasing the use of shared service centres and standardising our processes. This will reduce Pearson's employee base by roughly 3,000 roles but, more importantly, it will improve the way we operate as a company and respond to the needs of a changing educational landscape.

Looking ahead

We are optimistic about what the future holds and expect to make further progress in 2018. At the same time, we know that we will continue to see challenging headwinds in US higher education courseware for the next few years, and we've planned for that. We will offset these headwinds by the broader 70% of Pearson that is stabilising or growing, by creating further cost efficiencies, and by the strength of our cash flow generation and our balance sheet.

It won't be easy, and it will take time. However, I am confident that we will deliver because no other learning company can match our scale, investment and expertise, which includes the incredible, mission-driven talent at Pearson that each day helps people make progress in their lives through learning.

Thank you for your ongoing support of Pearson.

John Fallon
Chief Executive

Future of skills | Employment in 2030

Preparing people for the jobs of the future is core to Pearson's mission of helping people make progress in their lives through learning.

A student entering formal education today will be making decisions about his or her career by the year 2030.

That is why in 2017 Pearson partnered with Nesta and the Oxford Martin School, on a research project designed to advance the conversation about the future of work past fears of automation. Offering the most comprehensive research on this topic to date, it better predicts how major societal and economic trends – and the interactions between them – will affect the future of work, and the skills needed to succeed in the future.

Along with technology, factors such as globalisation and climate change are changing our economy and our labour market. This presents challenges, but also creates an opportunity for real change.

Clearly we need to re-evaluate the skills employers and individuals will need – but we also need to update education systems, better support teachers and create effective new tools to support future teaching and learning. The future will be marked by lifelong learning, and we cannot afford to leave anyone behind.

This research provides an optimistic blueprint for reforming education for the needs of this rapidly changing future.

For Pearson, this is a significant opportunity. Our hope is that employers, education systems and policymakers will collaborate to redesign jobs, retrain individuals and encourage greater skills development in order to make a future economy and world where more people can flourish and make meaningful progress throughout their lives.

Read more: www.futureskills.pearson.com

CEO's strategic overview

Executive team

John Fallon Chief Executive

Coram Williams Chief Financial Officer

Albert Hitchcock Chief Technology & Operations Officer

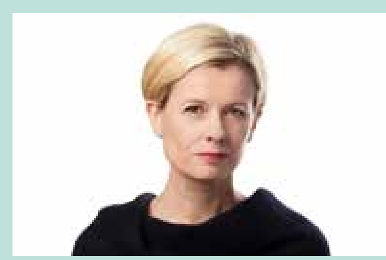
Anna Vikström Persson Chief Human Resources Officer

Bob Whelan President Pearson Assessments

Bjarne Tellmann General Counsel & Chief Legal Officer

Giovanni Giovannelli President Growth Markets

Jonathan Chocqueel-Mangan Chief Strategy Officer



Kate James Chief Corporate Affairs & Global Marketing Officer

Kevin Capitani President North America

Rod Bristow President UK & Core Markets

Tim Bozik President Global Product

Market trends

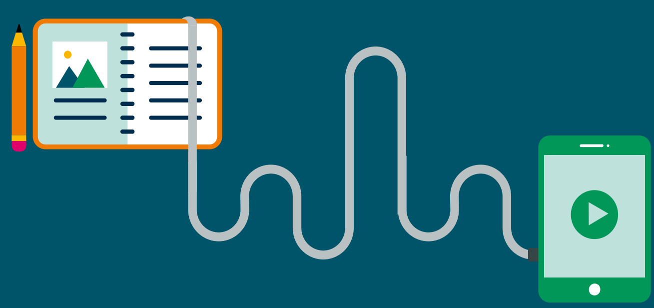
Technology is changing expectations and increasing possibilities in education.

The future of work is about skills not jobs

Much of the conversation about the future of work revolves around fears of technology making workers obsolete. However, when we solely talk about how automation will change the nature of work, we are missing the bigger picture. Rather than jobs disappearing, what is more likely is that the jobs that exist in the future will be broadly recognisable but the skills required to do them will have shifted. To succeed in the future, individuals, employers and education systems need to respond to the notion that while we are not able to control the jobs that will be available, we can prepare people with the skills that will be most valuable for their ongoing success.

Decline of the traditional textbook?

While many students across the world still use traditional textbooks, the rapid pace of technology means that learners increasingly expect to consume educational content in digital format. This is driving rapid advances in accessibility, affordability and a user experience that is immersive, utilising sophisticated technologies designed to help educators increase engagement and produce measurable outcomes for learners.



Rise of personalised learning, virtual and augmented reality

Through the move to digital education, these rapid advances in technology are also enabling individual, adaptive learning to take place at scale. The rise of Artificial Intelligence and virtual reality in the classroom, training centres and workplace brings exciting new opportunities for learners, schools, colleges and educators, which will help increase lifelong learning, student engagement and, ultimately, improve learning outcomes.

Our strategy

Our business

We are transforming our business to meet the evolving needs of our customers. We will do that by combining content and assessment powered by services and technology, leading to more effective teaching and personalised learning at scale.

CONTENT + ASSESSMENT = More effective teaching and personalised learning at scale

Powered by services and technology

Our strategic priorities

Our strategy is focused on the major growth opportunities – sectors and channels. Our products and services are becoming more personalised, accessible and affordable. And we are becoming leaner and more efficient.

1. Grow market share through digital transformation
2. Invest in structural growth markets
3. Become simpler and more efficient

Efficacy programme see p22

Sustainability plan see p24

Stakeholder value

Our business model and strategy

Better learning. More personalised, flexible and engaging with better outcomes. With anytime, anywhere technology. Giving people the freedom and flexibility they crave, and control over when they learn.

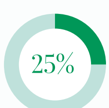
1 Grow market share through digital transformation

Our performance | Our market | Our approach and strengths

US higher education courseware

2017 sales
£1,146m

Percentage of Pearson's total sales



Size of market*	Size of new materials market**	Market position**
c.$7bn	$3.5bn	#1

Underlying market pressures relating to lower enrolment and print attrition to the secondary market persist for the next couple of years, but as we move to an access model and shift to digital we expect pressures to ease and that we will become a more predictable business with greater visibility

* Total student spend: (Pearson estimates)
** Source: MPI

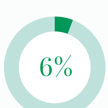
We serve three interrelated customers – students, faculty and administrators. We are meeting the needs of each group by:

- Moving from an ownership to access model
- Selling directly to institutions and B2C channels
- Accelerating digital formats
- Investing in better learning experiences and outcomes.

Core student assessment and qualifications

2017 sales
£256m

Percentage of Pearson's total sales



Size of market	Market position	Market position in General Qualifications
c.£700m	#1	#2

Demographics and demand for qualifications will drive overall growth. After a period of significant curriculum change, we expect greater stability from 2018

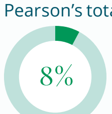
We serve students, teachers, schools and government through our qualifications business where we are the awarding body and own the IP (intellectual property). Our strengths include:

- Pioneering digital assessment platforms
- Strong brands built around quality at scale
- Investment in IP and new products.

US student assessment

2017 sales
£355m

Percentage of Pearson's total sales



Size of market	Market position	Market share
$1.2bn	#1	+35%

Stability returning after a period of policy change in recent years, we have continued to invest and are well positioned to grow again:

- Stable market outlook
- Better contract win momentum
- Increased partnering opportunities
- Better margins in digital.

We remain the largest vendor and we have led the shift towards digital testing with our best-in-class platform TestNav.

Our business model and strategy

Our strategic priorities

US higher education courseware

Offering learners more affordable choices and better outcomes will help us take share through expanding our addressable market. We will do this by:

- The exciting pipeline of new products
- The deployment of our new Global Learning Platform to enable faster innovation and scalability
- Investing in services, such as analytics.

Core student assessment and qualifications

- Pioneering a shift to a more digital future, building on innovative online data analytics tool Results Plus, making access to marked exam scripts available online, free to all students, teachers and schools
- Investing in new products and services to drive growth and market share gain.

US student assessment

- Digitally administered tests now account for well over 50% of the total
- Digital lead is allowing us to develop strong partnerships and reduce regulatory risk
- Leading the adoption of artificial intelligence in assessment providing real-time, personalised feedback, supporting teachers to help learners focus on what they need to achieve.

The future of learning

What the future of learning looks like in US higher education courseware – Revel and the Global Learning Platform

Our world is changing. As the nature of work evolves, our solutions must foster the knowledge and skills students need to succeed both in school and in their careers.

Pearson is meeting this challenge head on. We are leveraging the latest technology to provide real-time feedback as students engage in open-ended challenges that foster critical thinking and effective communication.

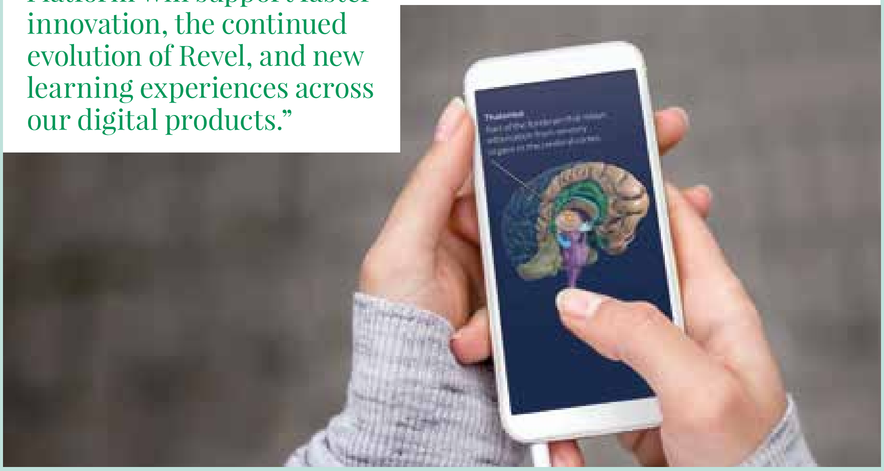
Today, Revel supports engaging learning experiences and activities, including automated essay feedback and scoring. The essay assignments ask students to answer open-ended questions to assess their understanding and communication skills. For selected essay prompts, Revel provides immediate feedback and generates a score for the instructor and students to review in the gradebook.

In the future, the product will offer enhanced automated essay grading and feedback services that leverage the latest developments in Artificial Intelligence, machine learning, and data science. In this way, an AI-based student essay scoring system will learn instructors' grading and feedback patterns and automatically apply them to subsequent essays at scale.

The scoring system will measure both what students say and how they say it, assessing both comprehension and ability to communicate a wider variety of knowledge and skills. Each student will receive personalised feedback on their essay and scores for their instructor's review. Students can then choose to revise their work based on the feedback and resubmit it to their instructor.

The Global Learning Platform will support faster innovation, the continued evolution of Revel, and new learning experiences across our digital products. That will allow us to respond more quickly to students and educators' needs, and deliver a more personalised approach to learning, on an unprecedented worldwide scale.

> "The Global Learning Platform will support faster innovation, the continued evolution of Revel, and new learning experiences across our digital products."



Our business model and strategy

2 Invest in structural growth markets

Our performance | Our market | Our approach and strengths

Virtual schools

2017 sales
£274m

Percentage of Pearson's total sales
6%

Size of market
$1.5bn+

Market position
#2

- Total virtual school enrolment in the US is about 330k
- Virtual schools are permitted in 34 states, covering about 80% of K-12 population, including the 'big three' – CA, TX, FL.

A digital business where we offer complete services for charter school partners, support for district programmes and blended offerings. Our strengths include:

- Strong brand, good learning outcomes, high parental satisfaction
- Domain knowledge; end-to-end solution
- Proven partner school model.

Online Program Management and other HE services

2017 sales
£253m

Percentage of Pearson's total sales
5%

Size of market
$1.2bn

Market position
#1

- Market growing at 10%
- Pearson has 40 global partners and runs over 250 programs
- 45 new programs signed and 14 new programs launched in 2017
- Course registration growth of 8%.

The digital promise of "anywhere, anytime learning" opens up one of our biggest structural growth markets:

- Strong brand and track record
- Domain knowledge; end-to-end solution; and can leverage further strengths in content and assessment
- Proven enterprise/undergraduate model
- Multi-programme and multi-discipline approach.

Professional certification

2017 sales
£474m

Percentage of Pearson's total sales
11%

Size of market
$1.2bn

Market position
#1

- Growing market driven by increasing demand for professional credentials and regulatory change.

We are the largest vendor in this market and have built our brand through:

- Security and reliability
- Leading digital platforms
- Global network of 20,000 testing centres.

English

2017 sales
£305m*

Percentage of Pearson's total sales
7%

Size of market
$5bn+

Market position in English courseware
#2

Market position in English assessment
#3

- 1.7bn English speakers globally, expected to be 2bn by 2020
- A growing opportunity – ELT courseware, assessment, PTE-Academic and adult school franchises.

- Better customer experience/outcomes
- Embedded in-course assessment and analytics
- Alignment to Global Scale of English consistency and scale.

* excluding WSE

Our business model and strategy

Our strategic priorities

Virtual schools
- Expand the addressable market with new partner schools
- Scale up in existing states while continuing to take market share.

Online Program Management and other HE services
- Strong pipeline of investment for longer-term growth
- Expansion of enterprise/undergraduate models, global growth and employer education.

Professional certification
- Near-term growth from US MCAT
- Long-term growth through leveraging operational excellence and expertise.

English
- Grow English courseware with new product pipeline that leverages strength in content and assessment
- Grow PTE-Academic, our leading digital test that gives faster, more accurate results
- Use insights from our direct delivery businesses in China to power a wide range of partners, deploying our brands, content, assessment and ability to scale online.

The future of learning › Virtual schools › Connections Academy

We are currently the number two player in virtual schooling in the US, but are growing more rapidly and have a strong reputation in the market.

We are aiming to build share by deepening existing relationships, accelerating the opening of new schools and investing to drive greater efficacy through our product offering.

Our model is proven, our results are strong academically and we have a powerful brand which is highly regarded by parents and educators alike.

Learner story › Alex LeViness › Ohio Connections Academy (OCA) virtual school graduate

In a letter to The Columbus Dispatch, Alex wrote:

"I enrolled in the online charter school before my junior year because I had a very difficult experience in my previous school. I had grown to hate everything about school (especially my math courses) and I didn't care if I finished high school. College wasn't even a consideration. Once I started at OCA, I discovered I could learn at my own pace and my teachers motivated me to dive deeper into subjects that interested me. Along the way, I started to love studying and learning and I even found that I actually liked science... I really don't think that I would be anywhere close to where I am today if I hadn't had the opportunity to attend Ohio Connections Academy... I wish to thank all my teachers and counselors at OCA who worked with me and inspired me. They really changed my life at a time when I thought education was pointless."

Alex recently graduated from the University of Alabama and plans to travel to Germany to conduct research as part of her Fulbright Scholarship to the Max Planck Institute for Plasma Physics, and then to begin her Ph.D. programme in physics at Princeton University.

"I started to love studying and learning and I even found that I actually liked science... I really don't think that I would be anywhere close to where I am today if I hadn't had the opportunity to attend Ohio Connections Academy..."

Our business model and strategy

3 Become simpler and more efficient

2013 ← c.£650m of cost savings[1] → **2016**

Focus areas

- Centralising functions for a simpler and leaner organisation
- Commence roll-out of single global Enterprise Resource Planning software

2017 ← c.£300m of cost savings[2] → **2020**

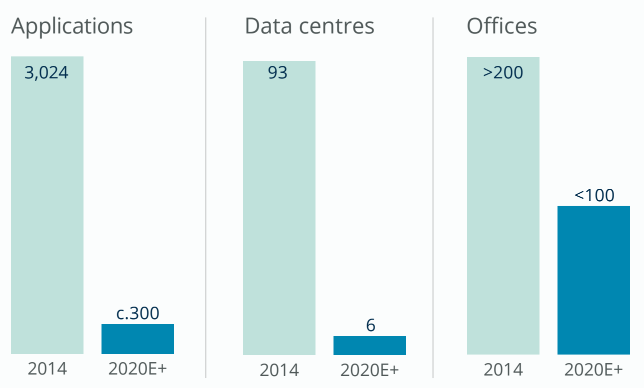
Focus areas

- Further simplification through shared services centres
- Leaner organisations through reduction in headcount
- Reduction in number of legacy applications, data centres and office locations
- Complete roll-out of global Enterprise Resource Planning

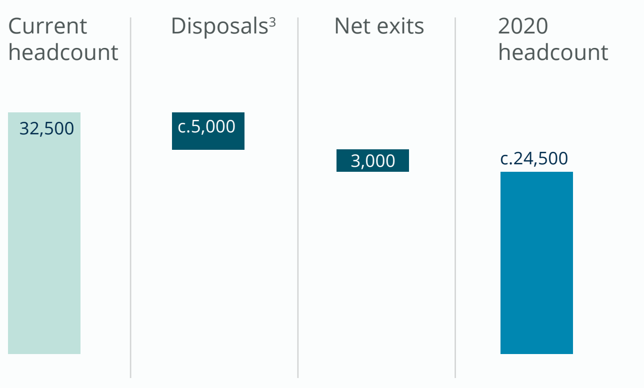
Recent activity

- US K-12 courseware Held-For-Sale in 2018
- Exited WSE, GEDU, Utel, smaller businesses in 2017

Infrastructure simplification



Headcount reduction



Our competitive advantage

Record level of investment

Pearson's strong balance sheet underpins the continuing investment in our digital transformation and structural growth markets. We are investing over £700m a year to become the winners in digital education.

Global player

We have a truly global scale and focus. We operate in over 70 markets worldwide. Our products and services benefit from being centrally developed, globally deployed with local expertise and capabilities ensuring success.

Move to digital

Pearson's products and services are becoming more digital and personalised, offering more affordable choices for students with better learning outcomes. This is building a more sustainable and profitable business with a more visible and predictable revenue profile, based around access not ownership models.

Common platforms

Our products and services are increasingly being delivered across common platforms, enabling a leaner Pearson, driving significant revenue and cost synergies.

Market leader

Our competitive position is strong and we occupy either number one or number two positions in all our major markets. We are focused on gaining share through our digital transformation and building sustainable, leading positions in our structural growth markets.

1 Calculated at year end 2016 exchange rates.
2 Phased plan first presented on August 4 2017, based on December 2016 FX rates. Note: A significant part of these costs and savings are in US Dollar and other non-Sterling currencies and so subject to FX movements over the implementation timeframe.
3 Not including US K-12 courseware.

Our business model and strategy

Helping create the future of learning

An interview with Cedrick Collomb, Senior Vice President for Global Product Technology

What excites you most about the work you do at Pearson?

CC

What excites me the most about working for Pearson is how we are using technology to revolutionise and drastically transform education. Our customers and learners are at the heart of everything that we do, and we are bringing them the best – and most advanced – technologies so that they have engaging, highly interactive experiences with our products. Leveraging the latest technologies such as artificial intelligence, machine learning, augmented reality, virtual reality, advanced real-time rendering, simulation, to name a few, will enable this experience, and ultimately improve their learning outcomes.

What is your main goal for 2018?

CC

This year, we are shaping the future of education by bringing our Global Learning Platform technology to life through next-generation software. The platform will enable us to deliver unparalleled learning experiences to our customers and learners around the world.

How are you helping Pearson in its transition to digital?

CC

Pearson's digital transformation isn't just taking our legacy products and making them digital, it is much more than that. Every aspect of the company is undergoing transformation; how we operate, our processes, how our teams work, how we build and deliver, it's everything. In building the Global Learning Platform, our teams have been laser focused on using the best data to learn as much as we can about our customers' behaviour and what we as a company need to do in order to give them world-class learning experiences.

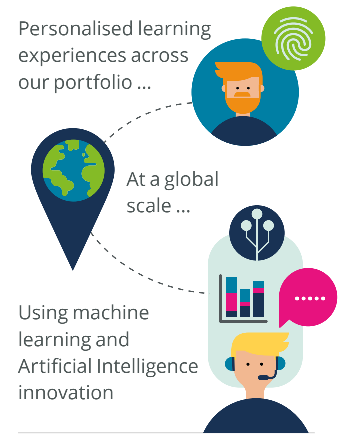
What is your biggest win at Pearson to date?

CC

Personally, I have enjoyed sharing the developments of the Global Learning Platform with our employees, especially the first-look demo which brought the idea of the Global Learning Platform to life and showed the promise of profound educational changes. Transforming education as we know it today is no easy feat, and I am humbled to be the leader of an exceptionally high-performing team, who collectively have delivered – and continue to deliver – so that we deliver on Pearson's mission. The team are not only building next-generation products and software, but are also serving our current customer base by ensuring all of the products across our portfolio are stable, reliable and deliver a quality experience for our customers.

Global Learning Platform *in one minute*

Over time, all of Pearson's products will be brought onto a single platform which **will allow us to deliver:**



GLP products will:

- be highly scalable and more reliable, speeding up innovation
- support customer and third party integration
- be a foundation for a lifelong learning ecosystem

> "Pearson's digital transformation isn't just taking our legacy products and making them digital... every aspect of the company is undergoing transformation."

CC Cedrick Collomb
Senior Vice President for Global Product Technology

Our business model and strategy

Value created for our stakeholders

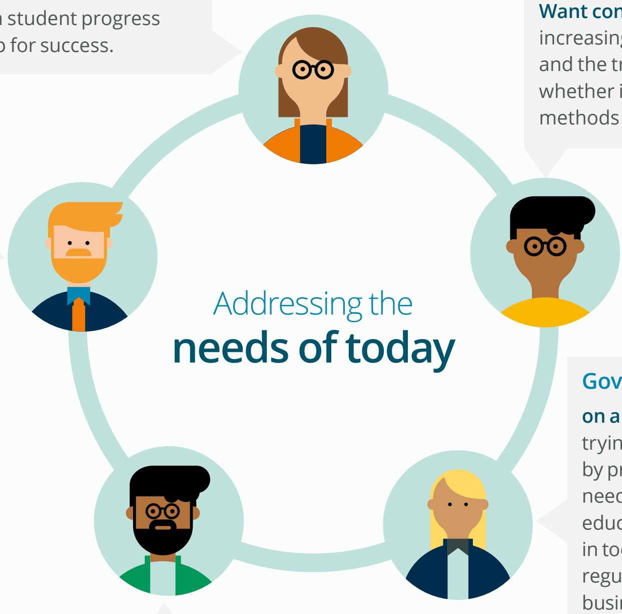
Our strategy is driven by the belief that education is evolving to meet the demands of today's learners, and we are a driving force behind that change. This will enable us to create long-term, sustainable value for our shareholders, customers, partners and learners across the world.

Educators

want more engaging ways to connect with their students and better and more timely feedback on student progress to help set them up for success.

Learners

Want control over their education and are increasingly questioning the value of an education, and the traditional trappings of institutions – whether it is courseware, outdated teaching methods or brick-and-mortar institutions.



Industry

is looking for the educational system to help drive growth and innovation by graduating students from high school prepared for college or a career, and for higher education to become more accessible and affordable. A strong education system is crucial to preparing people for prosperous employment and successful lifelong learning.

Government

on a local, state, federal and national level are trying to address inequities in the growing skills gap, by providing education systems attuned to the needs of the workforce and designed to deliver the education and training individuals need to prosper in today's labour market. Governments and regulators also set policy to ensure that both businesses and consumers are provided with the most effective legislative frameworks that help drive sustainable growth.

Administrators

in a cost-conscious environment, aim to deliver innovative and high-quality experiences that set students on a course to become prosperous lifelong learners.

Value for our customers

No one can predict with certainty what the future of learning will look like, but we know that technology has enabled autonomy and customisation for the individual. Education, without a doubt, has to follow suit. Not all students, educators and institutions are the same; they each have to choose what is most likely to make them successful.

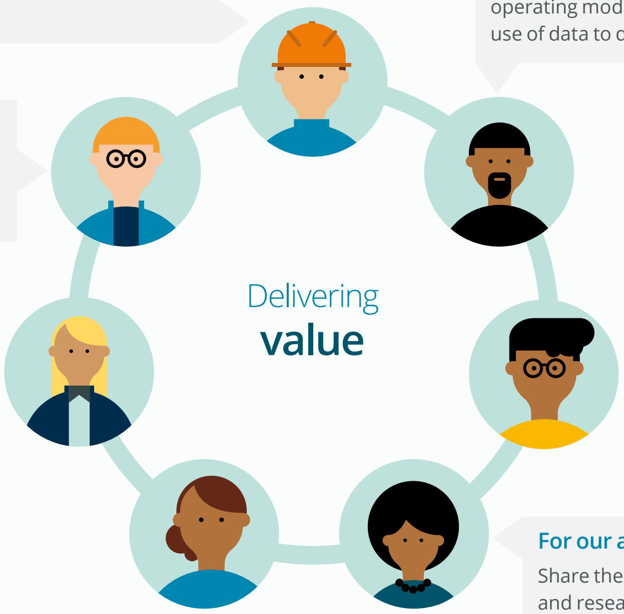
Building skills around lifelong learning, agility and innovation will give the next generation of learners the confidence to be successful, no matter what they do. We offer traditional tools and methods and continually innovate so that learners are given the power to choose what, how, when and where they learn.

Our business model and strategy

For our partners and suppliers:
Building successful business partnerships across the education ecosystem to build joint success and growth.

For our customers:
Building a truly customer-centric operating model based on effective use of data to drive strategic insights.

Channel partners:
Help ensure learners have the course materials they need to succeed in their studies.



For governments:
Building strong political and institutional relationships to support our stakeholders. We are committed to aligning our agendas – we provide counsel and share our knowledge on the future trends in global education; we create opportunities for private-public partnerships.

For our learners:
Developing an innovative technology platform to support and enable lifelong learning, focusing on achieving better learning outcomes.

For our authors:
Share their passion for teaching and research to bring new skills and concepts to life for learners.

For our employees:
Creating a healthier company, with clear expectations, sufficient resources, supportive relationships and clear accountability to deliver a very ambitious programme of change and transformation.

Our approach to value creation

We are developing new organisational capabilities to create value for all our stakeholders while keeping our learners at the heart of everything we do. Our culture will enable sustained success, capturing external ideas, fostering top-down innovation and driving business partnerships and collaboration.

Value for our shareholders:
This will ultimately help us achieve long-term sustainable growth for all our company shareholders.

Please see the stakeholder engagement section of the Governance report for more on how we build strong relationships with our diverse range of stakeholders on p88–89

Efficacy

We made a commitment in 2013 to report annually on the impact of use of our products on outcomes, and to externally audit the reports by 2018. From 2014–2016, we shared preliminary efficacy findings; this year we are proud to publish our first set of audited efficacy reports, certified by PricewaterhouseCoopers. Collectively these reports are representative of products impacting the lives of 18m learners. We are proud to be the only learning company committed to efficacy with such rigour and at such scale.

What we did and what we have learned

When we launched our commitment to report on the efficacy of our products, we aspired to have impact in three areas:

- evidencing that our in-market products improve the outcomes that matter most to customers and learners;
- supporting evidence-based product innovation; and
- galvanising the education sector and all learning companies to measure their impact by the outcomes they deliver for learners.

Over the past four years, working across all of Pearson's major digital product portfolios, we embedded efficacy and research across product development in both early-stage product strategy, design and development, and later stage product improvement. For the majority of our in-market digital supplemental products, we have evidence that there are statistically significant relationships between the use of our products and student achievement.

Learning

In order to understand where, when, how, why and for whom our products are effective, we focus on defining and collecting evidence of impact on the outcomes that matter most to our customers and learners, including access and engagement, competency and skill, achievement and progression.

We have evidence that there are statistically significant relationships between the use of many of our digital products and course achievement outcomes. However, the efficacy of a digital product cannot be separated from the way that product is implemented, or the context in which it is used. Who is using the product – what their prior knowledge and experience is, implementation – the way a product is integrated into teaching and learning – and product alignment – the way that the features of a product are designed, aligned and used to support the achievement of learning goals – all have a significant impact on the outcomes that can be achieved.

The more we can engage with our customers to better understand the outcomes that matter most to them; select products that have features that can support the delivery of those outcomes; and share best practices about how learning technologies can be integrated into their teaching, the more likely they will be to achieve their desired outcomes.

Product innovation

Our efficacy research to date has focused on measuring the impact of the use of digital supplemental products on course achievement goals. We have used what we have learned about our in-market products to make incremental improvements to existing products as well as to support new product innovation.

In parallel, we are further driving more evidence based approaches to product development by applying evidence about what works from the learning and data sciences to the design, development and ongoing improvement of products. We are focusing on helping learners develop the knowledge and the skills they need to be successful in the future.

As we progress with the development of fully digital learning experiences, we expect that the combination of these elements – paired with implementation support for our customers – will enable an even greater impact on learning.

Education sector

In 2013, Pearson was the first learning company to make a public commitment to reporting on the impact of use of our products on outcomes. Since then, both our traditional and non-traditional competitors have announced similar efforts. Today, we remain the only learning company in the world that is subjecting its efficacy statements to external audit and peer review. Put simply, we are the only company that has made a public, evidence-based commitment to helping more learners learn more.

https://www.pearson.com/corporate/efficacy-and-research.html

Connections

In 2017 we took a critical lens to better understand the efficacy of Connections Academy. This work was intended to help us evaluate how we are educating young people through our virtual schools. Through three different methodological approaches, we sought to better understand the students we serve, as well as their performance at Connections Academy relative to peers in brick and mortar schools with similar populations.

Our research confirms that our virtual schools serve a diverse and unique student body with some of the highest mobility rates in the United States. When we adjust for this student mobility and control for prior student achievement, our studies found that the academic performance of Connections students is comparable to that of students in brick and mortar schools.

We look forward to sharing this research with the virtual schools sector to help inform the discourse around virtual schools, so that students and families who may benefit from such learning environments have the opportunity to do so.

Efficacy

Helping create the future of learning

An interview with Kate Edwards, Senior Vice President Efficacy & Research

"In 2018, we will be the first learning company in the world to undertake, and release, non-financial reporting on the impact of use of our products on outcomes for learners."

KE Kate Edwards
Senior Vice President
Efficacy & Research

What excites you most about the work you do at Pearson?

KE

Working for a business that seeks to combine commercial growth with impact on learning. For me this is all about understanding the greatest learning-related challenges and needs our customers and learners have now, and will have in the future, and then applying outcomes-focused, evidence-based design to our solutions. This is what keeps me up at night (in a good way!) and what gets me up in the morning.

What are your main goals for 2018?

KE

At the company level, our efficacy & research goal is to continue to improve our impact on learning outcomes.
In 2018, we will be doing this by:

1. Developing evidence-based products, applying efficacy improvement activities and undertaking efficacy reporting
2. Using efficacy & research more frequently to help our colleagues have learner-led conversations with our customers
3. Developing the efficacy & research skills and expertise of our people
4. Actively participating in external conversations on efficacy & research

In particular, we want to apply this work to informing the design of products that develop the skills needed for both work and life in the future.

How are you helping Pearson in its transition to digital?

KE

I'm passionate about the role we need to play in exploring and explaining three things in digital teaching and learning: the role of the educator, the role of the student and the role of the technology.

What is the most important milestone Pearson has reached from an efficacy & research perspective to date?

KE

The most important milestone, to date, is yet to come. We will reach it at the end of March 2018 when we release our 2018 Efficacy Reports. We will be the first learning company in the world to undertake, and release, non-financial reporting on the impact of use of our products on outcomes for learners. External reporting and auditing for the first time is an important milestone for Pearson and efficacy. However, the ongoing commitment to external reporting is a means to an end: the primary goal being for Pearson to use evidence about how to improve learning to develop and sell best-in-class products and services.

Sustainability

Sustainability is integral to our company strategy. This is no accident as commercial success cannot be separated from ethical and sustainable business practice. It is fundamental to achieving our mission to help people progress in their lives through learning.

Two years ago, Pearson adopted its 2020 sustainability plan. It provides a framework for the business to focus on the most important ways we can contribute to solving some of the world's greatest social and environmental challenges, while helping to grow and strengthen our business at the same time. By setting a vision to integrate sustainability into every aspect of the company, the plan continues to guide us as we deliver on our business strategy.

The plan was designed to reflect the United Nations Sustainable Development Goals (SDGs), which together point towards a more equitable, ethical and environmentally sustainable world. Of the 17 SDGs, we have prioritised Goal 4 on quality education, Goal 8 on decent work and economic growth and Goal 10 on reducing inequalities. Quality education is both one of the goals but also a factor underpinning success across all the goals. As such, a stronger and more sustainable Pearson in turn will allow us to help more people progress.

Sustainability Plan

Our 2020 Sustainability Plan is designed to create value for our learners, shareholders and society. It is built around three pillars:

1. Be a trusted partner

2. Reach more learners

3. Shape the future of learning.

More information on our performance will be available later this year when we publish our 2017 Sustainability Report. In this section, we:

› Set out the key material issues for the company and how these relate to our risk management process

› Outline how sustainability is governed at Pearson

› Report on highlights from each of the three pillars.

Our material issues

Our 2020 Sustainability Plan is informed by our material issues – those most relevant to the sustainability of the business. They were identified following consultation with senior leaders and employees, external experts and stakeholders, and a review and benchmark of current policies and priorities. We then further prioritised nine key issues.

These issues represent both opportunities for growth as well as risks to revenue. We continue to map these sustainability issues against our enterprise risk management process. As part of our risk management process, company-wide risks are tracked across geographies and functions.

See *Our material issues* matrix p26

Sustainability governance

The Reputation & Responsibility Committee, a formal committee of the Board, provides ongoing oversight, scrutiny and challenge on both matters relating to our sustainability strategy and our corporate reputation. Learn more on p86.

The Pearson Executive drives implementation of business strategy, including responding to our sustainability issues. The Responsible Business Leadership Council oversees the development of the strategy on behalf of the Board. It is chaired by our Chief Corporate Affairs & Global Marketing Officer and comprises senior leaders from across the business.

Sustainability

Sustainability plan

Building a sustainable business is critical to achieving our mission and ensuring our long-term competitiveness. Our customers, employees, partners and learners expect us to uphold the highest business standards, to continuously enhance the quality of our products and to contribute to their communities.

To help achieve this, we have three sustainability pillars:

1 Be a trusted partner

- Deliver high-quality products and services
- Respect human rights
- Develop our people and communities
- Protect our natural environment
- Build a sustainable supply chain
- Ensure strong governance

2 Reach more learners

- Improve access to and affordability of products and services
- Collaborate to reach underserved learners

3 Shape the future of education

- Leverage technology for equitable learning outcomes
- Build skills that foster employability and inclusive economic growth
- Promote education for sustainable development
- Contribute to global research, dialogue and collective action on quality education

Our plan aligns with the United Nations SDGs creating better outcomes for customers and society, and stronger financial returns for shareholders.

4 – Quality education

8 – Decent work and economic growth

10 – Reduced inequalities

1 Be a trusted partner

Pearson has a set of commitments that together define responsible business for us. These are to:

- Ensure that our products and services are inclusive, appropriate in content to the age, location and ability of the learner and are easy and safe to use and access
- Respect and progress our employees and provide opportunities for them to get involved in their local communities
- Respect human rights, including protecting data entrusted to us by learners and our customers. More information on our approach to data privacy and security can be found in the Principal Risks section (p58)
- Extend our commitments on human rights and environmental responsibility to include our suppliers, franchisees and other business partners
- Deliver against our targets to make more efficient use of resources and on our response to climate change.

Deliver high-quality products and services

Learners trust and depend on Pearson to provide course materials that are relevant, appropriate, inclusive, safe and work well. Our primary responsibility to learners is through the products and services we sell and how we extend our reach. Our section on Efficacy (p22) describes the progress we have made in ensuring our products have their intended learning outcomes.

A focus area last year was the development and release of a new global editorial policy designed to ensure we consistently publish high-quality content and prevent errors or offensive content. The policy is global in scope and builds upon both existing editorial principles in operation today across our business as well as a review of external guidelines.

This work was happening at the same time as the discovery of inappropriate material in our Concepts in Nursing series of textbooks. We took immediate action – issuing a public apology, removing the offensive material and offering a free replacement copy to students who requested a reprinted copy.

We now have more work to do, and work will begin on training on the new policy early in 2018. This is a first step ahead of policy due diligence. We are also starting work in partnership with Stonewall on developing guidelines for our UK Schools business on how we can make our products more LGBT inclusive.

Respect and progress our employees

Our commitments to our people as a responsible employer are to:

- Inform, support and equip colleagues to work collaboratively
- Encourage and reward high performance, nurturing talent and creating a culture where all are able to realise their individual potential
- Provide a safe and healthy work environment for our employees and the learners we serve. See the Principal Risks section on p54 for more detail on how we manage this issue
- Help our employees understand how we are doing as a company, including how world and sector trends might affect them.

Sustainability

Our material issues

Materiality matrix

The following matrix shows how we mapped our 19 issues, and highlights the nine that we have deemed to be the most material for the purpose of our sustainability strategy.

We will evaluate, refine and talk with stakeholders about our material issues on an ongoing basis, in the spirit of continuous iteration and improvement.

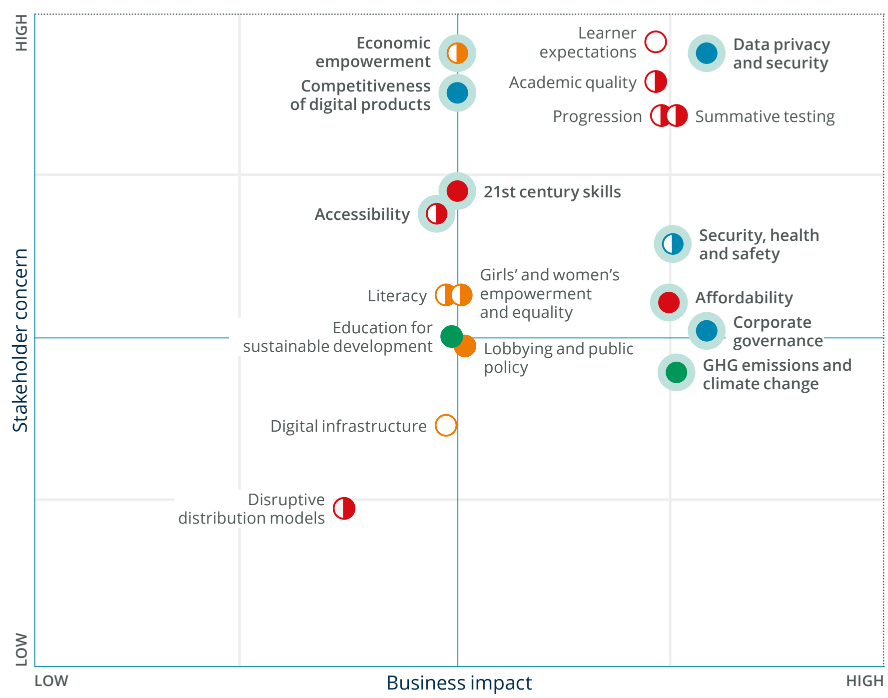
Key to material issues

Nine material issues in our sustainability plan and reporting

- Corporate functions
- Societal issues
- Education industry
- Environmental issues

Degree of control

High · Medium · Low



Alignment of material issues to principal and other Pearson risks

Sustainability report 2016 Material issues	Annual report 2017 Principal risk	Company-wide risk	Business area risk monitoring
Disruptive distribution models	2	YES	› Global Product › Core › Growth › North America › Environmental, Social & Governance
Competitiveness of digital products	2		
Affordability	2		
Learner expectations	2		
Academic quality	2		
Summative testing	5	YES	› Assessment › Core
Lobbying and public policy	4	YES	› Core › North America › Growth › Assessment
Data privacy and security	12	YES	› Global Product › North America › Legal › Core › Assessment › Tech & Ops › Growth
Digital infrastructure	8	YES	› Global Product › North America › Tech & Ops
Security, health and safety	6 7	YES	› Core › Assessment › Tech & Ops › Growth › Environmental, Social & Governance › HR
Accessibility*	–	–	› Assessment › Legal › Environmental, Social & Governance
GHG emissions and climate change	–	–	› Environmental, Social & Governance

* Emerging risk

See *Principal risks and uncertainties*, p50

Sustainability

Pearson continues to manage considerable amounts of change both within the business and outside it. We have introduced new business models as well as continued our investment programme in new platforms and products to help us simplify and standardise how we work.

During 2017, we announced additional plans to achieve annualised cost savings of £300m by 2020, including a target to reduce the total Pearson team by 3,000. We continue to provide comprehensive information on the trends behind these plans, regular communication with extra detail on the process for affected teams and consultation as well as support for colleagues leaving the company.

Culture, mission and values

Our values – to be brave, imaginative, decent and accountable – continue to guide us in implementing our strategy. They are embedded into our performance assessment, which means all employees are evaluated on and rewarded for acting consistently with them.

The Pearson Code of Conduct underpins our values by setting out the ethical, social and environmental standards of behaviour we expect from employees, and we have a companion code for business partners.

The Code was refreshed and last circulated in September 2017. We make sure everyone in Pearson is aware of the Code and confirms they understand and will comply with it. Agreeing to the Code is a mandatory part of the on-boarding process for all new Pearson employees. We have achieved our target of 100% of employees having signed up to the Code.

Many of the areas covered by the Code are supported by detailed policies and procedures. For example, anti-bribery & corruption, health & safety & safeguarding. Learn more about these issues in our section on Principal Risks (p54–55).

Employee engagement survey

Employee engagement remains a consistent priority as we navigate changes to our business. Last year, each member of the Pearson Executive Management team committed to respond to the key themes highlighted in our 2016 Employee Engagement Survey. Each Executive developed a plan with progress monitored quarterly. Highlights from those plans:

Aspect	Issue	Response
Career Development and Mentoring	More information for employees on how to progress their careers at Pearson	Over 1,500 employees participated in Career Development Workshops across 111 sessions in 27 locations in 23 countries. Over 100 mentoring relationships have been established.
Company Strategy	To do more to communicate on our products and reporting on progress	We introduced Discovery Days – forums to engage employees on our strategy, products and brand and provide workshops to gain new skills. 24 Discovery Days were held in 2017 in 14 countries. Since 2016, 24% of Pearson employees have attended a Discovery Day.
Learning and Development	More opportunity to develop functional and management skills	Academies were launched on Technology, Product, Sales and Finance to strengthen expertise and career development. We introduced Workforce 2020 capabilities defining who we are, how we act and what we do. These provide guidance on the capabilities Pearson expects. We launched our Leadership Academy, delivering what leadership looks like at all levels in the organisation. The Academy offers a range of programmes, resources and support. It includes a pilot of a new Manager Fundamentals training programme to help prepare new managers for success. All of the above are available through Pearson U and open to all employees. In 2017, 25,725 employees took at least one course in Pearson U.

During 2017, we followed up by asking 1,700 Pearson leaders to take an organisational health survey to help us understand areas where we could further boost performance. Key findings include the following:

Aspect:	Action taken:
Being clear on our strategy	Set our three strategic priorities, published a company-wide performance dashboard, appointed a new Chief Strategy Officer and been clear on our priorities as part of our brand focus
Accountability and ownership	Have been more explicit on expectations of individuals to collaborate and deliver against the strategy
Innovation and partnership	Invested in new platforms and partnerships
Insight	Created a global research and insight function
Operational excellence	Accelerated the investment in centres of excellence, driving efficiency through investment in technology
Diversity and inclusion	Established a new committee and global team to help us better reflect the communities we serve

Sustainability

Working with the 30% Club on women's mentorship and empowerment

To support Pearson's commitment to progressing women within our organisation and supporting women in leadership, we joined forces with the 30% Club on a mentorship programme in the UK.

The 30% Club is dedicated to bringing the percentage of women on Boards and in executive management up to 30%. Expanding mentorship for women is a key part of reaching that goal.

Our Women in Learning and Leadership (WILL) group in the UK worked with the 30% Club to facilitate a cross-company mentorship for talented mid-career Pearson women via a scheme that began four years ago.

At a 2017 award ceremony, the 30% Club named Pearson 'Dynamic Mentoring Organisation of the Year' for our work around expanding diversity and inclusion; for developing events and services to harness the power of mentoring; and for supporting mentors and mentees to make time for meetings and fully embrace the value of mentoring. In the same award ceremony, Pearson employee Carol Hill was awarded Committed Mentee of the Year Runner Up.

"Being a mentee in the 30% Club scheme has been an amazing experience for me. I was paired with a mentor from the banking industry who acted as an unbiased sounding board for me as I tried to work my way through my career goals."

Carol Hill, Director of Global Product Lifecycle Implementation at Pearson

We operate a free, independent, confidential telephone helpline and website available to anyone who wants to raise a concern. We have a clear non-retaliation policy in place to encourage people to share the issues they have and we ask about how comfortable people are in raising concerns in our employee engagement survey. In 2017, we had 87 concerns (107 in 2016), which were investigated and, where possible, the outcome shared with the whistleblower. As in previous years, the majority of the concerns related to HR practices. Material concerns are reported to the Pearson Audit Committee.

Diversity, equality and inclusion

At Pearson, we value the power of our differences. Our global Diversity & Inclusion (D&I) programme aims to build a better, stronger company for our employees, our learners and the communities we serve.

Our commitment is to aspire to maintain a work environment that's inclusive as well as diverse, in which our people can be themselves. And we are building a culture of innovation and learning where every idea and perspective is valued, so that our products reflect the people we serve – our teachers and learners.

Highlights of our activity include:

- Expansion of the new global D&I team and appointment of a senior leadership role to drive the agenda.
- Establishment of a new Executive level committee led by the General Counsel and Chief Legal Officer to provide strategic oversight.
- Around 2,400 employees get involved in our eight global employee resource networks. The networks are for women, parents, veterans, Latinos, the LGBT community, generational differences, people with disabilities and employees of black and/or African ancestry.
- Reached more than 6m people through initiatives such as our #DiscussDiversity Twitter chats
- Over 2,400 people completed D&I related training courses
- For a fifth year, achieved a perfect score of 100% in the 2017 Corporate Equality Index run by LGBT advocacy group the Human Rights Campaign.

Respect human rights

In 2017, Pearson undertook a review of its approach to human rights. Drawing on the expertise of BSR (Business for Social Responsibility), we considered how our operations, products and services, as well as the activities of our business partners, may have a positive or negative impact. The work considered the rights of learners, parents, employees and contractors, teachers and educators, customers, supply chain workers and the broader community.

Pearson also looked at how its policies seek to respect human rights standards defined by internationally agreed principles: the International Bill of Human Rights; the International Labour Organization Declaration on Fundamental Principles and Rights at Work; and the United Nations Guiding Principles on Business and Human Rights.

As a result of the human rights review, we have identified priority human rights risks and opportunities and have developed a roadmap to address them. For more, see the section on compliance in Principal Risks on p59.

Our Business Partner Code of Conduct sets out our requirements of third parties and, as part of our global approach to procurement, we include specific obligations relating to human rights compliance in new and renewed supplier agreements. We audit suppliers in high-risk categories in our book printing supply chain.

A concern across the value chain is for ensuring our activities are free from slavery, servitude, forced or compulsory labour and human trafficking. A statement on the steps taken by Pearson to combat modern slavery was approved by the Board and can be viewed on the Pearson website (www.pearson.com).

As a result of our review on human rights, we have identified relevant areas of risk and opportunity for Pearson. These include providing a safe and inclusive environment for learners, employees and contractors as well as analysing how technology and partnerships impact on rights. We do not currently have an overarching human rights policy, although we intend to introduce one in 2018. We do have policies in place for key elements of human rights including editorial content, health & safety, safeguarding and data privacy.

Sustainability

Protect our natural environment

Climate change remains a focus for us as one of the most serious issues facing the planet and GHG emissions is one of our material sustainability issues.

Minimising our environmental impact is not just the right thing to do; it helps deliver cost savings.

The environmental impact of our directly controlled operations – our buildings and business travel – is low. Our single most significant impact area is energy use and this accounts for less than 1% of our supply chain cost. As such, environmental risk has been considered and does not feature as a Principal Risk for the company.

Nevertheless, good environmental stewardship by companies is expected by stakeholders. This is why GHG emissions was identified as a material sustainability issue for the company.

We maintained our climate neutral status for our directly controlled operations – a commitment first introduced in 2009. Our strategy is for:

- Reduction: A 50% reduction in operational emissions as at the end of 2017 compared with a 2009 base year.
- Renewables: We maintained our record of purchasing 100% of the electricity we use from renewable sources and generate our own renewable electricity at five of our sites.
- Offset: Since 2009, we have now protected over 1,600 hectares of forest. One of our offset providers – the Woodland Trust – has also again provided offsets equivalent to those generated by the printing of this report.

Pearson has had an environment policy in place since 1992. We remain certified against the Carbon Trust Standard for our global operations and were the second ever organisation to secure the standard which recognises leadership in measuring, managing and reducing year-on-year carbon emissions. We also continue to be certified against ISO 14001, the environmental management standard in the UK and Australia. This standard incorporates both internal and external audit.

The Task Force on Climate-related Financial Disclosures has published recommendations for voluntary, consistent climate-related financial risk disclosures for use by companies. The biggest impact on the environment for Pearson is in its supply chain through the purchase of paper and the associated carbon emissions. During 2018, we will consider the extent to which Pearson should amend its disclosures in light of the taskforce recommendations.

On paper, our focus is on sustainability of supply, being efficient in how we use paper and on promoting responsible forest management. We:

- Have a policy on environmental sourcing of paper
- Discuss our approach with suppliers, customers, environmental groups and investors
- Are active members of industry bodies dedicated to responsible forest management
- Hold Forest Stewardship Council (FSC) chain of custody in the UK as does LSC Communication, our outsource partner in North America, allowing books in those markets to carry the FSC label.

We will publish full details of our environmental performance including other materially important emissions such as water use and embedded carbon dioxide in purchased raw materials in our 2017 Environment Report.

Key performance indicators
Gender diversity

Women in Pearson %

Pearson works hard to create an environment where women have the opportunity to build careers in all functions and at all management levels of the organisation.

At Board level, 30% of our members were female as at the end of 2017. As a founder member of the 30% Club, we remain committed to the target of a minimum of 30% representation of women on the Board.

	2015	2016	2017
Board of Directors	33%	30%	**30%**
Senior leadership*	34%	32%	**30%**
All employees	59%	60%	**61%**

* Two reporting lines from the Chief Executive.

Over the last two years, we have seen a fall in the proportion of women at senior leadership level. To help reverse this, we will increase our focus and investment in diversity for 2018. Our CEO has recently become a signatory to the latest 30% Club challenge to reach and maintain a minimum of 30% representation of women in senior leadership.

In the UK, the government has introduced new regulations designed to help address the gender pay gap. Pearson has provided information on its gender pay gap in the UK and has made a commitment to extend our reporting globally by 2020.

Key performance indicators
Global Greenhouse Gas emissions data

Metric tonnes of CO_2e

Emissions from	2015	2016	2017
Combustion of fuel and operation of facilities (GHG Protocol Scope 1)	22,343	19,093	**15,691**
Electricity (GHG Protocol Scope 2)	88,831	77,579	**61,047**
Emissions relating to air and rail travel, electricity transmission, waste and water (GHG Protocol scope 3)	35,644	29,714	**27,646**
Total	**146,368**	**126,386**	**104,384**
Intensity ratios	**2015**	**2016**	**2017**
Scope 1 and 2/sales revenue	24.8	21.2	**17**
Scope 1 and 2/FTE	2.7	2.95	**2.53**

Methodology: We have reported on all of the emission sources required under the Companies Act 2006 (Strategic Report and Directors' Reports) Regulations 2013. These sources fall within our consolidated financial statement. We do not have responsibility for any emission sources that are not included in our consolidated statement. The method we have used to calculate GHG emissions is the GHG Protocol Corporate Accounting and Reporting Standard (revised edition), using the location-based scope 2 calculation method, together with the latest emission factors from recognised public sources, including, but not limited to, the UK Department for Business Energy & Industrial Strategy, the International Energy Agency, the US Energy Information Administration, the US Environmental Protection Agency and the Intergovernmental Panel on Climate Change. The data in the table above has been independently verified by Corporate Citizenship.

Sustainability

2 Reach more learners

Reaching more learners is integral to both our business goals and our sustainability strategy. Through growing our business, we can both achieve our financial targets and help more people to progress through learning. The commitments we make are designed to contribute to a quality education for all, decent jobs and equality:

- Expand access to education and make learning more affordable for people everywhere, including the most disadvantaged groups
- Harness the power of new technologies to bring education and opportunities to more people in more places
- Work together with charities, teachers, education experts, governments and others to tackle some of the biggest education challenges related to gender inequality, conflicts and emergencies, and illiteracy.

We are taking steps to tackle some of the barriers underserved learners face, such as geographic, cultural or socioeconomic obstacles, or personal constraints, such as the need to balance education with work and family responsibilities.

For example, products like Revel (our next-generation US higher education courseware product) help students learn in smaller, bite-sized chunks and shorter time periods, so they are able to carve out a few minutes from their busy days or make use of transition times like commuting when they would not otherwise be able to study. Personalised, adaptive solutions in products like MyLab can identify students who are behind and help them stay on track. Our inclusive access subscription model helps students to access their materials at a lower price.

Ability and access

Accessibility is one of our nine material sustainability issues as tailoring the learning experience to the ability level of the learner is a key factor in reaching more learners.

Standards on accessibility for people with disabilities are evolving. Focusing on higher education, Pearson has adopted a road map to invest in integrating accessibility standards into existing products while committing to apply those standards into new product development. In 2017, we announced that we will make 100% of our digital portfolio accessible for people with disabilities by 2020.

As an employer, disability is part of our wider commitment to inclusion. We work to ensure that appropriate procedures, training and support are in place for people with disabilities to ensure fair access to career and progression opportunities. One of our eight employee resource groups is Pearson Able – its remit is to improve company practice for learners and employees.

Innovating to address youth unemployment in South Africa

Through Tomorrow's Markets Incubator, Pearson employee Carolynne Lengfeld, Head of Learning Innovation in South Africa, is leading a team that has worked to develop Project Boost, a recruitment, job preparation and integration service in South Africa.

Boost aims to address the unemployment challenge for low-income youth, while making recruitment of high-quality candidates more efficient for potential employers. Unemployed young people who participate will receive support and training at no cost and will have access to jobs that offer the chance to build a CV, establish a network of contacts, gain work experience and increase their earnings.

The project is in its early R&D phase and will be piloted with a small group of unemployed young people alongside a number of employers who have shown interest in the service.

The initiative is targeted at young people between the ages of 18 and 34 who are below or close to the poverty line. This group remains vulnerable in the labour market with an unemployment rate of 37.1%, which is 10.6% higher than the national average. Pearson aims to replicate the model in other countries in Africa in due course.

The DFID Business Partnership Fund is supporting this project by providing a combination of technical assistance and a financial grant to the value of £225,210 over 20 months.

Sustainability

Community contribution

Pearson focuses on a small number of campaigns and issues where, working together with others, we can both improve access to education for underserved groups as well as be relevant to our commercial objectives. We invest in a small number of partnerships, making sure we provide opportunities for our employees to bring their energy and enthusiasm in getting involved in social impact work.

Our 2017 investment in social innovation and impact was £7.2m or 1.4% of adjusted pre-tax profits and included a number of programmes:

- Our Every Child Learning partnership with Save the Children and Tomorrow's Markets Incubator, which supports Pearson employees to develop new products and services, as well as overall business models, to bring high-quality education to learners in low-income and underserved communities. Our investment in the Incubator seeks to identify commercially viable market opportunities as well as social return
- Our award-winning flagship campaign is Project Literacy. Founded and convened by Pearson, the global campaign brings together not-for-profits and companies with a shared aim of bringing the power of words to the world, by building partnerships and driving action
- Our people are our best ambassadors and advocates. We support them to give time and money to invest in communities around where they work as well as in good causes around the world.

Additionally, the Pearson Affordable Learning Fund invests 'patient capital' in independently run, for-profit, education start-ups using innovative approaches to improving learning outcomes and increasing access, at scale.

	Community Investment	Social Innovation
Project Literacy	£3.6m	–
Every Child Learning	£0.9m	–
Tomorrow's Markets Incubator	–	£1.2m
Employee engagement/ other partnerships/ local gifts	£1.5m	–
Total	£6.0m	£1.2m

Our performance sustainability rankings

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

This year, we were delighted to be recognised in the Dow Jones Sustainability Indices as best in class for the global media sector.

Dow Jones Sustainability Indexes

2017	Gold Class & Media Sector leader
2016	Silver Class
2015	Bronze Class
2014	Bronze Class

FTSE4Good

2017	Yes
2016	Yes
2015	Yes
2014	Yes

Yes signifies inclusion in FTSE4Good

2017	Yes
2016	Yes
2015	Yes
2014	Yes

Inclusion in Global 100 most sustainable corporations (Corporate Knights)

Sustainability

3 Shape the future of education

The pace of change in education is faster than ever before.

We have a responsibility to play our part in shaping a future where learning does even more to foster inclusive and equitable societies and economies. This means ensuring our learners are equipped with the skills they need to build careers and communities, navigate uncertainty, address the world's biggest sustainable development challenges and thrive in the 21st century and beyond.

Cutting-edge technology, insights and partnerships will help us deliver. We contribute to a growing body of research, working with others to together help global education systems better serve the next generation of students.

To equip learners for jobs, Pearson's Career Success Programme aims to meet the needs of both colleges and employers by providing a digital suite of assessments, learning modules and tools that help students identify career goals and the gaps in their academic and career skills that they need to fill.

Delivering the knowledge, skills and understanding students need to prepare for their chosen career, BTECs can support progression to higher or further education or into employment. Pearson VUE helps individuals prepare for their next educational or career opportunity through credentials that verify the skills and learning required for a specific job or educational programme.

There is rising demand from educators for the integration of sustainable development topics into content, courses and curricula. By integrating sustainability-related content into our products, we can explore new market opportunities while making a direct contribution to the SDGs and inspiring the next generation to improve their world. We are collaborating with leading experts in the space to advance education for sustainability and respond to our customer needs.

Pearson and Everglades University prepare learners for careers in green building

Pearson has partnered with Everglades University in the United States and the US Green Building Council (USGBC) to develop an Introduction to Sustainability digital course designed to put students on the path to high-demand careers in green energy and building design.

Through a combination of online and hands-on learning, the course improves students' preparation for Leadership in Energy and Environmental Design (LEED) certification in growing fields such as construction; alternative and renewable energy; environmental policy and management; land and energy; and crisis and disaster management.

Upon completion of the course, students earn certificates that can be featured in the form of digital badges and added to their résumés, demonstrating their education in and commitment to sustainability.

Ultimately, this partnership will benefit thousands of students, dozens of university staff and faculty members, and the community at large surrounding Everglades University's four locations.

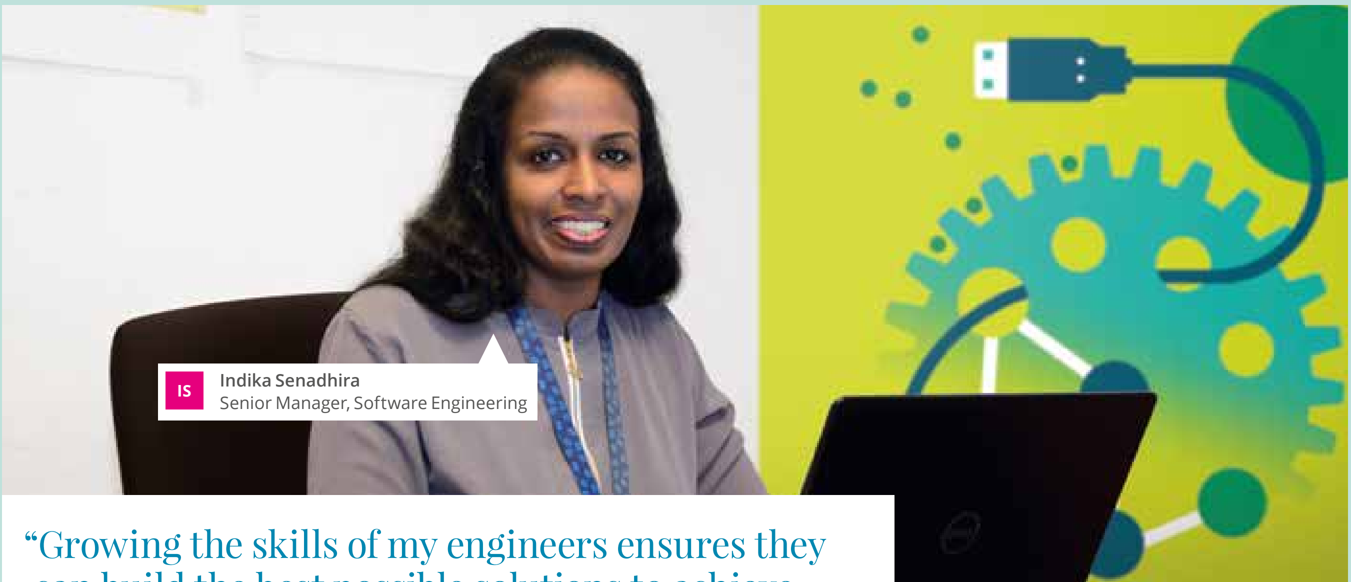
"Through our partnership with the USGBC and Pearson, we are improving the quality of our course offerings and student learning outcomes, thereby further educating, training, and certifying the future leaders in these growing fields."

Kristi Mollis, President and Chief Executive Officer, Everglades University

Sustainability

Helping create the future of learning

An interview with Indika Senadhira, Senior Manager, Software Engineering, Pearson Technology Delivery Centre, Colombo, Sri Lanka.



IS Indika Senadhira
Senior Manager, Software Engineering

> "Growing the skills of my engineers ensures they can build the best possible solutions to achieve Pearson's goals."

What excites you most about the work you do at Pearson?

IS

I'm most excited by the continuous learning opportunities available at Pearson that help me to grow in my career. There is a friendly environment and great team culture too, and I often feel like Pearson is my second home.

What is your main goal for 2018?

IS

My main goal for 2018 is to increase the technical and behavioural skills of myself and my teams. Primarily, this will help us to contribute more effectively to the development of highly scalable solutions for the business in line with Engineering Best Practices.

How are you helping Pearson in its transition to digital?

IS

I have three teams working on Next Generation technology projects that are used in Revel, eText and Learning Applications. Those applications are providing a more sophisticated digital experience for our learners and customers.

Another way I contribute to the digital transition is by encouraging a team culture of continuous learning and providing the opportunity for my team to grow. Growing the skills of my engineers ensures they can build the best possible solutions to achieve Pearson's goals.

What is your biggest win at Pearson to date?

IS

I am one of Pearson's 'home grown' managers. I joined eCollege (which was later acquired by Pearson) 13 years ago as an Associate Software Engineer. I then moved up in my career to become a Senior Manager. During that journey, the biggest win for me has been acquiring IEng accreditation with the UK's prestigious Institute of Engineering & Technology. That has opened up the opportunity for me to learn both professionally and academically, as well as contribute my knowledge to Pearson and to wider society.

The Technology Delivery Centre *in one minute*

WHO

The Technology Delivery Centre is a team of

2,230 digital specialists

used by program and product teams across Pearson.

WHAT

Capabilities include:

- Mobile
- Content
- Salesforce
- Integration
- User interface
- Digital Marketing
- Performance testing
- Security testing
- Accessibility testing
- Analytics & Big Data
- Oracle

WHERE

Operates out of Sri Lanka, India, the US and UK

WHEN

24/7, 365

Financial review

"We expect ongoing headwinds in our US higher education courseware business to be offset by improving conditions in our other businesses."

Coram Williams
Chief Financial Officer

Profit and loss statement

In 2017, Pearson's sales decreased by £39m in headline terms to £4,513m. Adjusted operating profit fell £59m to £576m (2016: £635m).

Currency movements, primarily from the depreciation of Sterling against the US Dollar and other currencies during the period, increased sales by £126m and operating profits by £23m.

The effect of disposals reduced sales by £54m and continuing adjusted operating profits by £24m.

Stripping out the impact of portfolio changes and currency movements, revenues were down 2% in underlying terms while adjusted operating profit fell £58m or 9%.

Trading contributed £58m to this decline in adjusted operating profit, other operating factors including increased amortisation expense and staff incentive contributed £95m to the decline and cost inflation, an estimated £55m. This was partly offset by a £150m year-on-year benefit from restructuring savings.

Net interest payable in 2017 was £79m, compared with £59m in 2016. The increase was primarily due to additional charges relating to the early redemption of various bonds during the year and higher US interest rates.

Our adjusted tax rate in 2017 was 11.1% (2016: 16.5%). The decrease in tax rate was primarily due to uncertain tax position provision releases following the expiry of the relevant statutes of limitation.

Adjusted earnings per share were 54.1p (2016: 58.8p).

Cash generation

Operating cash flow rose by 1% in headline terms, despite a decrease in adjusted operating profit, driven by a strong cash conversion of 116% driven by tight working capital control, strong collections and high Penguin Random House cash dividends.

Return on invested capital

On a gross basis ROIC decreased from 5.0% in 2016 to 4.3% in 2017 and from 7.2% in 2016 to 6.2% in 2017 on a net basis. The movement largely reflects lower profit in the year and increased tax payments.

Statutory results

Our statutory profit from continuing operations of £451m in 2017 compares with a loss of £2,497m in 2016. The loss in 2016 is mainly attributable to an impairment charge to North American goodwill and the higher level of restructuring spend.

Financial summary

Business performance

£ millions	2017	2016	Headline growth	CER growth	Underlying growth
Sales	**4,513**	4,552	(1)%	(4)%	(2)%
Adjusted operating profit	**576**	635	(9)%	(13)%	(9)%
Operating cash flow	**669**	663	1%		
Adjusted earnings per share	**54.1p**	58.8p	(8)%		
Dividend per share	**17p**	52p	(67)%		
Net debt	**(432)**	(1,092)	60%		

Growth rates stated on a headline basis are calculated by comparing the reported results. Growth rates on a constant exchange rate (CER) basis are calculated after excluding the effect of exchange. Underlying growth rates exclude both the effect of exchange and portfolio changes arising from acquisitions and disposals.

Statutory results

£ millions	2017	2016	Headline growth	CER growth	Underlying growth
Sales	**4,513**	4,552	(1)%	(4)%	(2)%
Operating profit/(loss)	**451**	(2,497)	n/a		
Profit/(loss) for the year	**408**	(2,335)	n/a		
Cash generated from operations	**462**	552	(11)%		
Basic earnings/(loss) per share	**49.9p**	(286.8)p	n/a		

The business performance measures include our adjusted performance measures which are non-GAAP measures. An explanation of these measures is included in this financial review section and full reconciliations to the equivalent statutory heading under IFRS are included in the financial key performance indicators section on p192–195.

Financial review

Capital allocation

Our capital allocation policy remains unchanged: to maintain a strong balance sheet and a solid investment grade rating, to continue to invest in the business, to have a sustainable and progressive dividend policy, and to return surplus cash to our shareholders.

Balance sheet

Net debt to EBITDA was 0.6x (or 2.1x on a simplified credit agency view adjusting for leases and other items). Net debt decreased to £432m (2016: £1,092m) reflecting disposal proceeds, operating cash flow and a benefit from the weakening of the US Dollar relative to Sterling, partially offset by restructuring costs, pension contributions, including amounts related to agreements regarding the disposals of the FT and Penguin, interest, tax, dividend payments and the share buyback.

During 2017, we took steps to reduce our level of gross debt and optimise our balance sheet, successfully executing market tenders repurchasing $383m of our $500m 3.75% US Dollar Notes due 2022 and $406m of our $500m 3.25% US Dollar Notes due 2023. In addition, we redeemed the $300m 4.625% Senior Notes due June 2018 and the $550m 6.25% Notes due May 2018.

During January 2018, we also successfully repurchased a total of $569m of debt at an average interest rate of around 2.5% by tendering for €250m of our Euro 1.875% Notes due May 2021 and €200m of our Euro 1.375% Notes due May 2025 and cancelling the associated currency swaps.

Pension plan

The overall surplus on the UK Group Pension Plan of £158m at the end of 2016 has increased to a surplus of £545m at the end of 2017. This has arisen due to increased contributions, including £227m as part of the agreements relating to the Penguin Random House merger in 2013 and FT Group sale in 2015, together with the impact of favourable movements in assumptions.

The UK Group Pension Plan used its strong funding position to purchase two insurance buy-in policies with Legal & General and Aviva, covering approximately £1.2bn (one-third) of its total liabilities. This put the Plan in an even stronger position and substantially reduced Pearson's future pension funding risk, at no further cost to the company.

Dividend

In line with our policy, the Board is proposing a final dividend of 12p (2016: 34p) which results in an overall dividend of 17p (2016: 52p) subject to shareholder approval.

Share buyback

We launched a £300m share buyback, beginning on 18 October 2017 utilising part of the proceeds from the disposal of a 22% stake in Penguin Random House. We completed the programme on 16 February 2018.

Businesses held for sale

Following the decision to sell both WSE and the K-12 school courseware business in the US, the assets and liabilities of those businesses have been classified as held for sale on the balance sheet at 31 December 2017.

2018 outlook

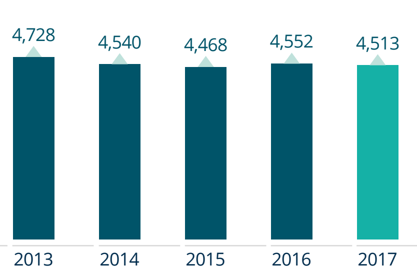
2017 was a year of progress for Pearson, delivering adjusted operating profit at the top end of our guidance range and continuing to invest in the digital transformation and simplification of the company. We expect to make further progress in 2018, with underlying profit growth, reporting adjusted operating profit of between £520m and £560m and adjusted earnings per share of 49p to 53p. This reflects our portfolio and exchange rates as at 31 December 2017 and the factors outlined overleaf.

Key performance indicators *Maintain long-term growth*

See a summary of all our KPIs on p2–3

Sales (£m)

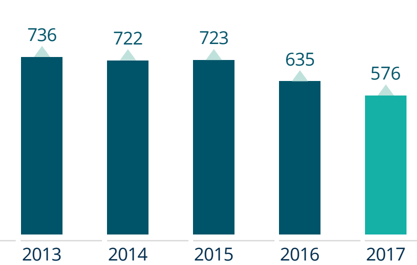
£4,513m
-1%



Sales decreased in headline terms by £39m or 1% and fell by 4% in CER terms and 2% in underlying terms. The underlying decline was due to a 4% decline in North America, partially offset by stabilisation in Core and Growth. Over the last five years, revenues have benefited from growth in digital and the relative strength of the dollar but this has been offset by pressure on print revenues, cyclical and policy factors and adverse currency movements in some of our markets.

Adjusted operating profit (£m)

£576m
-9%



Adjusted operating profit fell by 9% in headline terms with the impact of lower sales, other operating factors, including increased amortisation and staff incentives, and cost inflation offsetting the benefit from restructuring savings. Over the last five years, adjusted operating profit has declined due to the pressure on revenues in higher margin businesses, portfolio changes and increased investment in digital, partially offset by benefits from restructuring.

Financial review

Trading

We expect ongoing headwinds in our US higher education courseware business to be offset by improving conditions in our other businesses.

Portfolio changes

We completed the sale of a 22% stake in Penguin Random House and our Chinese English test preparation business GEDU in 2017. The annualised impact of these disposals will reduce 2018 operating profit by £44m. We expect to complete the disposal of WSE and our stake in Mexican joint venture Utel in the first half of 2018 and have announced that we have concluded the strategic review of our US K-12 courseware business and have classified the business as held for sale. WSE contributed £195m to 2017 sales and WSE and Utel contributed £5m to 2017 adjusted operating profit and £5m to statutory profit. US K-12 courseware is expected to contribute £385m to 2018 sales and around £11m to 2018 adjusted and statutory profit.

Other operational factors, incentives and inflation

Our 2018 guidance incorporates cost inflation of around £50m together with other operational factors and incentives of £30m.

Restructuring benefits

We expect incremental in-year benefits from the 2017–2019 restructuring programme of £80m in 2018. Exceptional restructuring costs of £90m will be excluded from adjusted operating profit in line with our recent practice.

Interest and tax

We expect a 2018 net interest charge of around £45m and a tax rate of 20%.

Currency

In 2017, Pearson generated approximately 61% of its sales in the US, 7% in Greater China, 5% in the Eurozone, 3% in Brazil, 3% in Canada, 3% in Australia, 2% in South Africa and 1% in India and our guidance is based on exchange rates at 31 December 2017.

We calculate that a 5 cent move in the US Dollar exchange rate to Sterling would impact adjusted earnings per share by between 2p and 2.5p.

Adjusted performance measures

The Group's adjusted performance measures are non-GAAP financial measures and are included as they are key financial measures used by management to evaluate performance and allocate resources to business segments. The measures also enable investors to more easily, and consistently, track the underlying operational performance of the Group and its business segments by separating out those items of income and expenditure relating to acquisition and disposal transactions, and major restructuring programmes.

The Group's definition of adjusted performance measures may not be comparable to other similarly titled measures reported by other companies. A reconciliation of the adjusted measures to their corresponding statutory reported figures is shown in summary below and in more detail on p192–195.

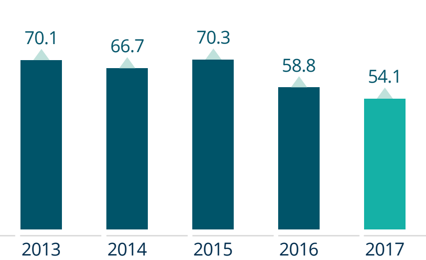
Key performance indicators *Deliver sustainable returns*

See a summary of all our KPIs on p2–3

Performance over the last five years reflects the market pressures we have faced. But we are building a strong future returns potential.

Adjusted earnings per share (£m headline)

54.1p
-8%

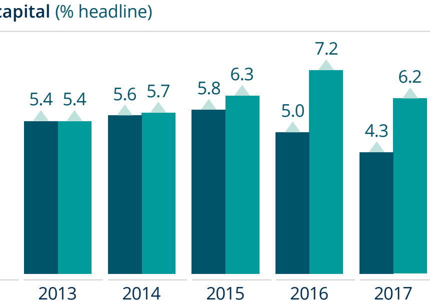


Adjusted earnings per share (EPS) is down 8% in 2017, reflecting lower adjusted operating profit and increased interest charges partially offset by a decrease in the tax rate. Over the last five years EPS has declined in line with the decline in adjusted operating profit.

Return on invested capital (% headline)

4.3%
-0.7
percentage points

Gross basis
Net basis



Return on invested capital (ROIC) fell by 0.7 percentage points to 4.3% in 2017 mainly due to lower adjusted operating profit and higher cash tax paid. We have also presented ROIC on a net basis after removing impaired goodwill from the invested capital balance. The net approach assumes that goodwill which has been impaired is treated in a similar way to goodwill disposed as it is no longer being used to generate returns.

Financial review

Adjusted operating profit

Adjusted operating profit includes the operating profit from the total business, including the results of discontinued operations when relevant. There were no discontinued operations in either 2016 or 2017. A reconciliation of the statutory measure to the adjusted measure is shown below:

£ millions	2017	2016
Operating profit/(loss)	**451**	(2,497)
Add back: Cost of major restructuring	**79**	338
Add back: Other net (gains) and losses	**(128)**	25
Add back: Intangible charges	**166**	2,769
Add back: Impact of US tax reform	**8**	–
Adjusted operating profit	**576**	635

In January 2016, the Group announced that it was embarking on a restructuring programme to simplify the business, reduce costs and position the company for growth in its major markets. The costs of this 2016 restructuring programme in 2016 were significant enough to exclude from the adjusted operating profit measure so as to better highlight underlying performance. A new restructuring programme, the 2017-2019 restructuring programme announced in May 2017, began in the second half of 2017 and is expected to drive further significant cost savings. This new programme has also been excluded from the adjusted operating profit measure.

These major restructuring costs are analysed below:

£ millions	2016
2016 restructuring programme	
Combining into one single product organisation	77
Integrating our assessment operations	33
Reducing exposure to large-scale direct delivery	67
Making efficiency improvements in enabling functions	110
Rationalising our property portfolio and consolidating major supplier agreements	51
Total major restructuring cost	338

£ millions	2017
2017-2019 restructuring programme	
Adjusting the cost base in our US higher education courseware business	**23**
Further efficiency improvements in enabling functions through back office change programmes in Human Resources, Finance and Technology	**23**
Further rationalisation of property and supplier agreements	**33**
Total major restructuring cost	**79**

Other net gains and losses that represent profits and losses on the sale of subsidiaries, joint ventures, associates and other financial assets are excluded from adjusted operating profit as it is important to highlight their impact on operating profit, as reported, in the period in which the disposal transaction takes place in order to understand the underlying trend in the performance of the Group. Other gains of £128m in 2017 largely relate to the sale of the test preparation business in China which resulted in a profit on sale of £44m and the part sale of the Group's share in Penguin Random House which resulted in a profit of £96m. In 2016, the losses mainly relate to the closure of the English language schools in Germany and the sale of the Pearson English Business Solutions business in North America.

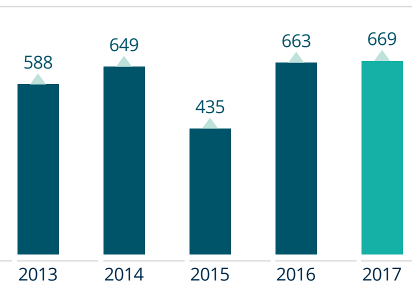
Charges relating to acquired intangibles and acquisitions are also excluded from adjusted operating profit when relevant as these items reflect past acquisition activity and do not necessarily reflect the current year performance of the Group. In 2016, intangible charges included an impairment of goodwill in our North American business of £2,548m.

Key performance indicators *Manage cash effectively*

See a summary of all our KPIs on p2–3

Operating cash flow (£m headline)

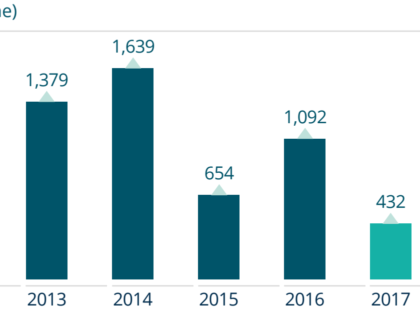
£669m
+1%



Operating cash flow increased by 1% in 2017, despite the reduction in adjusted operating profit, reflecting continued tight working capital control, strong cash collections and higher dividends from Penguin Random House.

Net debt (£m headline)

£432m
+60%



The Group's net debt decreased from £1,092m at the end of 2016 to £432m at the end of 2017 as the proceeds from disposals, operating cash flow and the positive effect of exchange rate movements more than offset restructuring spend, tax, interest, pension and dividend payments.

Financial review

As a result of US tax reform, the reported tax charge on a statutory basis includes a benefit from revaluation of deferred tax balances to the reduced federal rate of £5m and a repatriation tax charge of £6m. In addition to the impact on the reported tax charge, the Group's share of profit from associates was adversely impacted by £8m. These adjustments have been excluded from adjusted operating profit and the adjusted tax charge as they are considered to be transition adjustments that are not expected to recur in the near future.

Adjusted earnings per share

Adjusted earnings includes adjusted operating profit and adjusted finance and tax charges. A reconciliation to the statutory profit is shown below:

£ millions	2017	2016
Profit/(loss) for the year	408	(2,335)
Non-controlling interest	(2)	(2)
Add back: Cost of major restructuring	79	338
Add back: Other net (gains) and losses	(128)	25
Add back: Intangible charges	166	2,769
Add back: Other net finance (income)/costs	(49)	1
Add back: Impact of US tax reform on profit from associate	8	–
Tax benefit relating to items added back	(42)	(317)
Adjusted earnings	440	479
Weighted average number of shares (millions)	813.4	814.8
Adjusted earnings per share	54.1p	58.8p

Net finance costs classified as other net finance costs or income are excluded in the calculation of adjusted earnings.

Finance income relating to retirement benefits are excluded as management believes the presentation does not reflect the economic substance of the underlying assets and liabilities. Finance costs relating to acquisition transactions are also excluded as these relate to future earn-outs or acquisition expenses and are not part of the underlying financing.

Foreign exchange and other gains and losses are also excluded as they represent short-term fluctuations in market value and are subject to significant volatility. Other gains and losses may not be realised in due course as it is normally the intention to hold the related instruments to maturity.

In 2017, the total of these net finance cost items excluded from adjusted earnings was a gain of £49m compared with a loss of £1m in 2016. Finance income relating to retirement benefits decreased from £11m in 2016 to £3m in 2017, but this decrease was more than offset by foreign exchange gains on unhedged cash and cash equivalents and other financial instruments that generated losses in 2016.

The adjusted income tax charge excludes the tax benefit or charge on items that are excluded from the profit or loss before tax. In addition, the tax benefit from tax deductible goodwill and intangibles is added to the adjusted income tax charge as this benefit more accurately aligns the adjusted tax charge with the expected rate of cash tax payments.

Operating cash flow

Operating cash flow is presented in order to align the cash flows with corresponding adjusted operating profit measures. A reconciliation to operating cash flow from net cash generated from operations, the equivalent statutory measure, is shown below:

£ millions	2017	2016
Net cash generated from operations	462	522
Dividends from joint ventures and associates	146	131
Capital expenditure on property, plant, equipment and software	(237)	(247)
Add back: Cost of major restructuring paid	71	167
Add back: Special pension contribution paid	227	90
Operating cash flow	669	663

In addition to the dividends received from associates above, there were dividends from Penguin Random House in 2017 of £312m relating to the recapitalisation of Penguin Random House following the sale of part of the Group's interest in the venture. This cash flow is not related to the underlying trading of the business and has not been included in the adjusted operating cash measure.

Costs of major restructuring paid in 2017 include cash flow from both the 2016 restructuring programme (£44m) and the 2017–2019 programme (£27m).

Special pension contributions of £227m in 2017 were made as part of the agreements relating to the Penguin Random House merger in 2013 (£202m) and the sale of the FT Group in 2015 (£25m). In 2016, special pension contributions of £72m (net of tax) relate to the sale of the FT Group.

Return on invested capital (ROIC)

ROIC is a non-GAAP measure and has been disclosed as it is part of Pearson's key business performance measures. ROIC is used to track investment returns and to help inform capital allocation decisions within the business. Average values for total invested capital are calculated as the average monthly balance for the year.

For the first time in 2017, we have presented ROIC on a net basis after removing impaired goodwill from the invested capital balance. The net approach assumes that goodwill that has been impaired is treated in a similar fashion to goodwill disposed as it is no longer being used to generate returns.

	2017	2016	2017	2016
£ millions	Gross basis		Net basis	
Adjusted operating profit	576	635	576	635
Operating cash tax paid	(75)	(63)	(75)	(63)
Return	501	572	501	572
Average invested capital	11,568	11,464	8,126	7,906
ROIC	4.3%	5.0%	6.2%	7.2%

Financial review

Other financial information

Net finance costs

£ millions	2017	2016
Net interest payable	**(79)**	(59)
Finance income in respect of retirement benefits	**3**	11
Other net finance income/(costs)	**46**	(12)
Net finance costs	**(30)**	(60)

Net interest payable was £79m in 2017, compared with £59m in 2016. The increase was primarily due to higher US interest rates in 2017, additional charges relating to the early redemption of various bonds during the year and some additional interest on tax provisions. In March and November 2017 respectively, the Group redeemed the $550m 6.25% global Dollar bonds and the $300m 4.625% US Dollar notes, both originally due in 2018. In addition, in August 2017, the Group redeemed $383m out of the $500m 3.75% US Dollar notes due in 2022 and $406m out of the 3.25% US Dollar notes due in 2023. Although there is a charge in respect of the early redemptions, there are partial year interest savings as a result which have flowed through the income statement in the period since redemption, with the full annualised savings coming through in 2018.

In 2017, the total of other net finance income excluded from adjusted earnings was a gain of £49m compared with a loss of £1m in 2016. Finance income relating to retirement benefits decreased from £11m in 2016 to £3m in 2017 reflecting the comparative funding position of the plans at the beginning of each year. This decrease was more than offset by foreign exchange gains on unhedged cash and cash equivalents and other financial instruments that generated losses in 2016.

Capital risk

The Group's objectives when managing capital are:

- To safeguard the Group's ability to continue as a going concern and retain financial flexibility by maintaining a strong balance sheet
- To maintain a solid investment grade credit rating
- To provide returns for shareholders.

The Group is currently rated BBB (negative outlook) by Standard and Poor's and Baa2 (negative outlook) by Moody's.

Net debt

The net debt position of the Group is set out below:

£ millions	2017	2016
Cash and cash equivalents	**645**	1,459
Marketable securities	**8**	10
Derivative financial instruments	**–**	(93)
Bank loans and overdrafts	**(15)**	(39)
Bonds	**(1,062)**	(2,420)
Finance lease liabilities	**(8)**	(9)
Net debt	**(432)**	(1,092)

Net debt was reduced during the year following the partial disposal and recapitalisation of the Group's stake in Penguin Random House.

Bond debt was reduced to £1.1bn from £2.4bn through debt repayments of £1.3bn which reduced cash balances. The Group holds Dollar debt as a natural hedge of the Group's largest earnings generating region, North America.

Despite the low balance sheet gearing, the Group has significant operating lease liabilities of around £1.2bn which are not currently included as balance sheet liabilities but are included by the credit rating agencies within debt.

Liquidity and funding

The Group had a strong liquidity position at 31 December 2017, with over £600m of cash and an undrawn US Dollar denominated Revolving Credit Facility due in 2021 of $1.75bn (at 31 December 2016, the Group had cash of over £1.4bn and an undrawn Revolving Credit Facility due 2021 of $1.75bn). To ensure efficient use of the Group's cash balances, the Group repaid €450m (around £400m) of bond debt in January 2018 at a premium broadly equivalent to interest due for 2018, which will result in a reduced interest charge from 2019.

Taxation

The effective tax rate on adjusted earnings in 2017 was 11.1% compared with an effective rate of 16.5% in 2016. The decrease in tax rate was primarily due to uncertain tax position provision releases due to the expiry of relevant statutes of limitation.

The reported tax charge on a statutory basis in 2017 was £13m (3.1%) compared with a benefit of £222m (8.7%) in 2016. The statutory tax benefit in 2016 was mainly due to the release of deferred tax liabilities relating to tax deductible goodwill that was impaired. Operating tax paid in 2017 was £75m compared with £63m in 2016.

As a result of US tax reform, the reported tax charge on a statutory basis includes a benefit from revaluation of deferred tax balances to the reduced federal rate of £5m and a repatriation tax charge of £6m. The Group continues to analyse the detail of the new legislation and this may result in revisions to these impacts. In addition to the impact on the reported tax charge, the Group's share of profit from associates was adversely impacted by £8m.

Other comprehensive income

Included in other comprehensive income are the net exchange differences on translation of foreign operations. The loss on translation of £262m in 2017 compares with a gain in 2016 of £913m and has arisen due to the relative weakness of the US Dollar compared with Sterling. A significant proportion of the Group's operations are based in the US and the US Dollar weakened in 2017 from an opening rate of £1:$1.23 to a closing rate at the end of 2017 of £1:$1.35. At the end of 2016 most of the currencies that Pearson is exposed to had strengthened relative to Sterling following the Brexit vote. In 2016, the US Dollar had strengthened in comparison with the opening rate moving from £1:$1.47 to £1:$1.23.

Also included in other comprehensive income in 2017 is an actuarial gain of £182m in relation to post-retirement plans of the Group and our share of the post-retirement plans of Penguin Random House. The gain arises from the impact of favourable movements in mortality assumptions, discount rates, member options on retirement and asset returns which offset the impact of the UK Group plan's purchase of insurance buy-in policies. The gain in 2017 compares with an actuarial loss in 2016 of £276m.

Financial review

Post-retirement benefits

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

The charge to profit in respect of worldwide pensions and retirement benefits amounted to £72m in 2017 (2016: £70m) of which a charge of £75m (2016: £81m) was reported in adjusted operating profit and an income of £3m (2016: £11m) was reported against other net finance costs.

The overall surplus on the UK Group pension plan of £158m at the end of 2016 increased to a surplus of £545m at the end of 2017. The increase has arisen principally due to the impact of favourable movements in assumptions discussed above but also due to increased contributions, including £227m as part of the agreements relating to the Penguin Random House merger in 2013 and FT Group sale in 2015.

In total, our worldwide net position in respect of pensions and other post-retirement benefits increased from a net asset of £19m at the end of 2016 to a net asset of £441m at the end of 2017.

Dividends

The dividend accounted for in our 2017 financial statements totalling £318m represents the final dividend in respect of 2016 (34.0p) and the interim dividend for 2017 (5.0p). We are proposing a final dividend for 2017 of 12p, bringing the total paid and payable in respect of 2017 to 17p. This final 2017 dividend, which was approved by the Board in February 2018, is subject to approval at the forthcoming AGM and will be charged against 2018 profits. For 2017, the dividend is covered 3.2 times by adjusted earnings and, after excluding the contribution from Penguin Random House, the dividend is covered 2.5 times.

Share buyback

The £300m share buyback programme announced in October 2017 was completed on 16 February 2018. At 31 December 2017, 21m shares at a value of £153m had been purchased. Cash payments of £149m had been made in respect of the purchases with the outstanding £4m settlement made at the beginning of January 2018. This £4m together with the remaining value of the buyback programme (£147m) was recorded as a liability on the balance sheet at 31 December 2017. A further 22m shares were repurchased under the programme in 2018.

Businesses held for sale

Following the decision to sell both our Wall Street English language teaching business and the K-12 school courseware business in the US, the assets and liabilities of those businesses have been classified as held for sale on the balance sheet at 31 December 2017.

Goodwill and intangible assets

Amortisation and impairment charges in 2017 were £166m compared with a charge of £2,769m in 2016. The 2016 charge includes an impairment charge to North American goodwill of £2,548m. This charge arose following trading in the final quarter of 2016 and the consequent revision to strategic plans which reflected underlying issues in the US higher education courseware market that were more severe than had previously been anticipated. These issues related to declining student enrolments, changes in buying patterns of students and correction of inventory levels by distributors and bookshops.

Acquisitions and disposals

There were no significant acquisitions in 2017 or 2016. In 2017, disposals in total gave rise to a profit of £128m. These disposals included the sale of our test preparation business in China (GEDU) which resulted in a profit on sale of £44m and the sale of a portion of our stake in Penguin Random House to our venture partner, Bertelsmann, resulting in a reduction in our interest from 47% to 25% and a profit on sale of £96m. In 2016, we closed our English language schools in Germany and also sold the Pearson English Business Solutions business. These two disposals, together with other smaller disposal related items, gave rise to an aggregate loss of £25m.

Related party transactions

Transactions with related parties are shown in note 36 of the consolidated financial statements.

Post-balance sheet events

During January 2018, Pearson successfully executed market tenders to repurchase €250m of its €500m Euro 1.875% Notes due May 2021 and €200m of its €500m Euro 1.375% Notes due May 2025.

On 16 February 2018, Pearson completed its £300m share buyback programme. In aggregate between 18 October 2017 and 16 February 2018, Pearson repurchased 42,835,577 shares, including 21,839,676 repurchased since 31 December 2017, at a cost of £151m.

Coram Williams
Chief Financial Officer

Financial review

Helping create the future of learning 〉 An interview with Alvaro Castro, Product Management Analyst, Pearson Test of English

What excites you most about the work you do at Pearson?

AC

In Pearson I have the amazing opportunity to work with different geographies all over the world. PTE Academic is delivered in over 50 countries and part of my job is really to understand the singularities of each market. I particularly enjoy engaging with the geographies and providing them with data insights that can inform their business strategy.

What is your main goal for 2018?

AC

To support the growth of the PTE Academic test, our main goal as a team is to improve the operational infrastructure around the test, and to redevelop the customer journey. My role is to help the team achieve this goal by analysing operational performance, identifying areas of improvement and working with stakeholders to make them.

How are you helping Pearson in its transition to digital?

AC

PTE Academic is a computer-based test and I have been involved in the operational and technology improvements of the product. As with every digital product, we can generate valuable operational data that can turn into evidence based decision-making.

What is your biggest win at Pearson to date?

AC

I am proud of my work producing genuine data reporting that has been used by teams, colleagues and management. In addition to providing valuable insight and informing decision-making at all levels, I have been able to introduce a data-driven culture within the team and with the geographies. These reporting capabilities have also served to provide accurate forecasting and a robust test centre capacity plan, which has been instrumental for supporting the growth of the test.

Pearson Test of English *in one minute*

The Pearson Test of English Academic is the computer-based English test trusted by universities, colleges and governments around the world.

250 centres
around the world

"The test is a *true reflection* of what's required in communicating ... Reading, Writing, Speaking and Listening"

Elizabeth Karanja, Australia, October 2017

Differentiated consumer experience drove c.70% volume growth

+c.70%

"I introduced a *data-driven culture.* More accurate forecasting has supported the growth of the test."

AC Alvaro Castro
Product Management Analyst

Operating performance

North America

Market summary

Our largest market includes all 50 US states and Canada.

Contribution to Group revenues

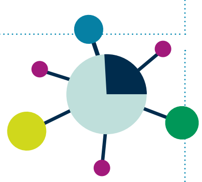
65%

Sales

£2,929m

Adjusted operating profit

£394m



Efficacy finding

Working with Penn State University, we found that students in Introductory Physics courses who do better on their Mastering Physics homework tended to perform better in exams and external assessments.

Revenues declined 4% in underlying terms, primarily due to anticipated declines in higher education and school courseware, school assessment and Learning Studio, a learning management system we are retiring.

North American higher education courseware fell 3%. School courseware fell high-single digits, impacted by a lower adoption participation rate and weak Open Territory sales in the second half of the year. School assessment declined high-single digits, due to previously announced contract losses. Learning Studio revenues continued to decline as we move towards the retirement of the product in 2019. Offsetting that, we saw modest growth in both virtual schools and Online Program Management (OPM) due to good underlying volume growth partially offset by some contract exits and in-sourcing. Revenues in North American Professional Certification were flat on phasing of new contracts and a slowdown in IT certification late in 2017.

Adjusted operating profits fell 10% in underlying terms, due primarily to the impact of lower sales and other operating factors partially offset by restructuring savings.

Courseware

School

In school, revenue declined high-single digits primarily due to sharp declines across Open Territory states in the second half of the year. This was partially offset by growth in Adoption state revenues where strong performance in Texas Grades K-12 Spanish, Indiana Grades K-12 Science and South Carolina Grades 6-8 Science outweighed a lower adoption participation rate resulting from our decision not to compete for the California Grades K-8 English Language Arts (ELA) adoption with a core basal programme.

Our new adoption participation rate fell to 61% from 64% in 2016. We won an estimated 38% share of adoptions competed for (30% in 2016) and 29% of total new adoption expenditure of $365m (19% of $470m in 2016).

Higher education

In higher education, total US college enrolments, as reported by the National Student Clearinghouse, fell 1.1%, with combined two-year public and four-year for-profit enrolments declining 2.5%. Enrolment weakness was particularly focused on part-time students where enrolment declined 3.3%, a bigger decline than in any of the last five years. Full-time enrolment grew 0.3%, the first expansion since autumn 2010.

Net revenues in our higher education courseware business declined 3% during the year. We estimate around 2% of this decline was driven by lower enrolment; just over 1% from the adoption of Open

Market spotlight North American Assessment

Association of American Medical Colleges

The Association of American Medical Colleges (AAMC) has selected Pearson VUE to deliver the prestigious Medical College Admission Test® (MCAT®) beginning in 2018.

"We are proud to enter into an agreement with the AAMC to deliver this important exam to tomorrow's doctors," says Bob Whelan, President, Pearson Assessments. "We understand the AAMC's commitment to excellence and we are proud to be part of their continued commitment to examinees and the testing community. As an extension of the AAMC to its test takers, we will deliver each exam with care, consistency and the highest levels of customer service."

Pearson VUE will deliver the MCAT exam in its premium, patented, owned-and-operated network of Pearson Professional Centres and several Pearson VUE Authorized Test Centre Selects globally. In addition to the existing test centres, Pearson VUE is investing in an expansion of its test centre network to provide additional capacity for test takers.

The Pearson Professional Centres are the gold standard in exam delivery, offering test takers a professional, highly secure and consistent testing experience.

Operating performance

Link to strategic priorities 1 Grow share through digital transformation 2 Invest in structural growth markets See *Our strategy*, p13–21

Educational Resources (OER); around 5% from the secondary market, new initiatives and other factors, primarily the growth in print rental; offset by c.3% benefit from institutional selling and the shift to digital and a 2% benefit in 2017 from lower returns by the channel.

In 2017, Pearson's US higher education courseware market share, as reported by MPI, was in the upper half of the c.40–41.5% range seen over the last five years.

During 2017, we performed strongly in Statistics and Business Statistics, Biology and Accounting. Statistics benefited from the popularity of "best in class" learning application *StatCrunch*, Biology from the success of *Campbell Biology 11e* and *MasteringBiology*, and Accounting from the success of *Miller-Nobles Horngren Accounting 11e* and *MyAccountingLab*. This was offset by weakness in Information Technology, particularly in the for-profit sector and continued softness in Developmental Mathematics.

Digital revenues grew 9% benefiting from continued growth in direct sales, favourable mix and selected price increases. Global digital registrations of MyLab and related products fell 1%. In North America, digital registrations fell 3% with good growth in Science, Business & Economics and Revel offset by lower overall enrolment and continued softness in Developmental Mathematics. Revel registrations grew more than 50%. Including stand-alone eBook registrations, total North American digital registrations were flat.

The actions announced in early 2017 to promote access over ownership met with success. We reduced the rental price of 2,000 eBook titles and saw eBook revenues increase more than 20% in response. Our print rental programme has had a successful start, and we have added more than 90 further titles. In institutional courseware solutions we signed 210 institutions to our Inclusive Access (Direct Digital Access, DDA) solutions, taking the total to over 500. During the year, we delivered over 1m course enrolments with inclusive access rising to c.5% of our higher education revenue as more colleges and faculties see the benefit of this model.

Assessment

School assessment

In school assessment (State and National assessments), revenues declined high-single digits due to previously announced contract losses.

Pearson secured contract extensions in Virginia, Indiana, Arizona, Minnesota, Puerto Rico, Kentucky, New York City and North Carolina and for the National Assessment of Educational Progress.

We delivered 25.3m standardised online tests to K-12 students, up 7% from 2016. TestNav 8, Pearson's next-generation online test platform, supported a peak load of 752,000 tests in a single day and provided 99.99% up time. Our AI scoring systems scored 35m responses to open-ended test items, around 30% of the total. Paper-based standardised test volumes fell 7% to 20.4m.

Professional Certification

In Professional Certification, VUE global test volume rose 1% to over 15m. Revenues in North America were flat, with continued growth in certification for professional bodies, offset by modest declines in US teacher certification and the GED High School Equivalency Test, after strong performance last year, and by weakness in higher level IT certifications in the second half.

We signed over 50 new contracts in 2017 including a multi year contract with the Association of American Medical Colleges (AAMC) to administer the MCAT, and multi-year contracts with ExxonMobil and the Project Management Institute. Our renewal rate on existing contracts continues to be over 95%.

Helping create the future of learning An interview with Glenn Hubbard, Pearson author, economist and academic

"This digital experience will completely change the way we teach."

The digital experience that students get can really shape their understanding of the subject. Digital gives a much better experience for students – it gives them a real world feel, with first class pedagogy and assessment built in – I can't imagine a better way to learn.

This digital experience will completely change the way we teach. It meets students at their point of need. Students are able to go as fast or slow through the content as they need, getting a great learning experience. From the professor's perspective, they know their student is getting help to prepare for class.

We are in the early days of an incredibly exciting future of learning. Students come to economics as they care about the world and want to learn about it. A product that can bring the real world together with a user-friendly interface for students is a game changer. The technology we have makes that future possible.

We are going to see a future in less than ten years' time where students are no longer lugging a big bag of textbooks around. Instead they will have a simple interface that gives them a great learning experience.

Operating performance

North America

Clinical assessment

Clinical assessment sales declined slightly on an absence of new major product introductions. Q-Interactive, Pearson's digital solution for Clinical Assessment administration, saw continued strong growth in licence sales with sub-test administrations up more than 33% over the same period last year.

Services

Connections Education

Connections Education, our virtual school business, served nearly 78,000 Full Time Equivalent students through full-time virtual and blended school programmes, up 6% on last year.

Two new full-time online, state-wide, partner schools opened for the 2017–2018 school year. Enrolment growth from new and existing schools was partially offset by the termination of a school partnership at the end of the 2016–2017 school year.

Revenues grew modestly as enrolment growth was partially offset by increased in-sourcing, as some partners took non-core services in-house.

Enrolment and revenue is expected to grow in 2018 as growth in existing school partnerships and the opening of new partner schools for the 2018–2019 school year offsets the termination of two further contracts and the in-sourcing of services by some customers.

The 2017 Connections Academy Parent Satisfaction Survey showed strong results with 92% of families with students enrolled in full-time online partner schools stating they would recommend the schools to others and 95% agreeing that the curriculum is of high quality. Results from the survey are available at pear.sn/HPTn30dCNHH.

Pearson Online Services

In Pearson Online Services, revenues declined high-single digits, primarily due to a decline in Learning Studio revenues as we retire the product and the restructuring of smaller non-OPM contracts. Learning Studio declined by just over 50% to a revenue contribution of £11m in 2017. In OPM, we grew revenues modestly as course enrolments grew strongly, up 8% to more than 341,000, boosted by good growth and programme extensions at key partners, including Arizona State University Online, Maryville University, Rutgers University and University of Alabama at Birmingham and from new partners, partially offset by contract exits.

We signed 45 multi-year programmes in 2017, renewed 19 programmes and launched 14 new programmes at partners, including Maryville University, Duquesne University and Ohio University. During the year, we also agreed the termination of nine programmes that were not mutually viable and did not renew a further six programmes.

Brinker International, Inc. (NYSE: EAT), one of the world's leading casual dining restaurant companies and owner of Chili's® Grill & Bar and Maggiano's Little Italy®, with over 1,600 owned, operated and franchised restaurant locations, partnered with Pearson to launch a comprehensive employer-education programme Best You EDU that provides free educational opportunities to Brinker employees, including foundational, GED and Associate Degree programmes.

2018 outlook

US higher education courseware

In US higher education courseware, we expect revenues to be flat to down mid-single digit percentages as similar pressures seen in the last two years continue with lower college enrolments, increased use of OER and attrition from growth in the secondary market driven by print rental are partially offset by growth in digital revenues, benefits from our actions to promote access over ownership and a continued normalisation of channel returns behaviour.

Evidence of a marginally slower rate of decline in US student enrolment, together with slightly lower than expected attrition from OER in 2017, means that we are now planning for an underlying decline in demand of around 6% in US higher education courseware, slightly improved from our prior range of 6% to 7%.

North American student assessment

We expect stable testing revenues in North American student assessment as new contracts offset a continued contraction in revenue associated with our PARCC contract.

Connections Education

Connections Education is expected to grow modestly as new partner school openings and good growth in enrolment are partially offset by in-sourcing of non-core services by some partners and contract exits.

Professional Certification

North American Online Program Management is expected to see modest growth in revenue as investment in new programs begin to ramp up. Professional certification is expected to grow revenues in the mid-single digits benefiting from new contracts, including our nationwide contract with the AAMC.

Author view | North American Services | Jean M Twenge, Professor of Psychology at San Diego University and Pearson author

A Pearson author's view on the future

As a professor, staying relevant to my students is not just about what I teach, but the way I teach it. With the advent of iGen – the smartphone generation – academics and publishers need to be evolving. This means offering digital, interactive learning to stay successfully switched on by the students of today and of the future.

Operating performance

Link to strategic priorities 1 Grow share through digital transformation 2 Invest in structural growth markets See *Our strategy*, p13–21

Core

Market summary

Our international business in established and mature education markets including the UK, Australia and Italy.

Contribution to Group revenues

18%

Sales

£815m

Adjusted operating profit

£50m

Efficacy finding

Research to understand the impact of Bug Club on pupils' literacy learning, their attitudes to reading and school, and their reading activity found children made 30 months of progress in 18 months.

Revenues grew 1% in headline terms, were down 1% at CER and flat on underlying terms, primarily due to growth in OPM in the UK and Australia and growth in Pearson Test of English offset by declines in school, higher education, English courseware and student assessment and qualifications.

Adjusted operating profit declined 14%, or £8m, in underlying terms due to revenue mix, investment in new products and services and business exits, partially offset by restructuring savings.

Courseware

- School
- Higher education
- English

Courseware revenues declined moderately. In school, revenues declined in Australia, due to market contraction in the primary sector partly offset by slight growth in secondary, and declines in smaller markets in Europe and Africa. In higher education, revenues were down slightly due to declines in smaller markets, while in Australia and the UK an increase in direct to institution sales and a further shift to digital offset declines in traditional textbook sales. In English, there were declines in smaller markets.

Assessment

- Student assessment and qualifications

In student assessment and qualifications, revenues declined mid-single digits primarily due to lower AS level, iGCSE and apprenticeship volumes as a result of policy changes. BTEC revenues also declined modestly as revenues recognised in 2017 lagged the greater stability we have seen in registrations and billed revenue in the year. We successfully delivered the National Curriculum Test for 2017, marking 3.5m scripts, up slightly from 2016.

- Clinical assessment

Clinical assessment grew strongly with revenues benefiting from strong growth in the new editions of the Wechsler Intelligence Scale for Children (WISC-V) and the Clinical Evaluation of Language Fundamentals (CELF-5).

- Pearson Test of English (PTE)

Pearson Test of English (PTE) saw continued strong growth in test volumes, which rose 84% from 2016, driven primarily by its use to support visa applications to the Australian Department of Immigration and Border Protection and good growth in New Zealand.

- Professional Certification

In Professional Certification, revenues were flat as the impact of last year's renegotiated terms of the UK Driving Theory test for the DVSA was offset by growth from new and existing contracts.

The future of learning | Further education Core | BTEC

They chose BTEC – will you?

This year, we've been proud to partner once again with some high profile leaders who've told us why they love their careers – and why they believe in BTEC.

The 'I Choose BTEC' campaign was all about our BTEC Ambassadors telling their stories to show how BTEC opens doors to university, an apprenticeship – and a thriving career.

Business entrepreneurs Peter Jones CBE, Jamal Edwards MBE and Sharmadean Reid MBE and double Olympic Gold medallist Max Whitlock MBE all featured on London buses, posters in schools and colleges, and in online campaigns.

Olympic hero Max Whitlock MBE said: "I'm the type of person that likes to get stuck in and really involved in what I do. That's the way I learn best. It's not about being the hardest worker in the room – it's about being the smartest. I would definitely recommend BTEC to other people."

www.ichoosebtec.com

Operating performance

Services

Higher education services

In higher education services, revenues grew strongly. Our OPM revenues were up 33%. In Australia, we saw good growth due to our successful partnership with Monash University, and continued success of the Graduate Diploma in Psychology. We have a total of c.9,300 course registrations across the seven programs in Australia up from c.6,900 in 2016. In the UK, we launched five new programs in addition to the two launched in 2016. UK course registrations grew, reaching c.1,400 compared with c.370 in 2016.

English services

English services grew, with strong growth in WSE Italy, due to the opening of new centres in 2015 and 2016, partially offset by declines in Japan.

2018 outlook

In Core, we are expecting modest growth driven by our recent investments in student assessment and qualifications, where we are offering new products and services of considerably greater value, along with continued growth in PTE and OPM with ten new program launches in the UK, and growth in existing programs in Australia.

Growth

Market summary

Our growth markets in emerging and developing economies with investment priorities in Brazil, China, India and South Africa.

Contribution to Group revenues

17%

Sales

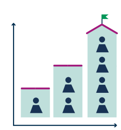
£769m

Adjusted operating profit

£38m

Efficacy finding

Speakout: Students report that Speakout with MyEnglishLab has increased their confidence, motivation and enjoyment.



Revenues were flat in both headline and underlying terms due to growth in China, school courseware in South Africa and Pearson Test of English, offset by declines in higher education services primarily due to lower enrolment at CTI and business disposals in India, and declines in Brazil. Revenues were down 4% at CER due to the disposal of GEDU.

Adjusted operating profit increased 3% in underlying terms, reflecting the higher revenues in China, South Africa school courseware and PTE in India, together with the benefits of restructuring, partially offset by lower revenues in Brazil.

Courseware

Courseware revenues grew moderately, due to strong growth in school textbook sales in South Africa and English language courseware in China, partially offset by weakness in Brazil.

Helping create the future of learning | An interview with teachers from Gyananda School, Dehradun

Thank you MyPedia

"For a new school like ours, MyPedia has been a great support in terms of curriculum planning, assessments and teacher support. It challenges both teachers and students to break away from the conventional teaching learning methodology and encourages them to explore and derive their own conclusions."

Meenakshi Mehta Headteacher

"MyPedia is user friendly software for the teachers. I was hesitant using it earlier but now it has become an integral part of my teaching plan. It has everything that a teacher can wish for. Thank you MyPedia."

Pooja Bisht, Teacher

Gyananda

Operating performance

Link to strategic priorities 1 Grow share through digital transformation 2 Invest in structural growth markets See *Our strategy*, p13–21

Services

English services

In English services, growth in Wall Street English in China, due to new centre openings, was offset by declines in Brazil due to macroeconomic pressures.

School services

In school services, revenue fell, with student enrolment in our sistemas business in Brazil falling 14% primarily due to NAME, our public sistema, where we took the strategic decision to exit two-thirds of our contracts with municipalities due to unattractive economic prospects, together with a reduction in student enrolments in our Dom Bosco private sistema due to challenging economic conditions. In India, Pearson MyPedia, an inside service 'sistema' solution for schools, expanded to over 500 schools with approximately 157,000 learners.

Higher education services

In higher education services, revenues declined sharply due to a 14% fall in total student enrolment at CTI, our university in South Africa driven by the cumulative impact of economic factors in recent years, partially offset by improved new student enrolments in 2017, together with business exits in India.

Assessment

Pearson Test of English

Professional Certification grew strongly. Pearson Test of English saw over 30% growth in the volume of tests taken in India.

2018 outlook

In our growth markets we expect a modest increase in revenues, with growth in China in ELT products, PTE and in South Africa due to improving enrolments in CTI partially offset by declines in school courseware after a strong 2017. In Brazil, we expect revenue to increase modestly from growth in Wizard and school sistemas, partially offset by declines in government contracts. In India, we expect PTE and MyPedia to continue growing.

Penguin Random House

Following the disposal of a 22% stake on 5 October 2017 Pearson owns 25% of Penguin Random House, the first truly global consumer book publishing company.

Penguin Random House performed in line with our expectations with revenues up slightly on a headline and underlying basis year on year on rising audio sales, broadly stable print sales and modest ongoing declines in demand for eBooks, while the business benefited from bestsellers by Dan Brown, R.J. Palacio, John Grisham, Jamie Oliver and Dr. Seuss.

2018 outlook

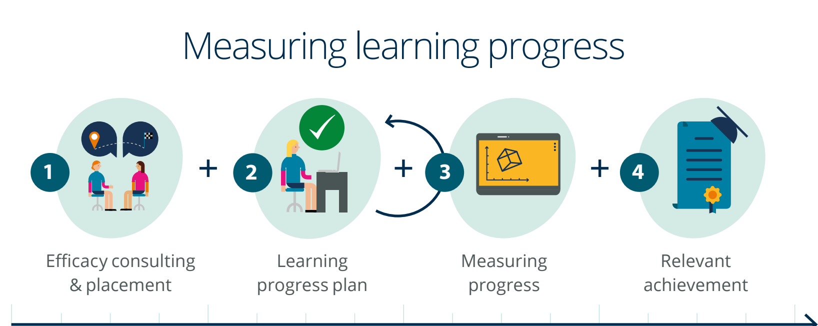
In Penguin Random House, we anticipate a broadly level publishing performance and expect an annual after-tax contribution of around £60–65m to our adjusted operating profit.

Helping create the future of learning

An interview with Alan Palau, Innovation & Efficacy Delivery Director, Hispano-America, Pearson

MePro: A new English Learning solution in Hispano-America

"MePro is a new and innovative English Learning programme launching spring 2018 in Hispano-America initially, with plans to roll it out further across markets such as China, Brazil and the Middle East. English Learning opens up a world of opportunities and future careers and continues to grow as an indispensable core competency in non-English speaking countries – Pearson has the opportunity to reach millions of learners and teachers across the Growth markets through MePro which can help meet this need by leveraging successful existing content, assessment and enhanced technology solutions and platforms to deliver personalised learning for students measured by Global Scale of English learning outcomes."



Risk management

The goal of our approach to Enterprise Risk Management (ERM), summarised in the framework below, is to support Pearson in meeting its strategic and operational objectives, as set out by the Chairman and the Chief Executive on p6–10. Our framework aligns to international standards (e.g. COSO and ISO 31000) and aids our compliance with the Financial Reporting Council's (FRC) UK Corporate Governance Code guidance on risk management.

Foundations

Risk foundations are all the elements (as set out in this framework) which underpin successful ERM, and risk management more broadly, across Pearson.

Governance and oversight

The Board, assisted by the Audit Committee, oversees the ERM framework, validates risk appetite targets, risk status and mitigation plans, plus verifies the viability statement process.

Roles and responsibilities

Day-to-day ERM is undertaken by a dedicated team. For a list of their responsibilities, as well as other key risk stakeholders, see p84 'Governance'.

Policy, framework, processes and tools

Our policy, framework and supporting guidance outline our commitment to managing risk and set what we consider to be the minimum standards. These can be tailored by a business area as long as they align with the policy. The process is assessed during the annual effectiveness review, covered in more detail on p84 in 'Governance'.

Appetite and tolerance

Pearson leadership sets the target risk appetite for each risk they own, validated by the Audit Committee and Board. Understanding the degree of risk the Board will accept determines the most appropriate risk treatment.

For example, a legal or compliance risk has a low target appetite where we try to eliminate risk as much as we can. Whereas a business transformation risk is often also a strategic opportunity and likely to have a higher appetite, where we would take well-informed and well-managed risks to achieve our goals.

Working with third-parties

The use of third-parties (for example, suppliers or partnerships) can create risk, such as an interruption to operations or an impact on reputation. In 2017, we drafted a third-party risk management policy. We also created risk identification questions to help us flag areas requiring investigation. Questions cover principal risks as well as material issues, e.g. environmental matters and respect for human rights, as described in 'Sustainability' on p24–33. This process is being rolled out in phases as part the implementation of a new procurement system.

Managing risk

Our approach to managing risk has remained consistent with our approach in 2016.

Context

The risk context sets the criteria against which risks are identified and assessed. It defines the external and internal parameters to be taken into account, as well as the scope of the risk management process.

The risk management policy, framework and supporting guidance set out how to manage risks, such as determining probability and impact as well as instructions on how to translate these into an overall risk rating. Adaptations of these matrices, tailored for a specific business area, are in use and align with the policy.

Risk management

Assessment

At least twice a year, the ERM team facilitates a risk assessment process through discussions with leadership, senior management and key stakeholders from each business area. For each risk, the probability of it materialising and its potential impact is rated. The adequacy of action plans to address any remaining control gaps is then assessed.

We do this for both new risks identified as well as those already being monitored. Horizon scanning also takes place throughout the year to aid in the identification of new risks.

Treatment

Once assessed, the most appropriate course of action for each risk is decided, taking into account the size of the gap that needs to be closed between its current status versus its risk appetite target. This can include 'avoid' (e.g. not doing something); implementing mitigation or contingency plans to change the probability or reduce the impact of a risk; accepting increasing risk in order to pursue an opportunity; or sharing the risk with another party or parties.

Monitoring and review

Reports are submitted to the Board and Audit Committee bi-annually. This gives them the opportunity to review, challenge and validate the ERM process and key risks. The reports cover current risk status as well as an update on risk mitigation initiatives and their effectiveness. Discussions focus on where there is either a) the greatest change in rating or b) the biggest gap between current rating and the target appetite, with the emphasis on the strength of mitigation plans in place. The risk maps for each business area are also included in these reports.

Risk deep dives also take place at the Audit Committee throughout the year. In 2017, some of the risks covered included business transformation, data privacy and security (including GDPR), tax and treasury. You can read the details in the Chairman of the Audit Committee's report on p76–78.

Culture

The ERM framework is also used to drive the integration of risk management approaches into the culture of the organisation.

Communication, training, education and awareness

Our Code of Conduct remained in place throughout 2017 to drive ethical behaviours across the organisation. The ERM team is committed to raising awareness among employees on the importance of better managing their day-to-day risks. In 2017, the team regularly attended leadership and team meetings to highlight best practice and conducted specific training events.

Embedding risk in decision-making

A key focus area for the ERM team in 2017 was the further embedding of risk management across the wider organisation to support the business in making risk aware decisions.

All Pearson business functions continued to maintain their own risk map, with the spotlight in 2017 on the robustness of the mitigation plans. Business functions follow the same framework for identifying, assessing, treating and monitoring risk. Each identified risk is also assigned a risk appetite target. This work underpins the assessment of the company-wide risks. 2017 saw greater ownership and extension of risk processes by individual business areas.

Continuous improvement

At the end of 2014, we reviewed our current risk management maturity against this risk framework and set maturity targets for the following three years.

In 2018 we will be implementing a more integrated approach to assurance across Pearson (based on a model which outlines the different levels of assurance responsibilities from business management through to external audit and oversight), as well as updating our framework to ensure it continues to align with the 2017 update of the COSO ERM standard.

Principal risks and uncertainties

The Board of Directors confirms that throughout 2017 they undertook a robust assessment of the principal risks facing the company, in accordance with provision C.2.1 of the 2016 UK Corporate Governance Code.

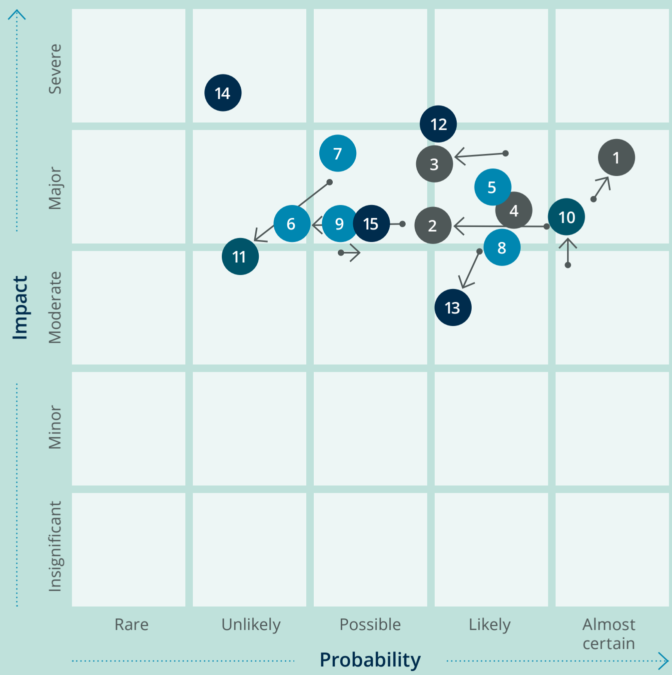
Our principal risks
(as of 31 December 2017)

Listed in the table below (and shown on the adjacent risk map) are the most significant risks that may affect Pearson's future. A longer list of company-wide risks, plus emerging risks, was monitored and reviewed throughout the year. The most material of these are identified as principal risks. Principal risks are those which have a higher probability and significant impact on strategy, reputation or operations, or a financial impact greater than £50m.

The full impact of the UK's pending departure from the EU (Brexit) is still unclear, but we remain vigilant to potentially material risks for Pearson. Work continued throughout 2017 (led by a Steering Committee chaired by the CFO) to identify and mitigate any potential impact on (a) our principal risks below, such as treasury, tax or data privacy, or (b) other areas such as UK-EU supply chain and workforce mobility, including in the event of a 'no deal' exit scenario. We continue to believe that Brexit, in whatever form it takes, will not have a material adverse impact on Pearson as a whole.

The following principal risks also relate to the material issues considered in the 2017 sustainability report: products and services, testing failure, political and regulatory risk, data privacy, information security, customer digital experience, and safety and corporate security. You can read more in the Sustainability section on p24–33.

Principal risks: status and 2017 change



Key

0 **Net risk** Probability and impact are based on residual risk, i.e. after taking into account controls already in place and assumed to be operating effectively.

Indicates change in 2017

For more information see principal risks and uncertainties tables p51–60.

Risks are categorised into four main areas:

Category	#	Risk	Executive responsibility
Strategy & change Relating to the goals that support our strategy. This category is the most likely to contain 'opportunity' risks which typically have a higher risk appetite	1	**Business transformation and change**	Chief Executive Officer
	2	**Products and services**	President, Global Product
	3	**Talent**	Chief Human Resources Officer
	4	**Political and regulatory risk**	Chief Corporate Affairs and Global Marketing Officer
Operational Involving people, systems and processes	5	**Testing failure**	President, Assessments President, UK & Core Markets
	6	**Health and safety**	Chief Human Resources Officer
	7	**Safeguarding**	President, Assessments
	8	**Customer digital experience**	President, Global Product & Chief Technology and Operations Officer
	9	**Corporate security and business resilience**	Chief Financial Officer
Financial Involving financial planning, investments, budgeting, potential losses of and exposures to Pearson's assets	10	**Tax**	Chief Financial Officer
	11	**Treasury**	Chief Financial Officer
Legal & compliance Relating to the adherence to applicable laws and regulations. Risks in this category typically have a very low risk appetite.	12	**Data privacy and information security**	Chief Technology and Operations Officer & General Counsel
	13	**Intellectual property and rights, permissions and royalties**	General Counsel
	14	**Compliance**	General Counsel
	15	**Competition law**	General Counsel

Principal risks and uncertainties

Strategy & change

1 Business transformation and change

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

Incorporates 'Data quality and integrity' risk: Unavailability of timely complete and accurate data limits informed decision-making and increases risk of non-compliance with legal, regulatory and reporting requirements.

↑ Increase in impact and probability

Existing controls

- Transformation programme office
- Global learning platform (GLP) and the enabling programme (TEP) are standing Audit Committee agenda items. See 'Governance' p76–77
- Regular updates with Pearson Executive
- Executive owned Steering Committees in place
- Independent assurance on key programmes

Outcome of 2017 activities

In 2017, we continued to invest in the digital transformation and simplification of the company. The volume and accelerated pace of change combined with execution interdependencies as we go into 2018 are keeping this our highest rated (and slightly increased) risk. We also have capabilities we need to continue to develop internally to deliver transformation and change (See Talent risk on p52).

The £300m 2017-2019 cost efficiency programme remains on track to achieve its targets. Following the planning phase culminating in the August 2017 announcement, the programme transitioned to implementation.

HR Fusion, part of TEP, successfully went live in the US in June 2017. Significant progress was also made regarding data governance as our quality focus and scope expanded in 2017 to global data. We now have a much more top-down view of product data, moving on to sales, marketing, rights and royalties and fulfilment. We also started putting in place customer data governance.

2018 outlook and plans

Business transformation and change initiatives will continue to support our strategic goals to accelerate our digital transition in higher education, to manage the print decline, and to reshape our portfolio, as outlined by our Chief Executive on p8–10 and covered in more detail under our strategy in action on p14–21.

In 2018, we will continue with the development of the GLP, a single, cloud-based platform to support learners and our digital transformation, as well as the next phase of TEP to further progress the simplification of our business. Both programmes will continue to be closely monitored by the Audit Committee at each meeting (you can read more about their oversight of key programmes in the report from the Chair of the Audit Committee on p76–77).

Successful execution of all our change programmes in 2018 will depend on having the right change management skills (see also Talent risk on p52).

The focus on data quality in 2018 will be supporting the TEP North America implementation. In addition, the new EU data privacy law, the General Data Protection Regulation (GDPR) which will apply from May 2018 and spans all of our underlying systems, is a priority.

Principal risks and uncertainties

Strategy & change

2 Products and services

Failure to accelerate our shift to digital by developing and delivering (to time and quality) market leading global products and services that will have the biggest impact on learners and drive growth; ensuring Pearson offers products to market at the right price and with a deal structure that remains competitive as well as supports our strategy.

Decrease in probability

Existing controls

- Global product lifecycle process
- Portfolio management
- Audit Committee oversight of GLP

Outcome of 2017 activities

Successfully managing this risk underpins two of our key strategic priorities – growing our market share through digital transformation plus investing in structural growth opportunities (see p14–17).

The likelihood of this risk occurring reduced in 2017 due to the progress we've made towards implementing portfolio management practices and strategic investment recommendations, as well as on pricing strategy and governance in US higher education courseware.

In 2017, we progressed our understanding of the competitive and structural threats, especially to our courseware business in terms of general and student buying behaviour and have taken steps to mitigate these. For example, we are making good progress in shifting the business from ownership to 'pay for use', we reduced the price of a number of eBook rentals and also launched a print rental programme to give greater convenience and value to students.

2018 outlook and plans

Turning this risk into an opportunity – successfully accelerating our shift to digital as well as investing in and delivering the right products and services – is as key to successful business performance in 2018 as it was in 2017. A new Chief Strategy Officer joined at the start of 2018 see p63.

We will continue to improve the US higher education courseware integrated business strategy, product lifecycle and governance, as well as pricing strategy. In addition to the development of GLP, we are investing in other innovations, such as Artificial Intelligence, to ensure our products stay relevant and to become more agile in our delivery. We are also prioritising investment in our fastest growing businesses across Pearson. See p16–17 in Strategy in action.

Market research and analysis activity across Pearson was centralised into one Global Insights team in January 2018. Their remit is to develop customer insights to inform portfolio, product, channel and business strategy.

3 Talent

Failure to attract, retain and develop staff, including adapting to new skill sets required to run the business.

Decrease in probability

Existing controls

- Consistent performance, talent and succession management processes
- Employee policies including the Code of Conduct (see p27 in Sustainability)
- Employee engagement forums and action plans
- Turnover data monitored on a monthly basis
- Exit interviews conducted and monitored globally to identify any trends and concerns
- Learning programmes now offered on a single platform for all staff (Pearson U)
- Revamped external careers website and talent acquisition approach to improve attraction of digital skills
- Wide range of employee benefits

Outcome of 2017 activities

The likelihood of this risk occurring has reduced due to the mitigation activities successfully implemented in 2017. However, talent remains an ongoing priority for the company, with a focus on building the talent needed to deliver the business strategy for 2020 especially in key areas such as digital and change management skills.

Work was undertaken to ensure we have clarity on the key capabilities required to achieve our 2020 goals, using this to support learning and development, assessment, development and talent attraction.

Throughout 2017, there was a strong focus on leadership communication of the Pearson strategy, as well as increased visibility of the Pearson Executive and leadership teams.

Employee engagement action plans communicated across Pearson and the Executive are reporting progress to the Board on a quarterly basis. Highlights from these plans are listed on p27 in the Sustainability section.

An organisational health survey was conducted, and results and action plan shared in Q4.

Our platform for learning and development was upgraded in 2017, increasing accessibility to learning and development solutions and greater flexibility in goal-setting. Academies were also launched for leadership teams as well as Technology, Product, Marketing and Finance. These aim to increase both our capabilities and retention.

2018 outlook and plans

Pearson will implement further programmes to improve connection with the Pearson strategy, and to increase engagement and organisational health.

In order to build the talent we need to deliver the 2020 business strategy, there will additional focus on direct sourcing and construction of targeted talent pools to target skills (digital), address succession gaps, and increase diversity in leadership roles. We will also continue to support change activities through Change Leadership training and handbooks.

In 2018, there will be a stronger focus on development planning linked to further roll-out of career workshops. We will expand and upgrade Pearson U learning, launching new Sales Academy and leadership programmes that support succession planning and increase retention. We will also further refine the careers website to increase employee attraction.

The Pearson Executive will maintain their focus in 2018 on talent actions for the senior leadership group and succession through quarterly reviews.

Principal risks and uncertainties

Strategy & change

4 Political and regulatory risk

Changes in policy and/or regulations have the potential to impact business models and/or decisions across all markets.

Existing controls

- Board and Executive oversight
- Government relationship teams
- EU referendum Steering Committee

Outcome of 2017 activities

Although there has been no overall change in the risk rating, significant work has been done to ensure we can more proactively identify and mitigate political and regulatory risk.

Over the last two years, there has been a specific focus on leveraging resources across the US and UK to build global political/regulatory relationships, and an international political profile in order to understand future international risks and proactively mitigate them.

In the UK, 2017 was the year that GCSEs began their changeover from grades A*-G to 9-1 with English and Maths. Our focus was on working with government, regulator and other awarding organisations to demonstrate the professionalism and solidity of the system, which resulted in a stable set of results.

In the US, we continued to implement our ten priority state strategy engaging with new and existing office holders in key states and worked to shape the state and federal regulatory and legislative environment in favour of Pearson strengths. This work focused on Pearson solutions to affordability and access with stakeholders in Congress, the Administration and priority state capitals.

The full impact of the UK's pending departure from the EU is still unclear, but we remain vigilant to potentially material risks for Pearson. Work continued throughout 2017 (led by a Steering Committee chaired by the CFO) to identify and mitigate any potential impacts on our principal risks below, such as treasury, tax or data privacy, or on other areas such as UK-EU supply chain and workforce mobility, including in the event of a 'no deal' exit scenario. We continue to believe that Brexit, in whatever form it takes, will not have a material adverse impact on Pearson as a whole.

2018 outlook and plans

Pearson will continue to position itself as a leader in the education space, an innovator in higher education and establish the company as a key engine in workforce development and economic growth. We are also driving opportunities to engage directly with other businesses.

In the UK, there is ongoing concern about the amount of testing (and the sheer difficulty of the new tests) in primary schools. As a test administrator, we are mitigating this through a stakeholder outreach programme on assessment. In addition:

- The new 9-1 GCSEs will be awarded in almost all subjects
- Technical education: as the government becomes more clear about the role of T Levels we will need ongoing government relations, media and thought leadership work.

Across our educational markets in 2018, we believe the trend for more intrusive and voluminous regulation in our sector will continue. We will continue our work from 2016 and 2017 to mitigate this.

We will continue to assess the potential impacts of the UK's decision to leave the EU as the model that will replace our membership becomes clearer.

Principal risks and uncertainties

Operational

5 Testing failure

Failure to deliver tests and assessments and other related contractual requirements because of operational or technology issues, resulting in negative publicity impacting our brand and reputation.

Existing controls

We seek to minimise the risk of a breakdown in our student marking systems with the use of:

- Robust quality assurance procedures and controls
- Oversight of contract performance Investment in technology, project management and skills development of our people, including software security controls, system monitoring, pre-deployment testing, change controls and the use of root cause analysis procedures to learn from incidents and prevent recurrence
- Use of Amazon Web Services (AWS) in Clinical and Schools
- IBM counter-fraud tool.

Outcome of 2017 activities

Pearson is an education content, assessment and related services company and, as such, managing this risk remains a priority.

In the US, the majority of student testing is now conducted via AWS, resulting in improved availability and stability.

In the UK, we successfully delivered the UK summer exam series in 2017 to a high standard of quality.

2018 outlook and plans

The drive to continue improvements to availability and stability of testing systems continues. The migration and retirement of legacy systems in use will continue.

Given the high stakes nature of the UK testing business, there remains a risk of breaches of security either as a result of error or of a malicious nature. We are reviewing what additional measures we can put in place for 2018 to further mitigate against potential question paper security breaches.

The plan to upgrade Pearson's bespoke online marking system – ePEN – in the UK will continue throughout 2018 with full implementation due by the end of 2019, taking into account the complexity of our systems as well as external marking contract obligations.

Clinical's Q-global will be moving to AWS in Q1 of 2018. Additional technology stack updates will be implemented during 2018 to address 2017 issues.

6 Health and safety

Failure to adequately protect the health, safety and wellbeing of our employees, learners and other stakeholders from harm could adversely impact our reputation.

This risk previously incorporated Corporate security which is now part of risk 9 'Corporate security and business resilience'.

Decrease in probability

Existing controls

- Global health and safety (H&S) team
- Global policy and standards
- Global assurance and incident reporting system
- Audit programme
- Regional training

Outcome of 2017 activities

The likelihood of this risk occurring has decreased as a result of the outcomes of the following:

- Overall implementation status of Pearson's H&S minimum standards continues to improve globally
- The 2017 global H&S audit programme was completed across a wide range of our locations
- Our global H&S coordinator role has been formalised with a new terms of reference
- The global H&S team became a registered centre to teach the globally recognised Institution of Occupational Safety and Health (IOSH), Managing Safely course
- A completely revised global H&S Policy (with improved governance and responsibilities) and standards have been developed, which now include good practice goals, recognising the H&S maturity in many of our key markets
- Good progress was made across our 15–17 H&S Strategy.

2018 outlook and plans

- Implement the new global H&S Policy and standards and continue to improve the application of our H&S standards
- Refine and Implement a new 18–20 H&S Strategy
- Deliver the IOSH Managing Safely course to our global H&S coordinators
- Review our H&S systems to ensure they continually evolve to reflect our changing business
- Enhance our global assurance programme to not only provide risk-based auditing of key locations, but to also include advisory reviews and focused risk-based H&S Projects
- Continue to evolve our key risk reduction programmes covering:
  - Ergonomics
  - Occupational Road Risk
  - Occupational health risk management and wellbeing

Principal risks and uncertainties

Operational

7 Safeguarding

Failure to adequately protect children and learners, particularly in our direct delivery businesses.

Existing controls

- Safeguarding policy
- Internal procedures and controls
- Staff Code of Conduct
- Third-party risk management policy
- Safeguarding Steering Committee
- Local safeguarding coordinators

Outcome of 2017 activities

We continue to view safeguarding as a fundamental obligation to our learners and a high priority. Although the risk has been reduced due to our disposal of the majority of our direct delivery businesses, we are exposed to greater online risk as we move to more digital services. There is never a zero risk of a safeguarding incident and organisations should always challenge themselves and look to improve their practice. Hence the overall risk remains the same.

An exercise was conducted to test the response of selected businesses to an online safeguarding issue regarding a member of staff, the results of which were used to further refine training and awareness, ready for implementation in 2018.

A sexual harassment policy for our further education business has been developed and currently training is being produced to support its implementation in Q2 2018.

2018 outlook and plans

We will continue to develop and question our practices around safeguarding in 2018, with a focus on ongoing training and awareness across the business, especially with regard to online safeguarding.

We will also further refine our safeguarding metrics and the system used for reporting, as well as developing and implementing a system for external validation of our safeguarding practice.

8 Customer digital experience

Challenges with reliability and availability of customer facing systems could result in incidents of poor customer digital experience and impact our customer service responsiveness.

Existing controls

- Real-time monitoring of systems (for service disruptions) and reporting of operational performance used to identify issues
- Project management disciplines in place to ensure enhancements and new products meet required standards

Outcome of 2017 activities

Managing this risk is critical to achieving our strategic goal of accelerating our shift to digital products and services, and, crucially, becoming a trusted partner. Therefore this risk remains high, despite the significant improvements in 2017 to our product stability and execution.

Mitigations were put in place to prevent a recurrence of the 2016 back-to-school (BTS) issues experienced by customers. BTS stability in the second half of 2017 was significantly improved, resulting in only a few minor incidents and the highest availability levels seen in the last three years.

Further investment was made in 2017 in our global learning platform (GLP). You can read more on this and how it underpins our strategy and the learning experience in 'Our strategy in action' section on p14–15.

Customer support also improved response times for incoming calls and improved outgoing customer communications during the recent outages.

2018 outlook and plans

In 2018, there will be a continued focus on the performance, stability and usability of all product platforms as well as customer service quality and responsiveness.

Our GLP development, critical to our digital transformation strategy, will continue in 2018, with the first pilots due to go live. This platform will allow us to innovate faster as well as better support our learners.

Principal risks and uncertainties

Operational

9 Corporate security and business resilience

Corporate security: Failure to ensure security for our staff, learners, assets and reputation, due to increasing numbers of and variety of local and global threats.

Business resilience: Failure to plan for or prevent incidents at any of our locations. Incident management and technology disaster recovery (DR) plans may not be comprehensive across the whole Group.

Risk definition has changed from 'business continuity' in 2016 and now incorporates corporate security, previously reported as part of risk 6 'Health and safety'.

Existing controls

- Security and resilience policies
- Security minimum protection standards
- Incident management process
- Resilience governance Steering Committee
- Incident management and DR teams
- Global notification and incident reporting tools
- ISO audit programme
- PQS & VUE – ISO 22301 accredited

Outcome of 2017 activities

There were an increased number of incidents in 2017, which fortunately did not impact Pearson directly.

- Continued work across the 'Top 40' locations for planning, testing and response
- Increased collaboration across the organisation, improving understanding of current and future risks, particularly regarding incident response and DR planning
- Training of global incident management teams for different response levels
- A mass notification system was deployed in the UK and will be further deployed globally during 2018 in order to better communicate with our staff and confirm their safety during an incident
- We strengthened our travel security programme, including greater support provision for higher risk trips
- In physical security, the security policy and global property guidelines were released in early 2017, and contain advice and direction for all projects involving the build, refurbishment and disposal of properties. Security reviews in specific locations resulted in a reduction of risks and therefore improvements for staff and learners.

2018 outlook and plans

In 2018, we will:

- Continue to drive security as a proactive rather than reactive activity, with ongoing physical and travel security reviews
- Refine the incident response model towards a broader regional/geographic response
- Continue work on the sustainable and data specific roll-out of the Everbridge mass notification system
- Mandate travel security training for travel to high risk countries (due for deployment in February)
- Work to refine DR planning for any legacy systems and applications, as well as our support of the GLP, TEP and the £300m 2017-2019 cost efficiency programmes
- Grow our knowledge around cloud-based technologies and implement future digital resilience.

Principal risks and uncertainties

Financial

10 Tax

Legislative change caused by the OECD Base Erosion and Profit Shifting initiative, the UK exit from the EU, other tax reform or domestic government initiatives, potentially in response to the ongoing EU anti-tax abuse activities, results in a higher effective tax rate, double taxation and/or negative reputational impact.

↑ Increase in impact

Existing controls

Our tax strategy reflects our business strategy and the locations and financing needs of our operations. In common with many companies, we seek to manage our tax affairs to protect value for our shareholders, in line with our broader fiduciary duties. We do not seek to avoid tax by the use of 'tax havens' or by transactions that we would not fully disclose to a tax authority. We are guided by our taxation principles, which include complying with all relevant laws, including claiming available tax incentives and exemptions that are available to all market participants.

Oversight of the tax strategy is within the remit of the Audit Committee, which receives a report and risk deep dive on this topic at least once a year (see p78 for details). The CFO is responsible for tax strategy; the conduct of our tax affairs and the management of tax risk are delegated to a global team of tax professionals.

Outcome of 2017 activities

This risk increased in 2017 due to the US tax reform changes legislated in December and the announcement in November of the European Commission opening decision on the United Kingdom Controlled Foreign Companies exemption [see note 34, contingent liabilities on p175).

In August the Audit Committee received an update on our tax strategy and approved our first tax report which was published in September. A further update was given to the Audit Committee and Board in December mainly focusing on the impact of US tax reform.

US tax reform is not expected to have a material impact on our effective tax rate, however we continue to work through the detail and assess whether any changes to our strategy are appropriate.

The outcome of Brexit remains insufficiently clear to assess any impact on tax but we continue to monitor.

2018 outlook and plans

We will continue to assess (and implement mitigation plans if required) US legislation changes as well as monitoring potential tax law changes globally, along with Brexit implications and the State Aid situation.

2018 will see the publication of our second tax report.

Media and public scrutiny on tax issues will continue to be actively monitored by group tax and corporate affairs.

11 Treasury

Failure to manage treasury financial risks e.g. debt repayments, key corporate ratios, counterparty risk, rising interest rates and transactional FX exposure.

↓ Decrease in impact and probability

Controls

- Treasury policy (see note 19 starting on p156)
- The treasury strategy and policy is also subject to an Audit Committee risk 'deep dive'. See p78

Outcome of 2017 activities

Overall treasury risk has reduced over 2017 due to a proactive exercise to reduce gross debt and strengthen our balance sheet which has had a direct impact on refinancing, counterparty and interest rate risk.

Pearson has no debt maturities in 2018. We anticipate that cash from operations, our existing cash balances and cash equivalents, together with availability under our existing credit facility, and cash from operations, will be sufficient to fund our operations for at least the next 12 months.

Pearson maintains investment grade credit ratings with Moody's and Standard and Poor's which facilitate good access to capital markets. These credit ratings in February 2018 were Baa2 (negative outlook) with Moody's and BBB (negative outlook) with Standard and Poor's. The negative outlooks reflect perceived business risk as the business transforms, particularly in US Higher Education.

See note 19 starting on p156 for more information on credit, counterparty, interest rate and transactional FX activities in 2017.

2018 outlook and plans

In 2018, we will continue to operate in line with our treasury policy. More on this can be found in note 19, starting on p156.

Principal risks and uncertainties

Legal & compliance

12 Data privacy and information security

Risk of a data privacy incident or other failure to comply with data privacy regulations and standards, and/or a weakness in information security, including a failure to prevent or detect a malicious attack on our systems, could result in a major data privacy or confidentiality breach causing reputational damage, damage to the student experience, lack of compliance and financial loss.

Existing controls

- Information Security and Data Privacy Offices
- Privacy impact assessment process
- Regular audits
- Automated tools
- Annual data privacy training and awareness week
- Risk management framework
- Vendor oversight
- Audit Committee risk 'deep dive'. See p78

Outcome of 2017 activities

Risks concerning cyber-security and data privacy remain high due to complex external factors.

We now have clarity on the increased regulatory obligations and their impact on Pearson, such as the new EU data privacy law, the General Data Protection Regulation (GDPR) which will apply from May 2018 and introduce more onerous privacy obligations and more stringent penalties for non-compliance. The UK's departure from the EU is also adding another layer of uncertainty with regard to the regulator, and customers are also demanding more from us in terms of data privacy (e.g. GDPR and data sovereignty).

We continued to roll out our GDPR programme in 2017; our work to improve the security of our critical products; as well as our privacy impact assessment process for new vendors and programmes.

Many information security risks previously identified have been addressed, plus there was increased vendor oversight in 2017. However, ongoing assessments uncover new vulnerabilities and risk areas arising from increasingly sophisticated attack strategies, as well as Pearson's ongoing transition to digital products, services and cloud adoption.

In 2017, the information security team focused on an improvement programme for critical applications, core platforms and infrastructure to enable Pearson's digitisation and simplification strategy. In addition, we also instituted a programme to review our top vendor contracts to ensure they have the most up-to-date data privacy and information security wording and that they align with GDPR where relevant.

2018 outlook and plans

The Data Privacy Office continues to monitor developments relating to the UK's departure from the EU and, where necessary, adapt to any new UK specific privacy developments. As Pearson operates across several EU Member States, we will still need to comply with GDPR when the UK leaves the EU.

The information security team will continue to drive security maturity (and also thus security compliance to GDPR, PCI, HIPAA, FERPA and other regulatory requirements). A new risk management tool has been deployed so that security risk accountability can be cascaded effectively.

We are conducting an inventory of what personal and other sensitive data we hold and where in the organisation to better focus our resources and attention.

Joint data privacy and information security activities to build security and privacy controls into the design critical products (including the new global learning platform) will continue.

Increased vendor oversight is a critical initiative for security and broad compliance.

Principal risks and uncertainties

Legal & compliance

13 Intellectual property and rights, permissions and royalties

Failure to adequately manage, procure, register or protect intellectual property (IP) rights (including patents and general copyright) in our brands, content and technology or to prevent unauthorised printing and distribution of books and digital piracy may prevent us from enforcing our rights which will reduce our sales and/or erode our revenues.

Failure to obtain permissions, or to comply with the terms of permissions, for copyrighted or otherwise protected materials such as photos resulting in potential litigation; risk of authors alleging improper calculations or payments of royalties.

Decrease in probability

Existing controls

- Policies in place to manage and protect our IP
- Global trademark monitoring platform
- Cooperation with trade associations
- Monitoring of technology and legal advances
- Patent programme in place
- Establishment of Anti-piracy Committee
- Legal department provides ongoing monitoring and enforcement of print and digital copyright piracy

Outcome of 2017 activities

Overall risk has reduced due to careful litigation management, the continued negotiation of preferred vendor agreements, as well as the ongoing work to implement a new rights and royalties system which will further mitigate this risk. We started our phased implementation of this system in the UK in 2017.

We established an Anti-piracy Committee to manage piracy related risk in a coordinated manner. We conduct internet monitoring, takedown and internet 'search result' scrubbing to reduce digital piracy. We have also worked with our larger North America channel partners to adopt best-practice anti-counterfeit measures.

In 2017, we launched patent management technology to further improve our asset tracking, as well as implementing a global trademark monitoring platform to improve visibility of potential infringement threats.

2018 outlook and plans

We will continue to streamline our portfolios; procure and register expanded rights in our high value IP globally, including aggressively expanding our patent portfolio; monitor activities and regulations; and proactively enforce our rights, taking necessary legal action.

We will continue to implement the newly developed royalty and business practices, along with the new rights management system across the US and Canada during 2018.

A new author agreement is being rolled out in the first half of 2018.

14 Compliance

Failure to effectively manage risks associated with compliance (global and local legislation), including failure to vet third-parties, resulting in reputational harm, anti-bribery and corruption (ABC) liability, or sanctions violations.

Expanded from the previously reported anti-bribery and corruption risk.

Existing controls

- Audit Committee oversight
- ABC policy certification
- Internal procedures and controls
- Risk-based third-party due diligence
- Employee and business partner codes of conduct (see also 'Respect for human rights' under Sustainability on p28)
- Local Compliance Officers (LCOs)

Outcome of 2017 activities

Internal procedures, controls and training continue to mature, which are designed to prevent corruption. Pearson's Code of Conduct was refreshed and rolled out for all employee certification in September 2017, including references to ABC policy and requirements (also discussed under 'Sustainability on p28). Pearson's ABC policy reflects our zero tolerance towards bribery and corruption of any kind by establishing a consistent set of expectations and requirements regarding ABC for all our personnel and business partners to adhere to.

Pearson's 2016 ABC programme self-assessment served as a roadmap for work for 2017-2018. Progress was made on ABC risk assessments of the various regional and local business units.

We conducted due diligence on our highest risk third-parties and developed roll-out plans for further phases.

Pearson's ABC infrastructure includes a network of LCOs based in country, mainly members of the legal team. This programme continues to be successful with greater knowledge and competencies of the LCOs and better leadership, guidance and helpful tools and resources provided by the global compliance office.

2018 outlook and plans

In 2018, we will:

- Implement a comprehensive plan for risk-based roll-out of further ABC third-party due diligence, including new tools and resources
- Roll out a comprehensive refresh of the training programme on ABC and Code of Conduct globally
- Continue risk assessments in 2018 to ensure that the ABC programme reflects local market and business model risks, as well as plan actions to remediate issues revealed during those assessments
- Employ a more robust analytic framework to our investigative data to spot trends and root causes.

Principal risks and uncertainties

Legal & compliance

15 Competition law

Failure to comply with anti-trust and competition legislation could result in costly legal proceedings and/or adversely impact our reputation.

↑ Increase in probability

Existing controls

- Global policy published
- Training and guidance
- Regular internal communications
- Lawyer network

Outcome of 2017 activities

This risk increased during 2017, reflecting our participation in industry associations, including Board membership, as well as the recent activity of associations being challenged by anti-trust authorities such as in Spain.

A global policy, general training and guidance were launched in 2017 and contain all the measures, indicators and actions required to ensure anti-trust and competition compliance.

A lawyer network was launched in 2017 and training has taken place to improve their expertise around competition/anti-trust laws. An increasing number of employees have also been trained. All employees will need to be certified.

2018 outlook and plans

Training, including e-learning modules, is being further expanded in 2018 with metrics being developed to track engagement. The lawyer network is contributing more data to feed into training and risk assessment indicators.

Risk assessment of prospects and viability

This section should be read together with the full viability statement on p106.

Pearson's principal risks and our ability to manage them as outlined above are linked to our viability as a company. These risks have therefore been taken into account when preparing the viability statement.

The Board assessed the prospects of the company over a three-year period, longer than the minimum 12 months of the annual going concern review. The three-year period corresponds with Pearson's strategic planning process and represents the time over which the company can reasonably predict market dynamics and the likely impact of additions to the product portfolio.

The Board discusses the company's strategic plan on an annual basis taking account of a range of factors, including market conditions, the principal risks to the Group above, product and capital investment levels as well as available funding. Pearson's strategy and business model are discussed in more detail on p14–21.

The key assumptions which underpin our three-year strategic plan to December 2020 are as follows:

- Implementation of our 2017-2019 cost efficiency programme reducing our annualised cost base exiting 2019 by c.£300m
- Increased investment in the product technology platform to accelerate the shift to digital and enhance courseware service capabilities
- Further declines in enrolments and other downwards pressures in the US higher education courseware market
- US higher education courseware returns rates continue to improve as the previous inventory correction continues to unwind and sales become more direct to consumers
- Online Program Management grows, driven by global enrolment in undergraduate and post-graduate online courses
- US assessment revenues stabilise
- Other strategic priorities, including Online Blended Learning and Professional Certification, show modest growth.

In assessing the company's viability for the three years to December 2020, the Board analysed a variety of downside scenarios, including a scenario where the company is impacted by all principal risks. The primary modelling overlaid a 'severe but plausible' downside scenario onto the base case strategic plan for Pearson, focusing on the impact of the following assumptions and key risks:

- Failure to materialise anticipated benefits of our 2017-2019 cost efficiency programme
- Increased declines in enrolments and further channel disruption in US higher education courseware
- Failure to accelerate our shift to digital while successfully investing and delivering market leading global products and services
- Online Program Management fails to generate expected revenue growth
- US assessment revenues fail to stabilise
- Other strategic priorities, including Online Blended Learning and Professional Certification, do not achieve modest growth amid global economic uncertainty and local market pressures.

The Board also stress-tested the impact on our liquidity of all the principal risks occurring together. Although this is not regarded as a plausible scenario, the test showed that the company would still have liquid resources subject to a limited number of management actions.

The Board's confirmation of Pearson's viability for the three years to 2020, based on this assessment, is included alongside the going concern statement on p106.

Governance report

In this section

Governance overview

Sidney Taurel
Chairman

In this Governance section

UK Corporate Governance Code

This year, we are reporting against the 2016 edition of the UK Corporate Governance Code (the Code). The Board believes that during 2017 the company was in full compliance with all relevant provisions of the Code. A detailed account of the provisions of the Code can be found on the FRC's website at www.frc.org.uk and we encourage readers to view our compliance schedule on the company website at www.pearson.com/governance

Dear shareholders,

As I said last year, during times of change, good governance is paramount. As a Board we continue to organise our work around five major themes where we believe we can add value: governance and risk, strategy, performance, leadership and people, and shareholder engagement. A summary of the key items covered by the Board throughout the year appears on p68, and I have set out below further detail on our particular areas of focus during 2017.

Looking back on 2017, the Board is satisfied that external and internal expectations regarding performance have been met and that the company has achieved operational stability. We have been very focused throughout the year on the simplification of our portfolio and investment in our transformation programmes, including The Enabling Programme (TEP) and the Global Learning Platform (GLP). We are now in a position where, in addition to regularly monitoring performance and simplification, the Board can begin to pivot its attentions towards longer-term strategic opportunities through structural growth, digital transformation and in the lifelong learning sector.

Leadership & effectiveness

See full section on p64–75

In my letter to shareholders at this time last year, I set out a number of priorities for the Board during 2017. I am pleased to report that good progress has been made on all fronts, summarised below, and with further detail given throughout this report:

› monitor the company's strategic and tactical actions related to the refocusing of the business – the Board monitors financial and operational performance through a streamlined and effective dashboard, which is provided to the Directors on a monthly basis, enabling us to spend more time on strategic discussions during Board meetings

› implement previously signposted portfolio decisions – in 2016 we indicated that we intended to reduce our exposure to large-scale direct delivery businesses to focus on more scalable online, virtual, and blended services. In line with this strategy, we completed the sale of our English test preparation business in China, Global Education (GEDU), in August 2017. We also announced the sale of our English language learning business, Wall Street English (WSE), which is expected to complete in the first half of 2018. In addition, we indicated in early 2017 our intention to exit from our stake in Penguin Random House. Following negotiations with our partner in Penguin Random House, Bertelsmann, we agreed to divest a 22% stake in Penguin Random House, retaining an interest of 25%, and to recapitalise that business

› significantly drive down our cost structure – we announced in 2017 our plans to reduce Pearson's cost base by a further £300m exiting 2019. We are on track to deliver the planned savings, many of which will come through simplification of our technology architecture allowing the increased use of shared service centres enabling us to standardise processes and reduce headcount. This will facilitate further opportunities such as the greater centralisation of procurement and the reduction in the number of our office locations

› reduce the dividend – in 2017, we took the decision to rebase our dividend policy to reflect portfolio changes, the challenging market environment, the pace of investment required to transform the

Governance overview

business and the need to sustain a healthy balance sheet to ensure we have the financial flexibility to maintain a solid investment grade credit rating. Our policy reflects a sustainable and progressive dividend, comfortably covered by the earnings of our business and which can grow as our business expands into the opportunities in global education. For the 2017 financial year, we therefore propose to pay a total dividend of 17p per share – 5p per share at the interim, paid in September 2017, and 12p per share final dividend, subject to shareholder approval at the Annual General Meeting (AGM) in May 2018

› effect an optimal capital allocation, particularly following the outcome of negotiations regarding our investment in Penguin Random House, to ensure long-term sustainability and to reward our shareholders. The proceeds from the sale of the Penguin Random House stake have been used as follows: we undertook a buyback programme to repurchase £300m of ordinary shares which completed on 16 February 2018; $306m was utilised to pay down debt in the form of an early redemption of a US dollar denominated bond; and the remainder reinvested to build a strong balance sheet.

In the coming year, our main focus is to pivot towards our longer-term growth opportunities by delivering on the three strategic priorities described in this report and to continue to monitor progress against our dashboard and key milestones for 2018.

The Board continued to work closely with the Executive team to ensure ongoing leadership development throughout the year. At an Executive level, we recruited a Chief Strategy Officer, Jonathan Chocqueel-Mangan, and a new Chief Human Resources Officer, Anna Vikström Persson, both of whom joined the team in early 2018. The Board looks forward to working closely with Jonathan and Anna, who each have a key role to play in shaping Pearson as we continue to transform the business, hone our strategy and ensure we are able to attract and develop the talent that will lead the business forward.

The Board evaluation for 2017 was facilitated externally – the first external evaluation during my tenure as Chairman. I am pleased to report that there was unanimous agreement by all Directors that the Board is operating effectively. In times of transformation and disruption within Pearson itself and the wider sector in which we operate, it is imperative to ensure that our long-term strategy is appropriate, with shorter-term tactical actions that support delivery of that strategy. One particular theme arising from our evaluation was that the Board will spend even more time considering long-term strategy and ensure we are aligned on process and deliverables. Our Chief Strategy Officer will play an important role in this work during 2018.

Building on our 2016 evaluation, the Board and management gave consideration to the areas where we could particularly leverage external expertise and advice, and as a result Pearson established a Digital Advisory Network of external experts who are partnering with us to help maximise the opportunity from digital disruption. Lincoln Wallen was instrumental in the creation of this network, which held its inaugural meeting late in 2017. We are also pleased that Michael Lynton has been appointed as a Non-Executive Director with effect from 1 February 2018. Michael's experience leading businesses through times of digital disruption will further strengthen our capabilities in this area.

We recently announced that Harish Manwani, a Non-Executive Director of Pearson since 2013, is retiring from the Board at the forthcoming AGM, and will not be seeking re-election, in anticipation of his future commitments. The Board joins me in thanking Harish for his commitment and invaluable contribution to Pearson, and we wish him all the best in his future endeavours.

Accountability

See full section on p76–85

As a Board, we are accountable for Pearson's successes and addressing its challenges. We aim to communicate to you in a transparent manner the steps we have taken to ensure that we have a clear oversight of the business and the work we have undertaken in respect of Pearson's strategy throughout the year. Our Audit Committee, led by Tim Score, plays a key role in monitoring and evaluating our risk management processes, providing independent oversight of our external audit and internal control programmes, accounting policies, business transformation projects, such as TEP and GLP, and in assisting the Board in reporting in a fair, balanced and understandable manner to our shareholders.

Engagement

See full section on p86–89

The 2017 financial year has been one of significant engagement with our shareholders. I have enjoyed spending time throughout the year with many of you to ensure that we maintain an open, transparent dialogue, keep you updated on our strategy and receive your inputs. In common with most large, public companies, we have a wider range of stakeholders than just traditional investors, and our Reputation & Responsibility Committee has oversight of our sustainability and social impact initiatives, government and public affairs matters, and engagement with the education community. Board members also engage with the wider stakeholder population, including employees, customers and partners, both through formal Board events and by way of individual contributions to internal and external initiatives.

Remuneration

See full section on p90–105

Since our last AGM in May 2017, Elizabeth Corley, who chairs our Remuneration Committee, has led our work to engage with investors in connection with Pearson's remuneration policy and to listen to their concerns. It is clear that shareholders and other stakeholders would like our approach to remuneration to be simple, transparent, closely linked to our strategy and the company's performance. We have worked hard to develop an approach that the majority of our shareholders can support. Our approach is explained in more detail in the remuneration section of this report on p90–105.

Conclusion

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

Sidney Taurel
Chairman

Board of Directors

Chairman

Sidney Taurel Chairman
aged 69, appointed 1 January 2016

Sidney has over 45 years of experience in business and finance, and is currently a board director and chairman of the compensation committee at IBM Corporation. Sidney is an advisory board member at pharmaceutical firm Almirall. He was chief executive officer of global pharmaceutical firm Eli Lilly and Company from 1998 until 2008, chairman from 1999 until 2008, and has been chairman emeritus since 2009. He was also a director at McGraw Hill Financial, Inc., a role which he held from 1996 until April 2016, and at ITT Industries from 1996 to 2001. Sidney has received three US presidential appointments to: the Homeland Security Advisory Council, the President's Export Council and the Advisory Committee for Trade Policy and Negotiations, and is an officer of the French Legion of Honour.

Executive Directors

John Fallon Chief Executive
aged 55, appointed 3 October 2012

John became Pearson's Chief Executive on 1 January 2013. Since 2008, he had been responsible for the company's education businesses outside North America and a member of the Pearson management committee. He joined Pearson in 1997 as Director of Communications and was appointed President of Pearson Inc. in 2000. In 2003 he was appointed CEO of Pearson's educational publishing businesses for Europe, Middle East & Africa. Prior to joining Pearson, John was director of corporate affairs at Powergen plc and was also a member of the company's executive committee. Earlier in his career, John held senior public policy and communications roles in UK local government. He is an advisory board member of the Global Business Coalition for Education, a member of the Council of the University of Hull, and trustee and director of the Oracle Cancer Trust.

Coram Williams Chief Financial Officer
aged 44, appointed 1 August 2015

Coram joined Pearson in 2003 and has held a number of senior positions including Finance and Operations Director for Pearson's English Language Teaching business in Europe, Middle East & Africa, Interim President of Pearson Education Italia and Head of Financial Planning and Analysis for Pearson. In 2008, Coram became CFO of The Penguin Group and was latterly appointed CFO of Penguin Random House in 2013, where he oversaw the integration of the two businesses. Coram trained at Arthur Andersen, and subsequently worked in both the auditing and consulting practices of the firm. He is a non-executive director and chairman of the audit committee for the Guardian Media Group.

Non-Executive Directors

Linda Lorimer Non-Executive Director
aged 65, appointed 1 July 2013

Linda spent almost 40 years serving higher education. She retired from Yale in spring 2016 after 34 years at the university where she served in an array of senior positions including vice president for Global & Strategic Initiatives. She oversaw the development of Yale's burgeoning online education division and the expansion of Yale international programmes and centres. During her tenure, she was responsible for many administrative services, ranging from Yale's public communications and alumni relations to sustainability, human resources and the university press. Previously, Linda was president of Randolph-Macon Woman's College and chair of the board of the Association of American Colleges and Universities. She also served on the boards of several public companies, including as presiding director of the McGraw-Hill companies. She is a member of the Trilateral Commission and the Council on Foreign Relations.

Harish Manwani Non-Executive Director
aged 64, appointed 1 October 2013

Harish has an extensive background in emerging markets and senior experience in a successful global organisation. He was previously chief operating officer of consumer products company Unilever, having joined the company in 1976 as a marketing management trainee in India, and held senior management roles around the world, including North America, Latin America, Europe, Africa and Asia. He is non-executive chairman of Hindustan Unilever Limited in India, and serves on the boards of Whirlpool Corporation, Qualcomm Inc. and Nielsen Holdings. He is also on the board of the Indian School of Business and the Economic Development Board (EDB) of Singapore, and is global executive advisor at Blackstone Private Equity.

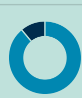
Pearson Board members bring a wide range of experience, skills and backgrounds which complement our strategy.

Executive experience of Chairman and Non-Executive Directors

Digital/technology experience
56%

Education/learning experience
33%

International markets experience
89%



Sustainable business practice experience
67%

Key to Committees A Audit N Nomination & Governance RR Reputation & Responsibility R Remuneration ● Committee chair

Board of Directors

Non-Executive Directors

Elizabeth Corley, CBE Non-Executive Director
aged 61, appointed 1 May 2014

Elizabeth was CEO of Allianz Global Investors, initially for Europe then globally, from 2005 to 2016, and continues to act as a senior adviser to the firm as vice-chair. She was previously at Merrill Lynch Investment Managers and Coopers & Lybrand. In addition to Pearson, Elizabeth serves on two other company boards as a non-executive director – BAE Systems plc and Morgan Stanley. She has various financial services industry roles including as a member of the FICC Markets Standards Board, the ESMA stakeholder group and the TheCityUK Advisory Council. Additionally she is a member of the Committee of 200 and a trustee of the British Museum. Elizabeth currently chairs a group advising the UK government on social impact investing. She is also a crime fiction author.

Vivienne Cox, CBE Senior Independent Director
aged 58, appointed 1 January 2012

Vivienne has wide experience in energy, natural resources and business innovation. She worked for BP plc for 28 years in global roles including executive vice president and chief executive of BP's gas, power and renewables business and its alternative energy unit. She is non-executive director of Stena International and chairman of the supervisory board of Vallourec, a leader in the seamless steel pipe markets. She is also non-executive director at pharmaceutical company GlaxoSmithKline plc and an advisory board member of the African Leadership Institute.

Josh Lewis Non-Executive Director
aged 55, appointed 1 March 2011

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

Tim Score Non-Executive Director
aged 57, appointed 1 January 2015

Tim has extensive experience of the technology sector in both developed and emerging markets, having served as chief financial officer of ARM Holdings plc, the world's leading semiconductor IP company, for 13 years. He is an experienced non-executive director and currently sits on the boards of The British Land Company plc and HM Treasury, in addition to being on the board of trustees of the Royal National Theatre and chairman of the group audit committee of the Football Association. He served on the board of National Express Group plc from 2005 to 2014, including time as interim chairman and six years as the senior independent director. Earlier in his career Tim held senior finance roles with Rebus Group, William Baird, LucasVarity plc and BTR plc.

Lincoln Wallen Non-Executive Director
aged 57, appointed 1 January 2016

Lincoln has extensive experience in the technology and media industries, having been CEO of DWA Nova, a software-as-a-service company spun out of DreamWorks Animation Studios in Los Angeles, a position he held until 2017. He worked at DreamWorks Animation for nine years in a variety of leadership roles including chief technology officer and head of animation technology. He was formerly CTO at Electronic Arts Mobile, leading EA's entry into the mobile gaming business internationally. He is currently a visiting associate in Computing and Mathematical Sciences at the California Institute of Technology (Caltech). Lincoln is also a non-executive director of the Smith Institute for Industrial Mathematics and Systems Engineering. Lincoln's early career involved 20 years of professional IT and mathematics research, including as a reader in Computer Science at Oxford.

Michael Lynton Non-Executive Director
aged 58, appointed 1 February 2018

Michael served as CEO of Sony Entertainment from 2012 until 2017, overseeing Sony's global entertainment businesses. He also served as chairman and CEO of Sony Pictures Entertainment from 2004. Prior to this, he held senior roles within Time Warner and AOL, and earlier served as chairman and CEO of Penguin Group where he extended the Penguin brand to music and the internet. Michael is chairman of Snap, Inc., and currently serves on the boards of Pandora Media Inc., IEX and Ares Management, L.P. He is also a member on the Council on Foreign Relations, the Harvard Board of Overseers and serves on the boards of the Los Angeles County Museum of Art, the Tate and the Rand Corporation. Michael holds a B.A. in History and Literature from Harvard College, where he also received his M.B.A.

Board governance and activities

Board of Directors

Composition of the Board As at the date of this report, the Board consists of the Chairman, Sidney Taurel, two Executive Directors: the Chief Executive, John Fallon, and Chief Financial Officer, Coram Williams, and eight independent Non-Executive Directors. As previously disclosed, Harish Manwani will step down from the Board at the forthcoming AGM.

Chairman and Chief Executive There is a defined split of responsibilities between the Chairman and the Chief Executive. The roles and responsibilities of the Chairman and Chief Executive are clearly defined, set out in writing and reviewed and agreed by the Board on an annual basis.

Chairman's significant commitments On 1 January 2017, Mr Taurel stepped down from his role as a senior adviser at the global investment bank, Moelis & Co, and on 30 November 2017 he stepped down from his role on the advisory Board of Takeda Pharmaceutical.

Roles and composition of the Board

Role	Name	Responsibility
Chairman	Sidney Taurel	The Chairman is primarily responsible for the leadership of the Board and ensuring its effectiveness. He ensures the Board upholds and promotes the highest standards of corporate governance, setting the Board's agenda and encouraging open, constructive debate of all agenda items for effective decision-making. He regularly meets the Chief Executive to stay informed. He also ensures that shareholders' views are communicated to the Board.
Chief Executive	John Fallon	The Chief Executive is responsible for the operational management of the business and for the development and implementation of the company's strategy as agreed by the Board and management. He is responsible for developing operational proposals and policies for approval by the Board, and promotes Pearson's culture and standards.
Chief Financial Officer	Coram Williams	The Chief Financial Officer is responsible for the preparation and integrity of Pearson's financial reporting and statements and also oversees other functional areas including tax, treasury, internal audit and corporate finance. He supports the Chief Executive in developing and implementing the strategy of the company as agreed by the Board and management.
Senior Independent Director	Vivienne Cox	The Senior Independent Director's role includes meeting regularly with the Chairman and Chief Executive to discuss specific issues, as well as being available to shareholders generally should they have concerns that have not been addressed through the normal channels. She also leads the evaluation of the Chairman on behalf of the other Directors.
Committee Chairmen	Elizabeth Corley Vivienne Cox Linda Lorimer Tim Score	The Committee Chairmen are responsible for leading the Board committees and ensuring their effectiveness. They set the Committees' agendas, in consultation with the company's management, and report to the Board on Committee proceedings. They lead on engagement with shareholders regarding matters within the remit of the Committees, alongside senior management.
Non-Executive Directors	Elizabeth Corley Vivienne Cox Josh Lewis Linda Lorimer Michael Lynton Harish Manwani Tim Score Lincoln Wallen	The Non-Executive Directors contribute to the development of our strategy and scrutinise and constructively challenge the performance of management in the execution of strategy and risk planning. They also engage with various stakeholders of the company and provide guidance and independent perspective to management.
Company Secretary	Stephen Jones	The Company Secretary acts as secretary to the Board and its committees, ensuring compliance with Board procedures and advising on governance matters. He is responsible, under the direction of the Chairman, for ensuring the Board receives accurate, timely and clear information. The Company Secretary supports the Chairman in delivery of the corporate governance agenda and organises Director inductions and ongoing training.

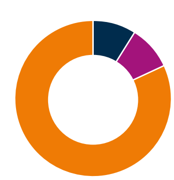
Gender split of Board

- Men 8
- Women 3

Nationality of Directors

- British 6
- USA 4
- Singapore 1

Ethnicity



- Asian 1
- Mixed 1
- White 9

Asian – Indian (1)
Mixed – White & Black Caribbean (1)
White – English/Welsh/Scottish/Northern Irish/British (6)
White – Any other White Background (3)

Length of tenure of Non-Executive Directors

- Under 3 years 2
- 3 to 6 years 4
- Over 6 years 2

Board governance and activities

Governance at Pearson

FLOW OF INFORMATION

Board of Directors

Board Committees

Audit Committee
Appraises our financial management and reporting and assesses the integrity of our accounting procedures and financial control.

Nomination & Governance Committee
Reviews corporate governance matters, including Code compliance and Board evaluation, considers the appointment of new Directors, Board experience and diversity, and reviews Board induction and succession plans.

Remuneration Committee
Determines the remuneration and benefits of the Executive Directors and oversees remuneration arrangements for the Pearson Executive.

Reputation & Responsibility Committee
Considers the company's impact on society and the communities in which Pearson operates, including to ensure strategies are in place to manage and improve Pearson's reputation.

Pearson Executive management (PEM)

PEM consists of John Fallon (Chief Executive) and his direct reports. They are the leadership group for Pearson, responsible for delivering Pearson's strategy under clearly defined accountabilities and in line with agreed governance and processes.

- Chief Executive
- Chief Financial Officer
- Chief Technology and Operations Officer
- Chief Corporate Affairs and Global Marketing Officer
- Chief Human Resources Officer
- Chief Strategy Officer
- General Counsel and Chief Legal Officer
- President, Core markets
- President, Growth markets
- President, North America
- President, Assessments
- President, Global Product

There were no other changes to the Chairman's significant commitments during 2017.

Independence of Chairman In accordance with the Code, Sidney Taurel was considered to be independent upon his appointment as Chairman on 1 January 2016.

Independence of Directors All of the Non-Executive Directors who served during 2017 were considered by the Board to be independent for the purposes of the Code. The Board reviews the independence of each of the Non-Executive Directors annually. This includes reviewing their external appointments and any potential conflicts of interest as well as assessing their individual circumstances in order to ensure that there are no relationships or matters likely to affect their judgement. In addition to this review, each of the Non-Executive Directors is asked annually to complete an independence questionnaire to satisfy requirements arising from Pearson's US listing.

Josh Lewis and Vivienne Cox have served on the Board for more than six years. Accordingly, their performance has been subject to a rigorous review, including with regard to their independence. The Board has determined that Josh Lewis and Vivienne Cox continue to be independent, nothwithstanding their length of service, taking into account their valuable contribution to Board discussions and constructive challenge of management.

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

Board governance and activities

Board meetings

The Board had seven formal meetings in 2017, with discussions and debates focused on the key strategic issues facing the company. This included two meetings each of three days' duration in São Paulo, Brazil and Boston, USA at which the Board considered growth markets and strategy. Major items covered by the Board in 2017 are shown in the table below.

In addition to the formal meetings, the Board meets as necessary to consider matters of a time-sensitive nature.

São Paulo, Brazil

At a three-day meeting at São Paulo in June, the Board and Pearson Executive focused primarily on the Pearson business in Brazil, while also taking a wider look at our Growth geographic markets, including time focusing on India and South Africa. They engaged with the Brazilian leadership team and wider employee population throughout the visit, and spent time gaining an insight into the macro-economic environment in Brazil.

The Board participated in demonstrations for three products in the learning and assessment sectors. In two groups, the Board and Executive then visited schools where they met students and teachers, considered the school culture and classroom innovations, and discussed the students' perspectives on the value of learning.

Boston, USA

The Board and the Pearson Executive visited Boston in October for a three-day meeting where they were joined by members of the North American senior management team to consider leadership, culture and the change agenda in Pearson North America. The Board also spent time considering Pearson's vision and strategy, including a financial overview and consideration of synergies and our product investment portfolio, US higher education courseware and key strategic initiatives and opportunities, before taking some time to review organisational health.

The Board and Executive participated in a range of engagement opportunities with a variety of Pearson stakeholders, including an event on Employment in 2030 – The Future of Skills, and customer panel sessions. On the final day of the three-day meeting, the Board attended a facilitated breakfast meeting with top talent and new employees and gained insight into employees' views on Pearson's current challenges and opportunities. Read more about the Board's engagement with these stakeholders on p89.

Board meeting focus during 2017

Area of responsibility	Activity	
Governance & risk	› Training on Market Abuse Regulation › Compliance with UK Corporate Governance Code › Income statement and Going concern and viability › Shareholder activism and defence plan › Enterprise risk management review	› Approval of division of responsibilities between Chairman and Chief Executive › Annual review of conflicts of interest › Pension scheme derisking › Approval of Committee terms of reference
Strategy	› Penguin Random House, WSE, GEDU and K-12 courseware – updates › Strategy meeting in São Paulo focusing on local Brazilian businesses and wider Growth strategy › Efficiency and simplification initiatives › US higher education courseware › Interactive product demonstrations	› Communications strategy and positioning › Capital structure › Product, technology and operations strategies › Digital advisory network update › Operating and strategic plan updates › Tax update
Performance	› 2016 preliminary results and annual report and accounts › Interim results and trading updates › Monthly dashboard and milestone reports	› 2017 operating plan › Final and interim dividend proposals › Draft 2018 operating plan and 2017 and 2018 goals
Leadership & people	› Chief Executive's goals › Talent and succession planning › Organisational health including review of Pearson's culture	› Dinner with senior local management and facilitated breakfasts with key talent at overseas strategy meetings. Read more on employee engagement on p27.
Shareholders & engagement	› Share buyback programme › Investor relations strategy and share price performance	› Major shareholders and share register analysis › Shareholder issues and voting › Focus on forthcoming AGM

Board governance and activities

Board in action

US higher education courseware

Robin Baliszewski, Managing Director, Higher Education Sales, leads a panel of student ambassadors at the Board's meeting in Boston

At the Board's request, US higher education courseware was an area of focus at each Board meeting during 2017 as Pearson looked to respond to and proactively mitigate against challenges in that market sector. At each meeting, the Board was joined by the Presidents of North America and Global Product and by the Chief Technology and Operations Officer to review the market and associated financial model, changes in the trading environment, possible short- and longer-term implications of those changes, and to consider and assess Pearson's strategic response, including the impact of the new digital and print rental models on both customer and competitor activity and on the traditional sales channel.

At its October meeting in Boston, the Board viewed an early stage product demonstration of the Global Learning Platform which would initially be focused on the higher education portfolio. The Board also engaged with panels of students and faculty members in order to gain a greater insight into how Pearson's higher education products and services are viewed by those that use them. Throughout the year, including between scheduled meetings, the Board also monitored progress through a monthly dashboard which enabled them to track Pearson's delivery of agreed strategic, performance and customer-focused metrics in the higher education courseware market.

Link to strategic priorities, ➔ See p14

1 Grow market share through digital transformation

Structural growth opportunities

Pearson considers Online Program Management (OPM) and virtual schools to be among its biggest growth opportunities. During the year, the Board considered Pearson's prospects in these areas, how to measure success, and what differentiates Pearson and provides real competitive advantage. The Board also considered what Pearson might look like in the medium term as these and other opportunities come to fruition, and the characteristics for these businesses in terms of revenues and profits. At its strategy meeting in October, the Board held a deep dive into each of these areas with the responsible Executives. In respect of OPM, the Board reviewed the global market opportunity, and considered how Pearson's expertise in courseware and assessment could continue to support partners in the development and delivery of online programmes that deliver demonstrable learner outcomes and superior student learning experience. The Board discussed how to deliver that strategy, and considered management's recommendations for next steps. Regular reporting to the Board of progress in this market has been introduced and OPM will be a particular item for the Board's ongoing consideration in 2018.

Link to strategic priorities, ➔ See p16

2 Invest in structural growth markets

Portfolio changes

Following the announcement of Pearson's strategy of reducing exposure to large-scale direct delivery businesses, the Board had considered its portfolio for strategic alignment, and had determined that its English test preparation business in China, Global Education (GEDU), and English language learning business, Wall Street English (WSE), were no longer aligned with Pearson's core strategy and accordingly that exits from these business would be explored. At a number of meetings during 2017, the Board considered input from the President, Growth markets, with responsibility for Pearson's business in China, and from the SVP Corporate Finance & Strategic Development, both of whom provided updates as the negotiations proceeded and the transactions took shape. The Board considered the potential terms of the transactions, the status of interested parties, and in light of all relevant factors – including the impact of the potential divestments on Pearson, its shareholders and wider stakeholders – gave approval for the sales of GEDU and WSE businesses in line with agreed terms.

Link to strategic priorities, ➔ See p18

3 Become simpler and more efficient

Board governance and activities

The role and business of the Board

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

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

The key responsibilities of the Board include:

- Overall leadership of the company and setting the company's values and standards
- Determining the company's strategy in consultation with management, reviewing performance against it and overseeing management execution thereof
- Major changes to the company's corporate, capital, management and control structures
- Approval of all transactions or financial commitments in excess of the authority limits delegated to the Chief Executive and other Executive management.

The Board receives timely, regular and necessary financial, management and other information to fulfil its duties. Comprehensive meeting papers are circulated to the Board and committee members at least one week in advance of each meeting and the Board receives a monthly dashboard and key milestones report and regular updates from the Chief Executive and CFO. In addition to meeting papers, a library of current and historic corporate information is made available to Directors electronically to support the Board's decision-making process. Directors can obtain independent professional advice, at the company's expense, in the performance of their duties as Directors. All Directors have access to the advice and services of the Company Secretary.

Standing Committee

A Standing Committee of the Board is established to approve certain operational and ordinary course of business items such as banking matters, guarantees, intra-group transactions and to make routine approvals relating to employee share plans.

The Committee has written terms of reference, reviewed and approved each year, which clearly set out its authority and duties. These can be found on the company website at www.pearson.com/governance.

Culture and values

Pearson's core values – to be brave, imaginative, decent and accountable – go to the heart of our mission to improve learning outcomes, and the Board and employees are committed to demonstrating these characteristics throughout their work and deliberations. The Board monitors the culture of the company and levels of employee engagement and advocacy with the assistance of its Reputation & Responsibility Committee and through regular updates from the Chief Human Resources Officer. It aims to foster a culture of collaboration, diversity and inclusion at all levels, including by engaging with employees from across Pearson at various events throughout the year. Pearson's Code of Conduct outlines how we work to our mission and values in an ethical and responsible manner.

Board attendance

Directors are expected to attend all Board and committee meetings but in certain exceptional circumstances, such as due to pre-existing business or personal commitments, Directors may be unable to attend. In these circumstances, Directors receive relevant papers and, where possible, will communicate any comments and observations in advance of the meeting for raising as appropriate during the meeting. They are updated on any developments after the meeting by the Chairman of the Board or committee, as appropriate. Individuals' attendance at Board and committee meetings is considered, as necessary, as part of the formal annual review of their performance. There was a high level of attendance by Directors at Board and committee meetings in 2017.

The following table sets out the attendance of the company's Directors at scheduled Board meetings during 2017:

	Board meetings attended
Chairman	
Sidney Taurel	7/7
Executive Directors	
John Fallon	7/7
Coram Williams	7/7
Non-Executive Directors	
Elizabeth Corley	7/7
Vivienne Cox	7/7
Josh Lewis	7/7
Linda Lorimer	7/7
Harish Manwani	7/7
Tim Score[1]	6/7
Lincoln Wallen	7/7

1 Unable to attend one meeting due to pre-existing commitment. Ahead of the meeting, Mr Score communicated his comments on the business of the Board to the Chairman.

Board governance and activities

Succession planning

The Board considers oversight of succession planning as one of its prime responsibilities, assisted by the Nomination & Governance Committee. As well as Board and Executive management succession, the Board oversees the process for all key positions throughout the business with a particular focus on high potential talent.

The company has formal contingency plans in place for the temporary absence of the Chief Executive for health or other reasons. The matter of Chief Executive succession is a standing item for discussion and review by the Chairman and the Board annually. Succession planning for the Board and Chairman is also considered annually by the full Board and on an ongoing basis by the Nomination & Governance Committee. There is also discussion and oversight of key positions at Executive management level, including the recent appointments of Jonathan Chocqueel-Mangan as Chief Strategy Officer and Anna Vikström Persson as Chief Human Resources Officer.

Directors' training and induction

All Directors receive training in the form of presentations about the company's operations, through Board meetings held at operational locations and by encouraging the Directors to visit local facilities and management as and when their schedule allows, including if they are travelling to a country or region on non-Pearson business. The Company Secretary and General Counsel, in conjunction with Pearson's advisers, monitor legal and governance developments and update the Board on such matters as agreed with the Chairman. In 2017, the Directors and other senior managers were briefed on:

- The EU Market Abuse Regulation, including the impact of regulatory guidance introduced during the year
- The latest regulatory framework, corporate governance reporting and Directors' remuneration report as part of a training session led by PwC
- Regular market updates for the Remuneration Committee on industry practice and regulation received from external advisers.

Our Directors can also make use of external courses.

Directors receive a significant bespoke induction programme and a range of information about Pearson when they join the Board. This includes background information on Pearson and details of Board procedures, Directors' responsibilities and various governance-related issues, including procedures for dealing in Pearson shares and their legal obligations as Directors. The induction also typically includes a series of meetings with members of the Board, external legal advisers and brokers, the Pearson Executive and senior management, presentations regarding the business from Senior Executives and a briefing on Pearson's investor relations programme.

The induction programme for Michael Lynton, our most recently appointed Non-Executive Director, will take place in 2018. The initial phase will include meetings with other Board members, business area familiarisation with members of the Pearson Executive, a briefing on Directors' duties and sessions with the SVP Internal Audit, Compliance and Risk and SVP Investor Relations, with the remainder of the induction tailored to Michael's particular areas of interest and aligned with the Board's focus areas.

Directors' indemnities

A qualifying third-party indemnity (QTPI), as permitted by the Articles and sections 232 and 234 of the Act, has been granted by the company to each of its Directors. Under the provisions of the QTPI, the company undertakes to indemnify each Director against liability to third-parties (excluding criminal and regulatory penalties) and to pay Directors' costs as incurred, provided that they are reimbursed to the company if the Director is found guilty, the court refuses to grant the relief sought or, in an action brought by the company, judgment is given against the Director. The indemnity has been in force for the financial year ended 31 December 2017 and is currently in force.

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

Board Committees

The Board has established four formal Committees: Audit, Nomination & Governance, Remuneration, and Reputation & Responsibility. The chairmen and members of these committees are appointed by the Board on the recommendation (where appropriate) of the Nomination & Governance Committee and in consultation with each relevant committee chairman. In addition to these formal Board Committees, the Standing Committee also operates with Board-level input.

Learn more about Pearson's governance structure on p67

More Committee information:

Audit Committee	p76
Nomination & Governance Committee	p74
Remuneration Committee	p90
Reputation & Responsibility Committee	p86
Standing Committee	p70

The Committees focus on their own areas of expertise, enabling the Board meetings to focus on governance and risk, strategy, performance, and leadership and people, thereby making the best use of the Board's time together as a whole. The Committee chairmen report to the full Board at each Board meeting immediately following their sessions, ensuring a good communication flow while retaining the ability to escalate items to the full Board's agenda if appropriate.

Board governance and activities

Board evaluation

The Board evaluation for 2017 was an externally facilitated process led by Heidrick & Struggles JCA Group, which was selected following a review by the Nomination & Governance Committee of various providers and consideration of the potential scope of the evaluation. In addition to facilitating the Board evaluation, Heidrick & Struggles JCA Group was also engaged by Pearson in relation to Non-Executive Director and Senior Executive search activity during the year.

In reporting back to the Board, the evaluator reported that conversations with Board members were positive, with unanimous agreement that the Board operates effectively. The evaluator noted that the Board had acknowledged the management team's commitment which has put the business in a much more positive position at the end of the year than it was at the beginning of the year. This was the first external evaluation since the appointment of Sidney Taurel as Chairman, and it was noted by the other Board members that he had created a different and positive dynamic, with his leadership style and experience. The evaluator reported that the relationship between the Executive and Non-Executive Directors remains positive, with the additions of Coram Williams and Lincoln Wallen to the Board further complementing that dynamic. The evaluator noted that the Board was particularly appreciative of Elizabeth Corley's commitment throughout 2017 in her engagement with investors in respect of remuneration matters.

More detail on the evaluation process and the priorities arising from it is given opposite, and the Nomination & Governance Committee will consider Heidrick & Struggles JCA Group's findings and recommendations in greater detail throughout 2018.

A number of actions were taken during 2017 in response to findings arising from the 2016 Board evaluation process. You can read more about progress on these in the table below.

Individual evaluation

In addition to the evaluation of the Board as a whole, Executives are evaluated each year on their performance against personal objectives under the company's annual incentive plan. These objectives are linked to certain strategic metrics, including efficiency and cost savings initiatives, driving the digital agenda, and growing market share in US higher education courseware. Progress against each of these metrics is reviewed by the Board on a monthly basis, as part of the dashboard of KPIs which we believe to be central to Pearson's turnaround.

The Chairman meets with each Non-Executive Director individually on a regular basis and, in assessing the contribution of each, has confirmed that each Director continues to make a significant contribution to the business and deliberations of the Board. The Non-Executive Directors, led by the Senior Independent Director, also conduct an annual review of the Chairman's performance.

Committee evaluation

All committees undertake an annual evaluation process to review their performance and effectiveness. For 2017, the process was facilitated externally by Heidrick & Struggles JCA Group as part of the Board evaluation. The Committees were considered to be working effectively, led well by their respective chairmen with appropriate agendas and a strong work ethic from each committee member. Read more on this in the pages that follow.

Progress on findings of 2016 evaluation

Finding	Response/Action taken
Continue to focus on US higher education courseware at every meeting, and build additional measures into the monthly dashboard to monitor this business.	US higher education courseware is a standing item at each Board meeting, with the responsible Executives providing updates on progress and initiatives. The regular monthly dashboard has been refined and provides more detail on US higher education courseware. The dashboard is kept under review and evolves as necessary with business and Board requirements.
Drive to increase use of external expertise in digital technologies.	Building on a scoping session involving Directors and members of the Pearson Executive, we launched a digital advisory network in 2017 to bring together a diverse cross-section of people with experience and knowledge of digital disruption. Learn more about the digital advisory network on p88.
Experience identified as valuable in new Board members, including digital transformation and disruption.	An agreed candidate specification was drawn up for any potential new Non-Executive Director appointments, resulting in the appointment of Michael Lynton.
Agree most appropriate format and scheduling for Non-Executive and Chairman only sessions	These sessions are a standing item at each Board, Audit Committee and Remuneration Committee meeting, to enable open discussion of issues and ensure the Board or committee continues to work effectively as a group. The Chairman also held a number of Non-Executive Director dinners in 2017.
Desire to build a compelling narrative about the role for Pearson in the future of learning.	Building on research with teachers and learners, a set of insights-driven communications principles and practices has been developed about who we are, what we do, and what that means for our customers.
Creation of a strategic framework to guide disposals.	This was discussed and agreed by the Board at a strategy session in late 2016 and the framework implemented in 2017.
Increase visibility of ROIC-style metrics in each part of portfolio.	Additional ROIC-style measures were introduced into the Board's reporting during 2017, and both gross and net ROIC were reported publicly in our 2017 full year results.
Continued focus on retention of key talent, both at senior levels and throughout organisation.	Key talent and 'regretted leavers' report considered regularly by Remuneration Committee. A 'managers' toolkit' has also been developed to encourage and enable retention of key employees.

Board governance and activities

External Board evaluation process 2017

Preparation

Following discussions with the Chairman, Senior Independent Director and Chief Executive, Heidrick & Struggles JCA Group (the evaluator) prepared a framework for discussion, as set out below, which formed the basis for all one-on-one meetings.

One-on-one meetings

The evaluator met individually with each of the Directors and the Company Secretary for an open, confidential, unattributed conversation using the framework for discussion as a prompt on proposed topics. The discussion was not limited to these topics if participants wanted to raise additional subjects.

Feedback to the Chairman and Senior Independent Director

The evaluator submitted a draft report to the Chairman and Senior Independent Director. This was followed by a discussion of the findings and a number of recommendations arising therefrom.

Feedback to the Board

The evaluator facilitated an open discussion with the Board in December 2017 on the findings of the evaluation process.

Final review with another Independent Director

For the purposes of good governance, the evaluator spoke with another Independent Non-Executive Director following the Board meeting to confirm all information provided was a fair reflection of the feedback from each of the Directors, and was not influenced inappropriately by any Director.

Discussion framework

A framework for an open discussion with Directors

- Chairman and roles
- Organisation
- Dynamics
- Strategy
- Performance
- Risk management
- Communications
- Succession management and planning
- Committees
- Composition

Key themes arising from the evaluation

- The Board and Committees work effectively, led well by their respective chairs, with a clear and significant personal commitment to Pearson demonstrated by all Board members
- The Non-Executive Directors recognised the inclusive and thoughtful approach of the Executive Directors in ensuring transparent communication between the Board and the Executive
- Effective processes and monthly reporting have helped the Board ensure the company achieves and maintains operational control and stability
- The Board members appreciate the sequencing of meetings, including overseas meetings, which afford them the opportunity to engage with the wider senior management team and to meet employees, customers and other stakeholders
- Board succession planning should consider future committee chairs, and other desirable expertise in new Board members
- Ensure ongoing strategic development aligned with business transformation activity. New Chief Strategy Officer to facilitate, enabling all Board members' strategic perspectives to be captured and considered
- Ongoing Board education to continue to focus on competitive landscape and digital technologies
- A desire for additional informal joint Board and Executive sessions to permit open dialogue and discussion in a less structured format
- Ensure continued understanding by the Board of significant shareholders' views to encourage constructive dialogue and clear communication of strategy
- New Chief Human Resources Officer to continue executive succession planning and complete a talent review aligned to the strategic needs of the business.

Nomination & Governance Committee report

Committee Chairman
Vivienne Cox

Members Elizabeth Corley, Vivienne Cox, Josh Lewis, Harish Manwani, Tim Score and Sidney Taurel

Committee responsibilities include:

Appointments Identifying and nominating candidates for Board vacancies.

Balance Ensuring that the Board and its Committees have the appropriate balance of skills, experience, independence, diversity and knowledge to operate effectively.

Succession Reviewing the company's leadership needs with a view to ensuring the continued ability of the organisation to compete in the marketplace.

Governance Review and oversight of Pearson's corporate governance framework, Board evaluation and training plans, and Board diversity policy.

Terms of reference

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

Attendance

Attendance by Directors at Nomination & Governance Committee meetings throughout 2017:

	Meetings attended
Elizabeth Corley	3/3
Vivienne Cox	3/3
Josh Lewis	3/3
Harish Manwani	3/3
Tim Score	3/3
Sidney Taurel	3/3

Board search

Pearson uses a number of leading firms in its Board search activities and ensures that we retain good relationships with them. During 2017, the services of Heidrick & Struggles JCA Group were availed for the appointment of Michael Lynton, Non-Executive Director, who joined the Board on 1 February 2018. During 2017, Heidrick & Struggles JCA Group also led the externally facilitated evaluation of the Board and its Committees, and was engaged in Senior Executive search activity. Heidrick & Struggles JCA Group is a signatory to the voluntary code of conduct for executive search firms.

Role and business of the Committee

The Committee monitors the composition and balance of the Board and of its Committees, identifying and recommending to the Board the appointment of new Directors and/or Committee members. The Committee also oversees talent and succession plans for senior roles.

As the remit of the Committee expanded in 2017, the Committee now also oversees the company's compliance with, and approach to, all applicable regulation and guidance related to corporate governance matters, including Board diversity, oversight of the annual Board evaluation processes, the company's corporate governance policies and practices, compliance with the Code, and oversight of Director induction and training. In respect of its governance remit, the Committee primarily has the role of reviewing current practices on behalf of the Board, and recommending actions or changes for the Board's formal approval.

The Committee is comprised of five independent Non-Executive Directors and the Chairman of the Board. The Chief Executive and other senior management attend Committee meetings by invitation.

Appointment of Michael Lynton

During the 2016 Board evaluation process, the Board considered the experience it would require in its next Non-Executive Director. Accordingly, the Committee met in early 2017 and agreed the specific skills and experience required in potential candidates, which included: a current or former CEO of a mid-to-large sized company; experience in an industry which has undergone digital disruption; and global experience, including of the US market. Other desired experience included marketing or branding and experience in the service sector. Pearson also expects all Non-Executives to demonstrate the highest level of integrity and credibility, independence of judgement, maturity, collegiality, a high interest in education and the commitment to devote the necessary time. Based on these criteria, candidates were then shortlisted for the proposed role at the Committee's next meeting and were interviewed by Heidrick & Struggles JCA Group and then the Committee. As a result of this process, the Committee was satisfied that Michael Lynton met the required skills and experience and also possessed the personal attributes that we would expect to see in any Pearson Non-Executive Director.

Diversity

The Board embraces the Code's underlying principles with regard to Board balance and diversity, including in respect of ethnicity, gender and age. In May 2017, the Committee adopted the Board diversity and inclusion policy. The objectives set out in the policy and our progress towards these objectives are shown in the table opposite. The Committee ensures that the Directors of Pearson demonstrate a broad balance of skills, background and experience, and nationalities, to support Pearson's strategic development and reflect the global nature of our business. The Committee also ensures that appointments are made on merit and relevant experience, while taking into account the broadest definition of diversity.

As at 31 December 2017, the gender diversity of the Board, exceeded Lord Davies' 2015 target with 30% female representation on the Board. However, as noted in the Board diversity and inclusion policy, we are committed to work towards the recommendations

Nomination & Governance Committee report

suggested by the Hampton-Alexander Review aimed at having at least 33% female representation on the Board by 2020.

Our Code of Conduct sets out our global standards and responsibilities with regard to diversity & inclusion (D&I) at all employee levels, including the Pearson Executive, and covers many aspects, including gender, age, disability and sexual orientation. This is underpinned by a global statement on D&I along with country and business specific policies. We are a founder member of the 30% Club and the Chief Executive has also signed a personal commitment to set an aspirational target of 30% women in Pearson's senior management team by 2020. The Chief Executive and the Chief Financial Officer are both members of the Board. Among the other ten members of the Executive team there are currently two women (20%) although for most of 2017 the percentage was 22% (two members out of nine). The senior leadership team, comprising the members of the Pearson Executive and their direct reports, has 30% female representation. We believe that we have a strong pipeline of women in leadership and senior management positions, and the Committee will monitor their development, and the development of all key talent, with care. The sustainability section provides more detail on how we implement our standards on D&I on p28.

Further, in the UK, the government has introduced new regulations designed to help address the gender pay gap. Pearson has published its gender pay gap report in Great Britain and has made a commitment to extend our reporting globally by 2020.

View details of the Board's diversity and breadth of professional experience on p64 & 66

Committee evaluation

The Committee undertook an annual evaluation to review its own performance and effectiveness. This evaluation was facilitated by Heidrick & Struggles JCA Group as part of the wider Board evaluation process. The Committee was considered to have operated effectively throughout 2017 with a clear agenda and effective leadership. In response to the findings of the 2017 evaluation, the Committee will consider succession planning as a priority in 2018, particularly for Committee chair roles.

Nomination & Governance Committee meeting focus during 2017

Area of responsibility	Activity	
Appointments	› Appointment of Michael Lynton as Non-Executive Director	
Balance	› Agreement of desired skills and experience of new Non-Executive Director	› Board diversity and inclusion policy
Succession	› Contingency succession planning for temporary absence of CEO › Succession planning for senior executives including CEO	› Succession planning and updates on search for Non-Executive Director
Governance	› Approval of committee terms of reference › Consideration of Board evaluation feedback	› Compliance with UK Corporate Governance Code

Committee aims for 2018

We will have a full agenda for 2018, with a particular focus on Non-Executive Directors' succession planning activity, Board and senior management diversity and inclusion plan, findings of the Board evaluation and review of the corporate governance framework in light of changes to the Code expected to come into effect during 2018.

Vivienne Cox
Chairman of Nomination & Governance Committee

Board diversity & inclusion objectives

The Committee has agreed the following objectives to support the Board diversity & inclusion policy:

Objectives	Progress
We will strive to maintain a Board composition of: › At least 25% female Directors, with a target of at least 33% female Directors by 2020 › At least one Director of colour	› 25% female Directors achieved › Achieved
All Board appointments will be made on merit, in the context of the skills and relevant experience that are needed for the Board to oversee Pearson's strategic development and that reflect the global nature of our business.	Achieved. Rigorous process used during recent search for Michael Lynton who has relevant experience and skills.
The Board will prioritise use of search firms which adhere to the Voluntary Code of Conduct for Executive Search Firms when seeking to make Board-level appointments.	Achieved. Availed services of Heidrick & Struggles JCA Group, which has signed the Voluntary Code.
The Board will continue to adopt best practice, as appropriate, in response to the Davies Review, the Hampton-Alexander Review and the Parker Review.	Suggestions noted by the Board.
Where appropriate, we will assist with the development and support of initiatives that promote all forms of diversity and inclusion in the Board, Pearson Executive and our senior management.	Adopted the Board diversity & inclusion policy. Board members personally sponsor Women in Learning & Leadership network.

Audit Committee report

Committee Chairman
Tim Score

Members Elizabeth Corley, Vivienne Cox, Linda Lorimer, Tim Score and Lincoln Wallen

Committee responsibilities include oversight of:

Reporting	The quality and integrity of financial reporting and statements and related disclosure.
Policy	Group policies, including accounting policies and practices.
External audit	External audit, including the appointment, qualification, independence and the performance of the external auditor.
Risk & internal control	Risk management systems and internal control environment, including the performance of the internal audit function.
Compliance & governance	Compliance with legal and regulatory requirements in relation to financial reporting and accounting matters.

Terms of reference

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

Attendance

Attendance by Directors at Audit Committee meetings throughout 2017:

	Meetings attended
Elizabeth Corley[1]	3/4
Vivienne Cox	4/4
Linda Lorimer	4/4
Tim Score	4/4
Lincoln Wallen	4/4

1. Unable to attend one meeting due to existing commitment pre-dating her appointment to the Committee. Ahead of the meeting, Ms Corley communicated her comments on the business of the Committee to the Chairman.

Audit Committee role

The Committee has been established by the Board primarily for the purpose of overseeing the accounting, financial reporting, internal control and risk management processes of the company and the audit of the financial statements of the company. As a Committee, we are responsible for assisting the Board's oversight of the quality and integrity of the company's external financial reporting and statements and the company's accounting policies and practices.

Pearson's SVP Internal Audit, Compliance and Risk has a dual reporting line to the Chief Financial Officer and to me, and external auditors have direct access to the Committee to raise any matters of concern and to report on the results of work directed by the Committee. As Audit Committee Chairman, I report to the full Board at every Board meeting immediately following a Committee meeting. I also work closely with the Chief Financial Officer and senior financial management outside the formal meeting schedule to ensure robust oversight and challenge in relation to financial control and risk management.

Audit Committee composition

The Committee comprises five independent Non-Executive Directors. As a committee, we have a good balance of skills and knowledge with competence and experience covering all aspects of the sector in which Pearson operates – education, digital and services – and our key geographic markets.

Fair, balanced and understandable reporting

We are mindful of the Code's provision C.1.1 relating to fair, balanced and understandable reporting and we build sufficient time into our annual report timetable to ensure that the full Board receives sufficient opportunity to review, consider and comment on the report as it progresses. Learn more about fair, balanced and understandable reporting on p109

Risk assessment, assurance and integrity

A key role of the Committee is to provide oversight and reassurance to the Board with regard to the integrity of the company's financial reporting, internal control policies and procedures for the identification, assessment and reporting of risk. During 2017, we conducted a number of deep dives into selected principal risks, and the key risks on which the Committee focused throughout the year are set out below. Learn more about principal risks and uncertainties on p50–60

Business transformation

Ongoing business transformation is one of Pearson's key risks and opportunities. The Enabling Programme (TEP) is an important operational simplification project covering Pearson's key enterprise resource planning technology and processes, including financial and HR systems and processes, and the Committee received an update at each meeting as TEP progressed during the year.

Audit Committee report

The primary areas of focus for the Committee throughout 2017 were monitoring the stabilisation of finance and operations systems in the UK which were implemented in the second half of 2016, and oversight of the planned implementation of finance and operations systems throughout our North American business. In particular, the Committee considered the phasing of the North America implementation which has been aligned to the business cycle to minimise associated risk. The Committee also considered lessons learned from the previous year's UK implementation, including employee training and design adaptations, and how these lessons would be applied to the next phase.

The Committee heard from the project team leading the North American design and implementation, as well as the senior management team in charge of the transformation programme. Customer experience, data quality and readiness were key areas under regular consideration by the Committee, and updates were considered at every meeting on adherence to key project milestones and budget. In addition to the continued finance and operations system implementation, new global procurement, supply chain and contingent worker systems were also rolled out across Pearson.

The Global Learning Platform (GLP) is a key customer- and learner-facing element of the transformation programme, and is a mitigating factor in a number of risks facing the business, including data security and accessibility. Accordingly, the Committee has introduced GLP as a standing item for consideration at each meeting as the project progresses. The Committee will continue to monitor progress on TEP and GLP throughout 2018 with the assistance of senior management.

Leveraging the progress made through TEP, a review of general controls operating in the business commenced in 2017 with the aim of moving the control environment to best-in-class standard, alongside processes and systems. To this end, a formal control Steering Committee was established with representation from finance, HR, and technology, chaired by the Deputy CFO. The Steering Committee has oversight for controls globally, and centres of excellence have been created for both financial and IT general controls. The controls transformation is expected to be a progressive programme, over a multi-year period, building on TEP, with automated controls. The "first line of defence" will also be strengthened to reduce reliance on mitigating and audit controls. The Committee approved the proposed framework at its meeting in May 2017, and progress reports are now a standing item for the Committee's consideration. Learn more about GLP on p15 and TEP on p51

Audit Committee meeting focus during 2017

Area of responsibility	Activity		
Reporting	› Accounting and technical updates › Impact of legal claims and regulatory issues on financial reporting › Fair, balanced and understandable, Going concern and viability statements	› 2016 annual report and accounts: preliminary announcement, financial statements and income statement › Review of interim results and trading updates	› Form 20-F and related disclosures, including annual Sarbanes-Oxley Act section 404 attestation of financial reporting internal controls › Significant issues reporting
Policy	› Accounting matters and Group accounting policies	› Analysis supporting viability statement › Annual review and approval of external auditor policy	› Treasury policy and strategy › Tax strategy
External audit	› Provision of non-audit services by PwC › Receipt of external auditors' report on Form 20-F and year-end audit › Half year review	› Reappointment of external auditors › Confirmation of auditor independence › 2017 external audit plan	› Remuneration and engagement letter of external auditors › Review opinion on interim results › Review of the effectiveness of external auditors
Risk & internal control	› Internal audit activity reports and review of key findings › Enterprise risk management › 2018 internal audit plan › Legacy product review	› Assessment of the effectiveness of internal control environment and risk management systems › Impact of transformation on contract royalties › Health and safety › Global Learning Platform	› Risk deep dives: data security; data privacy including GDPR; anti-bribery and corruption; tax; treasury; business resilience › Oversight of The Enabling Programme › Controls transformation initiative and subsequent Committee updates
Compliance & governance	› Fraud, whistleblowing reports and Code of Conduct matters › Schedule of authorities	› Compliance with accounting and audit-related aspects of the UK Corporate Governance Code › Internal audit terms of reference	› Committee terms of reference › Review of the effectiveness of the internal audit function

Audit Committee report

Data security and data privacy

In a deep dive led by the Chief Information Security Officer, the Committee considered the progress being made in security across Pearson's technology estate, where multiple workstreams arising from the business transformation programme have contributed to an improved remediation position in relation to risk. The risk level remains high overall, however, due primarily to the nature and volume of data held within our systems, particularly legacy systems, although decommissioning of these has accelerated under the simplification programme. The maturity of the security programme has improved through 2017, and business continuity and disaster recovery capabilities are expected to also improve as data centres are closed.

The Committee considered the balance to be struck between ongoing improvements to security maturity and the actions required by the Group-wide simplification initiatives, as well as the appropriate mix of talent required to both protect and remediate legacy systems and continue development of leading edge solutions.

The Chief Privacy Officer led a separate deep dive into Pearson's data privacy framework. The Committee considered a report on Pearson's readiness for the implementation of the General Data Protection Regulation (GDPR) in May 2018, and the plan in place to remediate the gaps identified. Also noted were the actions that were being taken to replace or retire legacy systems, and it was agreed that good progress had been made during the year in terms of Group-wide data privacy governance.

Tax and treasury

The Committee held two deep dives into Pearson's tax strategy, led by the SVP Tax, to keep abreast of developments at a time of uncertainty in the tax environment. External factors under consideration by the Committee included possible impacts of the proposed US tax reforms and activity at an EU level, including potential effects on Pearson and the sectors in which we operate. From an internal perspective, the Committee considered with management and PwC the appropriate level of provisioning in respect of historical tax issues, and how such provisioning might be applied going forward, taking into account the evolution of Pearson's size and structure in recent years.

Tax transparency is a particular topic of focus in the corporate sector as a whole, being a matter of public trust for companies and the taxation system. In September 2017, Pearson published a report on its tax strategy and financial information on a country-by-country basis for our 12 largest markets, the report being a matter of consideration for the Committee prior to publication.

The Committee also considered the direction of Pearson's treasury strategy, with input from the new SVP Treasury who joined the business in early 2017. Key findings were that the fundamentals of the Group's funding structure were sound and controls around dealing and cash payments were in good shape. Priorities moving forward were also considered, including the continued evolution of the treasury strategy aligned with the commercial direction of the business and the finance transformation programme, and ongoing integration of the insurance function within treasury to give a more holistic view of financial risk.

Audit Committee meetings and activities

At every meeting, the Committee considered reports on the activities of the internal audit and compliance functions, including the results of internal audits, risk reviews, project assurance reviews and fraud and whistleblowing reports. The Committee also monitored the company's financial reporting and risk management procedures, reviewed the services provided by PwC and considered any significant legal claims and regulatory issues in the context of their impact on financial reporting, each on a regular basis.

At our August meeting, the Committee considered the findings of our review of the performance and effectiveness of Pearson's internal audit function, a process which is undertaken annually. This review was conducted by distributing a questionnaire to the key stakeholders of the internal function – including Committee members, the lead external audit partner, members of the Pearson Executive, and senior financial, legal and operational management – and the findings indicated an effective internal audit function.

The Committee also considered Pearson's anti-bribery and corruption programme, and the planned governance framework in respect of new anti-facilitation of tax evasion legislation, which came into effect in September 2017. In February 2018, the Committee considered the 2017 annual report and accounts, including the preliminary results announcement, financial statements, strategic report and Directors' report.

Learn more about the key activities of the Audit Committee on p77

Members

All of the Audit Committee members are independent Non-Executive Directors and have financial and/or related business experience due to the senior positions they hold or have held in other listed or publicly traded companies and/or similar large organisations. Tim Score, Chairman of the Committee since April 2015, is the company's designated financial expert, having recent and relevant financial experience, and is an Associate Chartered Accountant. He also serves as Audit Committee Chairman for The British Land Company plc. The qualifications and relevant experience of the other Committee members are detailed on p64–65

Audit Committee report

Additional meeting attendees

In addition to the Committee members, advisers and executives from across the business also attended meetings during the year, as outlined in the table below. This gives the Committee direct contact with key leadership. The Chairman and Chief Executive each attend at least one meeting per year, and the Chief Executive also attends for discussion of matters with an operational focus. The Committee also met regularly in private with the external auditors, SVP Internal Audit, Compliance and Risk, and VP Internal Audit.

Attendees	Meetings attended
Chief Financial Officer	4/4
Deputy CFO	4/4
Legal Counsel	4/4
SVP Internal Audit, Compliance and Risk	4/4
SVP Finance, Group Reporting	4/4
VP Internal Audit*	3/3
Committee Secretary	4/4

* VP Internal Audit role created partway through 2017

Audit Committee training

The Committee receives regular technical updates as well as specific or personal training as appropriate. In August 2017, PwC led a training session for the Committee and other Board members on the current regulatory framework and corporate reporting.

Committee members also meet with local management on a periodic basis, such as when travelling for overseas Board meetings, in order to gain a better understanding of how Pearson's policies are embedded in operations.

Committee evaluation

In 2017, the Committee evaluation was undertaken by Heidrick & Struggles JCA Group as part of the wider Board evaluation process. The responses illustrated an effective Committee, which uses its time well and has an appropriate focus on the key issues. The key findings were:

- The combination of the Committee Chairman and CFO, who attends Committee meetings by invitation, is very effective and creates a well-functioning Audit Committee
- All Committee members contribute fully and the balance of challenge and support is felt to be appropriate
- The meetings are well run to a disciplined timetable ensuring appropriate allocation of time for discussion and agreement
- Risk management is given the right attention and review in the Committee's meetings, and there is appropriate escalation of matters to the full Board when necessary
- Directors who do not serve on the Committee feel well informed of its proceedings
- Succession for the role of Audit Committee Chairman should be borne in mind with future Non-Executive Director appointments, although this is not immediately pressing.

External audit

Oversight of external auditors

The Committee reviews and makes recommendations to the Board in respect of the appointment and compensation of the external auditors. This recommendation is made by the Committee after considering the external auditors' performance during the year, reviewing external auditor fees, conducting an effectiveness review and confirming the independence, objectivity, qualifications and experience of the external auditors.

The Committee reviewed the effectiveness and independence of the external auditors during 2017, as it does every year, and remains satisfied that the auditors provide effective independent challenge to management.

The external auditor review was conducted by distributing a questionnaire to key audit stakeholders, including members of the Audit Committee, the Chief Executive, Chief Financial Officer, Deputy CFO, Company Secretary, SVP Internal Audit, Compliance and Risk, SVP Finance for each business area and other heads of corporate functions. Overall, responses to the questionnaire were very positive, indicating an effective external audit process.

The Committee will continue to review the performance of the external auditors on an annual basis and will consider their independence and objectivity, taking account of all appropriate guidelines. There are no contractual obligations restricting the Committee's choice of external auditors. The external auditors are required to rotate the audit partner responsible for the Pearson audit every five years. A new lead audit partner, Giles Hannam, rotates onto the Pearson audit from 2018, with the outgoing partner, Stuart Newman, having led the audit for five years concluding at the end of the 2017 audit.

Audit tendering and rotation

Pearson's last audit tender was in respect of the 1996 year end, and resulted in the appointment of Price Waterhouse as auditors. Developments at an EU level regarding mandatory audit rotation for listed companies have changed the UK landscape on audit tendering and rotation. The Committee has reviewed the timetable for tendering and has taken into account relevant regulation and guidance. EU regulations and the ruling by the Competition and Markets Authority (CMA) impose mandatory tendering and rotation requirements, with EU rules requiring a new auditor to be appointed no later than for the 2024 financial year end.

In considering the appropriate audit tender timetable for Pearson in light of these requirements, the Committee has also taken account of the significant business change being experienced by the Group and is monitoring the extent to which the Group is drawing upon the services of other accounting firms. As noted elsewhere within this report, a series of programmes is well underway throughout Pearson to implement major simplification and efficiency improvements across all our enabling functions – particularly technology, finance, HR – to continue to bring the general and administrative costs of running Pearson more in line with global best practice. These include a major transformation programme – The Enabling Programme (TEP) – which includes the

Audit Committee report

implementation of new financial systems and changes to our transaction processing and control activities, which launched in the UK during 2016, and is expected to be rolled out throughout our businesses by 2020. Pearson is supported in these changes, such as in project assurance matters and, more broadly, by external advisers, including accounting firms.

Due to the status of TEP and the involvement of accounting firms advising on TEP and other change projects, the Committee is of the opinion that the level of disruption likely with a change of auditor, as well as the focus required by finance and management teams to conduct the tender process thoroughly and effectively, may unduly impact the Group and would not be in the best interests of shareholders. The rotation of lead audit partner at the start of 2018 gives us further confidence in the ongoing effectiveness, independence and challenge brought by the external auditor.

As noted last year, it is the current expectation of the Committee that an audit tender process would commence in 2022 in order for the auditor selected as a result of the tender to be appointed for the financial year ending 31 December 2023. It would be our intention to look to accelerate this timing if feasible and appropriate following the completion of TEP, and we would communicate any change in our plans to shareholders in advance of any decision. For the reasons outlined above, the Committee considers this timing to be in the best interests of Pearson's shareholders and will continue to monitor this annually in light of the effectiveness and independence of the current auditors, as well as considering whether the timing remains appropriate in light of business developments.

Once the next audit tender occurs, Pearson will adopt a policy of putting the audit contract out to tender at least every ten years, as required.

Compliance with the CMA Order

Pearson confirms that it was in compliance with the provisions of The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 during the financial year ended 31 December 2017.

Review of the external audit

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

At the August 2017 Audit Committee meeting, the Committee discussed and approved the external audit plan and reviewed the key risks of misstatement of Pearson's financial statements, which were updated at the December 2017 Committee meeting.

The table on p81–82 sets out the significant issues considered by the Audit Committee together with details of how these items have been addressed. The Committee discussed these issues with the auditors at the time of their review of the half-year interim financial statements in August 2017 and again at the conclusion of their audit of the financial statements for the full year in February 2018.

All the significant issues were also areas of focus for the auditors. Learn more in the Independent auditors' report on p112–117

In December 2017, the Committee discussed with the auditors the status of their work, focusing in particular on internal controls and Sarbanes-Oxley testing, and covering the significant issues outlined on the following pages.

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

› The work they had conducted over revenue, including over more complex revenue contracts and judgements in relation to provisions for returns

› Their work in evaluating management's goodwill impairment exercise, on a fair value less costs to sell basis, including assessing assumptions around sales and operating cash flow forecasts, longer-term growth rates and discount rates

› The work performed over the nature and presentation of non-trading items focusing on subjective judgements and the transparency with which related adjusted measures are presented

› The work they had done to determine the provisioning levels in respect of potential tax exposures and uncertain tax provisions and related disclosures

› Their evaluation of the recoverability of investments in digital platforms and pre-publication assets

› Their work over completed disposals and the assessment of certain businesses meeting the definition of held for sale

› The results of their controls testing for Sarbanes-Oxley Act section 404 reporting purposes and in support of their financial statements audit

› The results of their work over the company's going concern and viability statement reports

› Their work in relation to other matters which aren't classified as key audit matters, but may give rise to additional disclosure requirements e.g. the impact of new accounting standards.

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

Audit Committee report

Significant issues considered by the Audit Committee

Area of focus	Issue	Action taken by Audit Committee	Outcome
Impairment reviews	Pearson carries significant goodwill intangible asset balances. There is judgement exercised in the identification of CGUs and the process of allocating goodwill to CGUs and aggregate CGUs and in the assumptions underlying the impairment review. In 2016, Pearson made significant impairments to goodwill in its North American business. There were no impairments recorded in 2017.	The Committee considered the results of the Group's annual goodwill impairment review and the key assumptions which are considered to be the cash flows derived from strategic and operating plans, long-term growth rates and the weighted average cost of capital. The Committee considered the sensitivities to changes in assumptions and the related disclosures required by IAS 36 'Impairment of Assets'. The Committee considered sensitivity to assumptions in relation to the Group's CGUs noting that after a number of impairments in recent years even a relatively small change in assumptions could crystallise impairments particularly in the Group's Core CGU.	Annual impairment review finalised with confirmation of sufficient headroom in each of the CGUs.
Revenue recognition and IFRS 15	Pearson has a number of revenue streams where revenue recognition practices are complex and management assumptions and estimates are necessary. The Group also finalised its work on the disclosure required in connection with the transition to IFRS 15 'Revenue from Contracts with Customers' which will be applicable in 2018.	The Committee regularly reviews revenue recognition practice and the underlying assumptions and estimates. In addition, the Committee has visibility of internal audit findings relating to revenue recognition controls and processes and routinely monitors the views of external auditors on revenue recognition issues. During the year, the Committee continued to monitor the project to transition to the new revenue recognition standard, IFRS 15 'Revenue from Contracts with Customers'. The Committee noted the changes to revenue streams and the quantification of the impact on the opening balance sheet.	Assumptions underlying revenue recognition were reviewed and challenged and considered to be appropriate. Progress on the project to convert to IFRS 15 and final quantification and disclosures were reviewed and also agreed as appropriate.
Financial instruments	Pearson will adopt IFRS 9 'Financial Instruments' in 2018.	The Committee reviewed the work on the transition to IFRS 9 and noted the Group's new approach to hedge accounting, investment valuation and impairment. The Committee reviewed the impact on the opening balance sheet and in particular the impact on bad debt provisions.	Adjustments relating to IFRS 9 were reviewed and disclosure of impact in 2018 was considered appropriate.
Disposal transactions	The Group sold a significant portion of its stake in Penguin Random House and the China test preparation business, 'GEDU'. The Group also announced its intention to sell its English Language teaching business in China, 'WSE', and its K-12 school courseware business in the US.	The Committee reviewed the accounting for the disposal transactions, including the rationale for held for sale treatments in respect of proposed disposals. The Committee also considered the status of the remaining 25% investment in Penguin Random House and in particular considered whether Pearson continued to exert significant influence over the venture.	The Committee determined that disposal accounting had been correctly recorded and that the criteria for held for sale treatment in respect of potential disposals was appropriate. The Committee also agreed that the remaining investment in Penguin Random House should continue to be accounted for as an associate.

Audit Committee report

Significant issues considered by the Audit Committee (continued)

Area of focus	Issue	Action taken by Audit Committee	Outcome
Pension valuations	Pearson's UK pension plan includes a large defined benefit section. The valuation of this plan under IAS 19 'Employee Benefits' requires significant judgement.	The Committee looked at changes in the assumptions used to value the UK pension plan and in particular noted updated assumptions for mortality, discount rates and member options on retirement. The Committee also reviewed the accounting for the Plan's purchase of insurance buy-in policies during the year and for significant additional pension contributions made in respect of prior year business disposals.	Pension assumptions were considered appropriate and the pension surplus under IAS 19 was agreed to be fairly stated.
Comment letters received from regulators	During the year Pearson received comment letters from the Financial Reporting Council (FRC) in the UK and the Securities Exchange Commission (SEC) in the US.	Letters from the FRC and SEC were circulated to the Committee and responses by the company were reviewed. Where relevant additional disclosure was requested by the regulators this was also reviewed prior to publication in this report. In particular, the Committee reviewed proposed changes to disclosures relating to our alternative performance measures included in the Our KPIs section, the Financial Review section and the Financial key performance indicators section of this report.	The Committee agreed that the company's responses to comment letters were appropriate and ensured that disclosures were reviewed and updated. Both comment letter processes have been closed.
Restructuring	Pearson announced a new restructuring programme in May 2017. There are a number of accounting judgements to be made regarding categorisation and timing of recognition of cost.	The Committee reviewed progress on the restructuring programme and considered the judgements required in accounting for the costs of redundancy, asset impairment and property rationalisation mainly in respect of the Group's North America operations and enabling functions. The Committee also considered the disclosure of restructuring in Pearson's adjusted measures.	The Committee confirmed that the accounting and disclosure for the restructuring programme were appropriate.
Returns	In light of significant product returns in 2016 in the US higher education courseware business, we continued to review returns data and our policy on reserving for returns.	The Committee considered return provisioning for the US higher education courseware business following a high level of returns from retailers in 2016 and a subsequent change in methodology for establishing provisions. This methodology was subsequently refined in 2017.	Assumptions underlying the returns reserve methodology were reviewed and agreed as still being appropriate in the light of actual returns in 2017.
Tax	The impact of US tax reform and the trend for increased tax transparency, and provision levels.	The Committee reviewed tax provision levels and was updated on expanded annual report disclosures concerning tax provisions. The Committee addressed this matter through the presentation of two management reports on Pearson's tax affairs by the SVP Tax and through a presentation of the external auditors' assessment of the company's tax provisioning. In addition, the Committee considered the report on tax strategy issued in September 2017 prior to publication. The Committee was briefed by management on the anticipated impact of US tax reform in December 2017. As more information on the detailed application becomes available, these estimates may change, and the Committee will be updated as necessary.	The Committee was satisfied with Pearson's approach to tax provisioning, taking account of the views of management and the assessment of the external auditors. The Committee agreed that expanded disclosure in this report would be beneficial to users.

Audit Committee report

Auditors' independence

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

The Audit Committee approves all audit and non-audit services provided by PwC. Our policy on the use of the external auditors for non-audit services reflects the restriction on the use of pre-approval in the 2016 FRC Guidance on Audit Committees and, accordingly all non-audit services, irrespective of value, are required to be approved by the Audit Committee. In particular, we expressly prohibit the provision of certain tax, HR and other services by our external auditor. We review non-audit services on a case-by-case basis, including reviewing the ongoing effectiveness and appropriateness of our policy.

The Audit Committee receives regular reports summarising the amount of fees paid to the auditors. During 2017, Pearson spent £0.8m less on non-audit fees with PwC compared with 2016, due to a reduction in billing on tax services and on the efficacy programme. For 2017, non-audit fees represented 23% of external audit fees (35% in 2016). The policy on provision of non-audit services by external auditors in use in 2016 was in line with previous FRC requirements.

For all non-audit work in 2017, PwC was selected only after consideration that it was best able to provide the services we required at a reasonable fee and within the terms of our policy on external auditors. Where PwC is selected to provide audit-related services, we take into account its existing knowledge and experience of Pearson. Where appropriate, services were tendered prior to a decision being made as to whether to award work to the auditors.

Significant non-audit work performed by PwC during 2017 included:

- Audit-related work in relation to potential and actual corporate finance transactions
- Audit of IT general controls mandated by contractual commitments.

A full statement of the fees for audit and non-audit services is provided in note 4 to the consolidated financial statements on p137.

Tim Score
Chairman of Audit Committee

Risk governance and control

Control environment

The Board has overall responsibility for Pearson's systems of internal control and risk management, which are designed to manage, and where possible mitigate, the risks facing Pearson, safeguard assets and provide reasonable, but not absolute, assurance against material financial misstatement or loss. The Board confirms that it has conducted a review of the effectiveness of Pearson's systems of risk management and internal control in accordance with provision C.2.3 of the Code and the FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (FRC Guidance). The Board confirms these systems operated satisfactorily throughout the year and to the date of this report, and no significant failings or weaknesses were identified in the review process.

The Board has delegated responsibility for monitoring the effectiveness of the company's risk management and internal control systems to the Audit Committee. The Audit Committee oversees a risk-based internal audit programme, including periodic audits of the risk processes across the organisation. It provides assurance on the management of risk, and receives reports on the efficiency and effectiveness of internal controls. Each business area, including the corporate centre, maintains internal controls and procedures appropriate to its structure, business environment and risk assessment, while complying with company-wide policies, standards and guidelines.

Internal control and risk management

Our internal controls and risk oversight are monitored and continually improved to ensure their compliance with FRC Guidance. Our risk journey is described more thoroughly in the risk management section on p50–60.

The Board is ultimately accountable for effective risk management in Pearson and determines our strategic approach to risk. It confirms risk appetite targets and receives and reviews semi-annual reports on the enterprise risk management (ERM) process and the status of top enterprise-wide risks.

It is supported in the following ways:

- The Audit Committee is responsible for overseeing internal controls within Pearson which includes determining the risk appetite (recommended by Pearson Executive management), reviewing and commenting upon key risks and ensuring that risk management is effective
- Pearson's Executive and leadership teams are responsible for identifying and mitigating risks, supported by the ERM team
- Leaders and managers at all levels in Pearson are responsible for managing risk in their area of responsibility, including the identification, assessment and treatment of risk
- The ERM team owns the overall risk management framework for the company and facilitates consolidated reporting on risk
- The internal audit team provides independent assurance on the adequacy of the risk management arrangements in place. The internal audit plan is aligned to identified enterprise-wide risks reported by the ERM team and it presents issues and risks arising from internal audits at each Audit Committee meeting.

The involvement of the Board and Audit Committee in the design, implementation, identification, monitoring and review of risks (including setting risk appetite, determining which are principal to the company and how risk is being embedded in our culture) is outlined in more detail in the risk management section on p50–60.

Financial management and reporting

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

We have an ongoing process to monitor the risks and effectiveness of controls in relation to the financial reporting and consolidation process, including the related information systems. This includes up-to-date Pearson financial policies, formal requirements for finance to certify that they have been in compliance with policies and that the control environment has been maintained throughout the year, consolidation reviews and analysis of material variances, finance technical reviews, and review and sign-off by senior finance managers. The Group finance function also monitors and assesses these processes and controls through finance and technology compliance functions and a Controls Steering Committee comprising cross-functional experts.

These controls include those over external financial reporting which are documented and tested in accordance with the requirements of section 404 of the Sarbanes-Oxley Act, which is relevant to our US listing. One key control in this area is the Verification Committee, which submits reports to the Audit Committee. This Committee is chaired by the SVP Internal Audit, Compliance and Risk, and members include the Chief Financial Officer and/or their deputy, General Counsel, SVP Investor Relations and the Company Secretary as well as senior members of financial management. The primary responsibility of this Committee is to review Pearson's public reporting and disclosures to ensure that information provided to shareholders is complete, accurate and compliant with all applicable legislation and listing regulations. The effectiveness of key financial controls is subject to management review and self-certification and independent evaluation by the external auditors.

Risk governance and control

Internal audit

Pearson has an in-house internal audit function, supported by co-source agreements to augment our in-house resources, in areas such as providing specific subject matter expertise or language skills. The internal audit function is responsible for providing independent assurance to management and the Audit Committee on the design and effectiveness of internal controls to mitigate strategic, financial, operational and compliance risks. The SVP Internal Audit, Compliance and Risk reports formally to the Chairman of the Audit Committee and the Chief Financial Officer, with a reporting line to the General Counsel on compliance matters.

The internal audit mandate and plan are approved annually by the Audit Committee. Completion and changes to the plan are also reviewed and approved by the Audit Committee throughout the year. The internal audit plan is aligned to our greatest areas of risk as identified by the ERM process, and the Audit Committee considers issues and risks arising from internal audits. Management action plans to improve internal controls and to mitigate risks, or both, are agreed with the business area after each audit. Formal management self-assessments allow internal audit to monitor business areas' progress in implementing management action plans agreed as part of internal audits to resolve any control deficiencies. Progress of management action plans is reported to the Audit Committee at each meeting. Internal audit has a formal collaboration process in place with the external auditors to ensure efficient coverage of internal controls. Regular reports on the findings and emerging themes identified through internal audits are provided to Executive management and, via the Audit Committee, to the Board.

The SVP Internal Audit, Compliance and Risk oversees compliance with our Code of Conduct and works with senior legal and HR personnel to investigate any reported incidents, including ethical, corruption and fraud allegations. The Audit Committee is provided with an update of all significant matters received through our whistleblowing reporting system, together with an annual review of the effectiveness of this system. The Pearson anti-bribery and corruption programme provides the framework to support our compliance with various anti-bribery and corruption regulations such as the UK Bribery Act 2010 and the US Foreign Corrupt Practices Act.

Treasury management

The treasury department operates within policies approved by the Audit Committee on behalf of the Board, and treasury transactions and procedures are subject to regular internal audit. Major transactions are authorised outside the department at the requisite level, and there is an appropriate segregation of duties. Frequent reports are made to the Chief Financial Officer and regular reports are prepared for the Audit Committee and the Board. The treasury policy is described in more detail in note 19 to the consolidated financial statements.

Insurance

Pearson reviews its risk financing options regularly to determine how the company's insurable risk exposures are managed and protected. Pearson purchases comprehensive insurance cover and annually reviews coverage, insurers and premium spend, ensuring the programme is fit for purpose and cost-effective.

Pearson's insurance subsidiary, Spear Insurance Company Limited, is used to leverage Pearson's risk retention capability and to achieve a balance between retaining insurance risk and transferring it to external insurers.

Reputation & Responsibility Committee report

Committee Chairman
Linda Lorimer

Members Vivienne Cox, Linda Lorimer, Harish Manwani and Lincoln Wallen

Committee responsibilities include oversight of:

Reputation	Pearson's reputation among major stakeholders, including governments, investors, employees, customers, learners and the education community.
Risk	Oversight of Pearson's approach to reputational risk, including ensuring that clear roles have been assigned for management.
Sustainability	Oversight of 2020 sustainability plan and performance against sustainability goals and commitments.
Brand & culture	Management of the Pearson brand to ensure that its value and reputation are maintained and enhanced. Pearson's approach to monitoring and supporting the values and desired behaviours that form our corporate culture.
Ethics	Ethical business standards, including Pearson's approach to issues relevant to its reputation as a responsible corporate citizen.
Strategy	Strategies, policies and plans related to reputation and responsibility issues and the people, processes and policies that are in place to manage them.

Terms of reference

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

Attendance

Attendance by Directors at Reputation & Responsibility Committee meetings throughout 2017:

	Meetings attended
Vivienne Cox	4/4
Linda Lorimer	4/4
Harish Manwani	4/4
Lincoln Wallen	4/4

Reputation & Responsibility Committee role

The Committee forms an important part of the Board's oversight of the broader governance environment, working to advance Pearson's reputation across a range of stakeholders and to maximise the company's positive impact on society and the communities in which we work.

The Committee's agenda includes discussion of reputation, critical issues and initiatives, including those identified as material to Pearson's stakeholders and long-term sustainability, and consideration of immediate risks or opportunities. We are committed to promoting Pearson's 2020 sustainability plan, and the Committee works in alignment with the company's Responsible Business Leadership Council which comprises senior leaders from across the business.

Read more about our 2020 sustainability plan on p24–33.

Changes to the Committee

Lincoln Wallen joined the Committee with effect from 1 January 2017, in place of Josh Lewis who stepped down from the Committee at the end of 2016. I was pleased to take over the chairmanship of the Committee at the start of the year from Vivienne Cox, who remains a valuable member of the Committee.

Areas of focus during 2017

As part of Pearson's 2020 sustainability plan, the company has identified a shortlist of issues that are most relevant to the sustainability of our business. The Committee has an integral role in the oversight and governance of these issues, and during 2017 held a number of deep dives to consider specific issues, in particular considering the public goals and targets the company is setting to address these issues, and examining their associated reputational impacts.

At our August meeting, we reviewed proposals for Pearson's new global editorial policy, designed to ensure we consistently publish high-quality content and prevent errors. The Committee considered appropriate positioning and communication of the policy and discussed plans for training to be rolled out to content creators and editorial staff. We also discussed ways in which Pearson could adapt and modify its content to reflect local and cultural norms, while still being true to our values and purpose. During the year we also considered access enabled by affordability, particularly in the US higher education courseware market, and discussed plans to ensure our products meet the needs of learners, educators and administrators in accessing learning and teaching materials from anywhere, at any time. In addition, the Committee considered reports on other material sustainability issues, namely greenhouse gas emissions and climate change, 21st century skills and lobbying and public policy.

Read more about our material sustainability issues and our global editorial policy on p25–26.

During the year we reviewed the progress made by Pearson's ongoing social impact initiatives and partnerships. We focused on developing the next phases of Project Literacy and for the Pearson Affordable Learning Fund as well as studied the plans for Tomorrow's Markets Incubator.

Reputation & Responsibility Committee report

Brand strategy is an important part of the Committee's mandate, and we assessed the progress in rolling out the new Pearson brand and the recent market campaigns in North America. We have been attentive to how the communications are migrating more to digital dissemination to align with our customers' practices and preferences.

The US is our largest market, so it is important for the Committee to follow Pearson's reputation and brand in the US particularly. The likely impact of the US 2016 elections was outlined for us early in 2017, and we have received updates on issues and initiatives in our higher education business as they related to reputation. Pearson will be reporting publicly, starting in 2018, on the efficacy of our products and services to demonstrate their measurable impact. Throughout 2017, the Committee monitored the progress of our external reporting plans; we looked at how we are aligning our efficacy goals with our wider business strategy, and considered examples of product efficacy reports. We were joined for our efficacy sessions by PwC, which is providing external assurance for the efficacy reporting process.

In our report to shareholders last year, we noted that, as a Committee, we would continue to monitor the Pearson culture and employee engagement, particularly in light of the changes and rationalisations throughout the business in 2016. However, due to the importance of this topic, it was instead considered by the full Board in 2017. Culture and engagement continues to fall within the remit of the Committee, and we will consider the matter as appropriate during 2018.

Committee evaluation

In 2017, the Committee evaluation was undertaken by Heidrick & Struggles JCA Group as part of the wider Board evaluation process. Overall, the responses illustrated a collaborative and engaged Committee, and that the work of the Committee is increasingly aligned with the strategic agenda. The assessment indicated that there may be opportunity to evolve the Committee further by clarifying its focus. In particular, some overlap with the Audit Committee was identified. As a result, oversight on efficacy, health and safety and safeguarding will be lodged with this Committee rather than shared with the Audit Committee.

Committee aims for 2018

Over the next year we will continue to explore Pearson's material sustainability issues, including employability and 21st century skills as well as affordability, health and safety and safeguarding. We will hold a deep dive into sustainability considerations relating to our supply chain and review our 2018 efficacy reporting activity and plans for 2019. We will also review our Group-wide approach to reputational risk management and will consider culture and employee engagement, bearing in mind challenges and opportunities presented by the ongoing transformation and simplification across the business.

Linda Koch Lorimer

Linda Lorimer
Chairman of Reputation & Responsibility Committee

Reputation & Responsibility Committee meeting focus during 2017

Area of responsibility	Activity
Reputation	› Issue management – customer and media engagement in UK and US › Global editorial policy: meeting learner expectations › North American markets – new US administration and approach to government affairs and public policy
Sustainability	› Sustainability report › Tomorrow's Markets Incubator initiative › Efficacy reporting plans › Greenhouse gas emissions and climate change
Brand & culture	› Brand strategy › Marketing campaigns › Review of any incidents
Strategy	› Access and affordability of US higher education courseware › Community investment plan, including Project Literacy updates › One story and digital narrative

Stakeholder engagement

Engaging with shareholders

Access to capital is key to the long-term performance of our business. We work to ensure that our investors, analysts and other investment professionals have a good understanding of our strategy, performance and purpose.

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

Shareholder outreach In 2017, we continued with our shareholder outreach programme, conducting over 300 meetings in the UK, US, Canada and Continental Europe with over 260 investment institutions.

Trading updates There are five trading updates each year and the Chief Executive and Chief Financial Officer present our preliminary and interim results. They also attend regular meetings throughout the year with investors in the UK and around the world, tailored to investor requirements, to discuss the performance of the company, the company's strategy, our change programme, structural and cyclical changes in our markets, and risks and opportunities for the future.

The investor relations team Led by Joanne Russell, SVP Investor Relations, who joined in June 2017 after six years as Head of Investor Relations at Whitbread plc. The IR team met with investors throughout the year, including attending several investor conferences, and addressed regular investor and analyst enquiries.

Chairman and Non-Executive Directors The Chairman meets regularly with shareholders to understand any issues and concerns they may have. This is in accordance with the Code and consistent with the duties of investors under the UK Stewardship Code. The Non-Executive Directors meet informally with shareholders both before and after the AGM and respond to shareholder queries and requests as necessary. The Chairman ensures that the Board is kept informed of investors' and advisers' views on strategy and corporate governance. At each Board meeting, the Directors consider commentary from advisers on major shareholders' positions and Pearson's share price. In addition, the Nomination & Governance and Remuneration Committees consider shareholder views on corporate governance and remuneration matters, respectively, as required.

The 2017 financial year has been one of significant engagement with our shareholders. Sidney Taurel, Elizabeth Corley and our senior management team also consulted with our major shareholders and with shareholder representative bodies on our approach to Directors' remuneration following the vote against our Directors' remuneration report at our 2017 AGM.

Further details regarding Directors' remuneration can be found on p90–105

Private investors Institutional investors' holdings in Pearson account for around 90% of total shares outstanding, but private investors represent over 80% of the shareholders on our register and we make a concerted effort to engage with them regularly. Shareholders who cannot attend the AGM are

Non-Executive Director engagement

Save the Children, Jordan – Vivienne Cox

Last September, Vivienne Cox accompanied Kate James (Chief Corporate Affairs and Global Marketing Officer) and other Pearson colleagues to Amman, Jordan, on behalf of Pearson, to launch the next phase of Pearson's 'Every Child Learning' partnership with Save the Children. The team launched a new pilot education project in Jordan, in partnership with the Jordanian Ministry of Education, to help Syrian refugees, and local children living in host communities, to improve their learning outcomes, to build resilience and to help make their schools safer.

As part of the trip, the Pearson team:

- Visited a community centre in East Amman which over the previous 12 months had given us access to learners with whom to develop the maths learning app. The team met some of the refugee children and ran a focus testing group on the latest version of the app
- Took part in an official launch of our pilot education project at the Al Emama Al Shafe'e School with officials from the Jordanian Ministry of Education, British Ambassador and Save the Children. The team met children, parents, teachers and Save the Children Jordan Field Staff who were taking part in our pilot education project
- Visited Za'atari refugee camp to see various aid programmes run by Save the Children.

Digital Advisory Network – Lincoln Wallen

For Pearson, tackling a major social need – making education more accessible and effective – is why we exist and how we create value for our shareholders. In a world where work is increasingly disrupted by machine intelligence, the need to be always learning is greater now than ever. It is also a great challenge, as the legacy analogue businesses that still generate a lot of Pearson's profits are themselves being disrupted by technology.

At this pivotal time in the digital transformation of education, Pearson launched the Digital Advisory Network to bring together a diverse cross-section of people with experience and knowledge of disruption in other industries and to help us apply lessons learned and insights to shape Pearson's business strategy for the Board.

Lincoln Wallen has been an instrumental leader since the Network's inception and participated in the first Network Summit in October 2017. Lincoln continues to serve as a leader and adviser to both the Network and the Pearson Executive.

Stakeholder engagement

invited to e-mail questions to the Chairman in advance at chairman-agm@pearson.com

We encourage our private shareholders to become more informed investors and have provided a wealth of information on our website about managing Pearson shareholdings. We also encourage all shareholders, who have not already done so, to register their e-mail addresses through our website and with our registrar. This enables them to receive e-mail alerts when trading updates and other important announcements are added to our website. See Shareholder information on p196 or visit our website https://www.pearson.com/corporate/investors/managing-your-shares.html

Annual General Meeting

Our AGM, on 4 May 2018, is an opportunity for all shareholders to meet the Board and to hear presentations about Pearson's businesses and results.

Share dealing service

Due to its continued popularity, we intend to provide shareholders with smaller holdings the opportunity to use our registrar's low-cost share dealing service, giving them the chance to add to or reduce their stake in Pearson at significantly reduced dealing rates, or to donate shares to charity with ease. We believe it is important that our employees have a shared interest in the direction and achievements of Pearson and are pleased to say that a large number of our employees are shareholders in the company.

Vivienne Cox engaging with refugee children at a community centre in East Amman, Jordan during 'Every Child Learning' visit.

Engaging with all stakeholders

We post all company announcements on our website, www.pearson.com, as soon as they are released, and key shareholder presentations are made accessible via webcast or conference call. Our website contains a dedicated investor relations section with an extensive archive of past announcements and presentations, historical financial performance, share price data and a calendar of events. It also includes information about all of our businesses, links to their websites and details of our sustainability policies and activities. Learn more about our approach to Sustainability on p24–33

Engagement in action

Industry & marketplace

- Non-Executive Directors Josh Lewis and Linda Lorimer were engaged and instrumental in redefining the go-to-market strategy for Pearson's Online Program Management business, working alongside senior management
- The Board attended a discussion event on Future of Skills: Employment in 2030, at which they considered the future of work and implications for education. The Board was joined at the event by external business, policy and thought leaders from the Boston area
- Read more about the Future of Skills: Employment in 2030 on p10

Employees

- The Board met with local staff and senior management during 2017 visits to São Paulo and Boston. Dinners with senior local management and breakfasts with key talent allowed the Non-Executive Directors to share their experience and expertise with employees as well as allowing the Directors to better understand employees' abilities and motivations, helping them to assess the company's prospects and plans for succession
- Non-Executive Directors Elizabeth Corley and Vivienne Cox participated in Women in Leadership and Learning network (WILL) meetings, giving virtual talks to employees on professional development

Franchisees

- The Board had an opportunity to interact with an audience of 800 people from the Pearson franchisee sales team at the Wizard sales convention in São Paulo, Brazil
- During this event, the Board learned about the Wizard strategy, marketing campaigns and training provided to the franchisee sales team. The event also included recognition for high-performing employees

Customers

- The Board heard from faculty and students about the challenges and opportunities they face with digital teaching and learning at the Digital Teaching & Learning Customer Panels in Boston
- This session enabled the Board to understand the customer context to our higher education strategy

Remuneration overview

Committee Chairman
Elizabeth Corley

Members
Elizabeth Corley, Josh Lewis, Tim Score and Sidney Taurel

"After a thorough review and extensive shareholder engagement, we believe that our approach to remuneration is simpler, transparent, and a balanced reflection of the performance of the business."

Key changes to how we implement our remuneration policy for 2018

- › Maintaining lower award size for 2018 LTIP awards
- › Reduction in pension contributions for new hires
- › Shareholding guidelines to extend post-retirement
- › Simplified and balanced performance measures

In this remuneration section

Terms of reference

The Committee's full charter and terms of reference are available on the Governance page of the company's website. A summary of the Committee's responsibilities is shown on p105.

Board Committee attendance

The following table shows attendance by Directors at Committee meetings throughout 2017:

	Remuneration
Elizabeth Corley	5/5
Josh Lewis	5/5
Tim Score	5/5
Sidney Taurel	5/5

www.pearson.com/governance

Dear shareholders,

The vote on remuneration at last year's AGM gave us a clear message about how we managed executive pay for 2016. We made a commitment to respond in a constructive way and have taken a comprehensive look at the remuneration of our Executive Directors for 2017.

We have engaged with our shareholders

We have held extensive dialogue with major shareholders and shareholder representative bodies. We began this process in May 2017 and will continue it through this year's AGM. I would like to thank all those who contributed to the process. We have listened and sought to respond to the concerns we have heard. It is clear that shareholders and other stakeholders would like our approach to remuneration to be simpler, more transparent and with lower maximum levels of reward as the business goes through this challenging phase. Our investors continue to hold a diverse range of views regarding appropriate performance measures. We have endeavoured to develop an approach that the majority of shareholders can support.

Our approach to remuneration supports our strategy

Pearson is the world's learning company. We create educational tools, content, products and services that people need to help them make progress in their lives through learning. Our ambition is to be the leader in digital learning on a global basis. To deliver on this ambition we have a strong global management team, and we compete for talent in a demanding international business environment. The company's ability to attract and retain the high calibre executives needed to lead this complex and changing business is critical for our shareholders. As such, we have tried to take a balanced approach to these commercial pressures when determining executive pay.

We have reduced the LTIP awards for 2017 and 2018

The Remuneration Committee has reduced the 2017 grant of long-term incentives to the Executive Directors in the year by approximately 30%. This substantial reduction demonstrates a responsible approach to the operation of remuneration arrangements for our Executive Directors as we go through the current business transformation. The Committee has decided that we will maintain the same reduced award size for the LTIP grant to be made in 2018. Therefore, the 2018 awards will be made with the same face value as a % of salary as those in 2017. We have also reduced the proportion of these awards that will vest for threshold performance to 18% of the award.

These share awards will only vest to the extent that performance is delivered against stretching performance tests over the next three years. Any awards vesting will be subject to a further two-year holding period. The eventual value of the awards will depend on our share price performance and dividends paid to shareholders over a five-year period.

Remuneration overview

How we reflected our progress and performance in the annual bonus for 2017

Pearson delivered adjusted operating profit of £576m in 2017, which was at the top end of our guidance range, and underlying earnings per share of 54.1p, helped by an exceptional change to the tax rate during the year. The company continued to invest in digital transformation and simplification. In 2017, Pearson announced plans to deliver another c.£300m in cost savings over a three-year period, in addition to the c.£650m of cost savings delivered in the years immediately prior.

Pearson had strong cash flow generation in the year. The portfolio was further simplified with the partial disposal of Penguin Random House. A £300m share buyback programme was announced and the overall Net Debt of the business was reduced to £432m at the end of 2017 from £1.1bn in 2016. The proposed overall dividend for the year will be 17p. Further details of these results can be found elsewhere in this Annual Report.

The Committee took this progress and performance into account when determining the outcome of the annual incentive plan for 2017.

- During 2017, the board set a demanding plan for the business. The thresholds of the performance ranges for the Annual Incentive Plan for our Executive Directors were set above market consensus expectations at the time. As such, bonus was only payable to the Executive Directors for 2017 for performance delivered ahead of market expectations.
- The company delivered results in line with the demanding plan set for the year on operating profit and earnings per share. Good progress was made in delivering on a number of aspects of the strategic plan. Cash flow generation exceeded plan in the year driven by strong cash conversion of 116%.
- We announced a £300m share buyback beginning 18 October 2017 utilising part of the proceeds from the disposal of a 22% stake in Penguin Random House. We completed the programme on 16 February 2018. The share buy back programme did not benefit the outcome of incentives for the Executive Directors.
- Sales revenues in the year did not reach the stretch targets in the annual incentive plan.
- There is no benefit from foreign exchange movements in the year in determining the outcome of the annual bonus.

A year of progress and performance

- ✔ Remuneration simplified and balanced
- ↓ LTIP awards reduced for 2017 & 2018 by approximately 30%
- ↓ Discretionary reductions in annual bonus for 2017

Based on performance against targets, in 2017 the CEO achieved a bonus outcome of 61% of maximum and the CFO achieved a bonus outcome of 58% of maximum. The Remuneration Committee exercised its discretion and reduced these outcomes by 5% to account for the exceptional change in the tax rate during the year so that the Executive Directors did not benefit from this. This resulted in a bonus outcome of 56% of maximum for the CEO and 53% of maximum for the CFO.

The Remuneration Committee then moved to consider the bonus outcomes in the context of the shareholder experience in the year. Mindful of this experience, and the work still to be done, the Executive Directors, along with the Committee, have agreed it would not be appropriate to take the full bonus and that a further reduction in outcomes was appropriate. The Committee commends the Executive Directors for their approach in these matters and confirmed that we should further reduce the bonus outcome based on the following considerations:

- The degree of stretch in the targets set relative to plan was considered and the Committee were satisfied that the targets were appropriately calibrated;
- Outcomes against the targets were a reflection of the performance of the company in the year and were a fair and reasonable outcome;
- Management is making tangible progress in executing the strategy but, at the time of the Committee's deliberations, this was not fully reflected in the share price;
- A change in dividend policy resulted in a reduced payout of a proposed 17p;
- 2017 performance provides a solid foundation from which to build and positions the company well for a return to growth in 2018.

As a result, the annual bonus payable to the CEO for 2017 is 44% of maximum and for the CFO is 47% of maximum.

Remuneration overview

Understanding total remuneration for the CEO for 2017

Given the level of performance achieved and the progress made towards executing our longer term strategic plan, the overall reported 'single figure' for the total remuneration of John Fallon for 2017 is £1.758m. This is a 16% increase compared with 2016. The 'single figure' has increased because we have paid an annual bonus of 44% of the maximum opportunity for 2017. This is higher than the annual bonus for 2016, which was 24% of the maximum opportunity.

John Fallon did not receive a salary increase in 2017 and none of the 2015 LTIP award for the performance cycle from 2015 to 2017 vested. This was the sixth year in which none of the long-term incentive awards have vested, demonstrating the Remuneration Committee's consistent application of a rigorous approach to setting performance targets.

Having completed 20 years of service with Pearson, from October 2017 John Fallon had no further service accrual under his defined benefit pension arrangements.

Looking forward to 2018 – simpler, balanced performance measures

The base salary for the CEO and CFO will be increased by 2.5% in 2018 in line with the average increases for UK employees. This is the first increase in three years.

Working within our existing policy, to simplify the annual incentive plan (AIP) structure for 2018, and reflecting shareholder feedback, we have reduced the number of performance measures from five to four. We have replaced the two profit based measures previously included (Operating Profit and EPS) with a single Operating Profit measure, which will determine 40% of the outcome of the plan. This provides a greater focus on the metric used by management on a day-to-day basis to manage the business, whilst reducing the prominence of EPS in the overall remuneration framework. We have also made minor adjustments to the weightings of the other performance measures (Cashflow 20%, Revenue 20% and Strategic Measures 20%). We believe this creates an AIP that is appropriately balanced between key metrics and objectives for 2018. Each performance measure will operate independently. There will be no changes to the maximum annual incentive opportunities for 2018.

As noted above, the Remuneration Committee has decided to maintain the lower level of long-term incentive awards in 2018. In 2017, we reduced LTIP awards by approximately 30% from prior levels, whilst retaining stretching performance targets. We have also reduced the proportion of these awards that will vest for threshold performance from 25% to 18% of the award. We will adopt the same approach for the 2018 awards by maintaining the 2017 award levels. Therefore, the 2018 awards will be made with the same face value as a % of salary as those in 2017.

Responding to shareholder feedback we are rebalancing the performance measures for 2018 awards. One third of any award will vest based on each of Earnings Per Share (EPS), Gross Return On Invested Capital (ROIC) and Relative Total Shareholder Return (TSR) measured over three years. Awards will also be subject to a further two year holding period. The eventual value of the awards will depend on our share price performance and dividends paid to shareholders over a five year period.

Other important changes for the future

We will limit the pension allowance for future new external Executive Director appointments. This will reduce the maximum cash allowance in lieu of participation in a pension scheme from 26% to 16% of salary.

We are extending our minimum shareholding guidelines post-retirement. Executive directors will be expected to maintain a shareholding of at least half their normal guideline for two years following retirement.

Remuneration overview

Our remuneration policy is aligned with our strategy

Our shareholders approved our remuneration policy in 2017. Nevertheless, the Remuneration Committee considered carefully whether we should seek shareholder approval for a new policy at the AGM in 2018. The primary principle of our remuneration policy remains to support the company's strategy, which is focused on delivering sustainable performance and the creation of value over the long term for our stakeholders. The remuneration of our Executive Directors is closely tied to the achievement of annual and longer-term objectives, while remaining sensitive to the shareholder experience.

We concluded that we are able to operate within our current policy, which we believe underpins the company's strategic objectives and maintains an appropriate relationship between pay and performance. The policy has worked well in 2017 to provide the right framework to reflect strategy and execution priorities, while also allowing us to address the concerns raised by our shareholders as expressed at last year's AGM and also on subsequent engagement.

Conclusion

Pearson is undergoing substantial change as the business delivers on digital transformation and continuous improvements in efficiency, while addressing the needs of all our stakeholders. This demands a strong leadership, whom we need to reward appropriately in the context of the performance of the business, while remaining mindful of the investor context.

My conversations with shareholders have been invaluable in understanding a range of perspectives and I thank those shareholders who engaged with us. Your feedback has helped us to simplify and balance our remuneration approach and to increase the transparency you need. I look forward to receiving your support at our AGM in May 2018 and to continuing the dialogue.

Elizabeth Corley
Chairman of Remuneration Committee

14 March 2018

Summary of key Committee actions and decisions

2017 actions

- Comprehensive and multi-phased investor engagement
- 30% reduction in LTIP award levels
- Reduction in LTIP threshold vesting level from 25% to 18% of maximum
- LTIP subject to stretching targets set above market consensus expectations at the time
- AIP based on challenging targets with no benefit from buyback or currency movement
- Maximum payout would require maximum performance on each individual component and outperformance on any one element cannot compensate for others
- Discretionary downward adjustment to remove benefit of tax rate reduction
- Further reduction in outcomes

2018 decisions

- LTIP awards maintained at same reduced level as 2017
- AIP and LTIP measures simplified and adjusted in the light of investor feedback
- Stretching LTIP targets, disclosed prospectively for first time at Pearson
- Salary increases of 2.5%, in line with employees. First increases for three years
- Shareholding guidelines now extended to post-retirement
- Reduced pension policy for new hires

Our Executive remuneration framework and how we will implement it in 2018

Our remuneration policy was approved by shareholders at the AGM held on 5 May 2017 (and can be found in the Governance section of our website Pearson.com/governance). The table below summarises the key elements of the remuneration framework for Directors as set out in our Policy, including how we intend to implement it in 2018 and the changes being introduced as a result of our recent review (see remuneration overview for further context).

Base salary

Key features of each Policy element

- **Fixed pay** which reflects the level, role, skills, experience, the competitive market and individual contribution
- Under the Policy, **base salary** increases will not ordinarily exceed 10% per annum
- **Salary review** takes into account a range of factors, including: the level of increases made across the company as a whole; particular circumstances such as changes in role, responsibilities or organisation; the remuneration and level of increases for Executives in similar positions in comparable companies; general economic and market conditions; and individual performance

2018 implementation/changes

Salaries effective 1 April 2018:

John Fallon: £799,800 (+2.5%)

Coram Williams: £527,900 (+2.5%)

When reviewing salaries, the committee took into account the level of increases made across the company (which were 2.5% across the UK) as a whole, business and individual performance, and general economic and market conditions.

Allowances and benefits

Key features of each Policy element

- **Allowances and benefits** which reflect the local competitive market and can include travel and health-related benefits
- The **total value of allowances and benefits** for Executive Directors will not ordinarily exceed 15% of base salary in any year

2018 implementation/changes

Unchanged for 2018.

Retirement benefits

Key features of each Policy element

- **Current Executive Directors** are members of the Final Pay section of The Pearson Pension Plan, which is closed to new members. Additional cash allowances may apply in specific circumstances
- **New appointments** are eligible to join the Money Purchase section of The Pearson Pension Plan and receive contributions of up to 16% of pensionable salary (up to the earnings limit of £154,200 for 2017/18) or may receive a cash allowance of up to 26% of salary

2018 implementation/changes

There will be no changes to the pension provision of the existing Executive Directors.

With effect from 2018, the maximum cash allowance for any future Executive Director external appointments will be reduced from 26% to 16% of salary.

Annual incentive plan

Key features of each Policy element

- Motivate the **achievement of annual business goals** aligned to financial and strategic imperatives
- **Performance measures, weightings and targets** are set annually by the Committee to ensure continued alignment with strategy
- **Each AIP component is independent.** For the CEO to achieve the maximum overall payout (180%) would require maximum performance on each individual component and outperformance on any one element cannot compensate for others
- **Performance metrics** linked to strategic imperatives are selected to support Pearson's transformation strategy. A payout will only be made if a minimum level of performance has been achieved under the financial metrics
- **Stretching performance targets** are fully disclosed in the annual remuneration report for the relevant financial year
- **Malus and clawback** provisions apply

2018 implementation/changes

Maximum opportunity unchanged for 2018:

- 180% of base salary for the CEO
- 170% of base salary for the CFO

Performance metrics and associated weightings:

For 2018, the following balanced mix of financial and strategic measures will be used

Operating Profit (40%)
The two profit based measures previously included (Operating Profit and EPS) will be replaced with a single Operating Profit measure which will determine 40% of the outcome of the plan

We have also made minor adjustments to the weightings of the other performance measures:

Sales (20%)
Operating Cash Flow (20%)
Strategic Measures (20%)

Targets will be disclosed in the 2018 directors' remuneration report

Our Executive framework and how we will implement it in 2018

Long-term incentive plan

Key features of each Policy element

- **Drive long-term earnings, share price growth and value creation**
- **Align the interests of Executives and shareholders**
- **Awards** are made annually, and vest based on performance against stretching targets measured over a three-year performance period
- An additional **two-year holding period** applies following vesting
- The Committee will determine the performance measures, weightings and targets governing an award prior to grant to ensure continuing alignment with strategy and to ensure that targets are sufficiently stretching
- **Malus and clawback** provisions apply

2018 implementation/changes

Awards will be made at the same reduced level as in 2017:

- 275% of base salary for the CEO
- 245% of base salary for the CFO

Performance metrics, weightings and targets:

EPS (one-third)

Vesting schedule (% max)	EPS for FY20
15%	65p
65%	68p
100%	80p

ROIC (one-third)

Vesting schedule (% max)	ROIC for FY20
15%	5%
65%	6%
100%	8%

Relative TSR (one-third)

Vesting schedule (% max)	Ranked position versus FTSE 100
25%	Median
100%	Upper quartile

Note: Straight line vesting in between points shown, with no vesting for performance below threshold

Shareholding guidelines

Key features of each Policy element

- **Align the interests of Executives and shareholders** and encourage long-term shareholding and commitment to the company
- Executive Directors are expected to build up a substantial **shareholding in the company.** The target holding is 300% of salary for the Chief Executive and 200% of salary for other Executive Directors
- Executive Directors have five years from the date of appointment to reach the guideline

2018 implementation/changes

With effect from 2018, shareholding guidelines for Executive Directors will be extended post-retirement

Executive Directors will be required to retain half of the current guideline for a period of two years post-retirement in respect of shares vested from company incentive plans.

Non-Executive fees

Key features of each Policy element

- The **Chairman** is paid a single fee for all of his responsibilities
- The **Non-Executive Directors** are paid a basic fee. The Chairmen and members of the main Board Committees and the Senior Independent Director are paid an additional fee to reflect their extra responsibilities
- The **Chairman and Non-Executive Directors** receive no other pay or benefits, except for reimbursement of expenses, and do not participate in incentive plans
- A minimum of 25% of the Chairman's and Non-Executive Directors' basic fee is paid in shares

2018 implementation/changes

There will be no changes to fees for 2018:

Role	Fees for 2018
Chairman of the Board	£500,000
Base fee for Non-Executive Directors	£70,000
Additional SID fee	£22,000

Role	Chair	Member
Audit Committee	£27,500	£15,000
Remuneration Committee	£22,000	£10,000
Nomination & Governance Committee	£15,000	£8,000
Reputation & Responsibility Committee	£13,000	£6,000

2017 remuneration report

Certain parts of this report have been audited as required by the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 as amended. Those tables which have been subject to audit are marked with an asterisk.

Single total figure of remuneration and prior year comparison*

Total aggregate emoluments for executive and non-executive directors were £4,067m in 2017. These emoluments are included within the total employee benefit expense in note 5 to the financial statements (p138).

Executive Directors

The remuneration received by Executive Directors in respect of the financial years ended 31 December 2017 and 31 December 2016 is set out below.

Executive Director remuneration

Element of remuneration £000s	John Fallon 2017	John Fallon 2016	Coram Williams 2017	Coram Williams 2016
Base salary	780	780	515	515
Allowances and benefits	45	85	39	53
Annual incentives	624	343	412	193
Long-term incentives	0	0	0	–
Retirement benefits	309	310	52	47
Total remuneration	1,758	1,518	1,018	808

Notes to single figure table

Base salary

The base salary shown in the single figure table reflects salary paid in the financial year.

Allowances and benefits

Travel benefits comprise company car, car allowance, private use of a driver and reimbursements of a taxable nature resulting from business travel and engagements. Health benefits comprise healthcare, health assessment and gym subsidy. In addition to the above benefits and allowances, Executive Directors may also participate in company benefit or policy arrangements that have no taxable value. The allowances and benefits figure for 2016 reflects what was reported in the single figure table in the 2016 report. However, the figure includes an amount in respect of certain risk benefits which do not form part of John Fallon's taxable benefits and so that amount (being £35k in 2016) has not been included in the corresponding figure for 2017.

The breakdown is as follows for 2017:

	John Fallon	Coram Williams
Travel	43	37
Healthcare	2	2

Annual incentives

Annual incentives for the directors are funded by Pearson global annual financial and non-financial KPIs, and pay-outs take into account individual performance against personal objectives. For more detail, see below.

Long-term incentives

The single figure of remuneration for 2017 includes all long-term incentive awards that were subject to a performance condition where the performance period ended at 31 December 2017. In 2017, the performance conditions for the 2015 Long-Term Incentive Plan (LTIP) were not met and so this award will not vest in 2018.

Retirement benefits

Further detail on retirement benefits is presented later in this report.

2017 remuneration report

Executive Directors' annual incentive payments for 2017

Based on performance against targets, in 2017 the CEO achieved a bonus outcome of 61% of maximum and the CFO achieved a bonus outcome of 58% of maximum. The Remuneration Committee exercised its discretion and reduced these outcomes by 5% to account for the exceptional change in the tax rate during the year so that the Executive Directors did not benefit from this. This resulted in a bonus outcome of 56% of maximum for the CEO and 53% of maximum for the CFO.

The Remuneration Committee then moved to consider the bonus outcomes in the context of the shareholder experience in the year. Mindful of this experience, and the work still to be done, the Executive Directors, along with the Committee, have agreed it would not be appropriate to take the full bonus and that a further reduction in outcomes was appropriate. The Committee commends the Executive Directors for their approach in these matters and confirmed that we should further reduce the bonus outcome based on the following considerations:

- The degree of stretch in the targets set relative to plan was considered and the Committee were satisfied that the targets were appropriately calibrated;
- Outcomes against the targets were a reflection of the performance of the company in the year and were a fair and reasonable outcome;
- Management is making tangible progress in executing the strategy but, at the time of the Committee's deliberations, this was not fully reflected in the share price;
- A change in dividend policy resulted in a reduced payout of a proposed 17p;
- 2017 performance provides a solid foundation from which to build and positions the company well for a return to growth in 2018.

As a result, the annual bonus payable to the CEO for 2017 is 44% of maximum and for the CFO is 47% of maximum.

Overall outcome and discretionary adjustment

		Performance range				CEO payout		CFO payout	
Performance measure	% of total	Threshold	Target	Max	Actual results	% of max bonus opportunity	% of salary	% of max bonus opportunity	% of salary
Operating profit	22.5%	£535m	£579m	£661m	£576m	11.5%	21%	11%	18%
Group EPS	22.5%	45.6p	48.0p	55.7p	54.1p	20.5%	37%	20%	34%
Sales	15%	£4,572m	£4,635m	£4,728m	£4,513m	0%	0%	0%	0%
Operating cash flow	15%	£460m	£506m	£598m	£669m	15%	27%	15%	26%
Strategic measures	25%	See performance against strategic measures table over page				14%	25%	12%	21%
	100%				Performance outcome	**61%**	**110%**	**58%**	**99%**

Notes:
- Targets have been re-stated on a constant currency basis using the average 2017 exchange rate.
- Any share buybacks did not benefit Group EPS bonus outcomes for the year.
- At Threshold, the payout is 15% of maximum. At Target, the payout is 55% of maximum for the CEO (reflecting his on-target bonus of 100% of salary) and 50% of maximum for the CFO (reflecting his on-target bonus of 85% of salary).

	CEO payout		CFO payout	
	% of max bonus opportunity	% of salary	% of max bonus opportunity	% of salary
Group EPS adjusted to remove benefit of tax rate reduction				
Shareholders benefited from a significant reduction in the effective corporate tax rate in 2017 from 21% budgeted to 11%. However, for the purposes of the bonus calculation, the Committee used the budgeted rate. This resulted in a reduction in the total bonus outcome as shown:	56% (-5%)	101% (-9%)	53% (-5%)	90% (-9%)
Further discretionary adjustment				
Whilst the Committee were satisfied that the targets were appropriately calibrated and that the outcomes were reflective of the performance in the year, in light of the work still to be done, and the recent shareholder experience, the Executive Directors along with the Committee agreed it would not be appropriate to take the full bonus and that a further reduction in outcomes was appropriate.	44% (-12%)	80% (-21%)	47% (-6%)	80% (-10%)

2017 remuneration report

Performance against strategic measures

The targets (and outcomes) for performance against each of the strategic measures are shown in the table and supporting narrative below, with the outcome for each Executive Director shown in the table on the previous page.

Strategic measure	% of total funding	Threshold	Target	Max	Outcome
Delivery of efficiency and cost savings Measured by cost savings budgeted in 2018 Operating Plan through restructuring delivered in 2017 and underpinned by progress on The Enabling Programme (TEP)	10%	95% of Plan cost savings budgeted for 2018	Plan cost savings budgeted for 2018	110% of Plan cost savings budgeted for 2018	Management made encouraging progress, exceeding expected cost savings budgeted for 2018, as well as realising £15m of cost savings earlier than expected in 2017. Much of the savings will come from the simplification of the technology architecture under TEP, which allows the increased use of shared service centres enabling us to standardise processes and reduce headcount.
Driving digital agenda Delivery of key strategic milestones in support of accelerating digital transformation through the Global Learning Platform (GLP) and progress in US higher education courseware total net digital sales (NDS) in 2017	10%	Some key milestones on track and hold NDS	Key milestones on track and achieve Plan NDS	All milestones on track and improve on Plan NDS by 5%	Management are on track with digital transformation, delivering a strong performance on NDS, which grew by 9% in the year. There has been continued investment in the Global Learning Platform (GLP) and innovative product and future pipeline. A further 210 new institutions were signed to Inclusive Access (Direct Digital Access) in 2017, taking the total to over 500 institutions. During the year, over 1m course enrolments were delivered in this way.
Grow market share in our primary market US higher education courseware (25% of revenues) as measured by Management Practice Inc. (MPI)/American Association of Publishers (AAP) net sales for 2017	5%	40.0%	41.0%	41.5%	Achieved US higher education courseware 2017 market share of 41% as reported by MPI and in the upper half of the c40-41.5% range seen over the last five years.
Overall	25%				With management outperforming against some of the strategic targets set for 2017, and achievement against plan for others, the Committee felt overall that an on-target outcome was a fair result under the strategic measures for 2017. This translates to a pay-out of 25% of salary for the CEO and 21% of salary for the CFO as shown on the previous page.

Note: If an element of judgement was required to assess achievements that were not completely quantifiable, Internal Audit provided an independent assessment to the Committee.

Long-term incentives awarded in 2017*

One of the significant changes that we made in 2017 was to reduce the grant of long-term incentives made to the Executive Directors in the year by approximately 30%. This substantial reduction demonstrates a responsible approach to the operation of remuneration arrangements for our Executive Directors as the company goes through the current transformation of the business.

The Remuneration Committee has decided that we will maintain the same approach for LTIP awards to be made in 2018. Therefore, the 2018 awards will be made with the same face value as those in 2017. We have also reduced the proportion of these awards that will vest for threshold performance from 25% to 18% of the award.

Director	Date of award	Vesting date	Number of shares	Face value	Face value (% of base salary)	Value for threshold performance (% of maximum)	Perfomance Period
John Fallon	11 September 17	1 May 20	366,000	£2,144,760	275%	18%	1 Jan 17–31 Dec 19
Coram Williams	11 September 17	1 May 20	215,000	£1,259,900	245%	18%	1 Jan 17–31 Dec 19

Face value was determined using a share price of 586p (previous trading day closing price as at the date of grant).

The awards will vest on 1 May 2020 subject to the following performance conditions. Any shares which vest will be subject to an additional two-year holding period to 1 May 2022.

2017 remuneration report

Details of the performance targets for the 2017 long-term incentive awards are set out in the tables below.

Earnings per share (EPS) (40%)		Return on invested capital (ROIC) (30%)		Relative total shareholder return (TSR) (30%)	
Vesting schedule (% max)	Adjusted EPS for FY19	Vesting schedule (% max)	Adjusted ROIC for FY19	Vesting schedule (% max)	Ranked position vs FTSE 100
15%	55p	15%	4.5%	25%	Median
75%	62p	75%	5.5%	100%	Upper quartile
100%	75p or above	100%	7.5% or above		

Note 1: Straight-line vesting will occur in between the points shown, with no vesting for performance below threshold.

Note 2: Pearson's total shareholder return performance is measured relative to the constituents of the FTSE 100 Index over the performance period.

Directors' interests in shares and value of shareholdings

Shareholding guidelines

Executive Directors are expected to build up a substantial shareholding in the company in line with the policy of encouraging widespread employee share ownership and to align further the interests of Executive Directors and shareholders. The target holding is 300% of salary for the Chief Executive and 200% of salary for the other Executive Directors. Shares that count towards these guidelines include any shares held unencumbered by an Executive Director, their spouse and/or dependent children plus any shares vested but held pending release under a share plan. Executive Directors have five years from the date of appointment to reach the guideline. Once the guideline has been met, it is not retested, other than when shares are sold.

With effect from 2018, shareholding guidelines for Executive Directors have been extended post-retirement. Executive Directors are required to retain half of the current guideline for a period of two years post-retirement in respect of shares vested from company incentive plans.

The shareholding guidelines do not apply to the Chairman and Non-Executive Directors. However, a minimum of 25% of the basic Non-Executive Directors' fee is paid in Pearson shares that the Non-Executive Directors have committed to retain for the period of their directorships.

Directors' interests*

The share interests of the Directors and their connected persons are as follows:

Director	Current shareholding (ordinary shares) at 31 Dec 17	Conditional shares at 31 Dec 17	Total number of ordinary and conditional shares at 31 Dec 17	Guideline (% salary)	Guideline met?
Chairman					
Sidney Taurel	78,677	–	–	–	–
Executive Directors					
John Fallon	326,784	749,000	1,075,784	300%	Yes
Coram Williams	15,010	437,000	452,010	200%	n/a (see note 4)
Non-Executive Directors					
Elizabeth Corley	8,066	–	–	–	–
Vivienne Cox	5,263	–	–	–	–
Josh Lewis	11,033	–	–	–	–
Linda Lorimer	6,977	–	–	–	–
Harish Manwani	14,151	–	–	–	–
Tim Score	17,285	–	–	–	–
Lincoln Wallen	4,423	–	–	–	–

Note 1: The current value of the Executive Directors' shareholdings is based on the closing market value of Pearson shares of 725p on 1 March 2018 against base salaries at 31 December 2017.

Note 2: Ordinary shares include both ordinary shares listed on the London Stock Exchange and American Depositary Receipts (ADRs) listed on the New York Stock Exchange. The figures include both shares and ADRs acquired by individuals under the long-term incentive plan and any legacy share plans they might have participated in.

Note 3: Conditional shares means unvested shares which remain subject to performance conditions and continuing employment for a pre-defined period.

Note 4: Coram Williams has five years from the date of his appointment as an Executive Director to reach the shareholding guideline.

Note 5: There have been no changes in the interests of any director between 31 December 2017 and 12 March 2018, being the latest practicable date prior to the publication of this report.

2017 remuneration report

Movements in Directors' interests in share awards during 2017*

Plan	Date of award	Vesting date	Number of shares as at 1 Jan 2017	Awarded	Released	Lapsed	Number of shares as at 31 Dec 2017	Status
John Fallon								
LTIP	11 September 2017	1 May 2020	0	**366,000**			**366,000**	Outstanding subject to performance
	3 May 2016	3 May 2019	383,000				**383,000**	Outstanding subject to performance
	1 May 2015	1 May 2018	230,000			230,000		Lapses in 2018
Total			**613,000**	**366,000**	**0**	**230,000**	**749,000**	
Coram Williams								
LTIP	11 September 2017	1 May 2020	0	**215,000**			**215,000**	Outstanding subject to performance
	3 May 2016	3 May 2019	222,000				**222,000**	Outstanding subject to performance
	1 Aug 2015	1 Aug 2018	129,000			129,000		Lapses in 2018
Total			**351,000**	**215,000**	**0**	**129,000**	**437,000**	

Note 1: Released means where shares have been transferred to participants.

Note 2: TSR is measured relative to the constituents of the FTSE World Media Index for 2015 and 2016 LTIP awards. For the LTIP awards granted in 2017, TSR is measured relative to the constituents of the FTSE 100.

Note 3: The performance targets for the 2015 award were not met and therefore this award will lapse in 2018.

Note 4: Coram Williams' 2015 award was made on his appointment to the Board on 1 August 2015 and will vest three years from this date on 1 August 2018, subject to the same performance conditions and holding periods as for other Executives.

Note 5: The share price did not reach the 2014 worldwide save for shares option price of £8.112 during the maturity period so John Fallon's award exercisable in 2017 lapsed.

Performance targets for outstanding awards under the Long-Term Incentive Plan (LTIP)

The status of outstanding awards under the Long-Term Incentive Plan (LTIP) as described in the table above is set out in the following table.

Date of award	Share price on date of award	Vesting date	Performance measures	Weighting	Performance period	Payout at threshold	Payout at maximum
11 September 2017	586.0p	1 May 2020	Relative TSR	30%	1 Jan 2017 to 31 Dec 2019	25% at median	100% at upper quartile
			ROIC	30%	2019	15% for ROIC of 4.5%	100% for ROIC of 7.5%
			EPS	40%	2019	15% for EPS 55p	100% for EPS 75p
3 May 2016	805.0p	3 May 2019	Relative TSR	1/6	1 Jan 2016 to 31 Dec 2018	25% at median	100% at upper quartile
			ROIC	1/3	2018	25% for ROIC of 5.5%	100% for ROIC of 6.7%
			EPS	1/2	2018	25% for EPS 61.4p	100% for EPS 78.3p

Executive Directors' retirement benefits and entitlements

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

Director	Value of defined benefit over the period £000s	Other allowances in lieu of pension £000s	Total annual value in 2017 £000s	Accrued pension at 31 Dec 17 £000s
John Fallon	**106**	**203**	**309**	**103**
Coram Williams	**52**		**52**	**32**

Note 1: The accrued pension at 31 December 2017 is the deferred pension to which the member would be entitled on ceasing pensionable service on 31 December 2017. It relates to the pension payable from the UK plan. Normal retirement age is 62.

Note 2: The value of defined benefit over the period comprises the defined benefit input value, less inflation, less individual contribution.

Note 3: Other allowances in lieu of pension represent the cash allowances paid in lieu of the previous FURBS arrangements.

Note 4: Total annual value is the sum of the previous two columns and is disclosed in the single figure of remuneration table.

2017 remuneration report

Plans

John Fallon – The Pearson Group Pension Plan

Accrual rate of 1/30th of pensionable salary per annum, restricted to the plan earnings cap (£154,200 per annum in 2017/18).

John attained the maximum service accrual for this benefit when he reached 20 years' service in October 2017. With effect from this date he had accrued a benefit of two-thirds of his final pensionable salary and no further service-related benefits can accrue under the Plan. Based on the 2017/2018 earnings cap of £154,200, he will have accrued a pension of £102,800 per annum at this time. When the earnings cap under the Plan rules is increased in the future in line with increases in the UK retail price index, his final salary pension benefit will increase accordingly.

In addition, he received a taxable and non-pensionable cash supplement (of 26% of salary) in lieu of the previous FURBS arrangement. There are no enhanced early retirement benefits.

Coram Williams – The Pearson Group Pension Plan

Accrual rate of 1/60th of pensionable salary per annum, restricted to the plan earnings cap (£154,200 per annum in 2017/18), with continuous service with a service gap. There are no enhanced early retirement benefits.

Chairman and Non-Executive Director remuneration*

The remuneration paid to the Chairman and Non-Executive Directors in respect of the financial years ended 31 December 2017 and 31 December 2016 are as follows:

	2017						2016					
Director £000s	Salary/ basic fee	Committee chairmanship	Committee membership	SID	Taxable benefits	Total	Salary/ basic fee	Committee chairmanship	Committee membership	SID	Taxable benefits	Total
Sidney Taurel	500	–	–	–	12	512	500	–	–	–	16	516
Elizabeth Corley	70	22	20	–	0	112	70	22	–	–	0	92
Vivienne Cox	70	10	21	22	3	126	70	10	25	22	3	130
Josh Lewis	70	–	15	–	59	144	70	–	15	–	10	95
Linda Lorimer	70	12	15	–	5	102	70	–	20	–	4	94
Harish Manwani	70	–	11	–	4	85	70	–	5	–	3	78
Tim Score	70	28	15	–	0	113	70	28	10	–	3	111
Lincoln Wallen	70	–	21	–	6	97	70	–	13	–	3	86
Total	990	72	118	22	89	1,291	990	60	88	22	42	1,202

Note 1: A minimum of 25% of the Chairman's and Non-Executive Directors' basic fee is paid in shares, effective from the 2017 AGM policy approval.

Note 2: Taxable benefits refer to travel, accommodation and subsistence expenses incurred while attending Board meetings during 2017 that were paid or reimbursed by the company which are deemed by HMRC to be taxable in the UK. The amounts in the table above include the grossed-up cost of UK tax to be paid by the company on behalf of the Directors. Josh Lewis's tax position has changed now that he has been a non-executive director of Pearson for more than five years (as of March 2016) with a consequential increase in the taxable value of the expenses he incurs visiting the UK for board meetings. As such, the taxable benefits figure in the table above is materially higher than last year's figure and the figures for other non-executive directors.

Payments to former Directors

There were no payments made to former Directors in 2017.

Payments for loss of office

There were no payments for loss of office made to or agreed for Directors in 2017.

Executive Directors' Non-Executive directorships

Coram Williams is engaged as a NED of Guardian Media Group plc. He received fees of £37,750 during 2017 in respect of this role. His current remuneration is at the rate of £39,000 p.a. since 1 April 2017 when became chair of the audit committee. In accordance with our policy, Coram is permitted to retain these fees.

Historical performance and remuneration

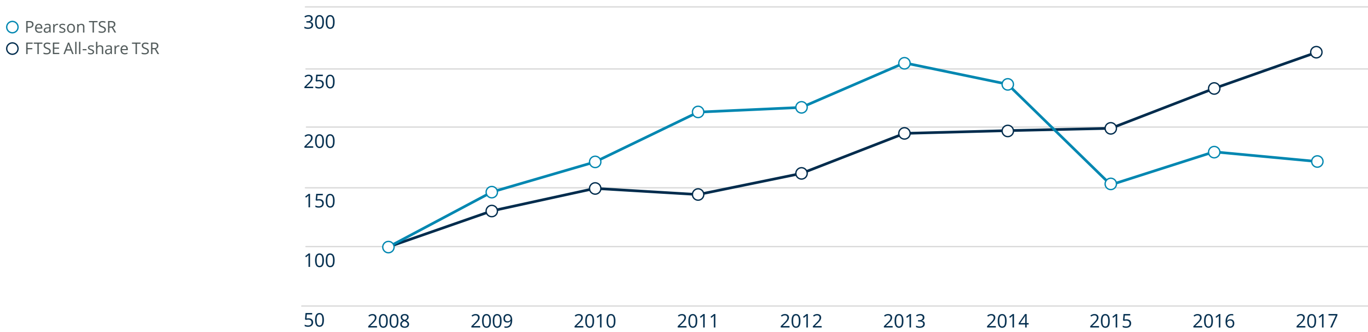
Total shareholder return performance

We set out on the next page Pearson's total shareholder return (TSR) performance relative to the FTSE All-Share index on an annual basis over the nine-year period 2008 to 2017. This comparison has been chosen because the FTSE All-Share represents the broad market index within which Pearson shares are traded. TSR is the measure of the returns that a company has provided for its shareholders, reflecting share price movements and assuming reinvestment of dividends (source: Datastream).

In accordance with the reporting regulations, this section also presents Pearson's TSR performance alongside the single figure of total remuneration for the CEO over the last nine years and a summary of the variable pay outcomes relative to the prevailing maximum at the time.

2017 remuneration report

Total shareholder return £



CEO remuneration	Marjorie Scardino				John Fallon				
Total remuneration (single figure, £000s)	6,370	8,466	8,340	5,330	1,727	1,895	1,263	1,518	**1,758**
Annual incentive (% of maximum)	91.3%	92.1%	75.7%	24.2%	34.3%	50.5%	Nil	24.4%	**44.4%**
Long-term incentive (% of maximum)	80.0%	97.5%	68.3%	36.7%	Nil	Nil	Nil	Nil	**Nil**

Annual incentive is the actual annual incentive received by the incumbent as a percentage of maximum opportunity.

Long-term incentive is the payout of performance-related restricted shares under the LTIP where the year shown is the final year of the performance period for the purposes of calculating the single total figure of remuneration.

Total remuneration is as reflected in the single total figure of remuneration table.

John Fallon's total remuneration opportunity is lower than that of the previous incumbent. Variable payouts under the annual and Long-Term Incentive Plans reflect performance for the relevant periods.

Comparative information

The following information is intended to provide additional context regarding the total remuneration for Executive Directors.

Relative percentage change in remuneration for CEO

The following table sets out the change between 2016 and 2017 in three elements of remuneration for the CEO, in comparison with the average for all employees. While the Committee reviews base pay for the CEO relative to the broader employee population, benefits are driven by local practices and eligibility is determined by level and individual circumstances which do not lend themselves to comparison.

Change in CEO remuneration 2016/17

Base salary	Allowances and benefits	Annual incentives
= no change	↓ 47% **(see note 1)**	↑ 82%

Change in employee remuneration 2016/17

Base salary	Allowances and benefits	Annual incentives
↑ 2%	↑ 5%	↑ 45% **(see note 2)**

Note 1: The above percentages relating to the CEO reflect the figures as shown in the single figure table on page 96. If the risk benefits are excluded from the allowances and benefits figure for 2016 (see the notes to the single figure table on page 96), the relevant percentage would be -10%.

Note 2: The figures for all employees reflect average salaries and average employee numbers each year at constant exchange rates. The change in annual incentives is an aggregate figure which includes all incentive arrangements across the company, including sales incentives. The equivalent year-on-year figure for the staff annual incentive plan for those eligible in 2017 was +127%.

2017 remuneration report

Relative importance of pay spend

The Committee considers Directors' remuneration in the context of the company's allocation and disbursement of resources to different stakeholders. In particular, we chose operating profit because this is a measure of our ability to reinvest in the company. We include dividends because these constitute an important element of our return to shareholders.

All figures in £ millions	2017	2016	Change £m	Change %
Adjusted operating profit	**576**	635	-59	**-9%**
Dividends	**318**	424	-106	**-25%**
Total wages and salaries	**1,567**	1,661	-94	**-6%**

Note 1: Adjusted operating profit is as set out in the financial statements.

Note 2: Wages and salaries include continuing operations only and include Directors. Average employee numbers for continuing operations for 2017 were 30,339 (2016: 32,719). Further details are set out in note 5 to the financial statements on p138.

Dilution and use of equity

Pearson can use existing shares bought in the market, treasury shares or newly issued shares to satisfy awards under the company's various share plans. For restricted stock awards under the LTIP, the company would normally expect to use existing shares.

There are limits on the amount of new-issue equity we can use. In any rolling ten-year period, no more than 10% of Pearson equity will be issued, or be capable of being issued, under all Pearson's share plans, and no more than 5% of Pearson equity will be issued, or be capable of being issued, under Executive or discretionary plans. The headroom available for all Pearson plans, executive or discretionary, and shares held in trust is as follows:

Headroom	2017
All Pearson plans	**8.4%**
Executive or discretionary plans	**5%**
Shares held in trust	**4.3%**

The Remuneration Committee in 2017

Role	Name	Title
Chairman	Elizabeth Corley	Independent Non-Executive Directors
	Josh Lewis	
	Tim Score	
	Sidney Taurel	Chairman of the Board
Internal attendees	John Fallon	Chief Executive
	Coram Williams	Chief Financial Officer
	Melinda Wolfe	Chief Human Resources Officer (to May 2017)
	Kate Bishop	Interim Chief Human Resources Officer (from June 2017)
	Stuart Nolan	SVP, Reward
	Stephen Jones	Company Secretary
External advisers	Willis Towers Watson (to June 2017)	
	Deloitte LLP (appointed in July 2017)	

Sidney Taurel was a member of the Committee throughout 2017 as permitted under the UK Corporate Governance Code.

Advisers to the Remuneration Committee

During 2017, the Remuneration Committee undertook a formal tender process, the outcome of which resulted in Deloitte LLP being appointed as independent Remuneration Committee advisers in July 2017. Deloitte LLP supplied the Committee with advice on current market trends and developments, incentive plan design and target setting, investor engagement and other general executive remuneration matters. In respect of their services to the Committee, Deloitte LLP were paid fees, which were charged on a time spent basis, of £165,000. Deloitte LLP were founding members of the Remuneration Consultants' Group and adhere to its code of conduct.

During the year, Deloitte LLP also provided Pearson PLC with certain tax and other advisory and consultancy services.

The Committee also received advice from Willis Towers Watson, which supplied survey data and advice on market trends, long-term incentives and other general remuneration matters. During the year, Willis Towers Watson was paid fees for advice to the Committee, which were charged on a time spent basis, of £87,000.Willis Towers Watson also advised the company on health and welfare benefits in the US and provided consulting advice directly to certain Pearson operating companies.

The Committee remains satisfied that advice provided by both Deloitte LLP and Willis Towers Watson was objective and independent and that the provision of other services in no way compromised their independence.

2017 remuneration report

Remuneration Committee meeting focus during 2017

Area of responsibility	Activities			
Market	Noted Willis Towers Watson's and subsequently Deloitte's overview of the current remuneration and governance environment.	Received a number of updates on changes to the corporate governance environment for executive compensation.		
Performance	Received input from the Audit Committee, Internal Audit and from management on the financial performance of the business and progress against strategic measures. Received input from Investor Relations on market consensus expectations.	Noted and reviewed the status of outstanding long-term incentive awards based on the current view of likely Pearson financial performance.	Reviewed the approach to the Annual Incentive Plan for Pearson executive management and the Management Incentive Plan for senior leaders.	Noted and reviewed the status of the 2016–2017 talent retention arrangements and impact on voluntary turnover.
Implementation	Reviewed and approved a pay freeze for 2017 for the Executive Directors and annual salary increases for Pearson executive management and senior leaders.	Reviewed and approved 2016 annual incentive plan payouts for the Executive Directors, Pearson executive management and senior leaders. Reviewed and approved 2017 individual annual incentive opportunities for the Executive Directors and Pearson Executive management. Reviewed and approved 2017 Pearson annual incentive plan targets including a detailed review of financial and non-financial targets.	Approved nil payout under 2014 long-term incentive plan awards. Reviewed and approved 2017 long-term incentive awards for the Executive Directors and Pearson executive management, including the quantum of awards. Noted 2017 long-term incentive awards for senior leaders and managers below Pearson executive management Considered shareholder feedback and market consensus for setting 2017 long-term incentive performance conditions. Further consideration of investor feedback and experience prior to granting of awards.	Noted remuneration packages for new appointments to the Pearson executive management team and termination arrangements for leavers Noted the deployment of 2016-17 retention arrangements and effectiveness of the arrangements in the retention of critical talent.
Governance	Noted the activity of the standing Committee of the Board in relation to the operation of the company's equity-based reward programmes.	Noted company's use of equity for employee share plans.	Conducted an evaluation of the Committee's performance.	Conducted a formal process to review the provision of external independent advice to the Committee.
Policy	Considered the Director's Remuneration Policy for approval by shareholders at the 2017 AGM. Reviewed and reconfirmed the operation of the Policy for 2018.			
Disclosure and engagement	Considered feedback from Committee Chairman's meetings with key shareholders and proxy bodies during 2017.	Reviewed and approved 2016 Directors' remuneration report Noted shareholder feedback on 2016 Directors' remuneration report.	Reviewed 2017 Annual General Meeting season, shareholder voting and engagement strategy.	Noted template and outline of 2017 Directors' remuneration report and shareholder engagement strategy.

2017 remuneration report

Terms of reference

The Committee's full charter and terms of reference are available on the Governance page of the company's website. A summary of the Committee's responsibilities is set out below.

Committee responsibilities:

Determine and review policy

Determine and regularly review the remuneration policies for the Executive Directors, the presidents and other members of the Pearson Executive management (who report directly to the CEO), and overview the approach for the senior leadership group. These policies include base salary, annual and long-term incentives, pension arrangements, any other benefits and termination of employment.

Shareholder engagement

Ensure the company maintains an appropriate level of engagement with its shareholders and shareholder representative bodies in relation to the remuneration policy and its implementation.

Review and approve implementation

Regularly review the implementation and operation of the remuneration policy for Executive management and approve the individual remuneration and benefits packages of the Executive Directors.

Approve performance related plans

Approve the design of, and determine targets for, any performance-related pay plans operated by the Group for Pearson Executive management and approve the total payments to be made under such plans.

Review long-term plans

Review the design of the company's long-term incentive and other share plans operated by the Group and where relevant recommend such plans for approval by the Board and shareholders.

Set termination arrangements

Advise and decide on general and specific arrangements in connection with the termination of employment of Executive Directors.

Review targets

Review and approve corporate goals and objectives relevant to Executive Directors' remuneration and evaluate the Executive Directors' performance in light of those goals and objectives.

Determine Chairman's remuneration

Delegated responsibility for determining the remuneration and benefits package of the Chairman of the Board.

Appoint remuneration consultants

Appoint and set the terms of engagement for any remuneration consultants who advise the Committee and monitor the cost of such advice.

Committee evaluation

In 2017, the Committee evaluation was undertaken by Heidrick & Struggles JCA Group as part of the wider board evaluation process. The responses illustrated an effective Committee, which uses its time well and has an appropriate focus on the key issues. The key findings were:

- The Committee is seen to be working effectively on the whole, led well by its Chair with an appropriate agenda and a strong work ethic from each member of the Committee.
- Meetings are run well and in a disciplined manner.
- Succession for the role of Committee chair should be borne in mind with future Non-Executive Director appointments, although this is not immediately pressing.
- Some consideration might be given to ensuring there is minimal duplication with other Committees (e.g. gender pay could fall under both Reputation & Responsibility Committee and the Remuneration Committee depending on the outcomes of the UK Corporate Governance Code review), or how duplication will be handled so as not to create any unnecessary work.

Voting at the 2017 AGM

The following table summarises the details of votes cast in respect of the remuneration resolutions at the 2017 AGM.

	% of votes cast for	% of votes cast against	Votes withheld
2017 Remuneration Policy vote	68.8% (404,615,934)	31.2% (183,100,737)	43,738,267
Annual remuneration votes	34.4% (202,512,759)	65.6% (385,996,157)	42,945,685

Following the 2017 AGM result, as part of our commitment to an ongoing dialogue, we have continued to engage actively with our investors to seek feedback on the reasons for the voting outcome. A number of our shareholders believed that there was a disconnect between pay and performance for 2016 and this was reflected in the voting outcome on the resolutions on remuneration. Since last year's AGM, Pearson has sought to address this in a number of ways that are explained in the remuneration overview section of this report. We appreciate and have acknowledged that feedback and are grateful to those shareholders who engaged with us.

The Directors' remuneration report has been approved by the Board on 14 March 2018 and signed on its behalf by:

Elizabeth Corley
Chairman of Remuneration Committee

Additional disclosures

Pages 62–109 of this document comprise the Directors' report for the year ended 31 December 2017.

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

Going concern

The Directors have made an assessment of the Group's ability to continue as a going concern and consider it appropriate to adopt the going concern basis of accounting.

Viability statement

As set out on p60, the Board has also reviewed the prospects of Pearson over the three-year period to December 2020 taking account of the company's strategic plans, a 'severe but plausible' downside case and further stress testing based on the principal risks set out on p50–60.

Based on the results of these procedures, and considering the company's strong balance sheet, the Directors have a reasonable expectation that Pearson will be able to continue in operation and meet its liabilities as they fall due over the three-year period ending December 2020. Further details of the Group's liquidity are shown in Financial review (see p34–40).

Share capital

Details of share issues and cancellations are given in note 27 to the consolidated financial statements on p170. The company has a single class of shares which is divided into ordinary shares of 25p each. The ordinary shares are in registered form. As at 31 December 2017, 802,053,752 ordinary shares were in issue. At the AGM held on 5 May 2017, the company was authorised, subject to certain conditions, to acquire up to 82,258,685 ordinary shares by market purchase. Shareholders will be asked to renew this authority at the AGM on 4 May 2018.

Share buyback

In July, we announced the sale of a 22% stake in Penguin Random House to Bertelsmann and recapitalisation of the business, generating total net proceeds of approximately $1bn.

The partial divestment of our stake in Penguin Random House was in line with our strategy for simplification and allowed us to crystallise some of the significant shareholder value created through our successful partnership with Bertelsmann over the prior four years.

We have set out clear capital allocation priorities as follows:

1. Maintaining a strong balance sheet and solid investment grade credit ratings through an appropriate capital structure. Accordingly, we intend to maintain a year end net debt/EBITDA of less than 1.5x
2. Simplifying our portfolio and investing in the business to drive sustainable organic growth
3. Delivering shareholder returns through a sustainable and progressive dividend policy, returning surplus cash to shareholders where appropriate through buybacks or special dividends.

In line with those priorities, the Board decided that we would use the proceeds from the transaction to maintain a strong balance sheet and invest in our business in addition to returning £300m of surplus capital to shareholders following the closing of the transaction.

The Board considered investor views on preferred methods of cash return, the amount being returned and other factors and concluded a share buyback was the most appropriate methodology to return that capital to our shareholders at that time.

We launched a £300m share buyback, beginning on 18 October 2017 and completed the programme on 16 February 2018 repurchasing a total of 42,835,577 shares at an average price of 700p. The reduction in average shares outstanding as a result of the buyback increased 2017 adjusted earnings per share (EPS) by less than 1%, but will have a larger impact on 2018 adjusted EPS.

Major shareholders

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

As at 31 December 2017, the company had been notified under DTR 5 of the following holders of significant voting rights in its shares.

	Number of voting rights	Percentage as at date of notification
Schroders plc	108,691,682	13.63%
Silchester International Investors LLP	89,160,115	11.18%
Lindsell Train Limited	41,393,237	5.17%
Ameriprise Financial, Inc. and its group	41,236,375	5.02%
Libyan Investment Authority[1]	24,431,000	3.01%

1. Based on notification to the Company dated 7 June 2010. We have been notified of no change to this holding since that date. Assets belonging to, or owned, held or controlled on 16 September 2011 by the Libyan Investment Authority and located outside Libya on that date, are frozen in accordance with Article 5(4) of Regulation 2016/44 of the Council of the European Union.

Between 31 December 2017 and 14 March 2018, being the latest practicable date before the publication of this report, the company received further notifications under DTR 5, with the most recent positions being as follows:

- Schroders plc disclosed a holding of 14.04%
- Silchester International Investors LLP disclosed a holding of 11.14%.

Annual General Meeting

The notice convening the AGM, to be held at 12 noon on Friday 4 May 2018 at IET London, 2 Savoy Place, London WC2R 0BL, is contained in a circular to shareholders to be dated 28 March 2018.

Registered auditors

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

Additional disclosures

Amendment to Articles of Association

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

Rights attaching to shares

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

Subject to any restrictions below, shareholders may attend any general meeting of the company and, on a show of hands, every shareholder (or his/her representative) who is present at a general meeting has one vote on each resolution and, on a poll, every shareholder (whether an individual or a corporation) present in person or by proxy shall have one vote for every 25p of nominal share capital held. A resolution put to the vote at a general meeting is decided on a show of hands unless before, or on the declaration of the result of, a vote on a show of hands, a poll is demanded. A poll can be demanded by the Chairman of the meeting, or by at least three shareholders (or their representatives) present in person and having the right to vote, or by any shareholders (or their representatives) present in person having at least 10% of the total voting rights of all shareholders, or by any shareholders (or their representatives) present in person holding ordinary shares on which an aggregate sum has been paid up of at least 10% of the total sum paid up on all ordinary shares. At this year's AGM, voting will again be conducted on a poll, consistent with best practice.

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

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

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

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

Voting at general meetings

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

The Board may decide that a shareholder is not entitled to attend or vote either personally or by proxy at a general meeting or to exercise any other right conferred by being a shareholder if he/she or any person with an interest in shares has been sent a notice under section 793 of the Act (which confers upon public companies the power to require information with respect to interests in their voting shares) and he/she or any interested person failed to supply the company with the information requested within 14 days after delivery of that notice. The Board may also decide, where the relevant shareholding comprises at least 0.25% of the nominal value of the issued shares of that class, that no dividend is payable in respect of those default shares and that no transfer of any default shares shall be registered.

Pearson operates an employee benefit trust to hold shares, pending employees becoming entitled to them under the company's employee share plans. There were 5,993,536 shares held as at 31 December 2017. The trust has an independent trustee which has full discretion in relation to the voting of such shares. A dividend waiver operates on the shares held in the trust.

Pearson also operates two nominee shareholding arrangements which hold shares on behalf of employees. There were 2,561,000 shares held in the Sharestore account and 432,375 shares held in the Global Nominee account as at 31 December 2017. The beneficial owners of shares held in Sharestore are invited to submit voting instructions online at www.shareview.co.uk and Global Nominee participants are invited to submit voting instructions by e-mail to nominee@equiniti.com. If no instructions are given by the beneficial owner by the date specified, the trustees holding these shares will not exercise the voting rights.

Transfer of shares

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

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

Additional disclosures

Variation of rights

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

(i) With the written consent of the holders of at least 75% in nominal value of the issued shares of the relevant class or

(ii) With the sanction of a special resolution passed at a separate general meeting of the holders of the shares of the relevant class.

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

Appointment and replacement of Directors

The Articles contain the following provisions in relation to Directors:

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

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

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

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

Powers of the Directors

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

Significant agreements

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

Under the $1,750,000,000 revolving credit facility agreement dated August 2014 which matures in August 2021 between, among others, the company, Barclays Bank plc (Agent) and the banks and financial institutions named therein as lenders (the Facility), any such bank may, upon a change of control of the company, require its outstanding advances, together with accrued interest and any other amounts payable in respect of such Facility, and its commitments, to be cancelled, each within 60 days of notification to the banks by the Agent. For these purposes, a 'change of control' occurs if the company becomes a subsidiary of any other company, or one or more persons acting either individually or in concert obtains control (as defined in section 1124 of the Corporation Tax Act 2010) of the company.

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

Additional disclosures

Other statutory information

Other information that is required by the Companies Act 2006 (the Act) to be included in the Directors' report, and which is incorporated by reference, can be located as follows:

Summary disclosures index	See more
Dividend recommendation	**p35**
Financial instruments and financial risk management	**p156–158**
Important events since year end	**p40**
Future development of the business	**p8–32**
Research and development activities	**p22–23**
Employment of disabled persons	**p28**
Employee involvement	**p25–28**
Greenhouse gas emissions	**p29**

With the exception of the dividend waiver described on p107, there is no information to be disclosed in accordance with Listing Rule 9.8.4.

No political donations or contributions were made or expenditure incurred by the company or its subsidiaries during the year.

Fair, balanced and understandable reporting and disclosure of information

As required by the Code, we have established arrangements to ensure that all information we report to investors and regulators is fair, balanced and understandable. A process and timetable for the production and approval of this year's report was agreed by the Board at its meeting in December 2017. The full Board then had opportunity to review and comment on the report as it progressed.

Representatives from financial reporting, corporate affairs, company secretarial, legal and internal audit, compliance and risk are involved in the preparation and review of the annual report to ensure a cohesive and balanced approach and, as with all of our financial reporting, our Verification Committee conducts a thorough verification of narrative and financial statements. We also have procedures in place to ensure the timely release of inside information, through our Market Disclosure Committee.

The Audit Committee is also available to advise the Board on certain aspects of the report, to enable the Directors to fulfil their responsibility in this regard. The Directors consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy.

The Directors also confirm that, for each Director in office at the date of this report:

- So far as the Director is aware, there is no relevant audit information of which the Group and company's auditors are unaware
- They have taken all the steps that they ought to have taken as Directors in order to make themselves aware of any relevant audit information and to establish that the Group and the company's auditors are aware of that information.

Directors in office

The following Directors were in office during the year and up until signing of the financial statements:

E P L Corley	**H Manwani**
V Cox	**T Score**
J J Fallon	**S Taurel**
S J Lewis	**L Wallen**
L K Lorimer	**C Williams**
M M Lynton (appointed 1 February 2018)	

The Directors' report has been approved by the Board on 14 March 2018 and signed on its behalf by:

Stephen Jones
Company Secretary

Statement of Directors' responsibilities

Statement of Directors' responsibilities

The Directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulation.

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

› Select suitable accounting policies and then apply them consistently

› State whether applicable IFRSs as adopted by the European Union have been followed for the Group and company financial statements, subject to any material departures disclosed and explained in the financial statements

› Make judgements and accounting estimates that are reasonable and prudent

› Prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group and company's transactions and disclose with reasonable accuracy at any time the financial position of the Group and company and enable them to ensure that the financial statements and the Directors' Remuneration Report comply with the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

The Directors are also responsible for safeguarding the assets of the Group and company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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

Each of the Directors, whose names and functions are listed on p64–65, confirms that, to the best of their knowledge:

› The Group financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit of the Group

› The strategic report contained in the annual report includes a fair review of the development and performance of the business and the position of the Group and company, together with a description of the principal risks and uncertainties that it faces.

This responsibility statement has been approved by the Board on 14 March 2018 and signed on its behalf by:

Coram Williams
Chief Financial Officer

Financial statements

In this section

Independent auditor's report to the members of Pearson plc

Report on the audit of the financial statements

Our opinion

In our opinion, Pearson Plc's Group financial statements and parent company financial statements (the "financial statements"):
- give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2017 and of the Group's profit and the Group's and the parent company's cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union and, as regards the parent company's financial statements, as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

We have audited the financial statements, included within the Annual Report and accounts (the "Annual Report"), which comprise: the Group and parent company balance sheets as at 31 December 2017; the Group's income statement and statement of comprehensive income, the Group and parent company statements of cash flows, and the Group and parent company statements of changes in equity for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the parent company.

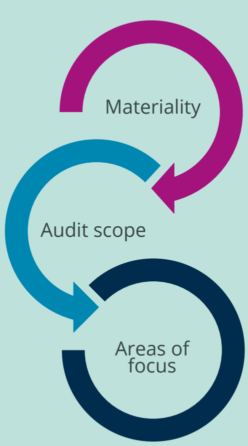
Other than those disclosed in note 4 to the financial statements, we have provided no non-audit services to the Group or the parent company in the period from 1 January 2017 to 31 December 2017.

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

We gained an understanding of the legal and regulatory framework applicable to the Group and the industry in which it operates, and considered the risk of acts by the Group which were contrary to applicable laws and regulations, including fraud. We designed audit procedures to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion. We designed audit procedures that focused on the risk of non-compliance related to the Companies Act 2006, the Listing Rules, and applicable tax legislation in the countries in which Pearson operates. Our tests included, but were not limited to, review of the financial statement

Our audit approach



Overview

- Overall Group materiality: £22m (2016: £23m), based on 4% of adjusted operating profit, adjusted for net finance costs.
- Overall parent company materiality: £20m (2016: £21m), 1% of net assets capped below Group materiality
- We conducted work in four key territories: US, UK, Brazil and China. In addition, we obtained an audit opinion on the financial information reported by the associate Penguin Random House.
- The territories where we conducted audit procedures, together with work performed at corporate functions and at the consolidated Group level, accounted for approximately: 67% of the Group's revenue; 62% of the Group's profit before tax; and 60% of the Group's adjusted profit before tax.
- Revenue recognition including risk of fraud (Group).
- Carrying values of goodwill and intangible assets (Group).
- Returns provisions (Group).
- Nature and presentation of non-trading items (Group).
- Provisions for uncertain tax liabilities (Group).
- Recoverability of pre-publication assets (Group).
- Major transactions (Group and parent).
- Retirement benefits and other post-retirement obligations (Group).

Independent auditor's report to the members of Pearson plc

disclosures to underlying supporting documentation, review of correspondence with legal advisors and tax authorities, enquiries of management, review of significant component auditors' work and review of internal audit reports in so far as they related to the financial statements. We did not identify any key audit matters relating to irregularities, including fraud. As in all of our audits we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. This is not a complete list of all risks identified by our audit.

Key audit matter	How our audit addressed the key audit matter
Revenue recognition including risk of fraud	
There are two types of complex contracts that require significant judgements and estimates, which could be subject to either accidental errors or deliberate fraud: › Multiple element arrangements, such as the sale of physical textbooks accompanied by digital content or supplementary workbooks, where revenue is recognised for each element as if it were an individual contractual arrangement requiring the estimation of its relative fair value; › Certain long-term contracts that span year end, where revenue is recognised using estimated percentage of completion based on costs. These include contracts to design, develop and deliver testing and accreditation, and contracts to secure students and support the online delivery of their teaching. These complex contracts generate material deferred revenue and accrued income balances and are areas where misstatements in the underlying assumptions or estimation calculations could have a material effect on the financial statements. In addition, there are material shipments towards the period end from major distribution locations giving rise to the potential risk of a cut-off error.	Where books are sold together with workbooks delivered later or companion digital materials available online, we assessed the basis for allocation of the purchase price between each element based on individual contractual arrangements, and then tested the detailed calculations supporting the revenue deferral calculations. This included validating adjustments for the extent of user take up in relation to digital content to underlying support. We found the revenue deferrals to be based on reasonable estimates of the relative fair value of each element and to be properly and consistently calculated. For a selection of the larger, more judgemental and more recent long-term contracts, covering both testing activities and online delivery of teaching, we read the contracts and assessed the accounting methodologies being applied to calculate the proportion of revenue being recognised. We also tested costs incurred to date and management's estimates of forecast costs and revenues by reference to historical experience and current contract status. Additionally, we have performed manual journals testing focusing on unusual or unexpected entries to revenue as well as unexpected users. Our testing showed that revenue recognition practices are in accordance with Group policies and related accounting standards with appropriate methods for calculating the revenue recognised. Refer to the returns provision areas of focus for our work over the risk of cut-off.
Carrying values of goodwill and intangible assets	
The Group recorded goodwill of £2,030m and intangible assets of £934m at 31 December 2017, including software, acquired customer lists, contracts and relationships, acquired trademarks and brands and acquired publishing rights. The Group recorded an impairment charge of £2,548m at 31 December 2016 against the North America CGU. The carrying values of goodwill and intangible assets are dependent on future cash flows of the underlying CGUs and there is a risk that if management does not achieve these cash flows it could give rise to further impairment. This risk increases in periods when the Group's trading performance and projections do not meet prior expectations, such as in 2016. The impairment reviews performed by management contain a number of significant judgements and estimates. Changes in these assumptions can result in materially different impairment charges or available headroom.	We obtained management's fair value less costs of disposal impairment model and tested and evaluated the reasonableness of key assumptions, including CGU identification; operating cash flow forecasts and key inputs to these forecasts; the appropriateness of the inclusion of restructuring cost savings; perpetuity growth rates; and discount rates. We tested the mathematical integrity of the forecasts and carrying values in management's impairment model and confirmed that management's estimate of each CGU's recoverable amount is appropriately based on the higher of fair value less costs of disposal and value-in-use. Our procedures have been focused on the North America and Core CGUs. We agreed the forecast cash flows to board-approved budgets, assessed how these budgets are compiled and understood key judgements and estimates within them, including short-term growth rates, cost allocations and restructuring costs and related savings. We used valuations specialists to assess the perpetuity growth rate and discount rate for each CGU by comparison with third-party information, past performance and relevant risk factors. We also considered management's estimate of disposal costs for reasonableness. We performed our own sensitivity analyses to understand the impact of reasonable changes in the key assumptions. We agree with management's decision to provide additional disclosures and sensitivities in note 11 of the financial statements, in relation to the North America and Core CGUs.

Independent auditor's report to the members of Pearson plc

Key audit matter	How our audit addressed the key audit matter
Returns provisions	
The Group has provided £170m for sales returns at 31 December 2017. The most significant exposure to potential returns within Pearson arises in the US higher education courseware business. Trends in this business, such as the growth of textbook rentals and the availability of free on-line content continue to affect this market and have the potential to impact returns levels if shipping practices and arrangements with retailers are not managed by Pearson in response to these trends: for example, returns in the first half of 2016 were higher and more volatile than had been anticipated. Management provides for returns based on past experience by customer and channel, using a three year average method.	We assessed management's evaluation of the trends in the market and their responses (including changed incentive arrangements and shipping practices) and considered whether management's methodology and three year averaging remained appropriate. We were satisfied that this was the case. We tested the returns provision calculations at 31 December 2017 and agreed inputs such as historical sales and returns experience to underlying records We performed detailed testing over shipment and returns levels around the year end in particular at major shipping locations in the US and UK and evaluated whether these gave rise to an increased risk of future returns. We concluded that management had adopted methods and reached estimates for future returns that were supportable and appropriate.
Nature and presentation of non-trading items	
In May 2017, management announced a further three year restructuring plan to the one announced in 2016, to continue to simplify the business and focus further on their global education strategy. As a result, management recorded a restructuring charge of £79m during 2017. Given the significance of this programme, management has excluded these costs from their adjusted profit measure in addition to certain other items which have been excluded on a consistent basis with prior years. There is a risk that inappropriate costs might be excluded from the underlying operating cost base in such a restructuring programme, and that the disclosures around the items excluded from adjusted performance measures might not be clear and transparent.	We identified no material adjustments in relation to the recording of the restructuring costs. We noted that for the majority of these items there was clear evidence to support the fact that they have arisen as a direct consequence of the Group's restructuring plans. There are certain costs where the classification as restructuring is subjective due to the circumstances in which they have arisen. Based on the audit evidence obtained, we have been able to conclude that, although subjective, there are valid arguments for associating these costs with the restructuring activities undertaken and therefore the classification is reasonable. We also considered the extent and clarity of the Group's reconciliations between the statutory and adjusted measures and the related explanations. We were satisfied that these were appropriate and consistent with the nature of the underlying items.
Provisions for uncertain tax liabilities	
The Group is subject to several tax regimes due to the geographical diversity of its businesses. At 31 December 2017 the Group had provisions for uncertain tax positions of £280m (see note 7). Management is required to exercise significant judgement in determining the appropriate amount to provide in respect of potential tax exposures and uncertain tax provisions. The most significant of these relate to US tax. Changes in assumptions about the views that might be taken by tax authorities can materially impact the level of provisions recorded in the financial statements.	We engaged our tax experts in support of our audit of tax and obtained an understanding of the Group's tax strategy and risks. We recalculated the Group's tax provisions and determined whether the treatments adopted were in line with the Group's tax policies and had been applied consistently. We evaluated the key underlying assumptions, particularly in the US and UK. In doing this, we considered the status of tax authority audits and enquiries. We considered the basis and support, in particular for provisions not subject to tax audit, in comparison with our experience for similar situations. We also evaluated the consistency of management's approach to establishing or changing prior provision estimates and validated that changes in prior provisions reflected a change in facts and circumstances. We are satisfied that management's provision estimates for uncertain tax positions were prepared on a consistent basis with the prior year and were adequately supported. We also evaluated the disclosures in note 7 in relation to uncertain tax provisions, and were satisfied that the disclosures were consistent with the underlying positions and with the requirements of IAS 1.
Recoverability of pre-publication assets	
The Group has £988m of pre-publication assets at 31 December 2017 including £247m recorded in businesses classified as held for sale (see below). Pre-publication assets represent direct costs incurred in the development of education platforms, programmes and titles prior to their public release. Judgement is required to assess the recoverability of the carrying value of these assets; this is further complicated by the transition to digital as the Group invests in new, less proven, inter-linked digital content and platforms.	We assessed the appropriateness of capitalisation and amortisation policies and selected a sample of costs deferred to the balance sheet as pre-publication assets to test their magnitude and appropriateness for capitalisation and the appropriateness of amortisation profiles against sales forecasts, including considering the impact of the transition towards digital products. We challenged the carrying value of certain pre-publication assets where products are yet to be launched, are less proven, or where sales are lower than originally anticipated. We assessed forecast cash flows against historical experience and obtained supporting evidence for management's explanations. Where the pre-publication assets formed part of a held for sale business we also considered the evidence supporting the expected disposal proceeds exceeding the carrying value of those assets. We found the Group's policies to be appropriate and consistently applied. Whilst the carrying value of some assets depends on future sales growth, overall we considered the year end carrying values to be supported and in line with the Group's policy.

Independent auditor's report to the members of Pearson plc

Key audit matter	How our audit addressed the key audit matter
Major transactions	
The Group has disposed of both a 22% share in its investment in the Penguin Random House associate and Global Education during 2017. Pre-tax gains on disposal of £96m and £44m have been recorded respectively on these disposals. Pearson continues to hold a 25% share in Penguin Random House. Additionally, at 31 December 2017 the K-12 and Wall Street English businesses have been classified as held for sale. Therefore assets of £760m and liabilities of £588m have been classified as held for sale on the face of the balance sheet. Management have recorded the held for sale assets at the lower of carrying value and fair value less costs to dispose. No impairments were recorded on classification of the businesses as held for sale.	We obtained and reviewed the sale agreements and evidence of proceeds received for both disposals. We also reviewed the contractual agreements to assess the accounting treatment and classification of proceeds and the gains on disposal of both Penguin Random House and Global Education. We consider the accounting treatment to be appropriate and the gains to have been appropriately calculated and disclosed. We have obtained evidence to support the held for sale determination including (for WSE) a signed sale agreement and (for K-12) supporting Board approval and evidence in support of a well advanced sales process. From the evidence we have obtained we were satisfied that both K-12 and Wall Street English have been appropriately measured and classified as held for sale at 31 December 2017.
Retirement benefits and other post-retirement obligations	
The Group operates a number of defined benefit and defined contribution retirement plans throughout the world. The total fair value of plan assets is £3,492m and the total present value of defined benefit obligations is £2,973m. The largest plan is the Pearson Group Pension Plan in the UK (UK Group plan) which has a net surplus of £545m. There have been a number of changes to the UK Group plan in the period including increased contributions; an update to certain actuarial assumptions; and the purchase of two insurance buy-in policies covering approximately £1.2bn of its total liabilities. Given the size of the UK Group plan, changes of this nature have a material impact on the net surplus.	We assessed the appropriateness of key assumptions supporting the Group's valuation of retirement benefit obligations with the support of our own actuarial specialists and undertook work to validate the valuation of assets. We considered the consistency of management's methodology with prior periods. Where changes to the basis of assumptions were made we obtained evidence in support of the revised basis, and where relevant to the changes in circumstances. Our assessment included benchmarking assumptions against our independent expected range and with other FTSE 100 companies with plans of similar duration. We consider the changes to be supportable and appropriate. We have circularised fund managers and custodians to confirm existence of pension assets and have performed independent valuation procedures. We have not identified any significant adjustments in relation to this work. We have reviewed contractual information and advice received from external advisers in relation to the insurance buy-in policies. We have confirmed that the accounting for these transactions is consistent with agreements entered into. We also evaluated the disclosures in note 25 and were satisfied that they appropriately addressed key changes in the period.

How we tailored our audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the Group and the parent company, the accounting processes and controls, and the industry in which they operate.

Overall Group materiality: £22m, which represents 4% of adjusted operating profit, adjusted for net finance costs as disclosed in note 8 to the consolidated financial statements. Refer to p116 for further details.

We conducted work in four key territories: US, UK, Brazil and China. In addition, we obtained an audit opinion on the financial information reported by the associate Penguin Random House.

The territories where we conducted audit procedures, together with work performed at corporate functions and at the consolidated Group level, accounted for approximately: 67% of the Group's revenue; 62% of the Group's profit before tax; and 60%% of the Group's adjusted profit before tax.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Independent auditor's report to the members of Pearson plc

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Parent company financial statements
Overall materiality	£22m (2016: £23m).	£20m (2016: £21m).
How we determined it	4% of adjusted operating profit, adjusted for net finance costs	1% of net assets capped below Group materiality
Rationale for benchmark applied	Note 8 of the financial statements explains that the Group's principal measure of performance is adjusted operating profit (£576m), which excludes the cost of major restructuring, other net gains and losses and acquired intangible asset amortisation, in order to present results from operating activities on a consistent basis. From adjusted operating profit we deducted net finance costs of £30m (see note 8) because these mainly reflect recurring finance charges. To the resulting number we then applied 4% (rather than the usual 5%) as our materiality calculation was based on an adjusted measure.	We consider net assets to be an appropriate benchmark for a Group holding company. However we have capped this below overall Group materiality.

For each component in the scope of our Group audit, we allocated a materiality that is less than our overall Group materiality. The range of materiality allocated across components was between £3m and £18m.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £2m (Group audit) (2016: £2m) and £2m (Parent company audit) (2016: £2m) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Going concern

In accordance with ISAs (UK) we report as follows:

Reporting obligation	Outcome
We are required to report if we have anything material to add or draw attention to in respect of the directors' statement in the financial statements about whether the directors considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements and the directors' identification of any material uncertainties to the Group's and the parent company's ability to continue as a going concern over a period of at least twelve months from the date of approval of the financial statements.	We have nothing material to add or to draw attention to. However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and parent company's ability to continue as a going concern.
We are required to report if the directors' statement relating to Going Concern in accordance with Listing Rule 9.8.6R (3) is materially inconsistent with our knowledge obtained in the audit.	We have nothing to report.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report and Governance report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, the Companies Act 2006, (CA06), ISAs (UK) and the Listing Rules of the Financial Conduct Authority (FCA) require us also to report certain opinions and matters as described below (required by ISAs (UK) unless otherwise stated).

Strategic Report and Governance report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Governance report for the year ended 31 December 2017 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements. (CA06)

In light of the knowledge and understanding of the Group and parent company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Governance report. (CA06)

The directors' assessment of the prospects of the Group and of the principal risks that would threaten the solvency or liquidity of the Group

We have nothing material to add or draw attention to regarding:

› The directors' confirmation on pages 60 and 106 of the Annual Report that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity.

› The disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.

› The directors' explanation on pages 60 and 106 of the Annual Report as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to

Independent auditor's report to the members of Pearson plc

continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We have nothing to report having performed a review of the directors' statement that they have carried out a robust assessment of the principal risks facing the group and statement in relation to the longer-term viability of the Group. Our review was substantially less in scope than an audit and only consisted of making inquiries and considering the directors' process supporting their statements; checking that the statements are in alignment with the relevant provisions of the UK Corporate Governance Code (the "Code"); and considering whether the statements are consistent with the knowledge and understanding of the group and parent company and their environment obtained in the course of the audit. (Listing Rules)

Other Code Provisions

We have nothing to report in respect of our responsibility to report when:

- The statement given by the directors, on page 110, that they consider the Annual Report taken as a whole to be fair, balanced and understandable, and provides the information necessary for the members to assess the Group's and parent company's position and performance, business model and strategy is materially inconsistent with our knowledge of the Group and parent company obtained in the course of performing our audit.
- The section of the Annual Report on page 76 describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.
- The directors' statement relating to the parent company's compliance with the Code does not properly disclose a departure from a relevant provision of the Code specified, under the Listing Rules, for review by the auditors.

Directors' Remuneration

In our opinion, the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006. (CA06)

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of directors' responsibilities, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the parent company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the parent company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report

This report, including the opinions, has been prepared for and only for the parent 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.

Other required reporting

Companies Act 2006 exception reporting

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

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the Audit Committee, we were appointed by the members on 6 February 1996 to audit the financial statements for the year ended 31 December 1996 and subsequent financial periods. The period of total uninterrupted engagement is 22 years, covering the years ended 1 January 1996 to 31 December 2017.

Stuart Newman
(Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London

14 March 2018

Consolidated income statement

Year ended 31 December 2017

All figures in £ millions	Notes	2017	2016
Continuing operations			
Sales	2	**4,513**	4,552
Cost of goods sold	4	**(2,066)**	(2,093)
Gross profit		**2,447**	2,459
Operating expenses	4	**(2,202)**	(2,480)
Other net gains and losses	4	**128**	(25)
Impairment of intangible assets	11	**–**	(2,548)
Share of results of joint ventures and associates	12	**78**	97
Operating profit/(loss)	2	**451**	(2,497)
Finance costs	6	**(110)**	(97)
Finance income	6	**80**	37
Profit/(loss) before tax		**421**	(2,557)
Income tax	7	**(13)**	222
Profit/(loss) for the year		**408**	(2,335)
Attributable to:			
Equity holders of the company		**406**	(2,337)
Non-controlling interest		**2**	2
Earnings per share/(loss) attributable to equity holders of the company during the year			
(expressed in pence per share)			
– basic	8	**49.9p**	(286.8)p
– diluted	8	**49.9p**	(286.8)p

Consolidated statement of comprehensive income

Year ended 31 December 2017

All figures in £ millions	Notes	2017	2016
Profit/(loss) for the year		**408**	(2,335)
Items that may be reclassified to the income statement			
Net exchange differences on translation of foreign operations – Group		**(158)**	910
Net exchange differences on translation of foreign operations – associates		**(104)**	3
Currency translation adjustment disposed		**(51)**	–
Attributable tax	7	**9**	(5)
Fair value gain on other financial assets		**13**	–
Attributable tax	7	**(4)**	–
Items that are not reclassified to the income statement			
Remeasurement of retirement benefit obligations – Group	25	**175**	(268)
Remeasurement of retirement benefit obligations – associates		**7**	(8)
Attributable tax	7	**(42)**	58
Other comprehensive (expense)/income for the year	29	**(155)**	690
Total comprehensive income/(expense) for the year		**253**	(1,645)
Attributable to:			
Equity holders of the company		**251**	(1,648)
Non-controlling interest		**2**	3

Consolidated balance sheet

As at 31 December 2017

All figures in £ millions	Notes	2017	2016
Assets			
Non-current assets			
Property, plant and equipment	10	**281**	343
Intangible assets	11	**2,964**	3,442
Investments in joint ventures and associates	12	**398**	1,247
Deferred income tax assets	13	**95**	451
Financial assets – derivative financial instruments	16	**140**	171
Retirement benefit assets	25	**545**	158
Other financial assets	15	**77**	65
Trade and other receivables	22	**103**	104
		4,603	5,981
Current assets			
Intangible assets – pre-publication	20	**741**	1,024
Inventories	21	**148**	235
Trade and other receivables	22	**1,110**	1,357
Financial assets – marketable securities	14	**8**	10
Cash and cash equivalents (excluding overdrafts)	17	**518**	1,459
		2,525	4,085
Assets classified as held for sale	32	**760**	–
Total assets		**7,888**	10,066
Liabilities			
Non-current liabilities			
Financial liabilities – borrowings	18	**(1,066)**	(2,424)
Financial liabilities – derivative financial instruments	16	**(140)**	(264)
Deferred income tax liabilities	13	**(164)**	(466)
Retirement benefit obligations	25	**(104)**	(139)
Provisions for other liabilities and charges	23	**(55)**	(79)
Other liabilities	24	**(133)**	(422)
		(1,662)	(3,794)

Consolidated balance sheet continued

As at 31 December 2017

All figures in £ millions	Notes	2017	2016
Current liabilities			
Trade and other liabilities	24	**(1,342)**	(1,629)
Financial liabilities – borrowings	18	**(19)**	(44)
Current income tax liabilities		**(231)**	(224)
Provisions for other liabilities and charges	23	**(25)**	(27)
		(1,617)	(1,924)
Liabilities classified as held for sale	32	**(588)**	–
Total liabilities		**(3,867)**	(5,718)
Net assets		**4,021**	4,348
Equity			
Share capital	27	**200**	205
Share premium	27	**2,602**	2,597
Treasury shares	28	**(61)**	(79)
Capital redemption reserve		**5**	–
Fair value reserve		**13**	–
Translation reserve		**592**	905
Retained earnings		**662**	716
Total equity attributable to equity holders of the company		**4,013**	4,344
Non-controlling interest		**8**	4
Total equity		**4,021**	4,348

These financial statements have been approved for issue by the Board of Directors on 14 March 2018 and signed on its behalf by

Coram Williams
Chief Financial Officer

Consolidated statement of changes in equity

Year ended 31 December 2017

All figures in £ millions	Share capital	Share premium	Treasury shares	Capital redemption reserve	Fair value reserve	Translation reserve	Retained earnings	Total	Non-controlling interest	Total equity
	Equity attributable to equity holders of the company									
At 1 January 2017	205	2,597	(79)	–	–	905	716	4,344	4	4,348
Profit for the year	–	–	–	–	–	–	406	406	2	408
Other comprehensive income/(expense)	–	–	–	–	13	(313)	145	(155)	–	(155)
Total comprehensive income/(expense)	–	–	–	–	13	(313)	551	251	2	253
Equity-settled transactions	–	–	–	–	–	–	33	33	–	33
Issue of ordinary shares under share option schemes	–	5	–	–	–	–	–	5	–	5
Buyback of equity	(5)	–	–	5	–	–	(300)	(300)	–	(300)
Purchase of treasury shares	–	–	–	–	–	–	–	–	–	–
Release of treasury shares	–	–	18	–	–	–	(18)	–	–	–
Changes in non-controlling interest	–	–	–	–	–	–	(2)	(2)	2	–
Dividends	–	–	–	–	–	–	(318)	(318)	–	(318)
At 31 December 2017	200	2,602	(61)	5	13	592	662	4,013	8	4,021

All figures in £ millions	Share capital	Share premium	Treasury shares	Capital redemption reserve	Fair value reserve	Translation reserve	Retained earnings	Total	Non-controlling interest	Total equity
	Equity attributable to equity holders of the company									
At 1 January 2016	205	2,590	(72)	–	–	(7)	3,698	6,414	4	6,418
Loss for the year	–	–	–	–	–	–	(2,337)	(2,337)	2	(2,335)
Other comprehensive income/(expense)	–	–	–	–	–	912	(223)	689	1	690
Total comprehensive income/(expense)	–	–	–	–	–	912	(2,560)	(1,648)	3	(1,645)
Equity-settled transactions	–	–	–	–	–	–	22	22	–	22
Issue of ordinary shares under share option schemes	–	7	–	–	–	–	–	7	–	7
Buyback of equity	–	–	–	–	–	–	–	–	–	–
Purchase of treasury shares	–	–	(27)	–	–	–	–	(27)	–	(27)
Release of treasury shares	–	–	20	–	–	–	(20)	–	–	–
Changes in non-controlling interest	–	–	–	–	–	–	–	–	(3)	(3)
Dividends	–	–	–	–	–	–	(424)	(424)	–	(424)
At 31 December 2016	205	2,597	(79)	–	–	905	716	4,344	4	4,348

The capital redemption reserve reflects the nominal value of shares cancelled in the Group's share buyback programme. The fair value reserve arises on revaluation of other financial assets. 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 2017

All figures in £ millions	Notes	2017	2016
Cash flows from operating activities			
Net cash generated from operations	33	**462**	522
Interest paid		**(89)**	(67)
Tax paid		**(75)**	(45)
Net cash generated from operating activities		**298**	410
Cash flows from investing activities			
Acquisition of subsidiaries, net of cash acquired	30	**(11)**	(15)
Purchase of investments		**(3)**	(6)
Purchase of property, plant and equipment		**(82)**	(88)
Purchase of intangible assets		**(150)**	(157)
Disposal of subsidiaries, net of cash disposed	31	**19**	(54)
Proceeds from sale of associates	31	**411**	4
Proceeds from sale of investments		**–**	92
Proceeds from sale of property, plant and equipment	33	**–**	4
Proceeds from sale of liquid resources		**20**	42
Loans (advanced)/repaid by related parties		**(13)**	14
Investment in liquid resources		**(18)**	(24)
Interest received		**20**	16
Dividends received from joint ventures and associates		**458**	131
Net cash generated from/(used in) investing activities		**651**	(41)
Cash flows from financing activities			
Proceeds from issue of ordinary shares	27	**5**	7
Buyback of equity	27	**(149)**	–
Purchase of treasury shares	28	**–**	(27)
Proceeds from borrowings		**2**	4
Repayment of borrowings		**(1,294)**	(249)
Finance lease principal payments		**(5)**	(6)
Transactions with non-controlling interest		**–**	(2)
Dividends paid to company's shareholders	9	**(318)**	(424)
Net cash used in financing activities		**(1,759)**	(697)
Effects of exchange rate changes on cash and cash equivalents		**16**	81
Net decrease in cash and cash equivalents		**(794)**	(247)
Cash and cash equivalents at beginning of year		**1,424**	1,671
Cash and cash equivalents at end of year	17	**630**	1,424

Notes to the consolidated financial statements

General information

Pearson plc (the company), its subsidiaries and associates (together the Group) are international businesses covering educational courseware, assessments and services, and consumer publishing through its associate interest in Penguin Random House.

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 14 March 2018.

1. Accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below.

a. Basis of preparation

These consolidated financial statements have been prepared on the going concern basis and in accordance with International Financial Reporting Standards (IFRS) and IFRS Interpretations Committee (IFRS IC) 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) at fair value through profit or loss.

1. Interpretations and amendments to published standards effective 2017 The following amendments and interpretations were adopted in 2017:

- Amendments to IFRS 12 Disclosure of Interests in Other Entities – Annual Improvements 2014-2016 cycle
- Amendments to IAS 7 Statement of Cash Flows – Disclosure Initiative
- Amendments to IAS 12 Income Taxes – Recognition of Deferred Tax Assets for Unrealised Losses

The adoption of these new pronouncements from 1 January 2017 does not have a material impact on the consolidated financial statements. Additional disclosure has been given where relevant.

2. Standards, interpretations and amendments to published standards that are not yet effective New accounting standards and interpretations have been published that are not mandatory for the year ended 31 December 2017. The Group has elected not to early-adopt these new standards and interpretations. The Group's assessment of the impact of these new standards is set out below.

IFRS 9 'Financial Instruments', effective for annual reporting periods beginning on or after 1 January 2018. The standard, which replaces IAS 39 'Financial Instruments: Recognition and Measurement', addresses the classification, measurement and derecognition of financial assets and financial liabilities, introduces new hedge accounting rules and a new impairment model for financial assets. The Group will adopt IFRS 9 as at 1 January 2018 and apply the new rules retrospectively, with the practical expedients permitted in the standard. Comparatives for 2017 will not be restated. The Group has assessed the impact of adopting IFRS 9 and is expecting the following impact:

Classification and measurement The Group has reviewed its financial assets and liabilities and does not expect any changes in classification or measurement as a result of adopting IFRS 9. Trade receivables will continue to be measured at amortised cost as they are held to collect contractual cash flows which represent solely payments of principal and interest, in accordance with the business model. There will be no impact on classification and measurement of financial liabilities as the new requirements only affect the accounting for financial liabilities which are designated at fair value through the profit and loss account, and the Group does not have any such liabilities. Derivative assets and liabilities will continue to be recognised at fair value with movements recognised in finance income or costs, unless the hedging strategy determines otherwise. The Group's equity financial investments will continue to be recognised at fair value and the Group has elected the option to recognise all movements in fair value in other comprehensive income (FVOCI). Gains or losses realised on the subsequent sale of these financial assets will no longer be recycled through the profit and loss account, but instead reclassified from the FVOCI reserve to retained earnings. During 2017, £nil of such gains/losses were recycled to the profit and loss account in relation to the disposal of available-for-sale assets.

Impairment IFRS 9 introduces a new impairment model which requires the recognition of impairment provisions based on expected credit losses rather than only incurred credit losses, as is the case under IAS 39. The Group expects this new impairment model will lead to a small increase in its provision for losses against trade debtors, representing anticipated losses (evidenced by both historical recovery rates and forward-looking indicators) where there has been no triggering event to suggest any impairment incurred to date. The Group expects its provision for losses against trade debtors as at 1 January 2018 to increase by an amount approximating 1% of gross trade debtors as a result of adopting the expected credit loss model for impairments. The Group does not anticipate the expected credit loss model having a material impact on profit before tax for 2018 unless market conditions or other factors change the outlook for credit losses.

Hedge accounting IFRS 9 introduces a new, simpler hedge accounting model with a principles-based approach designed to align the accounting result with the economic hedging strategy. The group currently uses fair value hedge relationships to hedge interest rate risk and currency risk on its bond borrowings and also uses net investment hedging relationships to hedge currency re-translation risk on its overseas assets. The Group has confirmed that its current hedge relationships will continue to qualify as hedges upon the adoption of IFRS 9. The Group does not currently undertake any cash flow hedging, but is reviewing its strategy with regard to currency risk. Should the Group decide to expand its hedging strategy in this area, changes in fair value relating to forward points or currency basis may, subject to hedge designation, be deferred in a cost of hedging reserve and recognised against the related hedge transaction when it occurs.

Notes to the consolidated financial statements

1. Accounting policies continued

a. Basis of preparation continued

IFRS 9 also requires additional disclosure which will be incorporated in the 2018 annual report.

IFRS 15 'Revenue from Contracts with Customers', effective for annual reporting periods beginning on or after 1 January 2018. The standard, which replaces IAS 18 covering contracts for goods and services, and IAS 11 covering construction contracts, addresses the recognition of revenue. The new standard is based on the principle that revenue is recognised to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the Group expects to be entitled in exchange for those goods or services. The Group will adopt the new standard as at 1 January 2018 and apply the modified retrospective approach. Comparatives for 2017 will not be restated and the cumulative impact of adoption will be recognised in retained earnings as at 1 January 2018.

The Group has reviewed the impact of adopting IFRS 15 across its various geographies and lines of business, with reference to underlying contractual terms and business practices, and has identified four areas of impact, as follows:

Unexercised customer rights (or breakage) The Group sells rights to future performance to customers which may go unexercised. While the customer has paid for future performance, usage is at the customer's discretion and those rights may expire prior to usage, or never be used. The Group maintains historical customer data to understand usage patterns over time (i.e. redemption rates). Where the Group expects to have no future obligation (based on these redemption rates), revenue has historically been recognised immediately for this portion of the sale. Under IFRS 15, where the Group currently recognises this breakage element on subscriptions, revenue instead will be recognised evenly over the period of use. Where breakage relates to sales of tests or vouchers, revenue will be recognised when the underlying tests are delivered. This revised treatment in respect of breakage primarily affects the school and higher education businesses in North America and will result in higher deferred revenue upon adoption on 1 January 2018.

Online Program Management (OPM) marketing Historically the OPM (Embanet) business recognised revenue for the pre-semester costs of marketing and recruitment as a separate performance obligation from course delivery during the semester (i.e. revenue was recognised in line with the marketing costs incurred). Under IFRS 15, revenue will be recognised on a straight-line basis over the semester with no revenue recognised up front for pre-semester recruitment and marketing costs based on management's judgement under the new standard's requirements assessing the start of the Group's contract and determining the Group's performance obligations. This revised treatment of pre-semester costs only affects the OPM business in North America and will result in a lower trade receivable balance upon adoption on 1 January 2018.

Administration fees This relates to non-refundable upfront administration fees charged to customers which do not relate to the transfer of a promised good or service to the customer. Rather these fees are charged to cover internal costs, such as registration fees for testing candidate exams. Historically administration fees have been recognised in revenue up front when charged. Under IFRS 15, such fees must be deferred and recognised over the period over which services are provided as they do not relate to a specific performance obligation. This revised treatment primarily affects the UK Assessments business and will result in higher deferred revenue upon adoption on 1 January 2018.

Commissions This relates to incremental costs of obtaining customer contracts, such as sales incentive plans or sales commissions specifically linked to obtaining new contracts. Historically such commissions have been charged to the profit and loss account as incurred. Under IFRS 15, sales commissions in respect of customer transactions with an accounting period of greater than one year will be capitalised and amortised over that accounting period, using practical expedients permissible under the new standard. This revised treatment affects the US Assessments business and will result in a higher contract asset upon adoption on 1 January 2018.

IFRS 15 also requires increased disclosure, in particular analysis of disaggregated revenues, contract balances and transaction price allocated to remaining performance obligations. This disclosure will be incorporated in the 2018 annual report.

Had the Group been applying IFRS 15 during 2017, both sales and profit before tax would have been around £2m higher, with the balance sheet impact at the beginning and end of the year being similar. The impact on sales and profit before tax for 2018 is not expected to be materially different to 2017, assuming a like-for-like business portfolio. The cumulative pre-tax impact of adopting IFRS 15 on 1 January 2018 is expected to reduce retained earnings by around £143m, with deferred revenue increasing by £106m, trade receivables reducing by £38m and contract assets increasing by £1m.

IFRS 16 'Leases', effective for annual reporting periods beginning on or after 1 January 2019. Early adoption is permitted. The new standard replaces IAS 17 'Leases' and related interpretations and details the requirements for the classification, measurement and recognition of lease arrangements. Adoption of the new standard is likely to have a material impact on the Group. Management continues to assess this impact but cannot reasonably estimate this impact due to judgements which are required to be made for each lease and the adoption methods available. The actual impact of applying IFRS 16 will depend on the composition of the Group's lease portfolio at the adoption date and the extent to which the Group chooses to use practical expedients and recognition exemptions. The Group plans to apply IFRS 16 on 1 January 2019, and anticipates using the modified retrospective approach. Under this approach, the cumulative effect of adopting IFRS 16 will be recognised as an adjustment to the opening balance of retained earnings on 1 January 2019, with no restatement of comparative information.

Notes to the consolidated financial statements

1. Accounting policies continued

a. Basis of preparation continued

Although the Group has not completed its detailed assessment, the following changes to lessee accounting are likely to have a material impact:

- Currently no lease assets are included on the Group's consolidated balance sheet for operating leases. Under IFRS 16 right-of-use assets will be recorded on the balance sheet for assets that are leased by the Group
- Currently no lease liabilities are included on the Group's consolidated balance sheet for future operating lease payments; these are disclosed as commitments. Under IFRS 16 liabilities will be recorded for future lease payments. As at 31 December 2017, the Group's future aggregate minimum lease payments under non-cancellable operating leases amounted to £1,201m, on an undiscounted basis (see note 35)
- Currently operating lease rentals, net of any incentives received, are expensed to the income statement on a straight-line basis over the period of the lease. Under IFRS 16 the lease expense will represent the depreciation of the right-of-use asset together with interest charged on lease liabilities
- Currently operating lease cash flows are included within operating cash flows in the Group's consolidated cash flow statement. Under IFRS 16 these cash flows will be recorded as cash flows from financing activities being the repayment of lease liabilities and related interest

Lessor accounting under IFRS 16 is similar to IAS 17 accounting and is not expected to have a material impact on the Group.

In June 2015, the IASB issued an exposure draft ED/2015/5 'Remeasurement on a Plan Amendment, Curtailment or Settlement/ Availability of a Refund from a Defined benefit Plan (Proposed Amendments to IAS 19 and IFRIC 14)'. The proposed amendments to IFRIC 14, which may have restricted the Group's ability to recognise a pension asset in respect of pension surpluses in its UK defined benefit plan, have now been withdrawn.

A number of other new standards and amendments to standards and interpretations are effective for annual periods beginning after 1 January 2017, and have not been applied in preparing these financial statements. None of these is expected to have a material impact on the consolidated financial statements.

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 and in the notes to the accounts where appropriate:

Consolidation: Business combinations – classification of investments (see note 1b(1))
Intangible assets: Goodwill (see note 1e(1))
Intangible assets: Pre-publication assets (see note 1e(5))
Taxation (see note 1m)
Revenue recognition including provisions for returns (see note 1p)
Employee benefits: Pensions (see note 1n(1))
Consolidation: Business combinations – determination of fair values (where relevant) (see note 1b(1))

b. Consolidation

1. Business combinations The acquisition method of accounting is used to account for business combinations.

The consideration transferred for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interest issued by the Group. The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition-related costs are expensed as incurred in the operating expenses line of the income statement. Identifiable assets acquired and identifiable liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The determination of fair values often requires significant judgements and the use of estimates, and, for material acquisitions, the fair value of the acquired intangible assets is determined by an independent valuer. The excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition date fair value of any previous equity interest in the acquiree over the fair value of the identifiable net assets acquired is recorded as goodwill (see note 30).

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.

IFRS 3 'Business Combinations' has not been applied retrospectively to business combinations before the date of transition to IFRS.

Management exercises judgement in determining the classification of its investments in its businesses, in line with the following:

2. Subsidiaries Subsidiaries are entities over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date that control ceases.

3. Transactions with non-controlling interests Transactions with non-controlling interests that do not result in loss of control are accounted for as equity transactions, that is, as transactions with the owners in their capacity as owners. Any surplus or deficit arising from disposals to a non-controlling interest is recorded in equity. For purchases from a non-controlling interest, the difference between consideration paid and the relevant share acquired of the carrying value of the subsidiary is recorded in equity.

Notes to the consolidated financial statements

1. Accounting policies continued

b. Consolidation continued

4. Joint ventures and associates Joint ventures are entities in which the Group holds an interest on a long-term basis and has rights to the net assets through contractually agreed sharing of control. Associates are entities over which the Group has significant influence but not the power to control the financial and operating policies, generally accompanying a shareholding of between 20% and 50% of the voting rights. Ownership percentage is likely to be the key indicator of investment classification; however, other factors, such as Board representation, may also affect the accounting classification. Judgement is required to assess all of the qualitative and quantitative factors which may indicate that the Group does, or does not, have significant influence over an investment. Penguin Random House is the Group's only material associate – see note 12 for further details on the judgements involved in its accounting classification. Investments in joint ventures and associates are accounted for by the equity method and are initially recognised at the fair value of consideration transferred.

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.

5. Contribution of a subsidiary to an associate or joint venture The gain or loss resulting from the contribution or sale of a subsidiary to an associate or a joint venture is recognised in full. Where such transactions do not involve cash consideration, significant judgements and estimates are used in determining the fair values of the consideration received.

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 $1.30 (2016: $1.33) and the year-end rate was $1.35 (2016: $1.23).

d. Property, plant and equipment

Property, plant and equipment are stated at historical cost less depreciation. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for intended use. Land is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate their cost less their residual values over their estimated useful lives as follows:

Buildings (freehold):	20–50 years
Buildings (leasehold):	over the period of the lease
Plant and equipment:	3–10 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

The carrying value of an asset is written down to its recoverable amount if the carrying value of the asset is greater than its estimated recoverable amount.

e. Intangible assets

1. Goodwill For the acquisition of subsidiaries made on or after 1 January 2010, goodwill represents the excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition date fair value of any previous equity interest in the acquiree over the fair value of the identifiable net assets acquired. For the acquisition of subsidiaries made from the date of transition to IFRS to 31 December 2009, goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets acquired. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisition of associates and joint ventures represents the excess of the cost of 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.

Notes to the consolidated financial statements

1. Accounting policies continued

e. Intangible assets continued

Goodwill is tested at least 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 of disposal and value in use. These calculations require the use of estimates in respect of forecast cash flows and discount rates and significant management judgement in respect of CGU and cost allocation. A description of the key assumptions and sensitivities is included in note 11. Goodwill is allocated to aggregated cash-generating units for the purpose of impairment testing. The allocation is made to those aggregated cash-generating units that are expected to benefit from the business combination in which the goodwill arose.

Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

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, contracts and relationships, trademarks and brands, publishing rights, content, technology and software rights. 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 lifecycle 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 involve a significant degree of judgement based on historical trends and management estimation of future potential sales. An incorrect amortisation profile could result in excess amounts being carried forward as intangible assets that would otherwise have been written off to the income statement in an earlier period.

Reviews are performed regularly to estimate recoverability of pre-publication assets. The carrying amount of pre-publication assets is set out in note 20.

f. Other financial assets

Other financial assets, designated as available for sale investments, are non-derivative financial assets measured at estimated fair value. Changes in the fair value are recorded in equity in the fair value reserve. On the subsequent disposal of the asset, the net fair value gains or losses are taken to the income statement.

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.

Notes to the consolidated financial statements

1. Accounting policies continued

i. Cash and cash equivalents

Cash and cash equivalents in the cash flow statement include cash in hand, deposits held on call with banks, other short-term highly liquid investments with original maturities of three months or less, and bank overdrafts. Bank overdrafts are included in borrowings in current liabilities in the balance sheet.

Short-term deposits and marketable securities with maturities of greater than three months do not qualify as cash and cash equivalents and are reported as financial assets. Movements on these financial assets are classified as cash flows from financing activities in the cash flow statement where these amounts are used to offset the borrowings of the Group or as cash flows from investing activities where these amounts are held to generate an investment return.

j. Share capital

Ordinary shares are classified as equity.

Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

Where any Group company purchases the company's equity share capital (treasury shares), the consideration paid, including any directly attributable incremental costs, net of income taxes, is deducted from equity attributable to the company's equity holders until the shares are cancelled, reissued or disposed of. Where such shares are subsequently sold or reissued, any consideration received, net of any directly attributable transaction costs and the related income tax effects, is included in equity attributable to the company's equity holders.

Ordinary shares purchased under a buyback programme are cancelled and the nominal value of the shares is transferred to a capital redemption reserve.

k. Borrowings

Borrowings are recognised initially at fair value, which is proceeds received net of transaction costs incurred. Borrowings are subsequently stated at amortised cost with any difference between the proceeds (net of transaction costs) and the redemption value being recognised in the income statement over the period of the borrowings using the effective interest method. Accrued interest is included as part of borrowings. Where a debt instrument is in a fair value hedging relationship, an adjustment is made to its carrying value in the income statement to reflect the hedged risk.

l. Derivative financial instruments

Derivatives are recognised at fair value and remeasured at each balance sheet date. The fair value of derivatives is determined by using market data and the use of established estimation techniques such as discounted cash flow and option valuation models.

Changes in the fair value of derivatives are recognised immediately in finance income or costs. However, derivatives relating to borrowings and certain foreign exchange contracts are designated as part of a hedging transaction. The accounting treatment is summarised as follows:

Typical reason for designation	Reporting of gains and losses on effective portion of the hedge	Reporting of gains and losses on disposal
Net investment hedge		
The derivative creates a foreign currency liability which is used to hedge changes in the value of a subsidiary which transacts in that currency.	Recognised in other comprehensive income.	On disposal, the accumulated value of gains and losses reported in other comprehensive income is transferred to the income statement.
Fair value hedges		
The derivative transforms the interest profile on debt from fixed rate to floating rate. Changes in the value of the debt as a result of changes in interest rates are offset by equal and opposite changes in the value of the derivative. When the Group's debt is swapped to floating rates, the contracts used are designated as fair value hedges.	Gains and losses on the derivative are reported in finance income or finance costs. However, an equal and opposite change is made to the carrying value of the debt (a 'fair value adjustment') with the benefit/cost reported in finance income or finance costs. The net result should be a zero charge on a perfectly effective hedge.	If the debt and derivative are disposed of, the value of the derivative and the debt (including the fair value adjustment) are reset to zero. Any resultant gain or loss is recognised in finance income or finance costs.
Non-hedge accounted contracts		
These are not designated as hedging instruments. Typically these are short-term contracts to convert debt back to fixed rates or foreign exchange contracts where a natural offset exists.	No hedge accounting applies.	

m. Taxation

Current tax is recognised at 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 balance sheet 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, associates and joint ventures other than where it is intended that those undistributed earnings will not be remitted in the foreseeable future.

Notes to the consolidated financial statements

1. Accounting policies continued

m. Taxation continued

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 tax provisions when it is considered probable that there will be a future outflow of funds to a tax authority. The provisions are based on management's best judgement of the application of tax legislation and best estimates of future settlement amounts (see note 7). 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 (see note 13).

n. Employee benefits

1. Pensions 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.

When the calculation results in a potential asset, the recognition of that asset is limited to the asset ceiling – that is the present value of any economic benefits available in the form of refunds from the plan or a reduction in future contributions. Management uses judgement to determine the level of refunds available from the plan in recognising an asset.

The determination of the pension cost and defined benefit obligation of the Group's defined benefit pension schemes depends on the selection of certain assumptions, which include the discount rate, inflation rate, salary growth and longevity (see note 25).

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to equity in other comprehensive income in the period in which they arise.

The service cost, representing benefits accruing over the year, is included in the income statement as an operating cost. Net interest is calculated by applying the discount rate to the net defined benefit obligation and is presented as finance costs or finance income.

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 medical and life assurance benefits are accrued over the period of employment, using a similar accounting methodology as for defined benefit pension obligations. The liabilities and costs relating to significant other post-retirement obligations are assessed annually by independent qualified actuaries.

3. Share-based payments The fair value of options or shares granted under the Group's share and option plans is recognised as an employee expense after taking into account the Group's best estimate of the number of awards expected to vest. Fair value is measured at the date of grant and is spread over the vesting period of the option or share. The fair value of the options granted is measured using an option model that is most appropriate to the award. The fair value of shares awarded is measured using the share price at the date of grant unless another method is more appropriate. Any proceeds received are credited to share capital and share premium when the options are exercised.

o. Provisions Provisions are recognised if the Group has a present legal or constructive obligation as a result of past events, it is more likely than not that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated. Provisions are discounted to present value where the effect is material.

The Group recognises a provision for deferred consideration. Where this is contingent on future performance or a future event, judgement is exercised in establishing the fair value.

The Group recognises a provision for onerous lease contracts when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under the contract.

The provision is based on the present value of future payments for surplus leased properties under non-cancellable operating leases, net of estimated sub-leasing income.

p. Revenue recognition

The Group's revenue streams are courseware, assessments and services. Courseware includes curriculum materials provided in book form and/or via access to digital content. Assessments includes test development, processing and scoring services provided to governments, educational institutions, corporations and professional bodies. Services includes the operation of schools, colleges and universities, including sistemas in Brazil and English language teaching centres around the world as well as the provision of online learning services in partnership with universities and other academic institutions.

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.

Notes to the consolidated financial statements

1. Accounting policies continued

p. Revenue recognition continued

Revenue from the sale of books is recognised when title passes. A provision for anticipated returns is made based primarily on historical return rates, customer buying patterns and retailer behaviours including stock levels (see note 22). If these estimates do not reflect actual returns in future periods then revenues could be understated or overstated for a particular period.

Revenue from the sale of off-the-shelf software is recognised on delivery or on installation of the software where that is a condition of the contract. In certain circumstances, where installation is complex, revenue is recognised when the customer has completed their acceptance procedures. Where software is provided under a term licence, revenue is recognised on a straight-line basis over the period of the licence.

Revenue from the provision of services to academic institutions, such as programme development, student acquisition, education technology and student support services, is recognised as performance occurs. 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 to 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. Percentage of completion is calculated on a cost basis using the proportion of the total estimated costs incurred to date. 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.

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 or online access with textbooks and multiple deliverables within testing or service contracts, revenue is recognised for each element as if it were an individual contractual arrangement. This requires judgement regarding the identification of the individual elements as well as the estimation of its relative fair value.

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.

q. Leases

Leases of property, plant and equipment where the Group has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalised at the commencement of the lease at the lower of the fair value of the leased property and the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges to achieve a constant rate on the finance balance outstanding. The corresponding rental obligations, net of finance charges, are included in financial liabilities – borrowings. The interest element of the finance cost is charged to the income statement over the lease period to produce a constant periodic rate of interest on the remaining balance of the liability for each period. The property, plant and equipment acquired under finance leases are depreciated over the shorter of the useful life of the asset or the lease term.

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases by the lessee. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

r. Dividends

Final 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 when paid.

s. Discontinued operations

A discontinued operation is a component of the Group's business that represents a separate major line of business or geographical area of operations that has been disposed of or meets the criteria to be classified as held for sale.

Discontinued operations are presented in the income statement as a separate line and are shown net of tax.

t. 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 highly probable that the carrying amount will be recovered 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 1p).

Notes to the consolidated financial statements

2. Segment information

The primary segments for management and reporting are geographies as outlined below. In addition, the Group separately discloses the results from the Penguin Random House associate.

The chief operating decision-maker is the Pearson executive.

North America Courseware, Assessments and Services businesses in the US and Canada.

Core Courseware, Assessments and Services businesses in more mature markets including UK, Australia and Italy.

Growth Courseware, Assessments and Services businesses in emerging markets including Brazil, China, India and South Africa.

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

							2017
All figures in £ millions	**Notes**	**North America**	**Core**	**Growth**	**Penguin Random House**	**Corporate**	**Group**
Sales		2,929	815	769	–	–	4,513
Adjusted operating profit		394	50	38	94	–	576
Cost of major restructuring		(60)	(11)	(8)	–	–	(79)
Intangible charges		(89)	(12)	(37)	(28)	–	(166)
Other net gains and losses		(3)	–	35	96	–	128
Impact of US tax reform		–	–	–	(8)	–	(8)
Operating profit		242	27	28	154	–	451
Finance costs	6						(110)
Finance income	6						80
Profit before tax							421
Income tax	7						(13)
Profit for the year							408
Segment assets		4,116	1,914	667	–	793	7,490
Joint ventures	12	–	–	3	–	–	3
Associates	12	4	3	–	388	–	395
Total assets		4,120	1,917	670	388	793	7,888
Other segment items							
Share of results of joint ventures and associates	12	5	1	1	71	–	78
Capital expenditure	10, 11	162	35	43	–	–	240
Pre-publication investment	20	218	84	59	–	–	361
Depreciation	10	56	13	21	–	–	90
Amortisation	11, 20	348	103	110	–	–	561
Impairment	11	–	–	–	–	–	–

Notes to the consolidated financial statements

2. Segment information continued

All figures in £ millions	Notes	North America	Core	Growth	Penguin Random House	Corporate	Group
							2016
Sales		2,981	803	768	–	–	4,552
Adjusted operating profit		420	57	29	129	–	635
Cost of major restructuring		(172)	(62)	(95)	(9)	–	(338)
Intangible charges		(2,684)	(16)	(33)	(36)	–	(2,769)
Other net gains and losses		(12)	(12)	(1)	–	–	(25)
Operating (loss)/profit		(2,448)	(33)	(100)	84	–	(2,497)
Finance costs	6						(97)
Finance income	6						37
Loss before tax							(2,557)
Income tax	7						222
Loss for the year							(2,335)
Segment assets		4,859	1,461	859	–	1,640	8,819
Joint ventures	12	–	–	2	–	–	2
Associates	12	1	4	–	1,240	–	1,245
Total assets		4,860	1,465	861	1,240	1,640	10,066
Other segment items							
Share of results of joint ventures and associates	12	(1)	1	(1)	98	–	97
Capital expenditure	10, 11	153	42	51	–	–	246
Pre-publication investment	20	235	92	68	–	–	395
Depreciation	10	56	12	27	–	–	95
Amortisation	11, 20	394	109	116	–	–	619
Impairment	11	2,548	–	–	–	–	2,548

There were no material inter-segment sales in either 2017 or 2016.

For additional detailed information on the calculation of adjusted operating profit as shown in the above tables, see p192-195 (Financial key performance indicators).

Adjusted operating profit is shown in the above tables as it is the key financial measure used by management to evaluate the performance of the Group and allocate resources to business segments. The measure also enables investors to more easily, and consistently, track the underlying operational performance of the Group and its business segments by separating out those items of income and expenditure relating to acquisition and disposal transactions and major restructuring programmes.

Cost of major restructuring In January 2016, the Group announced that it was embarking on a restructuring programme to simplify the business, reduce costs and position the Group for growth in its major markets. The costs of this programme of £338m in 2016 were significant enough to exclude from the adjusted operating profit measure so as to better highlight the underlying performance. These costs included costs associated with headcount reductions, property rationalisation and closure or exit from certain systems, platforms, products and supplier and customer relationships. A new programme of restructuring, announced in May 2017, to run between 2017 and 2019, began in the second half of 2017 and is expected to drive further significant cost savings. Costs incurred to date relating to this new programme were £79m at the end of 2017 and related to cost efficiencies in higher education and enabling functions together with further rationalisation of the property portfolio. The costs of this new programme have also been excluded from adjusted operating profit (see note 3).

Intangible charges These represent charges in respect of goodwill, including impairment, and intangible assets acquired through business combinations and the direct costs of acquiring those businesses. These charges are excluded as they reflect past acquisition activity and do not necessarily reflect the current year performance of the Group. In 2016, intangible charges included an impairment of goodwill in the Group's North America business of £2,548m (see note 11). There was no impairment in 2017.

Other net gains and losses These represent profits and losses on the sale of subsidiaries, joint ventures, associates and other financial assets and are excluded from adjusted operating profit as they distort the performance of the Group as reported on a statutory basis. Other net gains of £128m in 2017 largely relate to the sale of the test preparation business in China which resulted in a profit on sale of £44m and the part sale of the Group's share in Penguin Random House which resulted in a profit of £96m (see note 31). In 2016, the net losses in the Core segment mainly relate to the closure of the Group's English language schools in Germany and in the North America segment relate to the sale of the Pearson English Business Solutions business.

Notes to the consolidated financial statements

2. Segment information continued

Impact of US tax reform In 2017, as a result of US tax reform, the Group's share of profit from associates was adversely impacted by £8m. This amount has been excluded from adjusted operating profit as it is considered to be a transition adjustment that is not expected to recur in the near future.

Corporate costs are allocated to business segments on an appropriate basis depending on the nature of the cost and therefore the total segment result is equal to the Group operating profit.

Segment assets, excluding corporate 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 £nil (2016: £10m) (see note 30).

The following tables analyse the Group's revenue streams. Courseware includes curriculum materials provided in book form and/or via access to digital content. Assessments includes test development, processing and scoring services provided to governments, educational institutions, corporations and professional bodies. Services includes the operation of schools, colleges and universities, including sistemas in Brazil and English language teaching centres around the world as well as the provision of online learning services in partnership with universities and other academic institutions.

				2017
All figures in £ millions	**North America**	**Core**	**Growth**	**Group**
Sales:				
Courseware				
School Courseware	394	171	139	704
Higher Education Courseware	1,146	93	63	1,302
English Courseware	20	60	102	182
	1,560	324	304	2,188
Assessments				
School and Higher Education Assessments	355	256	23	634
Clinical Assessments	146	46	–	192
Professional and English Certification	341	138	60	539
	842	440	83	1,365
Services				
School Services	274	5	54	333
Higher Education Services	253	34	32	319
English Services	–	12	296	308
	527	51	382	960
Total	2,929	815	769	4,513

Notes to the consolidated financial statements

2. Segment information continued

All figures in £ millions	North America	Core	Growth	Group
				2016
Sales:				
Courseware				
School Courseware	418	173	127	718
Higher Education Courseware	1,147	92	60	1,299
English Courseware	21	65	97	183
	1,586	330	284	2,200
Assessments				
School and Higher Education Assessments	378	268	21	667
Clinical Assessments	143	40	–	183
Professional and English Certification	333	112	49	494
	854	420	70	1,344
Services				
School Services	259	6	54	319
Higher Education Services	269	29	46	344
English Services	13	18	314	345
	541	53	414	1,008
Total	2,981	803	768	4,552

The Group operates in the following main geographic areas:

	Sales		Non-current assets	
All figures in £ millions	2017	2016	2017	2016
UK	**384**	393	**796**	946
Other European countries	**262**	255	**128**	134
US	**2,770**	2,829	**2,247**	3,351
Canada	**126**	118	**240**	268
Asia Pacific	**643**	632	**151**	205
Other countries	**328**	325	**184**	232
Total	**4,513**	4,552	**3,746**	5,136

Sales are allocated based on the country in which the customer is located. This does not differ materially from the location where the order is received. The geographical split of non-current assets is based on the subsidiary's country of domicile. This is not materially different to the location of the assets. Non-current assets comprise property, plant and equipment, intangible assets, investments in joint ventures and associates and trade and other receivables.

Notes to the consolidated financial statements

3. Restructuring costs

An analysis of restructuring costs is as follows:

All figures in £ millions	2017	2016
By nature:		
Product costs	**15**	32
Employee costs	**11**	139
Depreciation and amortisation	**13**	29
Property and facilities	**24**	43
Technology and communications	**2**	7
Professional and outsourced services	**12**	31
General and administrative costs	**2**	48
Total restructuring – operating expenses	**79**	329
Share of associate restructuring	**–**	9
Total	**79**	338

In January 2016, the Group announced that it was embarking on a restructuring programme to simplify the business, reduce costs and position the Group for growth in its major markets. The costs of this programme in 2016 were significant enough to exclude from the adjusted operating profit measure so as to better highlight the underlying performance (see note 8). A new programme of restructuring, the 2017-2019 restructuring programme announced in May 2017, began in the second half of 2017 and is expected to drive further significant cost savings. The costs of this new programme have also been excluded from adjusted operating profit.

4. Operating expenses

All figures in £ millions	Notes	2017	2016
By function:			
Cost of goods sold		**2,066**	2,093
Operating expenses			
Distribution costs		**84**	88
Selling, marketing and product development costs		**896**	908
Administrative and other expenses		**1,207**	1,240
Restructuring costs	3	**79**	329
Other income		**(64)**	(85)
Total net operating expenses		**2,202**	2,480
Other net gains and losses		**(128)**	25
Impairment of intangible assets	11	**–**	2,548
Total		**4,140**	7,146

Included in other income is service fee income from Penguin Random House of £3m (2016: £4m). Included in administrative and other expenses are research and efficacy costs of £14m (2016: £23m). In addition to the restructuring costs shown above, there were restructuring costs in Penguin Random House of £nil (2016: £9m).

Notes to the consolidated financial statements

4. Operating expenses continued

All figures in £ millions	Notes	2017	2016
By nature:			
Royalties expensed		**246**	264
Other product costs		**564**	616
Employee benefit expense	5	**1,805**	1,888
Contract labour		**152**	206
Employee-related expense		**127**	122
Promotional costs		**229**	217
Depreciation of property, plant and equipment	10	**90**	95
Amortisation of intangible assets – pre-publication	20	**338**	350
Amortisation of intangible assets – software	11	**85**	84
Amortisation of intangible assets – other	11	**138**	185
Impairment of intangible assets	11	**–**	2,548
Property and facilities		**202**	243
Technology and communications		**218**	188
Professional and outsourced services		**322**	378
Other general and administrative costs		**140**	140
Costs capitalised to intangible assets		**(324)**	(318)
Other net gains and losses		**(128)**	25
Other income		**(64)**	(85)
Total		**4,140**	7,146

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

All figures in £ millions	2017	2016
The audit of parent company and consolidated financial statements	**4**	5
The audit of the company's subsidiaries	**2**	2
Total audit fees	**6**	7
Other assurance services	**1**	1
Other non-audit services	**1**	1
Total other services	**2**	2
Total non-audit services	**2**	2
Total	**8**	9

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

All figures in £ millions	2017	2016
Group audit fees including fees for attestation under section 404 of the Sarbanes-Oxley Act	**6**	7
Non-audit fees	**2**	2
Total	**8**	9

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

Included in non-audit fees are amounts related to carve-out audits for disposals of £1m (2016: £1m).

Notes to the consolidated financial statements

5. Employee information

All figures in £ millions	Notes	2017	2016
Employee benefit expense			
Wages and salaries (including termination costs)		**1,567**	1,661
Social security costs		**130**	124
Share-based payment costs	26	**33**	22
Retirement benefits – defined contribution plans	25	**57**	67
Retirement benefits – defined benefit plans	25	**19**	16
Other post-retirement medical benefits	25	**(1)**	(2)
Total		**1,805**	1,888

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

Average number employed	2017	2016
Employee numbers		
North America	**16,295**	16,841
Core	**5,291**	5,664
Growth	**8,268**	9,868
Other	**485**	346
Total	**30,339**	32,719

6. Net finance costs

All figures in £ millions	Notes	2017	2016
Interest payable		**(99)**	(74)
Net foreign exchange losses		**–**	(21)
Finance costs associated with transactions		**(6)**	–
Derivatives not in a hedge relationship		**(5)**	(2)
Finance costs		**(110)**	(97)
Interest receivable		**20**	15
Net finance income in respect of retirement benefits	25	**3**	11
Net foreign exchange gains		**44**	1
Derivatives not in a hedge relationship		**12**	10
Derivatives in a hedge relationship		**1**	–
Finance income		**80**	37
Net finance costs		**(30)**	(60)
Analysed as:			
Net interest payable reflected in adjusted earnings		**(79)**	(59)
Other net finance income/(costs)		**49**	(1)
Total net finance costs		**(30)**	(60)

Included in interest receivable is £1m (2016: £1m) of interest receivable from related parties. There was a net movement of £1m on fair value hedges in 2017 (2016: £nil), comprising a gain of £37m (2016: loss of £4m) on the underlying bonds, offset by a loss of £36m (2016: gain of £4m) on the related derivative financial instruments.

For further information on adjusted measures above, see note 8.

Notes to the consolidated financial statements

7. Income tax

All figures in £ millions	Notes	2017	2016
Current tax			
Charge in respect of current year		**(121)**	(66)
Adjustments in respect of prior years		**(2)**	27
Total current tax charge		**(123)**	(39)
Deferred tax			
In respect of temporary differences		**96**	277
Other adjustments in respect of prior years		**14**	(16)
Total deferred tax credit	13	**110**	261
Total tax (charge)/credit		**(13)**	222

The adjustments in respect of prior years in both 2017 and 2016 primarily arise from revising the previous year's reported tax provision to reflect the tax returns subsequently filed. This results in a change between deferred and current tax as well as an absolute benefit to the total tax charge.

The tax on the Group's profit/(loss) before tax differs from the theoretical amount that would arise using the UK tax rate as follows. Information for 2016 has been re-presented to give additional disclosure.

All figures in £ millions	2017	2016
Profit/(loss) before tax	**421**	(2,557)
Tax calculated at UK rate (2017: 19.25%, 2016: 20%)	**(81)**	511
Effect of overseas tax rates	**15**	424
Joint venture and associate income reported net of tax	**15**	19
Intangible impairment not subject to tax	**–**	(722)
Intra-group financing benefit	**26**	34
Movement in provisions for tax uncertainties	**49**	(37)
Impact of US tax reform	**(1)**	–
Net expense not subject to tax	**(39)**	(8)
Gains and losses on sale of businesses not subject to tax	**8**	15
Utilisation of previously unrecognised tax losses and credits	**(1)**	–
Unrecognised tax losses	**(16)**	(25)
Adjustments in respect of prior years	**12**	11
Total tax (charge)/credit	**(13)**	222
UK	**(36)**	46
Overseas	**23**	176
Total tax (charge)/credit	**(13)**	222
Tax rate reflected in earnings	**3.1%**	8.7%

The impact of US tax reform includes a benefit from revaluation of deferred tax balances to the reduced federal rate of £5m and a repatriation tax charge of £6m. The Group continues to analyse the detail of new legislation and this may result in revisions to these impacts.

Factors which may affect future tax charges include changes in tax legislation, transfer pricing regulations, the level and mix of profitability in different countries, and settlements with tax authorities.

The movement in provisions for tax uncertainties primarily reflects releases due to the expiry of relevant statutes of limitation. The current tax liability of £231m (2016: £224m) includes £280m (2016: £322m) of provisions for tax uncertainties principally in respect of a number of issues in the US, the UK and China. The issues provided for include the allocation between territories of proceeds of historic business disposals, and the potential disallowance of intra-group recharges and interest expense. The Group is currently under audit in a number of countries, and the timing of any resolution of these audits is uncertain. Of the balance of £280m, £38m relates to 2013 and earlier and is mostly under audit. In most countries tax years up to and including 2013 are now statute barred from examination by tax authorities. Of the remaining balance, £70m relates to 2014, £86m to 2015, £57m to 2016 and £29m to 2017. If relevant enquiry windows pass with no audit, management believes it is reasonably possible that provision levels will reduce by an estimated £60m within the next 12 months.

Notes to the consolidated financial statements

7. Income tax continued

In 2016 the Group impaired US goodwill (see note 11). The majority of this impairment charge is not deductible for tax purposes.

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

All figures in £ millions	2017	2016
Profit/(loss) before tax	421	(2,557)
Adjustments:		
Cost of major restructuring	79	338
Other net gains and losses	(128)	25
Intangible charges	166	2,769
Other net finance (income)/costs	(49)	1
Impact of US tax reform	8	–
Adjusted profit before tax	497	576
Total tax (charge)/credit	(13)	222
Adjustments:		
Tax benefit on cost of major restructuring	(26)	(84)
Tax charge/(benefit) on other net gains and losses	20	(14)
Tax benefit on intangible charges	(85)	(255)
Tax charge on other net finance (income)/costs	9	–
Impact of US tax reform	1	–
Tax amortisation benefit on goodwill and intangibles	39	36
Adjusted income tax charge	(55)	(95)
Tax rate reflected in adjusted earnings	11.1%	16.5%

For further information on adjusted measures above, see note 8.

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

All figures in £ millions	2017	2016
Net exchange differences on translation of foreign operations	9	(5)
Fair value gain on other financial assets	(4)	–
Remeasurement of retirement benefit obligations	(42)	58
	(37)	53

Notes to the consolidated financial statements

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	2017	2016
Earnings/(loss) for the year	**408**	(2,335)
Non-controlling interest	**(2)**	(2)
Earnings/(loss) attributable to equity holders of the company	**406**	(2,337)
Weighted average number of shares (millions)	**813.4**	814.8
Effect of dilutive share options (millions)	**0.3**	–
Weighted average number of shares (millions) for diluted earnings	**813.7**	814.8
Earnings/(loss) per share		
Basic	**49.9p**	(286.8)p
Diluted	**49.9p**	(286.8)p

Adjusted

For additional detailed information on the calculation of adjusted measures, see p192-195 (Financial key performance indicators). See note 2 for details of specific items excluded from or included in adjusted operating profit in 2017 and 2016.

In order to show results from operating activities on a consistent basis, an adjusted earnings per share is presented. The Group's definition of adjusted earnings per share may not be comparable with other similarly titled measures reported by other companies.

Adjusted earnings is a non-GAAP (non-statutory) financial measure and is included as it is a key financial measure used by management to evaluate the performance of the Group and allocate resources to business segments. The measure also enables investors to more easily, and consistently, track the underlying operational performance of the Group and its business segments by separating out those items of income and expenditure relating to acquisition and disposal transactions, and major restructuring programmes.

Adjusted earnings per share is calculated as adjusted earnings divided by the weighted average number of shares in issue on an undiluted basis. The following items are excluded from or included in adjusted earnings:

Cost of major restructuring In January 2016, the Group announced that it was embarking on a restructuring programme to simplify the business, reduce costs and position the Group for growth in its major markets. The costs of this programme in 2016 were significant enough to exclude from the adjusted operating profit measure so as to better highlight the underlying performance. A new programme of restructuring, announced in May 2017, began in the second half of 2017 and is expected to drive further significant cost savings. The costs of this new programme have also been excluded from adjusted operating profit. See note 3 for an analysis of these costs.

Other net gains and losses These represent profits and losses on the sale of subsidiaries, joint ventures, associates and other financial assets and are excluded from adjusted earnings as they distort the performance of the Group as reported on a statutory basis.

Intangible charges These represent charges in respect of goodwill, including impairment, and intangible assets acquired through business combinations and the direct costs of acquiring those businesses. These charges are excluded as they reflect past acquisition activity and do not necessarily reflect the current year performance of the Group.

Other net finance income/costs These include finance costs in respect of retirement benefits, finance costs of deferred consideration and foreign exchange and other gains and losses. Finance income relating to retirement benefits is excluded as management does not believe that the consolidated income statement presentation under IAS 19 reflects the economic substance of the underlying assets and liabilities. Finance costs associated with transactions are excluded as these relate to future earn-outs or acquisition expenses and are not part of the underlying financing. Foreign exchange and other gains and losses are excluded as they represent short-term fluctuations in market value and are subject to significant volatility. Other gains and losses may not be realised in due course as it is normally the intention to hold the related instruments to maturity. In 2017 and 2016, the foreign exchange gains and losses largely relate to foreign exchange differences on unhedged US dollar and euro loans, cash and cash equivalents.

Notes to the consolidated financial statements

8. Earnings per share continued

Adjusted continued

Impact of US tax reform In 2017, as a result of US tax reform, the Group's share of profit from associates was adversely impacted by £8m. This amount has been excluded from adjusted earnings as it is considered to be a transition adjustment that is not expected to recur in the near future.

Tax 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. As a result of US tax reform in 2017, the reported tax charge on a statutory basis includes a benefit from the revaluation of deferred tax balances to the reduced federal rate of £5m and a repatriation tax charge of £6m. This amount has been excluded from adjusted earnings as it is considered to be a transition adjustment that is not expected to recur in the near future. The tax benefit from tax deductible goodwill and intangibles is added to the adjusted income tax charge as this benefit more accurately aligns the adjusted tax charge with the expected rate of cash tax payments.

Non-controlling interest Non-controlling interest for the above items is excluded from adjusted earnings.

The following tables reconcile the statutory income statement to the adjusted income statement.

								2017
All figures in £ millions	**Statutory income statement**	**Cost of major restructuring**	**Other net gains and losses**	**Intangible charges**	**Other net finance income/ costs**	**Impact of US tax reform**	**Tax amortisation benefit**	**Adjusted income statement**
Operating profit/(loss)	**451**	**79**	**(128)**	**166**	**–**	**8**	**–**	**576**
Net finance costs	**(30)**	**–**	**–**	**–**	**(49)**	**–**	**–**	**(79)**
Profit/(loss) before tax	**421**	**79**	**(128)**	**166**	**(49)**	**8**	**–**	**497**
Income tax	**(13)**	**(26)**	**20**	**(85)**	**9**	**1**	**39**	**(55)**
Profit/(loss) for the year	**408**	**53**	**(108)**	**81**	**(40)**	**9**	**39**	**442**
Non-controlling interest	**(2)**	**–**	**–**	**–**	**–**	**–**	**–**	**(2)**
Earnings/(loss)	**406**	**53**	**(108)**	**81**	**(40)**	**9**	**39**	**440**
Weighted average number of shares (millions)	**813.4**							**813.4**
Weighted average number of shares (millions) for diluted earnings	**813.7**							**813.7**
Earnings per share (basic)	**49.9p**							**54.1p**
Earnings per share (diluted)	**49.9p**							**54.1p**

								2016
All figures in £ millions	**Statutory income statement**	**Cost of major restructuring**	**Other net gains and losses**	**Intangible charges**	**Other net finance income/ costs**	**Impact of US tax reform**	**Tax amortisation benefit**	**Adjusted income statement**
Operating (loss)/profit	(2,497)	338	25	2,769	–	–	–	635
Net finance costs	(60)	–	–	–	1	–	–	(59)
(Loss)/profit before tax	(2,557)	338	25	2,769	1	–	–	576
Income tax	222	(84)	(14)	(255)	–	–	36	(95)
(Loss)/profit for the year	(2,335)	254	11	2,514	1	–	36	481
Non-controlling interest	(2)	–	–	–	–	–	–	(2)
(Loss)/earnings	(2,337)	254	11	2,514	1	–	36	479
Weighted average number of shares (millions)	814.8							814.8
Weighted average number of shares (millions) for diluted earnings	814.8							814.8
(Loss)/earnings per share (basic)	(286.8)p							58.8p
(Loss)/earnings per share (diluted)	(286.8)p							58.8p

Notes to the consolidated financial statements

9. Dividends

All figures in £ millions	2017	2016
Final paid in respect of prior year 34.0p (2016: 34.0p)	**277**	277
Interim paid in respect of current year 5.0p (2016: 18.0p)	**41**	147
	318	424

The Directors are proposing a final dividend in respect of the financial year ended 31 December 2017 of 12.0p per share which will absorb an estimated £93m of shareholders' funds. It will be paid on 11 May 2018 to shareholders who are on the register of members on 6 April 2018. These financial statements do not reflect this dividend.

10. Property, plant and equipment

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Cost				
At 1 January 2016	359	508	22	889
Exchange differences	44	83	2	129
Additions	26	59	4	89
Disposals	(26)	(100)	–	(126)
Disposal through business disposal	(1)	(2)	–	(3)
Reclassifications	(4)	12	(8)	–
At 31 December 2016	398	560	20	978
Exchange differences	**(20)**	**(29)**	**(2)**	**(51)**
Additions	**26**	**40**	**24**	**90**
Disposals	**(13)**	**(34)**	**–**	**(47)**
Disposal through business disposal	**(11)**	**(5)**	**–**	**(16)**
Reclassifications	**5**	**8**	**(13)**	**–**
Transfer to intangible assets	**–**	**(11)**	**–**	**(11)**
Transfer to assets classified as held for sale	**(55)**	**(2)**	**–**	**(57)**
At 31 December 2017	**330**	**527**	**29**	**886**

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Depreciation				
At 1 January 2016	(192)	(377)	–	(569)
Exchange differences	(26)	(62)	–	(88)
Charge for the year	(34)	(61)	–	(95)
Disposals	22	95	–	117
Reclassifications	1	(1)	–	–
At 31 December 2016	(229)	(406)	–	(635)
Exchange differences	**12**	**23**	**–**	**35**
Charge for the year	**(35)**	**(55)**	**–**	**(90)**
Disposals	**9**	**26**	**–**	**35**
Disposal through business disposal	**6**	**3**	**–**	**9**
Transfer to assets classified as held for sale	**40**	**1**	**–**	**41**
At 31 December 2017	**(197)**	**(408)**	**–**	**(605)**
Carrying amounts				
At 1 January 2016	167	131	22	320
At 31 December 2016	169	154	20	343
At 31 December 2017	**133**	**119**	**29**	**281**

Notes to the consolidated financial statements

10. Property, plant and equipment continued

Depreciation expense of £23m (2016: £21m) has been included in the income statement in cost of goods sold and £67m (2016: £74m) in operating expenses.

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 £9m (2016: £10m).

11. Intangible assets

All figures in £ millions	Goodwill	Software	Acquired customer lists, contracts and relationships	Acquired trademarks and brands	Acquired publishing rights	Other intangibles acquired	Total
Cost							
At 1 January 2016	4,134	619	860	281	180	509	6,583
Exchange differences	752	85	157	65	31	135	1,225
Impairment	(2,548)	–	–	–	–	–	(2,548)
Additions – internal development	–	132	–	–	–	–	132
Additions – purchased	–	25	–	–	–	–	25
Disposals	–	(49)	(37)	–	–	–	(86)
Acquisition through business combination	3	–	–	7	–	3	13
Disposal through business disposal	–	–	(6)	–	–	(47)	(53)
Transfer to intangible assets – pre-publication	–	(14)	–	–	–	–	(14)
At 31 December 2016	2,341	798	974	353	211	600	5,277
Exchange differences	**(148)**	**(46)**	**(74)**	**(26)**	**(6)**	**(50)**	**(350)**
Impairment	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Additions – internal development	**–**	**133**	**–**	**–**	**–**	**–**	**133**
Additions – purchased	**–**	**17**	**–**	**–**	**–**	**–**	**17**
Disposals	**–**	**(23)**	**–**	**–**	**–**	**–**	**(23)**
Disposal through business disposal	**–**	**(4)**	**(9)**	**(19)**	**–**	**(27)**	**(59)**
Transfer from property, plant and equipment	**–**	**11**	**–**	**–**	**–**	**–**	**11**
Transfer to assets classified as held for sale	**(163)**	**(4)**	**(2)**	**(27)**	**(21)**	**(34)**	**(251)**
At 31 December 2017	**2,030**	**882**	**889**	**281**	**184**	**489**	**4,755**

Notes to the consolidated financial statements

11. Intangible assets continued

All figures in £ millions	Goodwill	Software	Acquired customer lists, contracts and relationships	Acquired trademarks and brands	Acquired publishing rights	Other intangibles acquired	Total
Amortisation							
At 1 January 2016	–	(357)	(430)	(155)	(163)	(314)	(1,419)
Exchange differences	–	(60)	(83)	(32)	(27)	(75)	(277)
Charge for the year	–	(84)	(85)	(22)	(8)	(70)	(269)
Disposals	–	38	37	–	–	–	75
Disposal through business disposal	–	–	6	–	–	47	53
Transfer to intangible assets – pre-publication	–	2	–	–	–	–	2
At 31 December 2016	–	(461)	(555)	(209)	(198)	(412)	(1,835)
Exchange differences	**–**	**30**	**43**	**13**	**4**	**36**	**126**
Charge for the year	**–**	**(85)**	**(77)**	**(18)**	**(3)**	**(40)**	**(223)**
Disposals	**–**	**21**	**–**	**–**	**–**	**–**	**21**
Disposal through business disposal	**–**	**2**	**8**	**18**	**–**	**22**	**50**
Transfer to assets classified as held for sale	**–**	**–**	**1**	**16**	**19**	**34**	**70**
At 31 December 2017	**–**	**(493)**	**(580)**	**(180)**	**(178)**	**(360)**	**(1,791)**
Carrying amounts							
At 1 January 2016	4,134	262	430	126	17	195	5,164
At 31 December 2016	2,341	337	419	144	13	188	3,442
At 31 December 2017	**2,030**	**389**	**309**	**101**	**6**	**129**	**2,964**

Goodwill

The goodwill carrying value of £2,030m relates to acquisitions completed after 1 January 1998. Prior to 1 January 1998 all goodwill was written off to reserves on the date of acquisition. For acquisitions completed between 1 January 1998 and 31 December 2002, no value was ascribed to intangibles other than goodwill which was amortised over a period of up to 20 years. On adoption of IFRS on 1 January 2003, the Group chose not to restate the goodwill balance and at that date the balance was frozen (i.e. amortisation ceased). If goodwill had been restated, then a significant value would have been ascribed to other intangible assets, which would be subject to amortisation, and the carrying value of goodwill would be significantly lower. For acquisitions completed after 1 January 2003, value has been ascribed to other intangible assets which are amortised.

Other intangible assets

Other intangibles acquired include content, technology and software rights.

Intangible assets are valued separately for each acquisition and the primary method of valuation used is the discounted cash flow method. The majority of acquired intangibles are amortised using an amortisation profile based on the projected cash flows underlying the acquisition date valuation of the intangible asset, which generally results in a larger proportion of amortisation being recognised in the early years of the asset's life. The Group keeps the expected pattern of consumption under review.

Amortisation of £17m (2016: £17m) is included in the income statement in cost of goods sold and £206m (2016: £252m) in operating expenses.

Notes to the consolidated financial statements

11. Intangible assets continued

Other intangible assets continued

The range of useful economic lives for each major class of intangible asset (excluding goodwill and software) is shown below:

Class of intangible asset	2017 Useful economic life
Acquired customer lists, contracts and relationships	3-20 years
Acquired trademarks and brands	2-20 years
Acquired publishing rights	5-20 years
Other intangibles acquired	2-20 years

The expected amortisation profile of acquired intangible assets is shown below:

All figures in £ millions	2017 One to five years	Six to ten years	More than ten years	Total
Class of intangible asset				
Acquired customer lists, contracts and relationships	215	75	19	309
Acquired trademarks and brands	56	31	14	101
Acquired publishing rights	5	1	–	6
Other intangibles acquired	97	32	–	129

Impairment tests for cash-generating units (CGUs) containing goodwill

Impairment tests have been carried out where appropriate as described below. Goodwill was allocated to CGUs, or an aggregation of CGUs, where goodwill could not be reasonably allocated to individual business units. Impairment reviews were conducted on these CGUs. The recoverable amount for each unit exceeds its carrying value therefore there is no impairment in 2017. The carrying value of the goodwill in each of the CGUs is summarised below:

All figures in £ millions	2017	2016
North America	1,013	1,295
Core	641	633
Growth (includes Brazil, China, India and South Africa)	–	–
Pearson VUE	376	413
Total	2,030	2,341

The recoverable amount of each aggregated CGU is based on fair value less costs of disposal. Goodwill is tested at least annually for impairment. 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.

Notes to the consolidated financial statements

11. Intangible assets continued

Key assumptions

For the purpose of estimating the fair value less costs of disposal of the CGUs, management has used an income approach based on present value techniques. The calculations use cash flow projections based on financial budgets approved by management covering a five-year period, management's best estimate about future developments and market assumptions. The fair value less costs of disposal measurement is categorised as Level 3 on the fair value hierarchy. The key assumptions used by management in the fair value less costs of disposal calculations were:

Discount rates The discount rate is based on the risk-free rate for government bonds, adjusted for a risk premium to reflect the increased risk in investing in equities. The risk premium adjustment is assessed for each specific CGU. The average post-tax discount rates range from 8.4% to 14.3%. Discount rates are lower for those businesses which operate in more mature markets with low inflation and higher for those operating in emerging markets with higher inflation.

Perpetuity growth rates A perpetuity growth rate of 2.0% was used for cash flows subsequent to the approved budget period for CGUs operating in mature markets. This perpetuity growth rate is a conservative rate and is considered to be lower than the long-term historical 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. CGU growth rates between 3.0% and 6.9% were used for cash flows subsequent to the approved budget period for CGUs operating in emerging markets with high inflation. These growth rates are also below the long-term historical growth rates in these markets.

The key assumptions used by management in setting the financial budgets for the initial five-year period were as follows:

Forecast sales growth rates Forecast sales growth rates are based on past experience adjusted for the strategic direction and near-term investment priorities within each CGU. Key assumptions include growth in Online Program Management, Online Blended Learning and Professional Certification, stabilisation in UK Qualifications and US Assessments, and ongoing pressures in the US higher education courseware market. The five-year sales forecasts use average nominal growth rates between 3% and 6% for mature markets and between 5% and 14% for emerging markets with high inflation.

Operating profits Operating profits are forecast based on historical experience of operating margins, adjusted for the impact of changes to product costs and cost-saving initiatives, including the impact of the implementation of our cost efficiency programme.

Cash conversion Cash conversion is the ratio of operating cash flow to operating profit. Management forecasts cash conversion rates based on historical experience.

Sensitivities

The Group's impairment review is sensitive to a change in assumptions used, most notably the discount rates and the perpetuity growth rates.

The carrying value of goodwill in the Growth market CGUs was written down to £nil in 2015.

A 0.1% increase in discount rates would cause the fair value less costs of disposal of the North America CGU to reduce by £50m, the Core GGU by £17m and the VUE CGU by £21m.

A 0.1% reduction in perpetuity growth rates would cause the fair value less costs of disposal of the North America CGU to reduce by £39m, the Core CGU by £14m and the VUE CGU by £17m.

The Core CGU is highly sensitive to any reductions in short-term cash flows, whether driven by lower sales growth, lower operating profits or lower cash conversion. A 5% reduction in total annual operating profits, spread evenly across all CGUs, would give rise to an impairment of £66m in the Core CGU. An increase in discount rates or a reduction in perpetuity growth rates would also give rise to an impairment in the Core CGU. The North America CGU is no longer considered to be highly sensitive to changes in impairment assumptions, with increased headroom when compared to 2016.

2016 impairment tests

At the end of 2016, following trading in the final quarter of the year, it became clear that the underlying issues in the US higher education courseware business market were more severe than anticipated. These issues related to declining student enrolments, changes in buying patterns of students and correction of inventory levels by distributors and bookshops. As a result, in January 2017, strategic plans and estimates for future cash flows were revised and we determined during the goodwill impairment review that the fair value less costs of disposal of the North America CGU no longer supported the carrying value of this goodwill and as a consequence impaired goodwill by £2,548m.

Notes to the consolidated financial statements

12. Investments in joint ventures and associates

The amounts recognised in the balance sheet are as follows:

All figures in £ millions	2017	2016
Associates	**395**	1,245
Joint ventures	**3**	2
Total	**398**	1,247

The amounts recognised in the income statement are as follows:

All figures in £ millions	2017	2016
Associates	**77**	98
Joint ventures	**1**	(1)
Total	**78**	97

Investment in associates

The Group has the following material associates:

	Principal place of business	Ownership interest	Nature of relationship	Measurement method
Penguin Random House Ltd	UK/Global	25%	See below	Equity
Penguin Random House LLC	US	25%	See below	Equity

On 1 July 2013, Penguin Random House was formed, upon the completion of an agreement between Pearson and Bertelsmann to merge their respective trade publishing companies, Penguin and Random House, with the parent companies owning 47% and 53% of the combined business respectively. On 5 October 2017, Pearson sold a 22% stake in Penguin Random House to Bertelsmann, retaining a 25% share (see note 31 for more information on disposal of associates). Pearson owns its 25% interest in Penguin Random House via 25% interests in each of the two entities listed in the table above. Despite the separate legal structures of the two Penguin Random House entities, Pearson regards Penguin Random House as one combined global business. Consequently, Pearson discloses Penguin Random House as one single operating segment and presents disclosures related to its interests in Penguin Random House on a combined basis.

The shareholder agreement includes protective rights for Pearson as the minority shareholder, including rights to dividends. Management considers ownership percentage, Board composition and the additional protective rights, and exercises judgement to determine that Pearson has significant influence over Penguin Random House and Bertelsmann has the power to direct the relevant activities and therefore control. Following the transaction in 2017 the assessment of significant influence has not changed. Penguin Random House does not have a quoted market price.

Notes to the consolidated financial statements

12. Investments in joint ventures and associates continued

Investment in associates continued

The summarised financial information of the material associate is detailed below:

All figures in £ millions	2017 Penguin Random House	2016 Penguin Random House
Assets		
Non-current assets	**1,048**	1,267
Current assets	**1,758**	1,587
Liabilities		
Non-current liabilities	**(859)**	(394)
Current liabilities	**(1,579)**	(1,074)
Net assets	**368**	1,386
Sales	**2,693**	2,620
Profit for the year	**171**	209
Other comprehensive expense	**(60)**	(14)
Total comprehensive income	**111**	195
Dividends received from associate in relation to profits	**146**	131
Re-capitalisation dividends received from associate	**312**	–

The information above reflects the amounts presented in the financial statements of the associate, adjusted for fair value and similar adjustments. The tax on Penguin Random House LLC is settled by the partners. For the purposes of clear and consistent presentation, the tax has been shown in the associate line items in the consolidated income statement and consolidated balance sheet, recording the Group's share of profit after tax consistently for the Penguin Random House associates.

A reconciliation of the summarised financial information to the carrying value of the material associate is shown below:

All figures in £ millions	2017 Penguin Random House	2016 Penguin Random House
Opening net assets	**1,386**	1,206
Exchange differences	**(18)**	179
Profit for the year	**171**	209
Other comprehensive expense	**(60)**	(14)
Dividends, net of tax paid	**(1,167)**	(194)
Tax adjustments in relation to disposals	**56**	–
Closing net assets	**368**	1,386
Share of net assets	**92**	651
Goodwill	**296**	589
Carrying value of associate	**388**	1,240

Notes to the consolidated financial statements

12. Investments in joint ventures and associates continued

Investment in associates continued

Information on other individually immaterial associates is detailed below:

All figures in £ millions	2017	2016
Profit for the year	7	–
Total comprehensive income	7	–

Transactions with material associates

The Group has loans to Penguin Random House which are unsecured and interest is calculated based on market rates. The amount outstanding at 31 December 2017 was £46m (2016: £33m). The loans are provided under a working capital facility and fluctuate during the year. The loan outstanding at 31 December 2017 was repaid in its entirety in January 2018.

The Group also has a current asset receivable of £19m (2016: £21m) from Penguin Random House and a current liability payable of £3m (2016: £nil) arising from the provision of services. Included in other income (note 4) is £3m (2016: £4m) of service fees. In addition, the Group will receive a further re-capitalisation dividend of £49m in April 2018, which was triggered by the Group's decision to sell a 22% stake in Penguin Random House in 2017.

Investment in joint ventures

Information on joint ventures, all of which are individually immaterial, is detailed below:

All figures in £ millions	2017	2016
Profit/(loss) for the year	1	(1)
Total comprehensive income/(expense)	1	(1)

13. Deferred income tax

All figures in £ millions	2017	2016
Deferred income tax assets	95	451
Deferred income tax liabilities	(164)	(466)
Net deferred income tax	(69)	(15)

Substantially all of the deferred income tax assets are expected to be recovered after more than one year.

Deferred income tax assets and liabilities shall be offset when there is a legally enforceable right to offset current income tax assets with current income tax liabilities and where the deferred income taxes relate to the same fiscal authority. At 31 December 2017, the Group has unrecognised deferred income tax assets of £32m (2016: £32m) in respect of UK losses, £18m (2016: £18m) in respect of US losses and approximately £86m (2016: £95m) in respect of losses in other territories. The UK losses are capital losses. The US losses relate to state taxes and therefore have expiry periods of between five and 20 years. Other deferred tax assets of £12m (2016: £9m) have not been recognised.

Deferred tax assets of £75m (2016: £95m) have been recognised in countries that reported a loss in either the current or preceding year. The majority arises in Brazil in respect of tax deductible goodwill. It is considered more likely than not that there will be sufficient future taxable profits to realise these assets.

The recognition of the deferred income tax assets is supported by management's forecasts of the future profitability of the relevant countries.

Notes to the consolidated financial statements

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	Returns provisions	Retirement benefit obligations	Deferred revenue	Goodwill and intangibles	Other	Total
Deferred income tax assets/(liabilities)							
At 1 January 2016	19	43	(9)	55	(348)	(44)	(284)
Exchange differences	3	7	10	15	(84)	27	(22)
Income statement (charge)/benefit	–	(15)	(4)	50	144	86	261
Disposal through business disposal	–	–	–	(3)	(7)	–	(10)
Tax benefit in other comprehensive income	–	–	40	–	–	–	40
At 31 December 2016	22	35	37	117	(295)	69	(15)
Exchange differences	**(2)**	**(3)**	**(4)**	**(8)**	**19**	**(8)**	**(6)**
Income statement (charge)/benefit	**(11)**	**6**	**7**	**(9)**	**118**	**(1)**	**110**
Disposal through business disposal	**–**	**–**	**–**	**–**	**–**	**(3)**	**(3)**
Tax charge in other comprehensive income	**–**	**–**	**(84)**	**–**	**–**	**(5)**	**(89)**
Transfer to assets/(liabilities) classified as held for sale	**–**	**(4)**	**–**	**(73)**	**3**	**8**	**(66)**
At 31 December 2017	**9**	**34**	**(44)**	**27**	**(155)**	**60**	**(69)**

Other deferred income tax items include temporary differences in respect of share-based payments, provisions, depreciation and royalty advances.

14. Classification of financial instruments

The accounting classification of each class of the Group's financial assets and their carrying values, is as follows:

		2017					2016				
		Fair value			Amortised cost		Fair value			Amortised cost	
All figures in £ millions	Notes	Available for sale	Derivatives held for trading	Derivatives in hedge relationship	Loans and receivables	Total carrying value	Available for sale	Derivatives held for trading	Derivatives in hedge relationship	Loans and receivables	Total carrying value
Investments in unlisted securities	15	**77**	**–**	**–**	**–**	**77**	65	–	–	–	65
Cash and cash equivalents	17	**–**	**–**	**–**	**518**	**518**	–	–	–	1,459	1,459
Cash and cash equivalents – within assets classified as held for sale	32	**–**	**–**	**–**	**127**	**127**	–	–	–	–	–
Marketable securities		**8**	**–**	**–**	**–**	**8**	10	–	–	–	10
Derivative financial instruments	16	**–**	**3**	**137**	**–**	**140**	–	3	168	–	171
Trade receivables	22	**–**	**–**	**–**	**760**	**760**	–	–	–	982	982
Trade receivables – within assets classified as held for sale		**–**	**–**	**–**	**22**	**22**	–	–	–	–	–
Total financial assets		**85**	**3**	**137**	**1,427**	**1,652**	75	3	168	2,441	2,687

The carrying value of the Group's financial assets is equal to, or approximately equal to, the market value.

Notes to the consolidated financial statements

14. Classification of financial instruments continued

The accounting classification of each class of the Group's financial liabilities, together with their carrying values and market values, is as follows:

		2017					2016				
		Fair value		Amortised cost			Fair value		Amortised cost		
All figures in £ millions	Notes	Derivatives held for trading	Derivatives in hedge relationship	Other liabilities	Total carrying value	Total market value	Derivatives held for trading	Derivatives in hedge relationship	Other liabilities	Total carrying value	Total market value
Derivative financial liabilities	16	–	(140)	–	(140)	(140)	(7)	(257)	–	(264)	(264)
Trade payables	24	–	–	(265)	(265)	(265)	–	–	(333)	(333)	(333)
Trade payables – within liabilities classified as held for sale		–	–	(20)	(20)	(20)	–	–	–	–	–
Liability to purchase own shares	24	–	–	(151)	(151)	(151)	–	–	–	–	–
Bank loans and overdrafts	18	–	–	(15)	(15)	(15)	–	–	(39)	(39)	(39)
Other borrowings due within one year	18	–	–	(4)	(4)	(4)	–	–	(5)	(5)	(5)
Borrowings due after more than one year	18	–	–	(1,066)	(1,066)	(1,070)	–	–	(2,424)	(2,424)	(2,385)
Total financial liabilities		–	(140)	(1,521)	(1,661)	(1,665)	(7)	(257)	(2,801)	(3,065)	(3,026)

Fair value measurement

As shown above, the Group's derivative assets and liabilities, unlisted securities and marketable securities are held at fair value. Financial instruments that are measured subsequently to initial recognition at fair value are grouped into levels 1 to 3, based on the degree to which the fair value is observable, as follows:

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).

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).

The Group's derivative assets valued at £140m (2016: £171m) and derivative liabilities valued at £140m (2016: £264m) are classified as level 2. The Group's marketable securities valued at £8m (2016: £10m) are classified as level 2. The Group's investments in unlisted securities are valued at £77m (2016: £65m) and are classified as level 3.

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

	2017	2016
All figures in £ millions	Investments in unlisted securities	Investments in unlisted securities
At beginning of year	65	143
Exchange differences	(4)	8
Acquisition of investments	3	6
Fair value movements	13	–
Disposal of investments	–	(92)
At end of year	77	65

The fair value of the investments in unlisted securities is determined by reference to the financial performance of the underlying asset, recent funding rounds and amounts realised on the sale of similar assets.

Notes to the consolidated financial statements

15. Other financial assets

All figures in £ millions	2017	2016
At beginning of year	**65**	143
Exchange differences	**(4)**	8
Acquisition of investments	**3**	6
Fair value movements	**13**	–
Disposal of investments	**–**	(92)
At end of year	**77**	65

Other financial assets comprise unlisted securities of £77m (2016: £65m).

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:

	2017			2016		
All figures in £ millions	Gross notional amounts	Assets	Liabilities	Gross notional amounts	Assets	Liabilities
Interest rate derivatives – in a fair value hedge relationship	**799**	**23**	**–**	2,157	68	(4)
Interest rate derivatives – not in a hedge relationship	**429**	**3**	**–**	1,187	3	(7)
Cross-currency rate derivatives – in a hedge relationship	**1,522**	**114**	**(140)**	1,622	100	(253)
Total	**2,750**	**140**	**(140)**	4,966	171	(264)
Analysed as expiring:						
In less than one year	**–**	**–**	**–**	162	–	–
Later than one year and not later than five years	**1,638**	**65**	**(95)**	2,776	86	(157)
Later than five years	**1,112**	**75**	**(45)**	2,028	85	(107)
Total	**2,750**	**140**	**(140)**	4,966	171	(264)

The Group has issued both euro and US dollar fixed rate debt. The fixed rate euro debt is converted to either a fixed or floating rate US dollar exposure using interest rate and cross-currency swaps. The Group's remaining fixed rate US dollar debt is held as fixed rate instruments.

The Group receives interest under its euro debt related swap contracts to match the interest on the bonds (ranging from a receipt of 1.375% on its euro 2025 notes to 1.875% on its euro 2021 notes) and, in turn, pays US dollar interest at rates ranging between US Libor + 0.84% to US Libor + 1.35%.

Interest rate swaps are then used to fix an element of the interest charge, in line with the Group's interest rate hedging policy, which requires a proportion of the Group's gross debt to be fixed in line with the Group's hedging policy. During 2017 Pearson executed a number of floating interest rate swaps to match the maturity of the 2021 and 2025 euro bonds mitigating the exposure to interest rate increases. The all-in rates (including the Libor spread) that the Group pays are between 2.78% and 3.58%. At 31 December 2017, the Group had contracts to fix $579m of debt over the next 12 months and $331m of outstanding fixed rate bonds bringing the total fixed rate debt to $910m.

At the end of 2017, 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 £(869)m, sterling £12m and euro £857m (2016: US dollar £(1,051)m, sterling £19m and euro £939m).

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.

Notes to the consolidated financial statements

16. Derivative financial instruments continued

Derivative financial assets and liabilities subject to offsetting arrangements are as follows:

All figures in £ millions	2017 Gross derivative assets	2017 Gross derivative liabilities	2017 Net derivative assets/ liabilities	2016 Gross derivative assets	2016 Gross derivative liabilities	2016 Net derivative assets/ liabilities
Counterparties in an asset position	103	(78)	25	30	(11)	19
Counterparties in a liability position	37	(62)	(25)	141	(253)	(112)
Total as presented in the balance sheet	140	(140)	–	171	(264)	(93)

All of the Group's derivative financial instruments are subject to enforceable netting arrangements with individual counterparties, allowing net settlement in the event of default of either party. Offset arrangements in respect of cash balances are described in note 17.

Counterparty exposure from all derivatives is managed, together with that from deposits and bank account balances, within credit limits that reflect published credit ratings and by reference to other market measures (e.g. market prices for credit default swaps) to ensure that there is no significant risk to any one counterparty.

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	2017	2016
Cash at bank and in hand	361	570
Short-term bank deposits	157	889
	518	1,459
Cash at bank and in hand – within assets classified as held for sale	127	–
	645	1,459

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

At the end of 2017, the currency split of cash and cash equivalents was US dollar 36% (2016: 34%), sterling 8% (2016: 40%), euro 7% (2016: 3%), renminbi 20% (2016: 10%) and other 29% (2016: 13%). At the end of 2017, a significant proportion of the renminbi cash relates to assets held for sale.

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	2017	2016
Cash and cash equivalents	518	1,459
Cash and cash equivalents – within assets classified as held for sale	127	–
Bank overdrafts	(15)	(35)
	630	1,424

The Group has certain cash pooling arrangements in US dollars, sterling, euro and Canadian dollars where both the company and the bank have a legal right of offset. At 31 December 2017, the offsetting amounts are presented gross in the balance sheet. Offset arrangements in respect of derivatives are shown in note 16.

Notes to the consolidated financial statements

18. Financial liabilities – borrowings

The Group's current and non-current borrowings are as follows:

All figures in £ millions	2017	2016
Non-current		
6.25% Global dollar bonds 2018 (nominal amount $550m)	–	469
4.625% US dollar notes 2018 (nominal amount $300m)	–	254
1.875% euro notes 2021 (nominal amount €500m)	463	453
3.75% US dollar notes 2022 (nominal amount $117m; 2016: nominal amount $500m)	85	407
3.25% US dollar notes 2023 (nominal amount $94m; 2016: nominal amount $500m)	69	402
1.375% euro notes 2025 (nominal amount €500m)	445	435
Finance lease liabilities	4	4
	1,066	2,424
Current		
Due within one year or on-demand:		
Bank loans and overdrafts	15	39
Finance lease liabilities	4	5
	19	44
Total borrowings	1,085	2,468

Included in the non-current borrowings above is £10m of accrued interest (2016: £18m). Included in the current borrowings above is £nil of accrued interest (2016: £nil).

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

All figures in £ millions	2017	2016
Between one and two years	3	726
Between two and five years	549	454
Over five years	514	1,244
	1,066	2,424

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

	2017			2016		
All figures in £ millions	Effective interest rate	Carrying value	Market value	Effective interest rate	Carrying value	Market value
Bank loans and overdrafts	n/a	15	15	n/a	39	39
6.25% Global dollar bonds 2018	n/a	–	–	6.46%	469	468
4.625% US dollar notes 2018	n/a	–	–	4.69%	254	250
1.875% euro notes 2021	2.04%	463	467	2.04%	453	454
3.75% US dollar notes 2022	3.94%	85	87	3.94%	407	396
3.25% US dollar notes 2023	3.36%	69	67	3.36%	402	381
1.375% euro notes 2025	1.44%	445	445	1.44%	435	432
Finance lease liabilities	n/a	8	8	n/a	9	9
		1,085	1,089		2,468	2,429

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.

Notes to the consolidated financial statements

18. Financial liabilities – borrowings continued

The carrying amounts of the Group's borrowings before the effect of derivatives (see notes 16 and 19 for further information on the impact of derivatives) are denominated in the following currencies:

All figures in £ millions	2017	2016
US dollar	**172**	1,559
Sterling	**1**	13
Euro	**911**	892
Other	**1**	4
	1,085	2,468

The Group has $1.75bn (£1.3bn) of undrawn capacity on its committed borrowing facilities as at 31 December 2017 (2016: $1.75bn (£1.4bn) undrawn). In addition, 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.

The maturity of the Group's finance lease obligations is as follows:

All figures in £ millions	2017	2016
Finance lease liabilities – minimum lease payments		
Not later than one year	**4**	5
Later than one year and not later than two years	**3**	3
Later than two years and not later than three years	**1**	1
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	**8**	9

The present value of the Group's finance lease obligations is as follows:

All figures in £ millions	2017	2016
Not later than one year	**4**	5
Later than one year and not later than five years	**4**	4
Later than five years	**–**	–
	8	9

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

Pearson's treasury function has primary responsibility for managing certain financial risks to which the Group is exposed. The Group's treasury policies are approved by the Board of Directors annually and the Audit Committee receives regular reports on the Group's treasury activities, policies and procedures. The Group's treasury function is not run as a profit centre and does not enter into any transactions for speculative purposes.

The treasury function is permitted to use derivatives for risk management purposes which may include interest rate swaps, rate caps and collars, currency rate swaps and forward foreign exchange contracts, of which interest rate swaps and forward foreign exchange swaps are the most commonly used.

Notes to the consolidated financial statements

19. Financial risk management continued

Capital risk

The Group's primary objective when managing capital is to safeguard its ability to continue as a going concern and retain financial flexibility by maintaining a strong balance sheet. The Group aims to maintain net debt at a level less than 1.5 times EBITDA, which is consistent with a solid investment grade rating (assuming no material deterioration in trading performance) and provides comfortable headroom against covenants. This should permit the business to invest in organic growth. Shareholder returns are made through a sustainable and progressive dividend policy. Any surplus cash is returned to shareholders via share buybacks or special dividends.

The Group is currently rated BBB (negative outlook) with Standard and Poor's and Baa2 (negative outlook) with Moody's.

Net debt

The Group's net debt position is set out below:

All figures in £ millions	2017	2016
Cash and cash equivalents	645	1,459
Marketable securities	8	10
Derivative financial instruments	–	(93)
Bank loans and overdrafts	(15)	(39)
Bonds	(1,062)	(2,420)
Finance lease liabilities	(8)	(9)
Net debt	**(432)**	(1,092)

Interest and foreign exchange rate management

The Group's principal currency exposure is to the US dollar which represents more than 60% of the Group's sales.

The Group's long-term debt is primarily held in US dollars to provide a natural hedge of this exposure, which is achieved through issued US dollar debt or by converting euro debt to US dollars using cross-currency swaps.

As at 31 December 2017, £674m of the Group's debt is held at fixed rates (2016: £650m), with £411m held at floating rates (2016: £1,818m), partially offset by US dollar cash balances which attract floating rate interest. As at 31 December 2017, a 1% movement in US dollar interest rates for one year would result in a £2m movement in the interest charge (2016: £13m).

Overseas profits are converted to sterling to satisfy sterling cash outflows such as dividends at the prevailing spot rate at the time of the transaction. To the extent the Group has sufficient sterling, US dollars may be held as dollar cash to provide a natural offset to the Group's debt or to satisfy future US dollar cash outflows.

The Group does not have significant cross border foreign exchange transactional exposures.

As at 31 December 2017, 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	77	–	–	(6)	7
Cash and cash equivalents	645	–	–	(54)	66
Marketable securities	8	–	–	–	–
Derivative financial instruments	–	(26)	26	1	(1)
Bonds	(1,062)	45	(48)	97	(118)
Other borrowings	(23)	–	–	2	(2)
Liability to purchase own shares	(151)	–	–	–	–
Other net financial assets	497	–	–	(41)	50
Total financial instruments	**(9)**	**19**	**(22)**	**(1)**	**2**

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. Other net financial assets comprises trade receivables less trade payables. A significant proportion of the movements shown above would impact equity rather than the income statement due to the location and functional currency of the entities in which they arise and the availability of net investment hedging.

Notes to the consolidated financial statements

19. Financial risk management continued

Interest and foreign exchange rate management continued

The Group's income statement is reported at average rates for the year while the balance sheet is translated at the year-end closing rate. Differences between these rates can distort ratio calculations such as debt to EBITDA and interest cover. Adjusted operating profit translated at year-end closing rates would be £22m lower than the reported figure of £576m at £554m (2016: £55m higher if translated at the year-end 2016 rate instead of the 2016 average rate at £690m compared with a reported figure of £635m). EBITDA translated at year-end closing rates would be £25m lower than the reported figure of £738m at £713m (2016: £63m higher if translated at the year-end 2016 rate instead of the 2016 average rate, at £848m, compared with a reported figure of £785m).

Liquidity and re-financing risk management

The Group regularly reviews the level of cash and debt facilities required to fund its activities. This involves preparing a prudent cash flow forecast for the next three to five years, determining the level of debt facilities required to fund the business, planning for shareholder returns and repayments of maturing debt, and identifying an appropriate amount of headroom to provide a reserve against unexpected outflows.

At 31 December 2017, the Group had cash of £0.6bn and an undrawn US dollar denominated revolving credit facility due 2021 of $1.75bn (£1.3bn). At 31 December 2016, the Group had cash of £1.5bn and an undrawn US dollar denominated revolving credit facility due 2021 of $1.75bn (£1.4bn).

The $1.75bn facility contains interest cover and leverage covenants which the Group has complied with for the year ended 31 December 2017.

At the end of 2017, the currency split of the Group's trade payables was US dollar £137m, sterling £58m and other currencies £90m (2016: US dollar £164m, sterling £67m and other currencies £102m) . Trade payables are all due within one year (2016: all due within one year).

The following table analyses the Group's bonds and derivative assets and liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash flows (including interest) and as such may differ from the amounts disclosed on the balance sheet.

	Analysed by maturity				Analysed by currency			
All figures in £ millions	Less than one year	Later than one year but less than five years	Five years or more	Total	USD	GBP	Other	Total
At 31 December 2017								
Bonds	**20**	**601**	**533**	**1,154**	**184**	**–**	**970**	**1,154**
Rate derivatives – inflows	**(38)**	**(975)**	**(684)**	**(1,697)**	**(53)**	**(751)**	**(893)**	**(1,697)**
Rate derivatives – outflows	**48**	**1,060**	**667**	**1,775**	**1,003**	**751**	**21**	**1,775**
Total	**30**	**686**	**516**	**1,232**	**1,134**	**–**	**98**	**1,232**
At 31 December 2016								
Bonds	82	1,308	1,292	2,682	1,732	–	950	2,682
Rate derivatives – inflows	(103)	(1,086)	(867)	(2,056)	(239)	(838)	(979)	(2,056)
Rate derivatives – outflows	82	1,202	891	2,175	1,308	838	29	2,175
Total	**61**	**1,424**	**1,316**	**2,801**	**2,801**	**–**	**–**	**2,801**

Financial counterparty risk management

Counterparty credit limits, which take published credit rating and other factors into account, are set to cover the Group's total aggregate exposure to a single financial institution. The limits applicable to published credit rating 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.

Cash deposits and derivative transactions are made with approved counterparties up to pre-agreed limits. To manage counterparty risk associated with cash and cash equivalents, the Group uses a mixture of money market funds as well as bank deposits. As at 31 December 2017, 58% of cash and cash equivalents was held with investment grade bank counterparties, 38% with AAA money market funds and 4% held with non-investment grade bank counterparties. As at 31 December 2017, the Group had a net exposure of £24m with investment grade counterparties for derivative transactions.

Notes to the consolidated financial statements

20. Intangible assets – pre-publication

All figures in £ millions	2017	2016
Cost		
At beginning of year	**2,417**	2,201
Exchange differences	**(168)**	380
Additions	**362**	395
Disposal through business disposal	**(1)**	(8)
Disposals	**(248)**	(565)
Transfer from intangible assets	**–**	14
Transfer to assets classified as held for sale	**(508)**	–
At end of year	**1,854**	2,417
Amortisation		
At beginning of year	**(1,393)**	(1,360)
Exchange differences	**109**	(250)
Charge for the year	**(338)**	(350)
Disposal through business disposal	**–**	4
Disposals	**248**	565
Transfer from intangible assets	**–**	(2)
Transfer to assets classified as held for sale	**261**	–
At end of year	**(1,113)**	(1,393)
Carrying amounts		
At end of year	**741**	1,024

Included in the above are pre-publication assets amounting to £504m (2016: £694m) 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	2017	2016
Raw materials	**4**	5
Work in progress	**2**	6
Finished goods	**142**	224
	148	235

The cost of inventories recognised as an expense and included in the income statement in cost of goods sold amounted to £324m (2016: £340m). In 2017, £38m (2016: £48m) of inventory provisions was charged in the income statement. None of the inventory is pledged as security.

Notes to the consolidated financial statements

22. Trade and other receivables

All figures in £ millions	2017	2016
Current		
Trade receivables	**739**	961
Royalty advances	**8**	22
Prepayments	**82**	124
Accrued income	**1**	15
Other receivables	**280**	235
	1,110	1,357
Non-current		
Trade receivables	**21**	21
Royalty advances	**20**	10
Prepayments	**15**	13
Accrued income	**10**	31
Other receivables	**37**	29
	103	104

The carrying value of the Group's trade and other receivables approximates its fair value. Trade receivables are stated net of provisions for bad and doubtful debts and anticipated future sales returns. The movements in the provision for bad and doubtful debts are as follows:

All figures in £ millions	2017	2016
At beginning of year	**(112)**	(64)
Exchange differences	**7**	(17)
Income statement movements	**(38)**	(53)
Utilised	**21**	22
Disposal through business disposal	**1**	–
Transfer to assets classified as held for sale	**5**	–
At end of year	**(116)**	(112)

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	2017	2016
Within due date	**661**	812
Up to three months past due date	**187**	232
Three to six months past due date	**48**	55
Six to nine months past due date	**18**	21
Nine to 12 months past due date	**13**	14
More than 12 months past due date	**3**	7
Total trade receivables	**930**	1,141
Less: provision for sales returns	**(170)**	(159)
Net trade receivables	**760**	982

The Group reviews its bad debt provision at least twice a year following a detailed review of receivable balances and historical payment profiles. Management believes all the remaining receivable balances are fully recoverable.

Notes to the consolidated financial statements

23. Provisions for other liabilities and charges

All figures in £ millions	Deferred consideration	Property	Disposals and closures	Legal and other	Total
At 1 January 2017	56	4	10	36	106
Exchange differences	(5)	–	–	(2)	(7)
Charged to income statement	–	–	–	4	4
Released to income statement	–	–	–	(7)	(7)
Utilised	(6)	–	(2)	(8)	(16)
Disposal through business disposal	–	(1)	3	(2)	–
At 31 December 2017	**45**	**3**	**11**	**21**	**80**

Analysis of provisions:

All figures in £ millions	Deferred consideration	Property	Disposals and closures	Legal and other	Total
					2017
Current	**5**	**1**	**11**	**8**	**25**
Non-current	**40**	**2**	**–**	**13**	**55**
	45	**3**	**11**	**21**	**80**
					2016
Current	6	1	8	12	27
Non-current	50	3	2	24	79
	56	4	10	36	106

Deferred consideration primarily relates to the formation of a venture in a North America business in 2011. The provision will be utilised over a number of years as payments are based on a royalty rate. Disposals and closures include liabilities related to the disposal of Penguin with the provisions utilised as the disposals and closures are completed. Legal and other includes legal claims, contract disputes and potential contract losses with the provisions utilised as the cases are settled. Restructuring provisions were not material in either 2017 or 2016.

24. Trade and other liabilities

All figures in £ millions	2017	2016
Trade payables	**265**	333
Social security and other taxes	**21**	25
Accruals	**447**	507
Deferred income	**322**	883
Interest payable	**45**	31
Liability to purchase own shares	**151**	–
Other liabilities	**224**	272
	1,475	2,051
Less: non-current portion		
Accruals	**26**	17
Deferred income	**35**	319
Other liabilities	**72**	86
	133	422
Current portion	**1,342**	1,629

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

The deferred income balance comprises advance payments in assessment, testing and training businesses; subscription income in school and college businesses; and obligations to deliver digital content in future periods.

The liability to purchase own shares relates to a liability arising under a buyback agreement for the purchase of the company's own shares (see note 27).

Notes to the consolidated financial statements

25. Retirement benefit and other post-retirement obligations

Background

The Group operates a number of defined benefit and defined contribution retirement plans throughout the world.

The largest plan is the Pearson Group Pension Plan (UK Group plan) in the UK, which is sectionalised to provide both defined benefit and defined contribution pension benefits. The defined benefit section was closed to new members from 1 November 2006. The defined contribution section, opened in 2003, is open to new and existing employees. Finally, there is a separate section within the UK Group plan set up for auto-enrolment. The defined benefit section of the UK Group plan is a final salary pension plan which provides benefits to members in the form of a guaranteed level of pension payable for life. The level of benefits depends on the length of service and final pensionable pay. The UK Group plan is funded with benefit payments from trustee-administered funds. The UK Group plan is administered in accordance with the Trust Deed and Rules in the interests of its beneficiaries by Pearson Group Pension Trustee Limited.

At 31 December 2017, the UK Group plan had approximately 24,000 members, analysed in the following table:

All figures in %	Active	Deferred	Pensioners	Total
Defined benefit	1	26	35	62
Defined contribution	8	30	–	38
Total	**9**	**56**	**35**	**100**

The other major defined benefit plans are based in the US. These are also final salary pension plans which provide benefits to members in the form of a guaranteed pension payable for life, with the level of benefits dependent on length of service and final pensionable pay. The majority of the US plans are funded.

The Group also has several post-retirement medical benefit plans (PRMBs), principally in the US. PRMBs are unfunded but are accounted for and valued similarly to defined benefit pension plans.

The defined benefit schemes expose the Group to actuarial risks, such as life expectancy, inflation risks, and investment risk including asset volatility and changes in bond yields. The Group is not exposed to any unusual, entity-specific or plan-specific risks.

The defined contribution section of the UK Group plan operates a Reference Scheme Test (RST) pension underpin for its members. Where a member's fund value is insufficient to purchase the RST pension upon retirement, the UK Group plan is liable for the shortfall to cover the member's RST pension. During the year, the UK Group plan revised its approach to securing the RST underpin by converting a member's fund value into a pension in the UK Group plan rather than purchasing an annuity with an insurer. A liability of £32m (2016: £181m) in respect of the underpin is included in the UK Group plan's defined benefit obligation, calculated as the present value of projected payments less the fund value. The UK Group plan's conversion factors are lower than the respective insurer annuity values and this has driven a reduction in the underpin liability, resulting in an actuarial gain through other comprehensive income and an increase in the surplus at 31 December 2017. From 1 January 2018, members who have sufficient funds to purchase an RST pension will be able to convert their fund value into a pension in the UK Group plan as an alternative to purchasing an annuity with an insurer. The Group does not recognise the assets and liabilities for members of the defined contribution section of the UK Group plan whose fund values are expected to be sufficient to purchase an RST pension without assistance from the UK Group plan. The defined contribution section of the UK Group plan had gross assets of £442m at 31 December 2017.

Notes to the consolidated financial statements

25. Retirement benefit and other post-retirement obligations continued

Assumptions

The principal assumptions used for the UK Group plan and the US PRMB are shown below. Weighted average assumptions have been shown for the other plans, which primarily relate to US pension plans.

All figures in %	2017 UK Group plan	2017 Other plans	2017 PRMB	2016 UK Group plan	2016 Other plans	2016 PRMB
Inflation	**3.2**	**1.6**	**1.5**	3.3	1.6	1.5
Rate used to discount plan liabilities	**2.5**	**3.0**	**3.0**	2.5	3.8	3.9
Expected rate of increase in salaries	**3.7**	**3.0**	**3.0**	3.8	3.0	3.0
Expected rate of increase for pensions in payment and deferred pensions	**2.1 to 5.1**	**–**	**–**	2.2 to 5.1	–	–
Initial rate of increase in healthcare rate	**–**	**–**	**6.5**	–	–	6.8
Ultimate rate of increase in healthcare rate	**–**	**–**	**5.0**	–	–	5.0

The UK discount rate is based on corporate bond yields adjusted to reflect the duration of liabilities. In 2017, the Group revised the portfolio of corporate bonds used to exclude bonds with an implicit government guarantee. Under the previous methodology, the 2017 UK discount rate would have been lower by around 0.1%.

The US discount rate is set by reference to a US bond portfolio matching model.

The inflation rate for the UK Group plan of 3.2% 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 2.2% has been used.

The expected rate of increase in salaries has been set at 3.7% for 2017 with a short-term assumption of 2.0% for three years.

For the UK plan, the mortality base table assumptions have been updated and are derived from the SAPS S2 for males and females, adjusted to reflect the observed experience of the plan, with CMI model improvement factors. A 1.5% long-term rate improvement on the CMI model is applied for both males and females.

For the US plans, the mortality table (RP – 2017) and 2017 improvement scale (MP – 2017) with generational projection for male and female annuitants has been adopted.

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:

All figures in years	UK 2017	UK 2016	US 2017	US 2016
Male	**23.6**	23.5	**20.8**	21.2
Female	**25.7**	25.6	**22.8**	23.2

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:

All figures in years	UK 2017	UK 2016	US 2017	US 2016
Male	**25.7**	25.5	**22.5**	22.9
Female	**27.9**	27.8	**24.4**	24.9

Although the Group anticipates that plan surpluses will be utilised during the life of the plan to address member benefits, the Group recognises its pension surplus in full in respect of the UK Group plan on the basis that it is management's judgement that there are no substantive restrictions on the return of residual plan assets in the event of a winding up of the plan after all member obligations have been met.

Notes to the consolidated financial statements

25. Retirement benefit and other post-retirement obligations continued

Financial statement information

The amounts recognised in the income statement are as follows:

All figures in £ millions	UK Group plan	Defined benefit other	Sub-total	Defined contribution	PRMB	Total
						2017
Current service cost	8	1	9	57	(1)	65
Administration expenses	9	1	10	–	–	10
Total operating expense	17	2	19	57	(1)	75
Interest on plan assets	(84)	(5)	(89)	–	–	(89)
Interest on plan liabilities	77	7	84	–	2	86
Net finance (income)/expense	(7)	2	(5)	–	2	(3)
Net income statement charge	10	4	14	57	1	72

All figures in £ millions	UK Group plan	Defined benefit other	Sub-total	Defined contribution	PRMB	Total
						2016
Current service cost	8	2	10	67	–	77
Curtailments	–	–	–	–	(2)	(2)
Administration expenses	6	–	6	–	–	6
Total operating expense	14	2	16	67	(2)	81
Interest on plan assets	(104)	(6)	(110)	–	–	(110)
Interest on plan liabilities	89	7	96	–	3	99
Net finance (income)/expense	(15)	1	(14)	–	3	(11)
Net income statement charge	(1)	3	2	67	1	70

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
				2017				2016
Fair value of plan assets	3,337	155	–	3,492	3,339	158	–	3,497
Present value of defined benefit obligation	(2,792)	(161)	(20)	(2,973)	(3,181)	(183)	(22)	(3,386)
Net pension asset/(liability)	545	(6)	(20)	519	158	(25)	(22)	111
Other post-retirement medical benefit obligation				(67)				(77)
Other pension accruals				(11)				(15)
Net retirement benefit asset				441				19
Analysed as:								
Retirement benefit assets				545				158
Retirement benefit obligations				(104)				(139)

Notes to the consolidated financial statements

25. Retirement benefit and other post-retirement obligations continued

Financial statement information continued

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

All figures in £ millions	2017	2016
Amounts recognised for defined benefit plans	175	(277)
Amounts recognised for post-retirement medical benefit plans	–	9
Total recognised in year	**175**	(268)

The fair value of plan assets comprises the following:

	2017			2016		
All figures in %	UK Group plan	Other funded plans	Total	UK Group plan	Other funded plans	Total
Insurance	29	–	29	–	–	–
Equities	1	1	2	2	1	3
Bonds	–	3	3	9	1	10
Property	8	–	8	8	–	8
Pooled asset investment funds	44	–	44	67	–	67
Other	14	–	14	12	–	12

The plan assets do not include any of the Group's own financial instruments, or any property occupied by the Group. The table below further disaggregates the UK Group plan assets into additional categories and those assets which have a quoted market price in an active market and those that do not:

	2017		2016	
All figures in %	Quoted market price	No quoted market price	Quoted market price	No quoted market price
Insurance	29	–	–	–
Non-UK equities	–	2	–	3
Fixed-interest securities	3	–	10	–
Property	–	8	–	8
Pooled asset investment funds	44	–	67	–
Other	–	14	–	12
Total	**76**	**24**	77	23

The liquidity profile of the UK Group plan assets is as follows:

All figures in %	2017	2016
Liquid – call <1 month	50	75
Less liquid – call 1–3 months	–	–
Illiquid – call >3 months	50	25

Notes to the consolidated financial statements

25. Retirement benefit and other post-retirement obligations continued

Financial statement information continued

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

All figures in £ millions	2017 UK Group plan	2017 Other plans	2017 Total	2016 UK Group plan	2016 Other plans	2016 Total
Fair value of plan assets						
Opening fair value of plan assets	3,339	158	3,497	2,803	135	2,938
Exchange differences	–	(8)	(8)	–	24	24
Interest on plan assets	84	5	89	104	6	110
Return on plan assets excluding interest	(140)	10	(130)	445	8	453
Contributions by employer	234	8	242	99	2	101
Benefits paid	(188)	(18)	(206)	(112)	(17)	(129)
Other	8	–	8	–	–	–
Closing fair value of plan assets	3,337	155	3,492	3,339	158	3,497
Present value of defined benefit obligation						
Opening defined benefit obligation	(3,181)	(205)	(3,386)	(2,466)	(175)	(2,641)
Exchange differences	–	13	13	–	(32)	(32)
Current service cost	(8)	(1)	(9)	(8)	(2)	(10)
Administration expenses	(9)	(1)	(10)	(6)	–	(6)
Interest on plan liabilities	(77)	(7)	(84)	(89)	(7)	(96)
Actuarial gains/(losses) – experience	126	6	132	12	–	12
Actuarial gains/(losses) – demographic	133	1	134	(47)	2	(45)
Actuarial gains/(losses) – financial	44	(5)	39	(689)	(8)	(697)
Contributions by employee	–	–	–	–	–	–
Other	(8)	–	(8)	–	–	–
Benefits paid	188	18	206	112	17	129
Closing defined benefit obligation	(2,792)	(181)	(2,973)	(3,181)	(205)	(3,386)

The weighted average duration of the defined benefit obligation is 16.9 years for the UK and 8.1 years for the US.

Notes to the consolidated financial statements

25. Retirement benefit and other post-retirement obligations continued

Financial statement information continued

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

All figures in £ millions	2017	2016
Opening defined benefit obligation	**(77)**	(76)
Exchange differences	**5**	(14)
Current service cost	**1**	–
Curtailments	**–**	2
Interest on plan liabilities	**(2)**	(3)
Actuarial gains/(losses) – experience	**1**	8
Actuarial gains/(losses) – demographic	**1**	2
Actuarial gains/(losses) – financial	**(2)**	(1)
Benefits paid	**6**	5
Closing defined benefit obligation	**(67)**	(77)

Funding

The UK Group plan is self-administered with the plan's assets being held independently of the Group in trust. The trustee of the plan is required to act in the best interest of the plan's beneficiaries. The most recent triennial actuarial valuation for funding purposes was completed as at 1 January 2015 and this valuation revealed a technical provisions funding shortfall of £27m which was eliminated by contributions paid during 2015.

As a consequence of the disposal of the FT Group, an agreement has been made between Pearson and the plan trustee to accelerate the funding of the plan. As a result, the plan is expected to be fully funded on a 'self-sufficiency' basis by 2019, inclusive of £202m paid in 2017 in relation to the Penguin Random House merger in 2013. This is a much higher level of funding than technical provisions. As a result, the plan expects to be able to provide benefits (in accordance with the plan rules) with a very low level of reliance on future funding from Pearson. A commitment has also been made to maintain that level of funding in future years.

Assets of the plan are divided into two elements: matching assets, which are assets that produce cash flows that can be expected to match the cash flows for a proportion of the membership, and include a liability-driven investment mandate (UK bonds, interest rate/inflation swaps and other derivative instruments), inflation-linked property and infrastructure; and return seeking assets, which are assets invested with a longer-term horizon to generate the returns needed to provide the remaining expected cash flows for the beneficiaries, and include diversified growth funds, property and alternative asset classes. The plan's long-term investment strategy allocates 85% to matching assets and 15% to return seeking assets.

In October 2017, the UK Group plan purchased pensioner buy-in policies with both Aviva and Legal & General totalling £1.2bn. The buy-ins cover around a third of its total liabilities and are split equally between the two insurers. The buy-ins transfer significant longevity risk to Aviva and Legal & General, reducing the pension risks being underwritten by the Group and providing additional security for members.

Regular contributions to the plan in respect of the defined benefit sections are estimated to be £6m for 2018.

Sensitivities

The effect of a one percentage point increase and decrease in the discount rate on the defined benefit obligation and the total pension expense is as follows:

	2017	
All figures in £ millions	1% increase	1% decrease
Effect:		
(Decrease)/increase in defined benefit obligation – UK Group plan	**(423)**	**575**
(Decrease)/increase in defined benefit obligation – US plan	**(14)**	**16**

Notes to the consolidated financial statements

25. Retirement benefit and other post-retirement obligations continued

Sensitivities continued

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

All figures in £ millions	2017 One year increase	2017 One year decrease
Effect:		
Increase/(decrease) in defined benefit obligation – UK Group plan	145	(152)
Increase/(decrease) in defined benefit obligation – US plan	8	(9)

The effect of a half percentage point increase and decrease in the inflation rate is as follows:

All figures in £ millions	2017 0.5% increase	2017 0.5% decrease
Effect:		
Increase/(decrease) in defined benefit obligation – UK Group plan	144	(132)
Increase/(decrease) in defined benefit obligation – US plan	–	–

The above sensitivity analyses are based on a change in an assumption while holding all other assumptions constant, although in practice this is unlikely to occur and changes in some assumptions may be correlated. When calculating these sensitivities, the same method has been applied to calculate the defined benefit obligation as has been applied when calculating the liability recognised in the balance sheet. This methodology is the same as prior periods.

26. Share-based payments

The Group recognised the following charges in the income statement in respect of its equity-settled share-based payment plans:

All figures in £ millions	2017	2016
Pearson plans	33	22

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 or five 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 American Depository Receipts (ADRs) with their accumulated funds at a purchase price equal to 85% of the lower of the market prices prevailing at the beginning or end of the period.

Long-Term Incentive Plan The plan was first introduced in 2001 and consists of restricted shares. The vesting of restricted shares is normally dependent on continuing service over a three to five-year period, and in the case of Executive Directors and 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 Executive Directors in September 2017, and to Executive Directors and senior management in May 2016, vest dependent on relative total shareholder return, return on invested capital and earnings per share growth. Restricted shares awarded to senior management in March 2016 and March 2017 vest dependent on earnings per share growth. Other restricted shares awarded in 2016 and 2017 vest depending on continuing service over a three-year period.

Management Incentive Plan The plan was introduced in 2017 combining the Group's Annual Incentive Plan and Long-Term Incentive Plan for senior management. The number of shares to be granted to participants is dependent on Group performance in the calendar year preceding the date of grant (on the same basis as the Annual Incentive Plan). Subsequently, the shares vest dependent on continuing service over a three-year period, and additionally in the case of Pearson Executive Management upon satisfaction of non market-based performance criteria as determined by the Remuneration Committee. Restricted shares awarded as part of the 2017 Management Incentive Plan will be granted in April 2018.

Notes to the consolidated financial statements

26. Share-based payments continued

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

	2017		2016	
	Number of share options 000s	Weighted average exercise price £	Number of share options 000s	Weighted average exercise price £
Outstanding at beginning of year	**2,978**	**8.14**	3,250	9.24
Granted during the year	**1,619**	**5.50**	1,544	6.94
Exercised during the year	**(9)**	**7.00**	(49)	7.07
Forfeited during the year	**(1,451)**	**8.04**	(1,695)	9.14
Expired during the year	**(156)**	**9.09**	(72)	8.95
Outstanding at end of year	**2,981**	**6.84**	2,978	8.14
Options exercisable at end of year	**350**	**8.18**	247	9.06

Options were exercised regularly throughout the year. The weighted average share price during the year was £6.71 (2016: £8.23). 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:

	2017		2016	
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	**–**	**–**	–	–
5–10	**2,697**	**2.52**	2,548	2.31
>10	**284**	**1.24**	430	2.25
	2,981	**2.40**	2,978	2.31

In 2017 and 2016, options were granted under the Worldwide Save for Shares Plan. The weighted average estimated fair value for the options granted was calculated using a Black–Scholes option pricing model.

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

	2017 Weighted average	2016 Weighted average
Fair value	**£1.24**	£1.01
Weighted average share price	**£6.83**	£7.85
Weighted average exercise price	**£5.50**	£6.94
Expected volatility	**34.75%**	27.38%
Expected life	**3.7 years**	3.7 years
Risk-free rate	**0.20%**	0.58%
Expected dividend yield	**7.61%**	7.49%
Forfeiture rate	**3.2%**	3.2%

The expected volatility is based on the historical 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:

	2017		2016	
	Number of shares 000s	Weighted average fair value £	Number of shares 000s	Weighted average fair value £
Long-Term Incentive Plan	**6,453**	**6.61**	6,833	8.24

Notes to the consolidated financial statements

26. Share-based payments continued

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. Participants under the plan 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.

27. Share capital and share premium

	Number of shares 000s	Share capital £m	Share premium £m
At 1 January 2016	821,068	205	2,590
Issue of ordinary shares – share option schemes	1,059	–	7
At 31 December 2016	822,127	205	2,597
Issue of ordinary shares – share option schemes	**923**	**–**	**5**
Purchase of own shares	**(20,996)**	**(5)**	**–**
At 31 December 2017	**802,054**	**200**	**2,602**

The ordinary shares have a par value of 25p per share (2016: 25p per share). All issued shares are fully paid. All shares have the same rights.

The £300m share buyback programme announced in October 2017 was completed on 16 February 2018. In 2017, the Group's brokers purchased 21m shares at a value of £153m of which £149m had been cancelled at 31 December 2017. Cash payments of £149m had been made in respect of the purchases with the outstanding £4m settlement made at the beginning of January 2018. This £4m together with the remaining value of the buyback programme of £147m was recorded as a liability at 31 December 2017 (see note 24). A further 22m shares were purchased under the programme in 2018 (see note 37). The shares bought back are being cancelled and the nominal value of these shares is transferred to a capital redemption reserve. The nominal value of shares cancelled at 31 December 2017 was £5m.

The Group manages its capital to ensure that entities in the Group will be able to continue as a going concern while maximising the return to shareholders through the optimisation of the debt and equity balance.

The capital structure of the Group consists of debt (see note 18), cash and cash equivalents (see note 17) and equity attributable to equity holders of the parent, comprising issued capital, reserves and retained earnings.

The Group reviews its capital structure on a regular basis and will balance its overall capital structure through payments of dividends, new share issues as well as the issue of new debt or the redemption of existing debt in line with the financial risk policies outlined in note 19.

28. Treasury shares

	Pearson plc	
	Number of shares 000s	£m
At 1 January 2016	6,705	72
Purchase of treasury shares	3,000	27
Release of treasury shares	(1,986)	(20)
At 31 December 2016	7,719	79
Purchase of treasury shares	**–**	**–**
Release of treasury shares	**(1,725)**	**(18)**
At 31 December 2017	**5,994**	**61**

The Group holds Pearson plc shares in trust to satisfy its obligations under its restricted share plans (see note 26). These shares, representing 0.8% (2016: 0.9%) 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 £1.5m (2016: £1.9m). Dividends on treasury shares are waived.

At 31 December 2017, the market value of Pearson plc treasury shares was £44m (2016: £63m).

Notes to the consolidated financial statements

29. Other comprehensive income

All figures in £ millions	Fair value reserve	Translation reserve	Retained earnings	Total	Non-controlling interest	Total
2017	Attributable to equity holders of the company					
Items that may be reclassified to the income statement						
Net exchange differences on translation of foreign operations – Group	–	(158)	–	(158)	–	(158)
Net exchange differences on translation of foreign operations – associates	–	(104)	–	(104)	–	(104)
Currency translation adjustment disposed	–	(51)	–	(51)	–	(51)
Attributable tax	–	–	9	9	–	9
Fair value gain on other financial assets	13	–	–	13	–	13
Attributable tax	–	–	(4)	(4)	–	(4)
Items that are not reclassified to the income statement						
Remeasurement of retirement benefit obligations – Group	–	–	175	175	–	175
Remeasurement of retirement benefit obligations – associates	–	–	7	7	–	7
Attributable tax	–	–	(42)	(42)	–	(42)
Other comprehensive income/(expense) for the year	13	(313)	145	(155)	–	(155)

All figures in £ millions	Fair value reserve	Translation reserve	Retained earnings	Total	Non-controlling interest	Total
2016	Attributable to equity holders of the company					
Items that may be reclassified to the income statement						
Net exchange differences on translation of foreign operations – Group	–	909	–	909	1	910
Net exchange differences on translation of foreign operations – associates	–	3	–	3	–	3
Currency translation adjustment disposed	–	–	–	–	–	–
Attributable tax	–	–	(5)	(5)	–	(5)
Items that are not reclassified to the income statement						
Remeasurement of retirement benefit obligations – Group	–	–	(268)	(268)	–	(268)
Remeasurement of retirement benefit obligations – associates	–	–	(8)	(8)	–	(8)
Attributable tax	–	–	58	58	–	58
Other comprehensive income/(expense) for the year	–	912	(223)	689	1	690

Notes to the consolidated financial statements

30. Business combinations

There were no significant acquisitions in 2017 or 2016.

Fair values for the assets and liabilities arising from acquisitions completed in the year are as follows:

All figures in £ millions	Notes	2017 Total fair value	2016 Total fair value
Intangible assets	11	–	10
Net assets acquired at fair value		–	10
Goodwill	11	–	3
Total		–	13
Satisfied by:			
Cash		–	(7)
Other liabilities		–	(6)
Total consideration		–	(13)

Goodwill of £3m arising on 2016 acquisitions is expected to be deductible for tax purposes.

Intangible assets acquired in 2016 have the following useful economic lives: trademarks and brands 15 years, and other acquired intangibles six years.

All figures in £ millions	2017	2016
Cash flow on acquisitions		
Cash – current year acquisitions	–	(7)
Deferred payments for prior year acquisitions and other items	(11)	(7)
Acquisition costs and other acquisition liabilities paid	–	(1)
Net cash outflow	(11)	(15)

31. Disposals including business closures

In August 2017, the Group completed the sale of the test preparation business in China (GEDU) and in October 2017 the sale of a 22% share in Penguin Random House, retaining a 25% share (see note 12).

		2017				2016
All figures in £ millions	Notes	GEDU	Penguin Random House	Other	Total	Total
Disposal of subsidiaries and associates						
Property, plant and equipment	10	(7)	–	–	(7)	(3)
Intangible assets	11	(2)	–	(7)	(9)	–
Investments in joint ventures and associates		–	(352)	–	(352)	–
Net deferred income tax assets	13	(1)	(2)	–	(3)	(10)
Intangible assets – pre-publication	20	–	–	(1)	(1)	(4)
Inventories		(1)	–	(1)	(2)	–
Trade and other receivables		(16)	–	–	(16)	(6)
Current income tax receivable		–	(5)	–	(5)	–
Cash and cash equivalents (excluding overdrafts)		(13)	–	–	(13)	(9)
Trade and other liabilities		33	–	1	34	21
Cumulative currency translation adjustment	29	3	48	–	51	–
Net assets disposed		(4)	(311)	(8)	(323)	(11)
Cash received		54	413	1	468	7
Costs		(6)	(6)	(5)	(17)	(16)
Gain/(loss) on disposal		44	96	(12)	128	(20)

Notes to the consolidated financial statements

31. Disposals including business closures continued

All figures in £ millions	2017	2016
Cash flow from disposals		
Cash – current year disposals	468	11
Cash and cash equivalents disposed	(13)	(9)
Costs and other disposal liabilities paid	(25)	(52)
Net cash inflow/(outflow)	430	(50)
Analysed as:		
Cash inflow/(outflow) from sale of subsidiaries	19	(54)
Cash inflow from sale of associates	411	4

32. Held for sale

The assets and liabilities related to Wall Street English language teaching businesses (WSE), part of the Core and Growth segments, and the K-12 school courseware business (K-12), part of the North America segment, have been presented as held for sale following the approval by the Group's management to sell both businesses.

		2017			2016
	Notes	WSE	K-12	Total	Total
Non-current assets					
Property, plant and equipment	10	16	–	16	–
Intangible assets	11	15	166	181	–
Deferred income tax assets		–	68	68	–
Trade and other receivables		4	23	27	–
		35	257	292	–
Current assets					
Intangible assets – pre-publication	20	8	239	247	–
Inventories		–	46	46	–
Trade and other receivables		12	36	48	–
Cash and cash equivalents (excluding overdrafts)	17	127	–	127	–
		147	321	468	–
Assets classified as held for sale		182	578	760	–
Non-current liabilities					
Deferred income tax liabilities		(2)	–	(2)	–
Other liabilities		(10)	(274)	(284)	–
		(12)	(274)	(286)	–
Current liabilities					
Trade and other liabilities		(152)	(150)	(302)	–
		(152)	(150)	(302)	–
Liabilities classified as held for sale		(164)	(424)	(588)	–
Net assets classified as held for sale		18	154	172	–

Notes to the consolidated financial statements

33. Cash generated from operations

All figures in £ millions	Notes	2017	2016
Profit/(loss)		**408**	(2,335)
Adjustments for:			
Income tax		**13**	(222)
Depreciation	10	**90**	95
Amortisation and impairment of acquired intangibles and goodwill	11	**138**	2,733
Amortisation of software	11	**85**	84
Net finance costs	6	**30**	60
Share of results of joint ventures and associates	12	**(78)**	(97)
Profit on disposal of subsidiaries, associates, investments and fixed assets		**(116)**	40
Net foreign exchange adjustment from transactions		**(26)**	43
Share-based payment costs	26	**33**	22
Pre-publication		**(35)**	(19)
Inventories		**24**	17
Trade and other receivables		**133**	156
Trade and other liabilities		**6**	61
Retirement benefit obligations		**(232)**	(106)
Provisions for other liabilities and charges		**(11)**	(10)
Net cash generated from operations		**462**	522
Dividends from joint ventures and associates		**458**	131
Re-capitalisation dividends from Penguin Random House		**(312)**	–
Purchase of property, plant and equipment		**(82)**	(88)
Purchase of intangible software assets		**(150)**	(157)
Proceeds from sale of property, plant and equipment and intangible software assets		**–**	4
Finance lease principal payments		**(5)**	(6)
Special pension contribution		**227**	90
Cost of major restructuring paid		**71**	167
Operating cash flow		**669**	663
Operating tax paid		**(75)**	(63)
Net operating finance costs paid		**(69)**	(51)
Operating free cash flow		**525**	549
Special pension contribution		**(227)**	(90)
Cost of major restructuring paid		**(71)**	(167)
Non-operating tax received		**–**	18
Free cash flow		**227**	310
Dividends paid (including to non-controlling interests)		**(318)**	(424)
Net movement of funds from operations		**(91)**	(114)
Acquisitions and disposals		**416**	19
Re-capitalisation dividends from Penguin Random House		**312**	–
Loans (advanced)/repaid (including to related parties)		**(13)**	14
Purchase of treasury shares	28	**–**	(27)
New equity		**5**	7
Buyback of equity	27	**(149)**	–
Other movements on financial instruments		**14**	4
Net movement of funds		**494**	(97)
Exchange movements on net debt		**166**	(341)
Total movement in net debt		**660**	(438)

Notes to the consolidated financial statements

33. Cash generated from operations continued

Net cash generated from operations is translated at an exchange rate approximating 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 (non-statutory) measures and have been disclosed and reconciled in the above table as they are commonly used by investors to measure the cash performance of the Group.

In the cash flow statement, proceeds from sale of property, plant and equipment comprise:

All figures in £ millions	2017	2016
Net book amount	**12**	9
Loss on sale of property, plant and equipment	**(12)**	(5)
Proceeds from sale of property, plant and equipment	**–**	4

The movements in the Group's current and non-current borrowings are as follows:

	2016	Financing cash flows	Foreign exchange movements	Fair value and other movements	2017
Financial liabilities					
Non-current borrowings	2,517	(1,292)	(149)	(10)	**1,066**
Current borrowings	9	(7)	(1)	3	**4**
Total	2,526	(1,299)	(150)	(7)	**1,070**

Non-current borrowings include bonds, derivative financial instruments and finance leases. Current borrowings include loans repayable within one year and finance leases, but exclude overdrafts classified within cash and cash equivalents.

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.

On 24 November 2017, the European Commission published an opening decision that the United Kingdom controlled foreign company group financing partial exemption (FCPE) constitutes State Aid. No final decision has yet been published, and it may be challenged by the UK tax authorities. The Group has benefited from FCPE in 2017 and prior periods in total by approximately £90m. At present the Group believes no provision is required in respect of this issue.

Notes to the consolidated financial statements

35. Commitments

At the balance sheet date there were no commitments for capital expenditure contracted for but not yet incurred.

The Group leases various offices and warehouses under non-cancellable operating lease agreements. The leases have varying terms and renewal rights. The Group also leases various plant and equipment under operating lease agreements, also with varying terms. Lease expenditure charged to the income statement was £178m (2016: £186m).

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

All figures in £ millions	2017	2016
Not later than one year	**156**	174
Later than one year and not later than two years	**139**	147
Later than two years and not later than three years	**121**	129
Later than three years and not later than four years	**100**	115
Later than four years and not later than five years	**86**	96
Later than five years	**599**	661
	1,201	1,322

In the event that the Group has excess capacity in its leased offices and warehouses it will enter into sub-lease contracts in order to offset costs. The future aggregate minimum sub-lease payments expected to be received under non-cancellable sub-leases are as follows:

All figures in £ millions	2017	2016
Not later than one year	**45**	44
Later than one year and not later than two years	**45**	46
Later than two years and not later than three years	**40**	44
Later than three years and not later than four years	**35**	39
Later than four years and not later than five years	**33**	34
Later than five years	**138**	155
	336	362

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.

Key management personnel

Key management personnel are deemed to be the members of the Pearson executive (see p11). It is this Committee which had responsibility for planning, directing and controlling the activities of the Group in 2017. Key management personnel compensation is disclosed below:

All figures in £millions	2017	2016
Short-term employee benefits	**12**	6
Retirement benefits	**1**	1
Share-based payment costs	**2**	1
Total	**15**	8

There were no other material related party transactions. No guarantees have been provided to related parties.

Notes to the consolidated financial statements

37. Events after the balance sheet date

During January 2018, the Group successfully executed market tenders to repurchase €250m of its €500m euro 1.875% notes due May 2021 and €200m of its €500m euro 1.375% notes due May 2025.

On 16 February, the Group completed its £300m share buyback programme. In aggregate between 18 October 2017 and 16 February 2018, the Group repurchased 42,835,577 shares, including 21,839,676 repurchased since 31 December 2017 at a cost of £151m.

38. Accounts and audit exemptions

The Pearson plc subsidiary companies listed below are exempt from the requirements of the Companies Act 2006 relating to the audit of individual accounts by virtue of section 479A.

	Company number
Aldwych Finance Limited	04720439
Edexcel Limited	04496750
Education Development International plc	03914767
Longman Group (Overseas Holdings) Limited	00690236
Major123 Limited	05333023
Pearson Affordable Learning Fund Limited	08038068
Pearson Australia Finance Unlimited	05578463
Pearson Books Limited	02512075
Pearson Brazil Finance Limited	08848874
Pearson Canada Finance Unlimited	05578491
Pearson Dollar Finance plc	05111013
Pearson Dollar Finance Two plc	06507766
Pearson Education Holdings Limited	00210859
Pearson Education Investments Limited	08444933
Pearson Education Limited	00872828
Pearson Funding Four plc	07970304

	Company number
Pearson International Finance Limited	02496206
Pearson Loan Finance No. 3 Limited	05052661
Pearson Loan Finance No. 4 Limited	02635107
Pearson Loan Finance Unlimited	05144467
Pearson Management Services Limited	00096263
Pearson Overseas Holdings Limited	00145205
Pearson Pension Nominees Limited	10809680
Pearson Pension Trustee Services Limited	10803853
Pearson PRH Holdings Limited	08561316
Pearson Real Estate Holdings Limited	09768242
Pearson Services Limited	01341060
Pearson Shared Services Limited	04623186
TQ Catalis Limited	07307943
TQ Clapham Limited	07307925
TQ Global Limited	07802458

Company balance sheet

As at 31 December 2017

All figures in £ millions	Notes	2017	2016
Assets			
Non-current assets			
Investments in subsidiaries	2	**6,691**	7,441
Amounts due from subsidiaries		**3,118**	133
Financial assets – derivative financial instruments	6	**140**	171
		9,949	7,745
Current assets			
Amounts due from subsidiaries		**209**	4,190
Amounts due from related parties		**46**	33
Cash and cash equivalents (excluding overdrafts)	4	**119**	867
		374	5,090
Total assets		**10,323**	12,835
Liabilities			
Non-current liabilities			
Amounts due to subsidiaries		**(3,530)**	(3,253)
Financial liabilities – borrowings	5	**–**	(254)
Financial liabilities – derivative financial instruments	6	**(140)**	(264)
		(3,670)	(3,771)
Current liabilities			
Amounts due to subsidiaries		**(1,739)**	(3,470)
Financial liabilities – borrowings	5	**(3)**	(13)
Current income tax liabilities		**(4)**	(52)
Other liabilities		**(158)**	(4)
		(1,904)	(3,539)
Total liabilities		**(5,574)**	(7,310)
Net assets		**4,749**	5,525
Equity			
Share capital	7	**200**	205
Share premium	7	**2,602**	2,597
Treasury shares	8	**(16)**	(34)
Capital redemption reserve		**5**	–
Special reserve		**447**	447
Retained earnings – including loss for the year of £163m (2016: loss of £1,288m)		**1,511**	2,310
Total equity attributable to equity holders of the company		**4,749**	5,525

These financial statements have been approved for issue by the Board of Directors on 14 March 2018 and signed on its behalf by

Coram Williams
Chief Financial Officer

Company statement of changes in equity

Year ended 31 December 2017

	Equity attributable to equity holders of the company						
All figures in £ millions	**Share capital**	**Share premium**	**Treasury shares**	**Capital redemption reserve**	**Special reserve**	**Retained earnings**	**Total**
At 1 January 2017	**205**	**2,597**	**(34)**	**–**	**447**	**2,310**	**5,525**
Loss for the year	**–**	**–**	**–**	**–**	**–**	**(163)**	**(163)**
Issue of ordinary shares under share option schemes*	**–**	**5**	**–**	**–**	**–**	**–**	**5**
Buyback of equity	**(5)**	**–**	**–**	**5**	**–**	**(300)**	**(300)**
Purchase of treasury shares	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Release of treasury shares	**–**	**–**	**18**	**–**	**–**	**(18)**	**–**
Dividends	**–**	**–**	**–**	**–**	**–**	**(318)**	**(318)**
At 31 December 2017	**200**	**2,602**	**(16)**	**5**	**447**	**1,511**	**4,749**

	Equity attributable to equity holders of the company						
All figures in £ millions	**Share capital**	**Share premium**	**Treasury shares**	**Capital redemption reserve**	**Special reserve**	**Retained earnings**	**Total**
At 1 January 2016	205	2,590	(27)	–	447	4,042	7,257
Loss for the year	–	–	–	–	–	(1,288)	(1,288)
Issue of ordinary shares under share option schemes*	–	7	–	–	–	–	7
Purchase of treasury shares	–	–	(27)	–	–	–	(27)
Release of treasury shares	–	–	20	–	–	(20)	–
Dividends	–	–	–	–	–	(424)	(424)
At 31 December 2016	205	2,597	(34)	–	447	2,310	5,525

The capital redemption reserve reflects the nominal value of shares cancelled in the Group's share buyback programme. The special reserve represents the cumulative effect of cancellation of the company's share premium account.

Included within retained earnings is an amount of £162m (2016: £162m) relating to profit on intra-Group disposals that is not distributable.

* Full details of the share-based payment plans are disclosed in note 26 to the consolidated financial statements.

Company cash flow statement

As at 31 December 2017

All figures in £ millions	Notes	2017	2016
Cash flows from operating activities			
Net loss		**(163)**	(1,288)
Adjustments for:			
Income tax		**70**	(80)
Net finance costs		**26**	7
Disposals, liquidations and impairment charges		**790**	1,337
Amounts due (to)/from subsidiaries		**(748)**	748
Net cash (used in)/generated from operations		**(25)**	724
Interest paid		**(21)**	(15)
Tax received		**9**	24
Net cash (used in)/generated from operating activities		**(37)**	733
Cash flows from investing activities			
Loans (advanced to)/repaid by related parties		**(13)**	14
Interest received		**7**	11
Net cash (used in)/received from investing activities		**(6)**	25
Cash flows from financing activities			
Proceeds from issue of ordinary shares	7	**5**	7
Buyback of equity		**(149)**	–
Net purchase of treasury shares		**–**	(27)
Repayment of borrowings		**(243)**	(30)
Dividends paid to company's shareholders		**(318)**	(424)
Net cash used in financing activities		**(705)**	(474)
Effects of exchange rate changes on cash and cash equivalents		**10**	(18)
Net (decrease)/increase in cash and cash equivalents		**(738)**	266
Cash and cash equivalents at beginning of year		**854**	588
Cash and cash equivalents at end of year	4	**116**	854

Notes to the company financial statements

1. Accounting policies

The financial statements on p178-189 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 have 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	2017	2016
At beginning of year	**7,441**	7,744
Subscription for share capital in subsidiaries	**164**	800
Disposals/liquidations	**(430)**	–
Impairments	**(360)**	(1,337)
Currency revaluations	**(124)**	234
At end of year	**6,691**	7,441

In 2017, impairments, disposals and liquidations relate to restructuring of intermediate holding companies. Impairments are largely offset by dividends received. In 2016, impairments relate to the carrying value of intermediate holding company investments following impairment reviews and the subsequent impairment of assets in the Pearson plc Group (see note 11 in the Group consolidated financial statements for further details).

3. Financial risk management

The company's financial instruments comprise amounts due to/from subsidiary undertakings, cash and cash equivalents, derivative financial instruments, a liability to purchase own shares (included within other liabilities) and current and non-current borrowings. Derivative financial instruments are held at fair value, with all other financial instruments held at amortised cost, which approximates fair value. 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 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 an £26m decrease in the carrying value of its financial instruments, with a 1% decrease in interest rates resulting in a £26m 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 £140m, while a 10% weakening in the value of sterling would increase the carrying value by £183m. 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

3. Financial risk management continued

The following table analyses the company's bonds and derivative assets and liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash flows (including interest) and as such may differ from the amounts disclosed on the balance sheet.

	Analysed by maturity				Analysed by currency			
All figures in £ millions	Less than one year	Later than one year but less than five years	Five years or more	Total	USD	GBP	Other	Total
At 31 December 2017								
Bonds	–	–	–	–	–	–	–	–
Rate derivatives – inflows	(38)	(975)	(684)	(1,697)	(53)	(751)	(893)	(1,697)
Rate derivatives – outflows	48	1,060	667	1,775	1,003	751	21	1,775
Total	10	85	(17)	78	950	–	(872)	78
At 31 December 2016								
Bonds	12	249	–	261	261	–	–	261
Rate derivatives – inflows	(103)	(1,086)	(867)	(2,056)	(239)	(838)	(979)	(2,056)
Rate derivatives – outflows	82	1,202	891	2,175	1,308	838	29	2,175
Total	(9)	365	24	380	1,330	–	(950)	380

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	2017	2016
Cash at bank and in hand	2	4
Short-term bank deposits	117	863
	119	867

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

At the end of 2017, the currency split of cash and cash equivalents was US dollar 82% (2016: 38%), sterling 17% (2016: 62%) and other 1% (2016: 0%).

Cash and cash equivalents have fair values that approximate 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	2017	2016
Cash and cash equivalents	119	867
Bank overdrafts	(3)	(13)
	116	854

Notes to the company financial statements

5. Financial liabilities – borrowings

All figures in £ millions	2017	2016
Non-current		
4.625% US dollar notes 2018 (nominal amount $300m)	–	254
	–	254
Current		
Due within one year or on demand:		
Bank loans and overdrafts	3	13
	3	13
Total borrowings	3	267

Movements in non-current borrowings during the year (including derivative financial instruments) comprise financing cash outflows of £243m, exchange gains of £124m and fair value and other movements of £(20)m. Current borrowings in both years are classified within cash and cash equivalents and do not give rise to financing cash flows.

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

All figures in £ millions	2017	2016
Between one and two years	–	254
Between two and five years	–	–
Over five years	–	–
	–	254

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

	2017			2016		
All figures in £ millions	Effective interest rate	Carrying amount	Market value	Effective interest rate	Carrying amount	Market value
Bank loans and overdrafts	n/a	3	3	n/a	13	13
4.625% US dollar notes 2018	n/a	–	–	4.69%	254	250
		3	3		267	263

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	2017	2016
US dollar	–	254
Sterling	3	8
Euro	–	5
	3	267

Notes to the company financial statements

6. Derivative financial instruments

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

All figures in £ millions	2017 Gross notional amounts	2017 Assets	2017 Liabilities	2016 Gross notional amounts	2016 Assets	2016 Liabilities
Interest rate derivatives – in a fair value hedge relationship	–	–	–	244	10	–
Interest rate derivatives – not in a hedge relationship	**1,228**	**26**	**–**	3,100	61	(11)
Cross-currency derivatives	**1,389**	**114**	**(140)**	1,622	100	(253)
Total	**2,617**	**140**	**(140)**	4,966	171	(264)
Analysed as expiring:						
In less than one year	–	–	–	162	–	–
Later than one year and not later than five years	**1,545**	**64**	**(97)**	2,776	86	(157)
Later than five years	**1,072**	**76**	**(43)**	2,028	85	(107)
Total	**2,617**	**140**	**(140)**	4,966	171	(264)

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	Share capital £m	Share premium £m
At 1 January 2016	821,068	205	2,590
Issue of ordinary shares – share option schemes	1,059	–	7
At 31 December 2016	822,127	205	2,597
Issue of ordinary shares – share option schemes	**923**	**–**	**5**
Purchase of own shares	**(20,996)**	**(5)**	**–**
At 31 December 2017	**802,054**	**200**	**2,602**

The ordinary shares have a par value of 25p per share (2016: 25p per share). All issued shares are fully paid. All shares have the same rights.

The £300m share buyback programme announced in October 2017 was completed on 16 February 2018. In 2017, the Group's brokers purchased 21m shares at a value of £153m of which £149m had been cancelled at 31 December 2017. Cash payments of £149m had been made in respect of the purchases with the outstanding £4m settlement made at the beginning of January 2018. This £4m together with the remaining value of the buyback programme of £147m was recorded as a liability at 31 December 2017. A further 22m shares were purchased under the programme in 2018. The shares bought back are being cancelled and the nominal value of these shares is transferred to a capital redemption reserve. The nominal value of shares cancelled at 31 December 2017 was £5m.

Notes to the company financial statements

8. Treasury shares

	Number of shares 000s	£m
At 1 January 2016	6,705	27
Purchase of treasury shares	3,000	27
Release of treasury shares	(1,986)	(20)
At 31 December 2016	7,719	34
Purchase of treasury shares	–	–
Release of treasury shares	**(1,725)**	**(18)**
At 31 December 2017	**5,994**	**16**

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 £1.5m (2016: £1.9m). At 31 December 2017, the market value of the company's treasury shares was £44m (2016: £63m). The gross book value of the shares at 31 December 2017 amounts to £61m. This value has been netted off with contributions received from operating companies of £45m, resulting in a net debit value of £16m.

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 (2016: £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 £122m (2016: £138m) and interest receivable from subsidiaries for the year of £111m (2016: £109m). Management fees payable to subsidiaries in respect of centrally provided services amounted to £42m (2016: £118m). Management fees receivable from subsidiaries in respect of centrally provided services amounted to £69m (2016: £76m). Dividends received from subsidiaries were £701m (2016: £87m).

Associates

Amounts due from related parties, disclosed on the face of the company balance sheet, relate to loans to Penguin Random House, an associate of the Group. These loans are unsecured and interest is calculated based on market rates. The amount outstanding at 31 December 2017 was £46m (2016: £33m). The loans are provided under a working capital facility and fluctuate during the year.

Key management personnel

Key management personnel are deemed to be the members of the Pearson executive.

It is this committee which had responsibility for planning, directing and controlling the activities of the company in 2017. Key management personnel compensation is disclosed in note 36 to the consolidated financial statements.

There were no other material related party transactions. No guarantees have been provided to related parties.

Notes to the company financial statements

12. Group companies

In accordance with section 409 of the Companies Act 2006 a full list of subsidiaries, partnerships, associates, joint ventures and joint arrangements, the country of incorporation, the registered address and the effective percentage of equity owned, as at 31 December 2017 is disclosed below. Unless otherwise stated, the shares are all indirectly held by Pearson plc. Unless otherwise stated, all wholly-owned and partly-owned subsidiaries are included in the consolidation and all associated undertakings are included in the Group's financial statements using the equity method of accounting. Principal Group companies are identified in **bold**.

Wholly-owned subsidiaries

Registered company name	Country of Incorp.	Reg office
A Plus Education Solutions Private Limited*	IN	2
Addison Wesley Longman, Inc.	US	3
Addison-Wesley Educational Publishers Inc.	US	4
AEL (S) PTE Limited	SG	5
Aldwych Finance Limited	UK	1
America's Choice, Inc.	US	4
ATI Professional Development LLC	US	4
Atkey Finance Limited	IE	7
Axis Finance Inc.	US	4
Beijing Wall Street English Training Centre Company Limited	CN	9
Blue Wharf Limited*	UK	6
Camsaw, Inc.	US	4
CAMSAWUSA, Inc.	US	11
Casapsi Livraria e Editora Ltda	BR	12
Centro Cultural Americano Franquias e Comércio Ltda.	BR	13
Century Consultants Ltd.	US	14
Certiport China Holding, LLC	US	4
Certiport, Inc.	US	4
Cogmed Systems AB	SE	15
Connections Academy of Alaska, LLC	US	16
Connections Academy of Arizona, LLC	US	17
Connections Academy of Arkansas, LLC	US	18
Connections Academy of DC, LLC	US	21
Connections Academy of Florida, LLC	US	22
Connections Academy of Georgia, LLC	US	23
Connections Academy of Indiana, LLC	US	25
Connections Academy of Iowa, LLC	US	26
Connections Academy of Kansas, LLC	US	27
Connections Academy of Kentucky, LLC	US	28
Connections Academy of Louisiana, LLC	US	29
Connections Academy of Maine, LLC	US	30
Connections Academy of Maryland, LLC	US	31
Connections Academy of Massachusetts LLC	US	3
Connections Academy of Minnesota, LLC	US	32
Connections Academy of Missouri, LLC	US	33
Connections Academy of Nevada, LLC	US	34
Connections Academy of New Jersey, LLC	US	14
Connections Academy of New Mexico, LLC	US	35
Connections Academy of New York, LLC	US	36
Connections Academy of North Carolina, LLC	US	37
Connections Academy of Oregon, LLC	US	40
Connections Academy of Pennsylvania LLC	US	41
Connections Academy of South Carolina, LLC	US	42
Connections Academy of Tennessee, LLC	US	43
Connections Academy of Texas, LLC	US	44
Connections Academy of Virginia, LLC	US	46
Connections Education LLC	US	4
Connections Education of Florida, LLC	US	22
Connections Education, Inc.	US	4
CTI Education Group (Pty) Limited	ZA	50
Dominie Press, Inc.	US	19
Dorian Finance Limited	IE	7
Dorling Kindersley Australasia Pty Limited	AU	51
EBNT Canada Holdings ULC	CA	127
EBNT Holdings Limited	CA	128
EBNT USA Holdings Inc.	US	4
eCollege.com	US	4
Edexcel Limited†	UK	52
Edexcel South Africa Pty Ltd*	ZA	50
Éditions Du Renouveau Pédagogique Inc.	CA	53
Education Development International Plc†	UK	1
Education Resources (Cyprus) Limited	CY	54
Educational Management Group, Inc.	US	55
Educational Resources (HK) Limited*	CN	56
Embanet ULC	CA	47
Embanet-Compass Knowledge Group Inc.	US	22
Embankment Finance Limited*	UK	6
English Language Learning and Instruction System, Inc.	US	57
Escape Studios Limited*	UK	6
Falstaff Holdco Inc.	US	4
Falstaff Inc.	US	58
FBH, Inc.	US	4
Franchise Support & Services, SL	ES	60
Gamma Master China, Limited	CN	61
Global Elite Education & Technology (Shanghai) Co. Limited	CN	63
Global George I Limited	KY	8
Global George II limited	CN	56
Global English India Private Limited	IN	2
Globe Fearon Inc.	US	19
Green Wharf Limited*	UK	6
Guangzhou Crescent Software Co., Ltd	CN	64
Heinemann Education Botswana (Publishers) (Proprietary) Limited	BW	65
Icodeon Limited*	UK	6
IndiaCan Education Private Limited	IN	2
Integral 7, Inc.	US	4
INTELLIPRO, INC.	US	14
J M Soluções Exportação e Importação Ltda	BR	67
Kagiso Education Pty Ltd*	ZA	50
Knowledge Analysis Technologies, LLC	US	20
LCCI International Qualifications (Malaysia) Sdn. Bhd.*	MY	68
LCCIEB Training Consultancy., Ltd	CN	69
LessonLab, Inc.	US	19
Lignum Oil Company	US	4
Linx Brasil Distribuidora Ltda.	BR	13
Longman (Malawi) Limited	MW	70
Longman Australasia Pty Ltd	AU	71
Longman Group(Overseas Holdings) Limited	UK	1
Longman Indochina Acquisition, L.L.C.	US	4
Longman Kenya Limited	KE	72
Longman Mocambique Ltda	MZ	45
Longman Swaziland (Pty) Limited	SZ	73
Longman Tanzania Limited*	TZ	74
Longman Zambia Educational Publishers Pty Ltd	ZM	75
Longman Zambia Limited	ZM	75
Longman Zimbabwe (Private) Ltd	ZW	76
Longmaned Ecuador S.A.	EC	77
Major123 Limited	UK	78
MeasureUp, LLC	US	4
Modern Curriculum Inc.	US	19
Multi Treinamento e Editora Ltda	BR	79
National Computer Systems Japan Co. Ltd	JP	80
NCS Information Services Technology (Beijing) Co Ltd	CN	81
NCS Pearson Pty Ltd	AU	51
NCS Pearson Puerto Rico, Inc.	PR	82
NCS Pearson, Inc.	US	32
Ordinate Corporation	US	19
Pearson (Beijing) Management Consulting Co., Ltd.	CN	83
Pearson (Guizhou) Education Technology Co., Ltd.	CN	84
Pearson Affordable Learning Fund Limited	UK	1
Pearson America LLC	US	4
Pearson Amsterdam B.V.	NL	85
Pearson Australia Finance Unlimited	UK	1
Pearson Australia Group Pty Ltd	AU	51
Pearson Australia Holdings Pty Ltd	AU	51
Pearson Australia Pty Ltd	AU	51
Pearson Benelux B.V.	NL	85
Pearson Books Limited†	UK	1
Pearson Brazil Finance Limited	UK	1
Pearson Business (Asia Pacific) Pte. Ltd.	SG	5
Pearson Business Services Inc.	US	4
Pearson Canada Assessment Inc	CA	86
Pearson Canada Finance Unlimited	UK	1
Pearson Canada Holdings Inc	CA	86
Pearson Canada Inc.	CA	86
Pearson Central Europe Spółka z ograniczoną odpowiedzialnością	PL	126
Pearson Charitable Foundation	US	57
Pearson College Limited	UK	1
Pearson DBC Holdings Inc.	US	4
Pearson Desarrollo y Capacitación Profesional Chile Limitada	CL	87
Pearson Deutschland GmbH	DE	88
Pearson Digital Learning Puerto Rico, Inc.	PR	82
Pearson Dollar Finance plc†	UK	1
Pearson Dollar Finance Two Limited	UK	1
Pearson Educacion de Chile Limitada	CL	89
Pearson Educacion de Colombia S A S	CO	90
Pearson Educacion de Mexico, S.A. de C.V.	MX	91
Pearson Educacion de Panama SA	PA	92
Pearson Educacion de Peru S.A.	PE	93
Pearson Educacion SA	ES	94
Pearson Education (Singapore) Pte Ltd	SG	5
Pearson Education Africa (Pty) Ltd	ZA	50
Pearson Education and Assessment, Inc.	US	4
Pearson Education Asia Limited	CN	56
Pearson Education Botswana (Proprietary) Limited	BW	65

Notes to the company financial statements

Registered company name	Country of Incorp.	Reg office
Pearson Education do Brasil S.A	BR	129
Pearson Education Hellas SA	GR	122
Pearson Education Holdings Inc.	US	4
Pearson Education Holdings Limited†	UK	1
Pearson Education Indochina Limited	TH	95
Pearson Education Investments Limited	UK	1
Pearson Education Korea Limited	KR	96
Pearson Education Limited	UK	1
Pearson Education Namibia (Pty) Limited	NA	97
Pearson Education Publishing Limited	NG	98
Pearson Education S.A.	UY	99
Pearson Education SA	AR	100
Pearson Education South Africa (Pty) Ltd	ZA	50
Pearson Education South Asia Pte. Ltd.	SG	5
Pearson Education Taiwan Ltd	TW	101
Pearson Education, Inc.	US	4
Pearson Educational Measurement Canada, Inc.	CA	39
Pearson Educational Publishers, LLC	US	4
Pearson Egitim Cozumleri Tikaret Limited Sirketi	TR	102
Pearson Falstaff (Holdings) Inc.	US	4
Pearson Falstaff Holdco LLC	US	4
Pearson France	FR	103
Pearson Funding Five plc†	UK	1
Pearson Funding Four plc†	UK	1
Pearson Funding Two Limited*†	UK	6
Pearson Holdings Inc.	US	4
Pearson Holdings Southern Africa (Pty) Limited	ZA	50
Pearson in Practice Holdings Limited*	UK	6
Pearson in Practice Skills Based Learning Limited*	UK	6
Pearson in Practice Technology Limited*	UK	6
Pearson Inc.	US	4
Pearson India Education Services Private Limited	IN	2
Pearson Institute of Higher Education	ZA	50
Pearson International Finance Limited†	UK	1
Pearson Investment Holdings, Inc.	US	4
Pearson IOKI Spółka z ograniczoną odpowiedzialnością	PL	104
Pearson Italia S.p.A	IT	105
Pearson Japan KK	JP	106
Pearson Lanka (Private) Limited	LK	107
Pearson Learning China (HK) Limited	CN	56
Pearson Lesotho (Pty) Ltd	LS	66
Pearson Loan Finance No. 3 Limited	UK	1
Pearson Loan Finance No. 4 Limited	UK	1
Pearson Loan Finance No.2 Unlimited*	UK	6
Pearson Loan Finance Unlimited	UK	1
Pearson Longman LLC	US	4
Pearson Longman Uganda Limited	UG	108
Pearson Malaysia Sdn. Bhd.	MY	62
Pearson Management Services Limited†	UK	1
Pearson Management Services Philippines Inc.	PH	109
Pearson Netherlands B.V.	NL	85
Pearson Netherlands Holdings B.V.	NL	85
Pearson Nominees Limited†	UK	1
Pearson Online Tutoring LLC	US	4
Pearson Overseas Holdings Limited†	UK	1
Pearson PEM P.R., Inc.	PR	82
Pearson Pension Nominees Limited	UK	1
Pearson Pension Property Fund Limited	UK	1

Registered company name	Country of Incorp.	Reg office
Pearson Pension Trustee Limited	UK	1
Pearson Pension Trustee Services Limited†	UK	1
Pearson PRH Holdings Limited	UK	1
Pearson Professional Assessments Limited	UK	1
Pearson Real Estate Holdings Inc.	US	4
Pearson Real Estate Holdings Limited†	UK	1
Pearson Schweiz AG	CH	110
Pearson Services Limited†	UK	1
Pearson Shared Services Limited†	UK	1
Pearson Strand Finance Limited†	UK	1
Pearson Sweden AB	SE	15
Pearson VUE Philippines, Inc.	PH	111
Peisheng Yucai (Beijing) Technology Development Limited*	CN	112
Penguin Capital, LLC	US	4
Phumelela Publishers (Pty) Ltd*	ZA	50
PN Holdings Inc.	US	4
Prentice-Hall Hispanoamericana SA de CV	MX	91
ProctorCam, Inc.	US	113
PT Efficient English Services	ID	114
Reading Property Holdings LLC	US	115
Rebus Planning Associates, Inc.	US	10
Reston Publishing Company, Inc.	US	4
Rycade Capital Corporation	US	4
Shanghai AWL Education Software Ltd	CN	116
Silver Burdett Ginn Inc.	US	4
Skylight Training and Publishing Inc.	US	55
Smarthinking, Inc.	US	4
Sound Holdings Inc.	US	4
Spear Insurance Company Limited†	BM	48
Stark Verlag GmbH	DE	88
Sunnykey International Holdings Limited (BVI)	VG	117
Tecquipment Services Limited*	UK	6
Testchange Limited*†	UK	6
The Financial Times (I) Pvt Ltd	IN	24
The Learning Edge International pty Ltd	AU	71
The SIOP Institute LLC	US	118
The Waite Group Inc	US	19
TQ Catalis Limited	UK	78
TQ Clapham Limited	UK	78
TQ Education and Training Limited	UK	78
TQ Education and Training Limited	SA	59
TQ Global Limited	UK	1
TQ Group Limited	UK	78
TQ Holdings Limited	UK	1
USLS Holdings LLC	US	4
Vue Testing Services Israel Ltd	IL	49
Vue Testing Services Korea Limited	KR	38
Wall Street English Training Centre (Shanghai) Company Limited	CN	119
Wall Street Institute Kft.	HU	120
Wall Street Institute Master Italia Srl	IT	121
WSE Hong Kong Limited	CN	61
WSE Training Centre (Guangdong) Co., Ltd.	CN	123
WSI Education GmbH	DE	124
WSI International, Inc.	US	125

* In liquidation

† Directly owned by Pearson plc

Subsidiary addresses

The following list includes all Pearson registered offices worldwide. Please see wholly-owned subsidiaries list opposite for each subsidiary's registered office code.

Registered office address	
1	80 Strand, London, WC2R 0RL, England
2	4th Floor Software Block, Elnet Software City, TS 140 Block 2 & 9, Rajiv Gandhi Salai, Taramani, Chennai, TN, 600113, India
3	C T Corporation System, 155 Federal St., Suite 700, Boston, MA, 02110, United States
4	The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, Wilmington, New Castle, DE, 19801, United States
5	9, #13-05/06, North Buona Vista Drive, The Metropolis Tower One, 138588, Singapore
6	Acre House, 11-15 William Road, London, NW1 3ER, England
7	1st Floor Riverview House, 21/23 City Quay, Dublin, D02FP21, Ireland
8	Maples Corporate Services Limited P.O. Box 309, Ugland House, South Church Street, George Town, Grand Cayman, KY!-1104, Cayman Islands
9	3F, Building R2 China Merchants Tower, No.118 Jianguo Road, Chaoyang District, Beijing, China
10	The Corporation Company, 40600 Ann Arbor Rd E Suite 201, Plymouth, MI, 48170, United States
11	The Prentice-Hall Corporation System, MA, 7 St. Paul Street, Suite 1660, Baltimore, MD, 21202, United States
12	No 15000, Francisco Matarazzo Avenue, Cj. 51 – Bloco 1 – Edificio New York, City of São Paulo, São Paulo, 05001-100, Brazil
13	Comendador Aladino Selmi Avenue, 4630, Galpao 1, Sala 1, Parque Cidade Campinas, City of Campinas, São Paulo 13069-036, Brazil
14	820, Bear Tavern Road, West Trenton, Mercer, NJ, 08628, United States
15	Gustavslundsvägen 137, 167 51 Bromma, Stockholm, Sweden
16	C T Corporation System, 9360 Glacier Hwy Suite 202, Juneau, AK, 99801, United States
17	C T Corporation System, 3800 N Central Ave Suite 460, Phoenix, AZ, 85012, United States
18	The Corporation Company, 124 West Capitol Avenue, Suite 1900, Little Rock, AR, 72201, United States
19	C T Corporation System, 818 West Seventh Street, Suite 930, Los Angeles, CA, 90017, United States
20	The Corporation Company, 7700 E Arapahoe Rd Suite 220, Centennial, CO, 80112-1268, United States
21	C T Corporation System, 1015 15th Street 10th Floor, Washington, DC, 20005, United States
22	1200, South Pine Island Road, Plantation, FL, 33324, United States
23	1201, Peachtree Street, NE, Atlanta, GA, 30361, United States
24	Plot No. 3, Bharti Colony Vikas Marg, New Dehli, DL 110092, India
25	CT Corporation System, 150 West Market Street, Suite 800, Indianapolis, IN, 46204, United States
26	C T Corporation System, 400 E Court Ave, Des Moines, IA, 50309, United States
27	The Corporation Company, Inc., 112 SW 7th Street, Suite 3C, Topeka, KS, 66603, United States
28	CT Corporation System, 306 W. Main Street, Suite 512, Frankfort, KY, 40601, United States
29	3867, Plaza Tower, 1st Floor, Baton Rouge, LA, 70816, United States
30	C T Corporation System, 128 State St #3, Augusta, ME, 04330, United States
31	7 St. Paul Street, Suite 1660, Baltimore, MD, 21202

Notes to the company financial statements

Registered office address
32 C T Corporation System Inc., 1010 Dale St N, St Paul, MN, 55117-5603, United States
33 120, 400, South Central Avenue, Clayton, MO, 63105, United States
34 The Corporation Trust Company of Nevada, 701 S Carson St, Suite 200, Carson City, NV, 89701, United States
35 C T Corporation System, 206 S Coronado Ave, Espanola, NM, 87532-2792, United States
36 CT Corporation, 111 Eighth Avenue, New York, NY 10011, United States
37 CT Corporation System, 160 Mine Lake Ct Suite 200, Raleigh, NC, 27615, United States
38 21, Mugyo-ro Jung-gu, Seoul, Republic of Korea
39 199 Bay Street, Commerce Court West, Suite 2800, Toronto, ON, M5L1A9, Canada
40 C T Corporation System, 388 State St Suite 420, Salem, OR, 97301, United States
41 C T Corporation System, 116 Pine Street, Suite 320, Harrisburg, Dauphin, PA, 17101, United States
42 C T Corporation System, 2 Office Park Court, Suite 103, Columbia, SC, 29223, United States
43 C T Corporation System, 800 S Gay St, Suite 2021, Knoxville, TN, 37929-9710, United States
44 CT Corporation System, 1999 Bryan Street, Suite 900, Dallas, TX, 75201, United States
45 Numero 776, Avenida 24 de Julho, Maputo, Mozambique
46 C T Corporation System, 4701 Cox Road, Suite 285, Glen Allen, Henrico, VA, 23060-0000, United States
47 3500, 855 – 2nd Street, S.W., Calgary, AB, T2P 4K7, Canada
48 Thistle House, 4 Burnaby Street, Hamilton, HM11, Bermuda
49 Derech Ben Gurion 2, BSR Building 9th Floor, Ramat Gan, 52573, Israel
50 Auto Atlantic, 4th Floor, Corner Hertzog Boulevard and Heerengracht, Cape Town, 8001, South Africa
51 707 Collins Street, Docklands, Melbourne, VIC, 3008, Australia
52 190, High Holborn, London, WC1V 7BH, England
53 1611, Boul. Cremazie Est, 10th Floor, Montréal, PQ, H2M 2P2, Canada
54 195, Archbishop Makarios III Avenue, Neocleous House, Limassol, 3030, Cyprus
55 Illinois Corporation Service Company, 700 S 2nd Street, Springfield, IL, 62703, United States
56 28/F, 1063 King's Road, Quarry Bay, Hong Kong
57 C/o Corporation Service Company, 2711 Centerville Road, Suite 400, Wilmington, Delaware, 19808, United States
58 111, 13th Floor, Eighth Avenue, New York, NY, 10011, United States
59 King Fahad Road, Olaya, Riyadh, 58774, 11515, Saudi Arabia
60 Tuset 20-24, No. 5, Barcelona, 08006, Spain
61 Level 54, Hopewell Centre, 183 Queen's Road East, Hong Kong
62 Unit 30-01, Level 30, Tower A, Vertical Business Suite, Avenue 3, Bangsar South, No 8, Jalan Kerinchi, 59200 Kuala Lumpur, Malaysia
63 Room 2001-2, Ambassador Road 18, Yangpu District, Shanghai City, China
64 Suite 1503, 1504, 1505, No. 376 Xingang Middle Road, Haizhu District, Guangzhou, China
65 Plot 50371, Fairground Office Park, Gaborone, Botswana
66 C/o Du Preez, Llebetrau & Co, 252 Kingsway, Next to USA Embassy, Maseru, Lesotho
67 João Scarparo Netto Avenue, 84, Bloco B, Ground Floor, Sala 44, Ed Unique Village Offices, Loteamento Center Santa Genebra, City of Campinas, São Paulo, 13080-655, Brazil

Registered office address
68 Unit 621, 6th Floor, Block A, Kelana Centre Point. No 3, Jalan SS7/9, Kelana Jaya 47301 Petaling Jaya, Selangor Darul Ehsan, Malaysia
69 Room 305, Building 2, 65555 Shangchuan Road, Pudong District, Shanghai, China
70 Parkway House, Hannover Avenue, Blantyre, Malawi
71 707 Collins Street, Docklands, Melbourne, VIC, 3008, Australia
72 Queensway House, Kaunda Street, Nairobi, Kenya
73 Robinson Bertram, 3rd Floor, Sokhzmlilio Bldg, Mbabane, Swaziland
74 P O Box 45, IPS Building, Maktaba Street, Dar es Salaam, Tanzania
75 Mlungushi Conference Centre, Centre Annex, Great East Road, Lusaka, Zambia
76 Stand 1515, Cnr Tourle Road/Harare Drive, Ardbennie, Harare, Zimbabwe
77 Andalucía y cordero E12-35. Edificio CYEDE piso 1, Oficina 11, Sector "La Floresta", Quito, Pichincha, Ecuador
78 The Pearson Academy of Vocational Training, Bangrave Road, Corby, Northamptonshire, NN17 1NN, England
79 Rodovia Anhanguera, km317, 4, Bloco B, modulo 27, Jardim Salgado Filho, Ribeirao Preto, São Paulo, 14.079-000, Brazil
80 Teikoku Hotel Tower 18F, 1-1-1 Uchi Saiwai-Cho, Chiyoda-ku, Tokyo, Japan
81 Suite 1201, Tower 2, No. 36 North Third Rign East Road, Dongcheng District, Beijing, China
82 268 Munoz Rivera Avenue, Suite 1400, San Juan, 00918, Puerto Rico
83 Suite 1212, 12/F, Tower 2, No. 36 North Third Rign East Road, Dongcheng District, Beijing, China
84 Zone B, 1/F, Digital Content Industrial Park, High Technical & Industrial Development District, Guiyang City, Guizhou Province, China
85 Gatwickstraat 1, Amsterdam, 1043 GK, Netherlands
86 26 Prince Andrew Place, Don Mills, Toronto, ON, M3C 2T8, Canada
87 Vitacura 5950, Comuna de Vitacura, Santiago, Chile
88 2, Lilienthalstrasse, Hallbergmoos, 85399, Germany
89 Jose Ananias #505, Macul, Santiago, Chile
90 Carrera 7 Nro 156 – 68, Piso 26, Bogota, Colombia
91 Calle Antonio Dovalijaime #70, Torre B, Piso 6, Col. Zedec ed Plaza Santa Fe, del. Álvaro Obregon, Ciudad de Mexico, CP 01210, Mexico
92 Punta Pacifica, Torres de las Americas, Torre A Piso 15 Ofic. 1517, Panama, 0832-0588, Panama
93 Calle Río de la Plata N° 152. Piso 5. San Isidro. Lima – Perú
94 28, Ribera del Loira, Madrid, 28042, Spain
95 87/1 Capital Tower Building, All Seasons Place unit 1604 – 6 16th floor, Wireless Road, Lumpini, Pathumwan, Bangkok, Thailand
96 6F Kwanjeong Building, 35, Cheonggyecheon-Ro, Jongno-gu, Seoul, 03188, Republic of Korea
97 Unit 7 Kingland Park, 98 Nickel Street, Prosperita, Windhoek, Namibia
98 8, Secretariat Road, Obafemi Awolowo Way, Alausa, Ikeja, Lagos State, Nigeria
99 Juan Benito Blanco 780 – Plaza Business Center Montevideo, Uruguay
100 Humboldt 1509 piso 6 (C1414CTM), Ciudad Autonoma de Buenos Aires, Argentina
101 No 219, Room D, 11F, Sec 3, Beixin Road, New Taipei City, Xindian District, 23143, Taiwan
102 Barbaros Bulvarı. No:149, Dr. Orhan Birman İş Merkezi Kat:3, Gayrettepe Beşiktaş, Istanbul, 34349, Turkey
103 3-15, Immeuble Terra Nova II, Rue Henri Rol Tanguy, Montreuil, 93100, France
104 Ulica Jana Henryka Dąbrowskiego 77A 60-529, Poznań, Poland
105 16, Corso Trapani, Turin, 10100, Italy

Registered office address
106 1-5-15, Kanda-Sarugakucho, Chiyoda-ku, Tokyo, Japan
107 Orion City, Irgel Building #752, Colombo, 09, Sri Lanka
108 Plot 8, Berkley Road, Old Kampala, Uganda
109 7/F North Tower, Rockwell Business Center COR. Sheridan & United Street, Brgy. Highway Hills, Mandaluyong, Philippines
110 Chollerstrasse 37, 6300 Zug, Switzerland
111 27/F Trident Tower, 312 Sen. Gil Puyat Avenue, Makati City, Metro Manila, Philippines
112 Suite 15A11,Tian Xing Jian Commercial Plaza, No. 47 Fuxing Road, Haidian District, Beijing, China
113 National Registered Agents, inc., 160 Greentree Dr Ste 101, Dover, Kent, DE, 19904, United States
114 30th Floor, Ratu Plaza Office Tower, Jl. Jend. Sudirman Kav 9, Jakarta, 10270, Indonesia
115 C/O Pearson Education, 501 Bolyston St, Boston, MA, 02116, United States
116 Suite 3H, No. 6, Block 2, 365 Nong Xin Hua Road, Changning District, Shanghai City, China
117 Commerce House, Wickhams Cay 1, P.O. Box 3140, Road Town, Tortola, British Virgin Islands
118 P O BOX 905, Carnelian Bay, CA, 96140, United States
119 Zone 1 3F, Jin Mao Tower, No.88 Century Avenue, Pilot Free Trade Zone, Shanghai City, China
120 Hermina út 17. 8th floor, Budapest, 1146, Hungary
121 79, Corso Buenos Aires, Milan, 20124, Italy
122 21, Amfitheas Avenue, Paleo Faliro Athens, 17564, Greece
123 2F, No.118 East Ti Yu Road, Tianhe District, Guangzhou, China
124 2, Lilienthalstrasse, Hallbergmoos, 85399, Germany
125 The Corporation Trust Incorporated, 351 West Camden Street, Baltimore, MD, 21201, United States
126 Ulica Szamocka 8 01-748, Warszawa, Poland
127 Suite 2600, Three Bentall Centre, P.O. Box 49314, 595 Burrard Street, Vancouver, BC, V7X 1L3, Canada
128 44 Chipman Hill, Suite 1000, Saint Jon, NB, E2L 4S6, Canada
129 Comendador Aladino Selmi Avenue, 4630, Galpão 1, Sala 3, Parque Cidade Campinas, City of Campinas,São Paulo, 13069-036, Brazil
130 Comendador Aladino Selmi Avenue, 4630, Galpão 1, Mezanino, Sala 5, Parque Cidade Campinas, City of Campinas,São Paulo, 13069-036, Brazil

Notes to the company financial statements

Partly-owned subsidiaries

Registered company Name	Country of Incorp.	% Owned	Reg office
Certiport China Co Ltd	CN	50.69	1
CG Manipal Schools Private Limited*	NP	51	2
Chongqing WSE Training Centre Co Ltd	CN	95	3
Educational Publishers LLP	UK	85	4
GED Domains LLC	US	70	5
GED Testing Service LLC	US	70	6
Heilongjiang WSE Training Centre Co Ltd	CN	95	7
Heinemann Publishers (Pty) Ltd	SA	75	8
Maskew Miller Longman (Pty) Limited	SA	75	8
Pearson Education Achievement Solutions (RF) (Pty) Limited	SA	97.3	8
Pearson South Africa (Pty) Ltd	SA	75	8

* In liquidation

Associated undertakings

Registered company Name	Country of Incorp.	% Owned	Reg office
ACT Aspire LLC	US	50	9
Affordable Private Education Center Inc‡	PH	29.36	10
Avanti Learning Centres Private Limited‡	IN	22.54	11
eAdvance Proprietary Limited‡	ZA	38.01	12
HE Distributions, LLC	US	35.3	13
Institute for Private Education & Training KSCC*	KU	49.02	14
Karadi Path learning Company Private Limited‡	IN	27.64	16
Learn Capital Special Opportunities Fund I, L.P.‡	US	99.59	22
Learn Capital Venture Partners II, L.P.‡	US	72.93	22
Learn Capital Venture Partners IIIA, L.P.‡	KY	99.00	15
Learn Capital Venture Partners, L.P.‡	US	99.15	22
Omega Schools Franchise Limited	GH	49.05	17
Peking University Pearson (Beijing) Cultural Development Co., Ltd	CN	45	18
Penguin Random House Limited	UK	25	4
Penguin Random House LLC	US	25	9
Scala Higher Education , S.C.	ME	45	19
Scala Latin America S.A.P.I. de C.V.	ME	45	19
Scala Student, S.A. de C.V.	ME	45	19
The Egyptian International Publishing Company-Longman	EG	49	20
Zaya Learning Labs Private Limited‡	IN	20	21

* In liquidation
‡ Accounted for as an 'Other financial asset' within non-current assets

Partly-owned subsidiaries & associated undertakings company addresses

	Registered office address
1	Suite 1804, No.99 Huichuan Road, Changning District, Shanghai City, China
2	Lalitpur, Sub-Metropolitan City, - 2, Bagmati, Nepal
3	9-4#, Unit 4, 24 Jintang Street, Yuzhong District, Chongqing, China
4	80 Strand, London, WC2R 0RL, England
5	C T Corporation System, 4701 Cox Road, Suite 285, Glen Allen, Henrico, VA, 23060-0000, United States
6	The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, Wilmington, New Castle, DE, 19801, United States
7	Room 503, 5F, Xin'an Building, No.238 Xinyang Road, Dao Li District, Harbin, China
8	Auto Atlantic, 4th Floor, Corner Hertzog Boulevard and Heerengracht, Cape Town, 8001, South Africa
9	C/o Corporation Service Company, 2711 Centerville Road, Suite 400, Wilmington, Delaware, 19808, United States
10	33rd Floor, Tower One & Exchange Plaza, Ayala Triangle, Ayala Avenue, Makati City, Philippines
11	16 Paschimi Marg, Vasant Vihar, New Delhi, DL, India
12	Office 201, Parktown Quarter, Corner 3rd & 7th Avenue, Parktown North, Johannesburg 2193. South Africa
13	United Corporate Services, Inc., 874 Walker Road Suite C, Dover, Kent, DE, 19904, United States
14	P.O. Box No. 6320, 32038 Hawalli, Kuwait City, Kuwait
15	Campbells Corporate Services Limited, Floor 4, Willow House, Cricket Square, Grand Cayman, KY1-9010, Cayman Islands
16	3A Dev Regency II, First Main Road, Gandhinagar, Adyar, Chennai, TN, India
17	2nd Floor OTS Building, off Accra-Winneba Road, Kasoa second, Kasoa P.O. Box WJ973, Weija, Accra. Ghana
18	Suite 216, No. 127-1 Zhongguancun North Street, Haidian District, Beijing, China
19	Calz. de la Naranja # 159, Col. Fracc. Industrial Alce Blanco, Naucalpan de Juarez, Edo. De Mex., 53370, Mexico
20	10a Hussein Wassef St, Midan Missaha, Dokki Giza, 12311, Egypt
21	Unit No. 404, New Udyog Mandir 2, Mogul Lane, Mahim(West), Mumbai, MH, 400016, India
22	Incorporating Services, Ltd. 3500 S Dupont Way, Dover, Kent DE, 19901 United States

Five-year summary

All figures in £ millions	2013	2014	2015	2016	2017
Sales: By geography					
North America	3,008	2,906	2,940	2,981	**2,929**
Core	1,008	910	815	803	**815**
Growth	712	724	713	768	**769**
Continuing	4,728	4,540	4,468	4,552	**4,513**
Discontinued	962	343	312	–	**–**
Total sales	5,690	4,883	4,780	4,552	**4,513**
Adjusted operating profit: By geography					
North America	464	444	480	420	**394**
Core	103	122	105	57	**50**
Growth	35	32	(3)	29	**38**
Penguin Random House	50	69	90	129	**94**
Continuing	652	667	672	635	**576**
Discontinued	84	55	51	–	**–**
Total adjusted operating profit	736	722	723	635	**576**

All figures in £ millions	2013	2014	2015	2016	2017
Operating margin – continuing	13.8%	14.7%	15.0%	13.9%	**12.8%**
Adjusted earnings					
Total adjusted operating profit	736	722	723	635	**576**
Net finance costs	(72)	(64)	(46)	(59)	**(79)**
Income tax	(97)	(118)	(105)	(95)	**(55)**
Non-controlling interest	(1)	1	–	(2)	**(2)**
Adjusted earnings	566	541	572	479	**440**
Weighted average number of shares (millions)	807.8	810.9	813.3	814.8	**813.4**
Adjusted earnings per share	70.1p	66.7p	70.3p	58.8p	**54.1p**

Five-year summary

All figures in £ millions	2013	2014	2015	2016	2017
Cash flow					
Operating cash flow	588	649	435	663	**669**
Operating cash conversion	80%	90%	60%	104%	**116%**
Operating free cash flow	324	413	255	549	**525**
Operating free cash flow per share	40.1p	50.9p	31.4p	67.4p	**64.5p**
Free cash flow	269	413	152	310	**227**
Free cash flow per share	33.3p	50.9p	18.7p	38.0p	**27.9p**
Net assets	5,706	5,985	6,418	4,348	**4,021**
Net debt	1,379	1,639	654	1,092	**432**
Return on invested capital					
Total adjusted operating profit	736	722	723	635	**576**
Operating tax paid	(191)	(163)	(129)	(63)	**(75)**
Return	545	559	594	572	**501**
Gross basis:					
Average invested capital	10,130	9,900	10,317	11,464	**11,568**
Return on invested capital	5.4%	5.6%	5.8%	5.0%	**4.3%**
Net basis:					
Average invested capital	10,130	9,835	9,422	7,906	**8,126**
Return on invested capital	5.4%	5.7%	6.3%	7.2%	**6.2%**
Dividend per share	48.0p	51.0p	52.0p	52.0p	**17.0p**

Financial key performance indicators

The following tables and narrative provide further analysis of the financial key performance indicators which are described in the financial review of the annual report on p34-40 , are shown within the key performance indicators on p2 of the annual report and shown in notes 2 and 8 of the notes to the consolidated financial statements.

Adjusted performance measures

The annual report and accounts reports results and performance on a headline basis which compares the reported results both on a statutory and on a non-GAAP (non-statutory) basis. The Group's adjusted performance measures are non-GAAP (non-statutory) financial measures and are also included in the annual report as they are key financial measures used by management to evaluate performance and allocate resources to business segments. The measures also enable investors to more easily, and consistently, track the underlying operational performance of the Group and its business segments by separating out those items of income and expenditure relating to acquisition and disposal transactions, and major restructuring programmes.

The Group's definition of adjusted performance measures may not be comparable to other similarly titled measures reported by other companies. A reconciliation of the adjusted measures to their corresponding statutory measures is shown below.

Sales

Underlying sales movements exclude the impact of portfolio changes arising from acquisitions and disposals and are stated at constant exchange rates. Portfolio changes are calculated by taking account of the additional contribution (at constant exchange rates) from acquisitions made in both the current year and the prior year. For acquisitions made in the prior year the additional contribution is calculated as the sales made in the period of the current year that corresponds to the pre-acquisition period in the prior year. Sales made by businesses disposed in either the current year or the prior year are also excluded. Constant exchange rates are calculated by assuming the average exchange rates in the prior year prevailed throughout the current year. These non-GAAP measures enable management and investors to track more easily, and consistently, the underlying sales performance of the Group.

All figures in £ millions	2017
Statutory sales 2017	4,513
Statutory sales 2016	4,552
Statutory sales decrease	(39)
Comprising:	
Underlying decrease	(111)
Portfolio changes	(54)
Exchange differences	126
Statutory sales decrease	(39)
Statutory decrease	(1)%
Underlying decrease	(2)%
Constant exchange rate decrease	(4)%

Financial key performance indicators

Adjusted operating profit

Adjusted operating profit excludes the cost of major restructuring; other net gains and losses on the sale of subsidiaries, joint ventures, associates and other financial assets; intangible charges, including impairment, relating only to goodwill and intangible assets acquired through business combinations and the direct costs of acquiring those businesses; and the impact of US tax reform in 2017. Further details are given below under 'Adjusted earnings per share'. Underlying adjusted operating profit movements exclude the impact of portfolio changes arising from acquisitions and disposals and are stated at constant exchange rates. Portfolio changes are calculated by taking account of the additional contribution (at constant exchange rates) from acquisitions made in both the current year and the prior year. For acquisitions made in the prior year the additional contribution is calculated as the operating profit made in the period of the current year that corresponds to the pre-acquisition period in the prior year. Operating profit made by businesses disposed in either the current year or the prior year is also excluded. Constant exchange rates are calculated by assuming the average exchange rates in the prior year prevailed throughout the current year. This non-GAAP measure enables management and investors to track more easily, and consistently, the underlying operating profit performance of the Group.

All figures in £ millions	2017	2016
Operating profit/(loss)	**451**	(2,497)
Cost of major restructuring	**79**	338
Other net gains and losses	**(128)**	25
Intangible charges	**166**	2,769
Impact of US tax reform	**8**	–
Adjusted operating profit	**576**	635

All figures in £ millions	2017
Adjusted operating profit decrease	**(59)**
Comprising:	
Underlying decrease	**(58)**
Portfolio changes	**(24)**
Exchange differences	**23**
Adjusted operating profit decrease	**(59)**
Underlying decrease	**(9)%**
Constant exchange rate decrease	**(13)%**

Adjusted earnings per share

Adjusted earnings includes adjusted operating profit and adjusted finance and tax charges. Adjusted earnings is included as a non-GAAP measure as it is used by management to evaluate performance and allocate resources to business segments and by investors to more easily, and consistently, track the underlying operational performance of the Group. Adjusted earnings per share is calculated as adjusted earnings divided by the weighted average number of shares in issue on an undiluted basis.

The following items are excluded from adjusted earnings:

Cost of major restructuring In January 2016 the Group announced that it was embarking on a restructuring programme to simplify the business, reduce costs and position the Group for growth in its major markets. The costs of this programme in 2016 were significant enough to exclude from the adjusted earnings measure so as to better highlight the underlying performance. A new programme of restructuring, announced in May 2017, began in the second half of 2017 and is expected to drive further significant cost savings. The costs of this new programme have also been excluded from adjusted earnings.

Other net gains and losses These represent profits and losses on the sale of subsidiaries, joint ventures, associates and other financial assets and are excluded from adjusted earnings as they distort the performance of the Group as reported on a statutory basis.

Intangible charges These represent charges in respect of goodwill, including impairment, and intangible assets acquired through business combinations and the direct costs of acquiring those businesses. These charges are excluded as they reflect past acquisition activity and do not necessarily reflect the current year performance of the Group.

Financial key performance indicators

Other net finance income/costs These include finance costs in respect of retirement benefits, finance costs of deferred consideration and foreign exchange and other gains and losses. Finance income relating to retirement benefits are excluded as management does not believe that the consolidated income statement presentation under IAS 19 reflects the economic substance of the underlying assets and liabilities. Finance costs relating to acquisition transactions are excluded as these relate to future earn outs or acquisition expenses and are not part of the underlying financing. Foreign exchange and other gains and losses are excluded as they represent short-term fluctuations in market value and are subject to significant volatility. Other gains and losses may not be realised in due course as it is normally the intention to hold the related instruments to maturity.

Impact of US tax reform In 2017, as a result of US tax reform, the Group's share of profit from associates was adversely impacted by £8m. This amount has been excluded from adjusted earnings as it is considered to be a transition adjustment that is not expected to recur in the near future.

Tax 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 tax benefit from tax deductible goodwill and intangibles is added to the adjusted income tax charge as this benefit more accurately aligns the adjusted tax charge with the expected rate of cash tax payments.

All figures in £ millions	2017	2016
Profit/(loss) for the year	408	(2,335)
Non-controlling interest	(2)	(2)
Cost of major restructuring	79	338
Other net gains and losses	(128)	25
Intangible charges	166	2,769
Other net finance income/costs	(49)	1
Impact of US tax reform	8	–
Tax	(42)	(317)
Adjusted earnings	440	479
Weighted average number of shares (millions)	813.4	814.8
Adjusted earnings per share	54.1p	58.8p

Return on invested capital

Return on invested capital (ROIC) is included as a non-GAAP measure as it is used by management and investors to track investment returns and by management to help inform capital allocation decisions within the business. ROIC is calculated as adjusted operating profit less operating cash tax paid expressed as a percentage of average invested capital. Invested capital includes the original unamortised goodwill and intangibles. Average values for total invested capital are calculated as the average monthly balance for the year. ROIC is also presented on a net basis after removing impaired goodwill from the invested capital balance. The net approach assumes that goodwill which has been impaired is treated consistently to goodwill disposed as it is no longer being used to generate returns.

All figures in £ millions	2017 Gross	2016 Gross	2017 Net	2016 Net
Adjusted operating profit	576	635	576	635
Operating tax paid	(75)	(63)	(75)	(63)
Return	501	572	501	572
Average goodwill	7,236	6,987	3,794	3,429
Average other non-current intangibles	2,606	2,481	2,606	2,481
Average intangible assets – pre-publication	995	926	995	926
Average tangible fixed assets and working capital	731	1,070	731	1,070
Average invested capital	11,568	11,464	8,126	7,906
Return on invested capital	4.3%	5.0%	6.2%	7.2%

Financial key performance indicators

Operating cash flow

Operating cash flow is calculated as net cash generated from operations before the impact of items excluded from the adjusted income statement plus dividends from joint ventures and associates (less the re-capitalisation dividends from Penguin Random House); less capital expenditure on property, plant and equipment and intangible software assets; plus proceeds from the sale of property, plant and equipment and intangible software assets; less finance lease principal payments; plus special pension contributions paid; and plus cost of major restructuring paid. Operating cash flow is included as a non-GAAP measure in order to align the cash flows with the corresponding adjusted operating profit measures.

All figures in £ millions	2017	2016
Net cash generated from operations	**462**	522
Dividends from joint ventures and associates	**458**	131
Re-capitalisation dividends from Penguin Random House	**(312)**	–
Purchase of property, plant and equipment	**(82)**	(88)
Purchase of intangible software assets	**(150)**	(157)
Proceeds from sale of property, plant and equipment and intangible software assets	**–**	4
Finance lease principal payments	**(5)**	(6)
Special pension contribution	**227**	90
Cost of major restructuring paid	**71**	167
Operating cash flow	**669**	663

For information, cash conversion, calculated as operating cash flow as a percentage of adjusted operating profit, is also shown as a non-GAAP measure as this is used by management and investors to measure underlying cash generation by the Group.

All figures in £ millions	2017	2016
Adjusted operating profit	**576**	635
Operating cash flow	**669**	663
Cash conversion	**116%**	104%

For information, operating cash flow, operating free cash flow and total free cash flow, which are non-GAAP measures, are disclosed and reconciled in note 33 of the notes to the consolidated financial statements as they are commonly used by investors to measure the cash performance of the Group.

Net debt and earnings before interest, tax, depreciation and amortisation (EBITDA)

For information, the net debt/EBITDA ratio is shown as a non-GAAP measure as it is commonly used by investors to measure balance sheet strength. EBITDA is calculated as adjusted operating profit less depreciation on property, plant and equipment and less amortisation on intangible software assets.

All figures in £ millions	2017	2016
Adjusted operating profit	**576**	635
Depreciation (excluding items included in 'cost of major restructuring')	**80**	80
Amortisation on intangible software assets (excluding items included in 'cost of major restructuring')	**82**	70
EBITDA	**738**	785
Cash and cash equivalents	**518**	1,459
Marketable securities	**8**	10
Derivative financial instruments	**–**	(93)
Bank loans and overdrafts	**(15)**	(39)
Bonds	**(1,062)**	(2,420)
Finance lease liabilities	**(8)**	(9)
Total	**(559)**	(1,092)
Cash and cash equivalents classified as held for sale	**127**	–
Net debt	**(432)**	(1,092)
Net debt/EBITDA ratio	**0.6x**	1.4x

Shareholder information

Pearson ordinary shares are listed on the London Stock Exchange and on the New York Stock Exchange in the form of American Depositary Receipts.

Corporate website

The investors' section of our corporate website www.pearson.com/investors.html provides a wealth of information for shareholders. It is also possible to sign up to receive e-mail alerts for reports and press releases relating to Pearson at https://www.pearson.com/news/media/email-alert-signup.html

Shareholder information online

Shareholder information can be found on our website https://www.pearson.com/investors/investor-information.html

Our registrar, Equiniti, also provides a range of shareholder information online. You can check your holding and find practical help on transferring shares or updating your details at www.shareview.co.uk. For more information, please contact our registrar, Equiniti, Aspect House, Spencer Road, Lancing, West Sussex, BN99 6DA. Telephone 0371 384 2233* or, for those shareholders with hearing difficulties, textphone number 0371 384 2255*.

Information about the Pearson share price

The company's share price can be found on our website at www.pearson.com. It also appears in the financial columns of the national press.

2017 dividends

	Payment date	Amount per share
Interim	15 September 2017	5 pence
Final	11 May 2018	12 pence

Payment of dividends to mandated accounts

Should you elect to have your dividends paid through BACS, this can be done directly into a bank or building society account, with the tax voucher sent to the shareholder's registered address. Equiniti can be contacted for information on 0371 384 2043*.

Dividend reinvestment plan (DRIP)

The DRIP gives shareholders the right to buy the company's shares on the London stock market with their cash dividend. For further information, please contact Equiniti on 0371 384 2268*.

Individual Savings Accounts (ISAs)

Equiniti offers ISAs in Pearson shares. For more information, please go to www.shareview.co.uk/dealing or call customer services on 0345 300 0430*.

Share dealing facilities

Equiniti offers telephone and internet services for dealing in Pearson shares. For further information, please contact their telephone dealing helpline on 03456 037 037* or, for online dealing, log on to www.shareview.co.uk/dealing. You will need your shareholder reference number as shown on your share certificate.

A postal dealing service is also available through Equiniti. Please telephone 0371 384 2248* for details or log on to www.shareview.co.uk to download a form.

* Lines open 8.30 am to 5.30 pm Monday to Friday (excluding UK public holidays).

ShareGift

Shareholders with small holdings of shares, whose value makes them uneconomic to sell, may wish to donate them to ShareGift, the share donation charity (registered charity number 1052686). Further information about ShareGift and the charities it has supported may be obtained from their website, www.ShareGift.org, or by contacting them at ShareGift, PO Box 72253, London, SW1P 9LQ.

American Depositary Receipts (ADRs)

Pearson's ADRs are listed on the New York Stock Exchange and traded under the symbol PSO. Each ADR represents one ordinary share. For enquiries regarding registered ADR holder accounts and dividends, please contact Bank of New York Mellon, Shareholder Correspondence (ADR), PO Box 505000, Louisville, KY 40233-5000, telephone 1 (866) 259 2289 (toll free within the US) or 001 201 680 6825 (outside the US). Alternatively, you may e-mail shrrelations@cpushareownerservices.com

Voting rights for registered ADR holders can be exercised through Bank of New York Mellon, and for beneficial ADR holders (and/or nominee accounts) through your US brokerage institution. Pearson will file with the Securities and Exchange Commission a Form 20-F.

Share register fraud: protecting your investment

Pearson does not contact its shareholders directly to provide recommendation advice and neither does it appoint third parties to do so. As required by law, our shareholder register is available for public inspection but we cannot control the use of information obtained by persons inspecting the register. Please treat any approaches purporting to originate from Pearson with caution.

For more information, please log on to our website at https://www.pearson.com/investors/managing-your-shares/share-register-fraud.html

Tips on protecting your shares

- Keep any documentation that contains your shareholder reference number in a safe place and shred any unwanted documentation
- Inform our registrar, Equiniti, promptly when you change address
- Be aware of dividend payment dates and contact the registrar if you do not receive your dividend cheque or, better still, make arrangements to have the dividend paid directly into your bank account
- Consider holding your shares electronically in a CREST account via a nominee.

2018 financial calendar

Ex-dividend date	**5 April**
Record date	**6 April**
Last date for dividend reinvestment election	**19 April**
Annual General Meeting	**4 May**
Payment date for dividend and share purchase date for dividend reinvestment	**11 May**

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Reliance on this document
The intention of this document is to provide information to shareholders and is not designed to be relied upon by any other party or for any other purpose.

Forward-looking statements
This document includes forward-looking statements concerning Pearson's financial condition, business and operations and its strategy, plans and objectives. In particular, all statements that express forecasts, expectations and projections, including trends in results of operations, margins, growth rates, overall market trends, the impact of interest or exchange rates, the availability of financing, anticipated cost savings and synergies and the execution of Pearson's strategy, are forward-looking statements.

By their nature, forward-looking statements involve known and unknown risks and uncertainties because they relate to events and depend on circumstances that may occur in the future. They are based on numerous expectations, assumptions and beliefs regarding Pearson's present and future business strategies and the environment in which it will operate in the future. There are various factors which could cause Pearson's actual financial condition, results and development to differ materially from the plans, goals, objectives and expectations expressed or implied by these forward-looking statements, many of which are outside Pearson's control. These include international, national and local conditions, as well as the impact of competition. They also include other risks detailed from time to time in Pearson's publicly-filed documents and, in particular, the risk factors set out in this document, which you are advised to read. Any forward-looking statements speak only as of the date they are made and, except as required by law, Pearson gives no undertaking to update any forward-looking statements in this document whether as a result of new information, future developments, changes in its expectations or otherwise. Readers are cautioned not to place undue reliance on such forward-looking statements.

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p19: Chet Strange
p33: Achala Saman

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