PHOTRONICS INC
Form 4
August 25, 2015

FORM 4

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL
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(Print or Type Responses)

1. Name and Address of Reporting Person *
TYSON MITCHELL G
(Last) (First) (Middle)
15 SECOR RD
(Street)
BROOKFIELD, CT 06804
(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
PHOTRONICS INC [PLAB]

3. Date of Earliest Transaction (Month/Day/Year)
08/21/2015

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer
(Check all applicable)
__X__ Director _____ 10% Owner
_____ Officer (give title below) _____ Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	08/21/2015		S		1,000 (1)	D	$ 9	71,579	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
TYSON MITCHELL G 15 SECOR RD BROOKFIELD, CT 06804	X			

Signatures

/s/ Richelle E. Burr, attorney-in-fact for Mitchell G. Tyson	08/25/2015
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) The sales reported on this Form 4 were effected pursuant to a 10b5-1 trading plan adopted by Mr. Tyson

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. t:4%">Net finance costs reduced by £64m, from £93m in 2014 to £29m in 2015. Net interest payable in 2015 was £46m, compared to £64m in 2014. The majority of the movement in net interest payable is due to the release of accrued interest following agreement of historical tax positions. For our debt portfolio, our fixed rate policy reduces the impact of changes in market interest rates, however we were still able to benefit from low average US dollar interest rates during the year as the majority of the Group s debt is US dollar denominated. Year-on-year, average three month US dollar LIBOR rose by 0.1% to 0.3%. This slight increase in floating market interest rates, along with the impact of changes in our debt portfolio, foreign exchange translation and the effect of slightly lower levels of average net debt in the period led to little change in the year-on-year interest charge on debt. Interest receivable on cash balances held overseas was reduced from the prior year due mainly to the weakening of emerging market currencies against sterling. The Group s average net debt fell by £61m, largely as a result of disposals in the fourth quarter of 2015 offsetting the translation of our predominantly US dollar debt. These combined factors contributed to the overall decrease in the Group s average net interest payable from 3.6% to 2.7%.

Other net finance costs are finance income and costs on retirement benefits, finance costs on related to deferred consideration associated with acquisitions, foreign exchange and other gains and losses. In 2015, the total of these items was a gain of £17m compared to a loss of £29m in 2014. Both the gain in 2015 and the loss in 2014 mainly relate to foreign exchange differences on unhedged cash and cash equivalents and other financial instruments. For a more detailed discussion of our borrowings and interest expenses see Liquidity and Capital Resources Capital Resources and Borrowings below and Item 11. Quantitative and Qualitative Disclosures about Market Risk .

Taxation

The total tax benefit in 2015 of £81m represents 18.7% of pre-tax losses and compares to a charge of £56m or 22.0% of pre-tax profits in 2014. Our overseas profits, which arise mainly in the US, are largely subject to tax at higher rates than that in the UK (which had an effective statutory rate of 20.25% in 2015 and 21.5% in 2014). The reduced rate in 2015 reflects the lack of tax relief on some of our goodwill impairments offset in part by adjustments arising from agreement of historical tax positions. Both these items were more significant in 2015 than they had been in 2014.

Discontinued operations

Profit from discontinued operations in 2015 was £1,175m compared to £271m in 2014 with the difference being due primarily to gains on disposals in the respective years.

Table of Contents

On 16 October 2015, Pearson substantially completed the sale of its 50% interest in the Economist to EXOR and on 30 November 2015 Pearson completed the sale of the Financial Times to Nikkei. The pre-tax gains on these sales were £473m and £711m respectively. We expect both of these transactions to qualify for substantial shareholder exemption in the UK and therefore there was no tax on the Economist gain and tax on the Financial Times sale amounted to £49m. The gains on these transactions and the results for both 2014 and 2015 to the respective sale dates have been included in discontinued operations.

The sale of Mergermarket to BC partners was completed on 4 February 2014 and resulted in a gain of £244m before tax. The gain on sale and the results for 2014 to the date of sale have been included in discontinued operations. Also included in discontinued operations in 2014 is a gain of £29m relating to adjustments to liabilities arising on the formation of the Penguin Random House group. Although this transaction completed in 2013 there were subsequent adjustments relating to the potential transfer of pension liabilities and tax.

Profit for the year

The profit for the financial year in 2015 was £823m compared to a profit in 2014 of £470m. The 2015 profit includes the gains on the sale of the Financial Times and Economist partly offset by significant impairment charges in the year. The net of these items were more significant than disposal gains and impairment charges had been in 2014.

Earnings per ordinary share

The basic earnings per ordinary share, which is defined as the profit for the financial year divided by the weighted average number of shares in issue, was 101.2p in 2015 compared to 58.1p in 2014 based on a weighted average number of shares in issue of 813.3m in 2015 and 810.9m in 2014. The increase in earnings per share was due to the increase in profit for 2015 described above and was not significantly affected by the movement in the weighted average number of shares.

A diluted earnings per ordinary share was not calculated in 2015 as a result of the loss from continuing operations in 2015. The diluted earnings per share of 58.0p in 2014 was not significantly different from the basic earnings per share in that year as the effect of dilutive share options was again not significant.

Exchange rate fluctuations

Currency movement increased sales by £137m and had only a small impact on operating profit. See Item 11. Quantitative and Qualitative Disclosures about Market Risk for a discussion regarding our management of exchange rate risks.

Sales and operating profit by segment

The following tables summarize our sales and adjusted operating profit for each of Pearson s business segments. Adjusted operating profit is a non-GAAP financial measure and is included as it is a key financial measure used by management to evaluate performance and allocate resources to business segments.

In our adjusted operating profit we have excluded other net gains and losses, acquisition costs and amortization and impairment of acquired intangibles. The intangible charges relate to intangible assets acquired through business combinations and acquisition costs are the direct costs of acquiring those businesses. Neither of these charges are considered to be fully reflective of the underlying performance of the Group. Other net gains and losses that represent profits and losses on the sale of subsidiaries, joint ventures, associates and other financial assets are also excluded from adjusted operating profit as they distort the performance of the Group.

Table of Contents

Adjusted operating profit enables management to more easily track the underlying operational performance of the Group. A reconciliation of operating profit to adjusted operating profit for continuing operations is included in the tables below:

	Year Ended December 31, 2015						
£m	**North America**	**Core**	**Growth**	**PRH**	**Continuing**	**Discontinued**	**Total**
Sales	2,940	836	692		4,468	312	4,780
	66%	*19%*	*15%*		*100%*		
Total operating profit	113	30	(595)	48	(404)	1,232	828
	89%	*32%*	*(25%)*	*4%*	*100%*		
Add back:							
Other net gains and losses	(19)	5		1	(13)	(1,184)	(1,197)
Acquisition costs							
Intangible charges	386	79	583	41	1,089	3	1,092
Adjusted operating profit: continuing operations	480	114	(12)	90	672		672
Adjusted operating profit: discontinued operations						51	51
Total adjusted operating profit	480	114	(12)	90	672	51	723
	66%	*16%*	*(2%)*	*13%*	*93%*	*7%*	*100%*

	Year Ended December 31, 2014						
£m	**North America**	**Core**	**Growth**	**PRH**	**Continuing**	**Discontinued**	**Total**
Sales	2,906	910	724		4,540	343	4,883
	64%	*20%*	*16%*		*100%*		
Total operating profit	336	100	(103)	15	348	325	673
	97%	*29%*	*(30%)*	*4%*	*100%*		
Add back:							
Other net gains and losses	(2)				(2)	(273)	(275)
Acquisition costs	2	1	3		6		6
Intangible charges	108	21	132	54	315	3	318
Adjusted operating profit: continuing operations	444	122	32	69	667		667
Adjusted operating profit: discontinued operations						55	55
Total adjusted operating profit	444	122	32	69	667	55	722
	61%	*17%*	*4%*	*10%*	*92%*	*8%*	*100%*

North America

North America sales increased by £34m or 1% from £2,906m to £2,940m and adjusted operating profit increased by £36m, or 8%, from £444m in 2014 to £480m in 2015. The increase in headline terms was a result of currency movements due to the strengthening of the US dollar against sterling. At constant exchange and after taking account of the contribution from acquisitions and disposals and adjustments made in respect of Connections Education, sales declined by 1% and adjusted profits increased by 1%, mainly reflecting sales declines in US Higher Education partially offset at a profit level by year-on-year cost savings.

In our statutory results in 2015 we recognized an impairment to our US goodwill of £282m following ongoing cyclical and policy related pressures in our main US markets and we also realized a gain on sale of

31

Table of Contents

PowerSchool of £30m net of the write down of related software assets. In addition to the gain on PowerSchool there were also small losses on the sale and write down of smaller investments of £11m. In 2014 we recognized a £38m loss on disposal of our 5% stake in Nook Media and a £40m gain on the disposal of our stakes in Safari Books Online and CourseSmart.

Overall adjusted operating margins in the North America business improved in 2015 to 16.3% compared to 15.3% in 2014 as a result of cost savings and the absence of restructuring costs following restructuring in 2014 and the benefit from list sales in 2015.

North America School

In School, strong enrolment growth in Connections Education, good growth in Clinical Assessments and market share gains in courseware were offset by the impact of a smaller textbook adoptions market and weakness in the open territories in K-12 courseware, and a change in revenue model at Connections Education which records revenue for services charged at cost on a net basis.

Connections Education, our virtual school business served over 68,000 full time equivalent students through full-time virtual and blended school programs in 2015, up 11% from 2014 as a result of underlying growth and a new state-wide school in North Carolina. Connections manages 30 virtual public schools with three new full-time state-wide virtual public schools approved for the 2016-17 school year to serve students in Arkansas, Washington and New Mexico. In its annual Parent Satisfaction Survey 93% of parents of students enrolled in full-time online partner schools recommend Connections to other families.

In courseware, revenue declined year on year despite strong market share performance primarily due to a smaller overall adoption market as compared to 2014. Overall market share increased slightly driven by a strong performance in new adoption markets where we won 31% (2014: 25%) of new adoptions competed for, or 29% (2014: 25%) of the total new adoption market of $730m in 2015 (2014: $910m), led by a strong performance in Grades K-6 Social Studies in Texas and Indiana and in Grades K-6 Science in Oklahoma. We expanded iLit, our digital reading intervention program, covering a broader range of students including English Language Learners. Research studies show that students using iLit gain two or more years of reading growth in a year using this tablet based program (http://pear.sn/PErhf). We launched ReadyGEN, a K-6 reading series and enVisionMATH2.0, the newest offering in the highly successful enVisionMATH K-6 math program.

In State and National Assessments, revenues for the full year declined due to contract losses. High-stakes online test volumes grew strongly, up 130% on 2014 to 26.4 million, as customers transitioned to computer based testing. Paper based high stakes test volumes grew 3% to 32.7 million. Pearson successfully delivered English Language Arts and Math PARCC assessments to over 4.8 million students across 11 states and the District of Columbia. ACT Aspire delivered Common Core aligned college and career readiness assessments to 1.3 million students up 67% from 2014 and was chosen for three new state-wide deployments in 2016. The states of Arkansas, Mississippi and Ohio will discontinue PARCC assessments in 2016. We were awarded contracts to deliver the Indiana Statewide Test of Educational Progress (ISTEP); renewed the Puerto Rican Tests of Academic Achievement (PPAA) and parts of the assessments contract awarded by the Texas Education Agency; and extended our contracts to administer the Mississippi Science Test and Mississippi Subject Area Testing Program. We ceased to administer the majority of the current Texas STAAR contract in September 2015. Pearson extended its partnership with the College Board for the SAT assessment with the award of a five-year contract for processing of the redesigned SAT and PSAT assessments. Pearson will continue to provide the essay-scoring component for the SAT until March 2016.

Clinical Assessment grew well benefiting from continued growth of the fifth edition of the *Wechsler Intelligence Scale for Children* (WISC-V), strong growth in *Behavior Assessment for Children 3e* (BASC) and rapid growth in Q-Interactive, Pearson s digital solution for Clinical assessment administration with geographic expansion and continued strong growth in active users to over 9,000 from 4,000 in 2014 with test administrations up over 400% to 1.3 million sub-tests.

Table of Contents

North America Higher Education

In Higher Education, market share gains in courseware were offset by lower enrolments (total US College enrolments fell 1.7%, with combined two-year public and four-year for-profit enrolments declining 4.4%, affected by a rising employment rate and regulatory change affecting the for-profit and developmental learning sectors), higher textbook returns and list sales. Strong enrolment growth at Pearson Online Services was offset by lower revenues from Learning Studio, a higher education Learning Management System (LMS) that we are retiring, and the impact of a change in revenue model.

Gross courseware revenues fell 1.5% (compared to industry gross revenue declines of 2.7%) due to lower college enrolments offset by market share gains. Net revenues declined 5.7% (compared to industry net declines of 7.5%) reflecting the impact of higher returns. Our market share in courseware benefited from strong performance from key titles including: Hubbard *Economics 5e*, Hibbeler *Engineering Mechanics 14e* and Marieb *Human Anatomy & Physiology 10e*.

Global digital registrations of MyLab and related products grew 3% to nearly 13 million. In North America, digital registrations grew 3% to almost 11 million with good growth in Science, Business & Economics, Statistics, REVEL and skills applications like Pearson Writer, offset by softness in developmental Mathematics. Faculty generated case studies indicate that the use of MyLab programs, as part of a broader course redesign, can support improvements in student test scores and lower institutional cost (http://pear.sn/IZxLE). We launched a suite of features that include Adaptive Practice in our MyLabs to personalize subjects including mathematics and nursing practice, Predictive Analytics Early Alerts in Mastering to help science instructors support at-risk students, gamification features in Business and rich learning analytics dashboards in numerous products that offer deep insight into students progress, performance and engagement.

In Pearson Online Services, our Higher Education Online Program Management (OPM) business, course enrolments grew strongly, up 25% to over 265,000, boosted by strong growth in Arizona State University Online where we renewed our partnership at the start of 2015. We extended our collaboration with Maryville University to launch a Bachelor and Master s in Cybersecurity and a Doctorate in Leadership. Ohio University is partnering with Pearson to launch a Master s in Financial Economics and Public Relations. University of Nevada Reno is partnering to increase access to the Master of Social Work degree program online. Pearson launched a new managed programs service model with Cincinnati State Technical and Community College, adapting traditional OPM services to the Community College market signing a landmark 10-year agreement to provide marketing, recruiting, admission, and retention services both to online and ground-based programs.

In enterprise solutions, Pearson signed significant large-scale, enterprise adoptions of cross-discipline digital content, where content is purchased via an upfront course fee and integrated with university IT systems, with Jones County College, National University, Algonquin College and the University of Missouri system. We signed an expanded strategic partnership agreement with Southern New Hampshire University s (SNHU) College of Online and Continuing Education (COCE). Pearson will support curriculum development, online tutoring, enterprise wide content and data integration, eBooks with a print-on-demand option and data and analytics services which will provide greater visibility into students achievement of learning outcomes. The Charles A. Dana Center at The University of Texas at Austin is collaborating with Pearson to provide web-based course resources to Community Colleges across Texas that dramatically shorten the time it takes for students to earn college credit in mathematics as part of the New Mathways Project. Three courses were launched in 2015: Foundations Mathematical Reasoning, Statistics Reasoning and Quantitative Reasoning, with more planned in 2016. Pearson was named as the premier US Green Building Council Education Partner and will offer curriculum and course services to universities, associations, training companies, corporations, and workforce education and apprenticeship programs. We are partnering with Broward College to launch new competency-based workforce certification pathways focused on IT and Healthcare. Pearson will support Broward s strategy by providing 12 industry certifications with existing workforce education courseware, as well as curriculum development services to build new courses towards certification and the Acclaim badging platform.

Table of Contents

North America Professional

In Professional, revenues grew strongly at VUE due to higher volumes of professional certification assessments. VUE global test volumes grew 11% year on year to 14.2 million, boosted by continued growth in IT, Professional and GED, with increased volumes from Microsoft Certified Professional (MCP) Program globally, National Council of State Boards of Nursing and US teacher certification programs. VUE renewed the Certiport Microsoft Office Specialists and Microsoft Technology Associate programs for an additional year and extended our partnership with Cisco Systems for three and half years.

Core

Sales in our Core markets decreased by £74m, or 8%, from £910m in 2014 to £836 in 2015 while adjusted operating profit decreased by £8m, or 7%, from £122m in 2014 to £114m in 2015. At constant exchange there was a decline in sales of 5% and a decline in profits of 2%. Acquisitions and disposals were not significant in the Core segment in either 2015 or 2014. Growth in Pearson Online Services in Australia, Wall Street English in Italy, Clinical Assessment in Germany and the Pearson Test of English in Australia was more than offset by revenue declines in UK qualifications as the business nears the end of a period of policy change, revenue declines at VUE, phasing and market weakness in Australian Higher Education courseware and the focusing of our UK school courseware on products that directly support Pearson Qualifications. Adjusted operating profit declines were due to lower revenue offset by tight cost control.

In our statutory results in 2015 we recognized an impairment to our goodwill of £37m mainly related to our English language teaching businesses in Europe.

Core School

In the UK, qualifications have been impacted by government policy, where changes to accountability measures have led to a further 20% decline in BTEC registrations in 2015. GCSE and GCE entries for summer 2015 grew modestly compared with 2014 resulting from increases in GCSE registrations in Sport, ICT and Business and strength in iGCSE entries. We successfully delivered the National Curriculum Test for 2015, marking 4 million scripts from 1.7 million students and successfully transitioned the marking of the test to an online-only model.

In courseware, UK school revenue fell with growth in primary school more than offset by declines in secondary as the vocational market contracted and our upper secondary revenues were impacted by lower market participation as we focus on products that directly support our qualifications. More than 5,400 UK Schools now subscribe to at least one Bug Club service, our primary school blended reading program, representing growth of nearly 16% in the year. There are over 1.8 million pupils, more than 9,000 schools and 152,000 teachers currently using a service on ActiveLearn Primary. Italy revenues declined slightly with market share gains in primary offset by market weakness and a lower share in upper secondary. Australia revenues declined, with growth and increased market share in primary more than offset by a weaker secondary market.

Clinical assessment grew well with Germany benefiting from strong growth in Kaufman *Assessment Battery for Children* (K-ABC), partly offset by declines in Australia after a strong year in 2014 driven by the release of Wechsler *Primary and Preschool Scale of Intelligence IV*.

Core Higher Education

In courseware, UK revenues declined, primarily due to a weak market. In Australia, revenues declined significantly due to phasing and market weakness. In online services, our Australian University Partnerships business grew strongly with combined course enrolments of nearly 4,000 up 380% from 2014. The growth of our partnership with Monash University was led by the Graduate Diploma in Psychology, which is now one of Monash s largest postgraduate courses. Our new partnership with Griffith University started very strongly

Table of Contents

seeing consistent demand for the MBA program and the launch of two further courses. Kings College London partnered with Pearson to launch online postgraduate degree programs in Psychology and Law. Total enrolled students at Pearson College doubled to 232.

Core Professional

The Pearson Test of English Academic (PTEA) saw strong growth in test volumes and revenues after gaining approval from the Australian Department of Immigration and Border Protection to administer a broad range of language tests linked to visa applications. Wall Street English revenues fell slightly with strong growth in Italy offset by declines in Germany.

Growth

Growth sales decreased by £32m, or 4%, to £692m in 2015 from £724m in 2014. Adjusted operating profit decreased by £44m to a loss of £12m in 2015 from a £32m profit in 2014. At constant exchange there was decline in sales of 1%. In China, revenues grew modestly reflecting strong sales of premium services in our direct delivery English Language Learning businesses offset by list disposals. In Brazil, revenues were stable with good growth in private sistemas and language schools offset by declines in government funded sistemas and language schools. In South Africa, revenues declined significantly due to a smaller textbook adoption cycle and lower enrolments at CTI, due to a reduction in the number of qualified students graduating from high school and tightening consumer credit affecting re-enrolment rates. In the Middle East, our business was impacted by the withdrawal from the Saudi Colleges of Excellence contracts.

Adjusted operating profit decreased due to the strengthening of Sterling against key Emerging Market currencies, revenue declines in South Africa, a contract termination charge arising from the transition of our three Saudi Arabian Colleges of Excellence to new providers, cost inflation and additional investment in China; partially offset by the benefits of restructuring and integration in Brazil.

In our statutory results, reflecting the significant economic and market deterioration in the Group s operations in emerging markets, we wrote down the balance sheet value of our goodwill and intangibles for businesses in Growth markets by £530m. This represented impairments of £269m for Brazil, £181m for China, £58m for South Africa and £22m for other Growth markets. In 2014 we impaired intangible assets in our Indian business by £77m largely reflecting the reduced value of online tutoring which was primarily focused on the US market.

Growth School

In South Africa, there was continued pressure on Government spending on textbooks due to budget pressures, which resulted in the value of the textbook market falling 60% from a peak of R2.9bn in 2013 to an estimated R1.15bn in 2015. We continued to perform well competitively and maintained a leading market share.

In Brazil, sistemas revenues grew well with strong growth in private sistemas partly offset by declines in NAME, our public sistema, following the cancellation of a large contract as a result of government spending cuts. Overall sistema enrolments fell 7% to nearly 449,000 with declines in NAME partly offset by growth in our three private sistemas, led by our largest sistema, COC. More than half of COC schools that participated in the High School National Exam (ENEM) ranked among the top 3 schools in their municipalities.

In India, enrolments at our managed schools grew 14% to nearly 27,000 students and we launched a pilot in more than 60 schools of MyPedia, an inside service sistema solution for schools comprising print and digital content, assessments and academic support services. Middle East school courseware and professional development revenues grew strongly on improved distribution.

Table of Contents

Growth Higher Education

In South Africa, after strong growth over a number of years, student enrolments at CTI universities fell by 16% to 11,300 driven by a 13% decline in qualified graduating high school students and tightening consumer credit affecting re-enrolment rates. In Mexico, our fully accredited online university partnership, UTEL, increased the number of students enrolled by 34% to nearly 12,600. In India, Higher Education courseware revenues grew strongly. Cornell University partnered with Pearson to launch the Cornell-ILR Experienced Managers Program in India, with a blended learning approach combining online and in-person instruction.

In the Middle East, our three-year partnership with Taibah University in Saudi Arabia, to enable its transformation to a fully blended and personalized learning model, is progressing with over 4,000 students enrolled in our solution in 2015. Our partnership with the Preparatory Year Deanship at Um Al Qura University (PYP-UQU) to provide online learning and assessment technology has delivered 13,000 MyMathLab, MyITLab and MasteringPhysics licences. We withdrew from an agreement to run three Saudi Colleges of Excellence, with the colleges transitioning to new providers from 30 June 2015. This resulted in a termination charge.

Growth Professional

In Pearson English, good growth in direct delivery in China, private expenditure in language schools in Brazil, and English Language Teaching (ELT) was partly offset by the impact of lower public expenditure in language schools in Brazil.

In China, Wall Street English (WSE) achieved strong revenue growth, reflecting success in the premium segment and the growth in VIP branded offerings. Overall enrolments grew modestly to over 67,000 with new enrolments growing strongly. We launched the New Student Experience (NSE) in six pilot centers during December 2015. The NSE delivers a major upgrade to the Wall Street English service with adaptive, personalized learning incorporating Pearson s Global Scale of English. Global Education achieved moderate revenue growth as the market shifted to more intensive premium courses with smaller class sizes and new products, which resulted in enrolments declining 6.5% to 85,110.

We launched around 30 new MyEnglishLab products including *Top Notch 3e* and *Progress*. MyTOEFLLab and the second edition of MyIELTSLab successfully launched in China in WSE and Global Education. Global student registrations for MyEnglishLab and other ELT digital courseware grew 14% to 739,000. Pearson Test of English grew strongly in India.

Grupo Multi in Brazil saw strong revenue growth at Wizard, our consumer facing franchised English language learning business, but this was offset by declines in government orders due to public spending cuts. We opened 40 new school-in-school units for Multi English franchises in K-12 sistemas partner schools.

Penguin Random House

Pearson owns 47% of Penguin Random House the first truly global consumer book publishing company. Our share of Penguin Random House adjusted operating profits were £90m compared to £69m for 2014.

Penguin Random House had a strong performance in 2015, boosted by publication of hundreds of Adult and Children s bestsellers across its territories, including the fiction mega-successes of *Grey* and *The Girl on the Train*, which each sold over 7 million copies.

The U.S. business published 584 *New York Times* print and e-book bestsellers in 2015 (2014: 760, based on a broader New York Times title count than 2015). The division benefited from the multi-million copy successes of *Grey* by E L James and the Adult debut novel *The Girl on the Train* by Paula Hawkins. Children s authors who extended their outstanding sales in 2015 include Dr. Seuss, John Green, R.J. Palacio, James Dashner, Rick Yancey, Drew Daywalt, and Oliver Jeffers. Additional notable Adult titles include *The Life-Changing Magic of Tidying Up* by Marie Kondo; *Rogue Lawyer* by John Grisham; *Lost Ocean* by Johanna Basford; *Between The World and Me* by Ta-Nehisi Coates; and the movie tie-in paperback *The Martian* by Andy Weir.

Table of Contents

The UK business published 201 titles on the *Sunday Times* bestseller lists (2014: 206). The division enjoyed outstanding sales for *Grey* and *The Girl on the Train*, which each sold more than 2 million copies, and for Harper Lee s *Go Set A Watchman* and Jamie Oliver s *Everyday Super Food*. Great demand continued for Jeff Kinney s *Diary of a Wimpy Kid* and John Green s titles, and for DK Publishing s Star Wars publications. Penguin Random House s promising 2016 publishing lists include new titles from Lisa Brennan-Jobs, Bill Bryson, Lee Child, Harlan Coben, Phil Collins, Janet Evanovich, Ina Garten, John Grisham, Jazz Jennings, Jeff Kinney, Marie Kondo, John le Carré, Jojo Moyes, Jamie Oliver, James Patterson, Nathaniel Philbrick, Pope Francis, Nora Roberts, John Sandford, Danielle Steel and Star Wars.

Penguin Random House completed the sale of Author Solutions, its supported self-publishing services company, to an affiliate of Najafi Companies, an international private-investment firm, on 31 December 2015, and sold its Australian online bookseller Bookworld to online retailer Booktopia in August 2015.

The integration of Penguin and Random House continued to provide net benefits through organizational alignments and systems and warehouse combinations in 2015, as well as for 2016 and thereafter. The North America warehouse consolidation was completed in February 2015, and in December, the UK business announced it will be gradually closing its Rugby distribution center and relocating its inventory to two other locations. The integration in Spain and Latin America of Santillana with Grupo Editorial Penguin Random House remains on course.

Results of operations

Year ended December 31, 2014 compared to year ended December 31, 2013

Consolidated results of operations

Sales

Our total sales from continuing operations decreased by £188m, or 4%, from £4,728m in 2013, to £4,540m in 2014. The overall decrease reflected growth on a constant exchange rate basis of 2% together with additional contributions from acquisitions, which was more than offset by the impact of currency movements. The 2014 sales, translated at 2013 average exchange rates, would have been £269m more at £4,809m.

North America sales declined by £102m or 3% from £3,008m to £2,906m, due to the strengthening of sterling against the US dollar. We estimate that after excluding acquisitions and disposals and the impact of exchange, North America sales growth was 2% in 2014 compared to 2013. North America continued to be the most significant source of our sales and as a proportion of sales contributed 64% in both 2014 and 2013. Revenue growth in Connections Education, VUE, Clinical and Higher Education was partially offset by declines in School courseware and State assessments.

Core sales declined by £98m or 10% from £1,008m in 2013 to £910m in 2014. We estimate that after excluding acquisitions and disposals and the impact of exchange, Core sales declined by 6%. Modest growth in Italy and good growth at VUE was offset by declines in UK assessment revenues, due to the impact of policy changes on our UK school qualifications business and reduction in partner market revenues, due to divestments and a move to distributor models implemented in 2013.

Growth sales increased by £12m or 2% from £712m in 2013 to £724m in 2014, despite the strength of sterling against key emerging market currencies. We estimate that after excluding both the impact of exchange rates sales grew by 12%, benefiting from the acquisition of Grupo Multi, and after excluding the impact of exchange rates and acquisitions and disposals were flat primarily due to the phasing of purchasing and a stronger school textbook adoption in South Africa in 2013. Growing English Language Learning enrolments in China and college enrolments in Saudi Arabia and South Africa were offset by a smaller school textbook market in South Africa, lower revenues in Brazil from sistemas, and ELT and higher education textbooks.

Table of Contents

Cost of goods sold and operating expenses

The following table summarizes our cost of sales and net operating expenses:

	Year Ended December 31	
	2014	2013
	£m	£m
Cost of goods sold	2,021	2,123
Operating expenses		
Distribution costs	84	88
Selling, marketing and product development costs	931	995
Administrative and other expenses	1,168	1,056
Restructuring costs	64	162
Other net gains and losses	(2)	16
Other income	(120)	(115)
Total net operating expenses	2,125	2,202
Impairment of intangible assets	77	
Total expenses	4,223	4,325

Cost of goods sold. Cost of sales consists of costs for raw materials, primarily paper, printing and binding costs, amortization of pre-publication costs, royalty charges, the cost of service provision in the assessment and testing business and the cost of teaching and facilities in direct delivery businesses. Our cost of sales decreased by £102m, or 5%, from £2,123m in 2013, to £2,021m in 2014. The decrease corresponds primarily to the decrease in sales, with cost of sales at 44.5% of sales in 2014 compared to 44.9% in 2013.

Distribution costs. Distribution costs consist primarily of shipping costs, postage and packing. Distribution costs decreased due to the shift to digital and services products.

Selling, marketing and product development costs. Our selling, marketing and product development costs decreased by £64m or 6% from £995m in 2013 to £931m in 2014. As a percentage of sales these costs were relatively consistent at 20.5% in 2014 and 21.0% in 2013, reflecting some benefits of restructuring and the effect of foreign exchange.

Administrative and other expenses. Our administrative and other expenses increased by £112m or 11% from £1,056m in 2013 to £1,168m in 2014 due to increased intangible amortization and increased IT costs.

Restructuring costs. Restructuring costs decreased to £64m in 2014 compared with £162m in 2013. In 2013 the Group began a significant transformation and restructuring program which incurred significant upfront costs primarily related to redundancies and property rationalization. These costs decreased in 2014 as the program reached completion.

Other net gains and losses. Included in other net gains and losses in 2014 are gains on the sale of joint venture interests in Safari Books Online and CourseSmart totaling £40m and a loss on the disposal of an investment in Nook Media of £38m. Included in 2013 is a loss on the disposal of the Japanese school and local publishing assets.

Other income. Other operating income mainly consists of freight recharges, sub-rights and licensing income and distribution commissions, together with the service fee income from Penguin Random House. Other operating income increased to £120m in 2014 compared to £115m in 2013 due to a full year of Penguin Random House service fee income of £41m in 2014 compared with a half year of income of £28m in 2013, offset by a decrease in gains on minor asset disposals in 2014 compared with 2013.

Table of Contents

Impairment. In 2014 we impaired intangible assets in our Indian business by £77m largely reflecting the reduced value of online tutoring which was primarily focused on the US market.

Share of results of joint ventures and associates

The contribution from our joint ventures and associates increased by £3m to £31m in 2014 from £28m in 2013. The increase is due to a full year contribution from Penguin Random House partly offset by intangible amortization.

Operating profit

Operating profit decreased by £83m or 19% from £431m in 2013 to £348m in 2014. In 2014 our operating profit included a £77m write down of the balance sheet value of intangibles in our Indian business, a £38m loss on disposal of our stake in Nook Media and a £40m gain on the disposal of our stake in Safari Books Online and CourseSmart. Currency movements adversely affected operating profit, and we estimate that operating profit would have been approximately £49m higher if translated at constant 2013 exchange rates.

Net finance costs

Net finance costs increased from £73m in 2013 to £93m in 2014. Net interest payable decreased from £71m in 2013 to £64m in 2014. Although our fixed rate policy reduces the impact of changes in market interest rates, we were still able to benefit from low average US dollar and sterling interest rates during the year. Year-on-year, average three month LIBOR (weighted for the Group s net borrowings in US dollars and sterling at each year end) fell by 0.1% to 0.2%. This decrease in floating market interest rates, along with the impact of foreign exchange translation and additional interest receivable on cash balances held overseas, more than offset the effect of higher levels of average net debt in the period. These factors contributed to the overall decrease in the Group s average net interest payable from 4.8% to 3.6%. The Group s average net debt rose by £260m, largely as a result of net acquisition activity and the translation of our predominantly US dollar debt.

Other net finance costs are finance income and costs on retirement benefits, finance costs on put options and deferred consideration associated with acquisitions, foreign exchange and other gains and losses. In 2014 the total of these items was a loss of £29m compared to a loss of £2m in 2013. Both the losses in 2014 and 2013 mainly relate to foreign exchange differences on un-hedged cash and cash equivalents and other financial instruments. For a more detailed discussion of our borrowings and interest expenses see Liquidity and Capital Resources Capital Resources and Borrowings below and Item 11. Quantitative and Qualitative Disclosures about Market Risk .

Taxation

The total tax charge in 2014 of £56m represents 22.0% of pre-tax profits compared to a charge of £88m or 24.6% of pre-tax profits in 2013. Our overseas profits, which arise mainly in the US, are largely subject to tax at higher rates than that in the UK (which had an effective statutory rate of 21.5% in 2014 and 23.25% in 2013). The decrease in the tax rate is mainly due to tax benefits arising on the increase in intangible charges partly offset by adjustment arising from settlements with tax authorities.

Discontinued operations

In October 2012, Pearson and Bertelsmann announced an agreement to create a new consumer publishing business by combining Penguin and Random House. The transaction completed on July 1, 2013 and from that point, Pearson no longer controlled the Penguin Group of companies and has equity accounted for its 47% associate interest in Penguin Random House.

Table of Contents

The loss of control resulted in the Penguin business being classified as held for sale on the Pearson balance sheet June 30, 2013 and a subsequent gain on sale of £202m was reported in the second half of 2013. Included in the gain reported in 2013 was a provision for amounts payable to Bertelsmann upon settlement of the transfer of pension liabilities to Penguin Random House. During 2014 it was decided that this transfer would not go ahead as planned and the costs have been credited back in the £29m gain reported against the disposal in 2014.

The results for Penguin in the first half of 2013 and the gains reported in both 2013 and 2014 have been included in discontinued operations. The share of results from the associate interest in Penguin Random House arising in the second half of 2013 and in 2014 has been included in operating profit in continuing operations.

On November 29, 2013 we announced the sale of the Mergermarket Group to BC Partners. The sale was completed on February 4, 2014 and resulted in a gain of £198m after tax. The gain on sale and the results for the Mergermarket business for 2013 and 2014 have been included in discontinued operations.

On 16 October 2015, Pearson substantially completed the sale of its 50% interest in the Economist to EXOR and on 30 November 2015 Pearson completed the sale of the Financial Times to Nikkei. The results of the Economist and the Financial Times are included in discontinued operations in 2013 and 2014.

Profit for the year

The profit for the financial year in 2014 was £470m compared to a profit in 2013 of £539m. The 2014 profit includes a gain on sale of Mergermarket of £198m and the 2013 profit includes a gain on the sale of Penguin of £202m, as described above.

Earnings per ordinary share

The basic earnings per ordinary share, which is defined as the profit for the financial year divided by the weighted average number of shares in issue, was 58.1p in 2014 compared to 66.6p in 2013 based on a weighted average number of shares in issue of 810.9m in 2014 and 807.8m in 2013. The decrease in earnings per share was due to the decrease in profit for 2014 described above and was not significantly affected by the movement in the weighted average number of shares.

The diluted earnings per ordinary share of 58.0p in 2014 and 66.5p in 2013 was not significantly different from the basic earnings per share in those years as the effect of dilutive share options was again not significant.

Exchange rate fluctuations

Currency movement reduced sales by £269m and reduced operating profit by £49m. See Item 11. Quantitative and Qualitative Disclosures about Market Risk for a discussion regarding our management of exchange rate risks.

Sales and operating profit by segment

The following tables summarize our sales and adjusted operating profit for each of Pearson s business segments. Adjusted operating profit is a non-GAAP financial measure and is included as it is a key financial measure used by management to evaluate performance and allocate resources to business segments.

In our adjusted operating profit we have excluded other net gains and losses, acquisition costs and amortization and impairment of acquired intangibles. The intangible charges relate to intangible assets acquired through business combinations and acquisition costs are the direct costs of acquiring those businesses. Neither of these charges are considered to be fully reflective of the underlying performance of the Group. Other net gains and losses that represent profits and losses on the sale of subsidiaries, joint ventures, associates and other financial assets are also excluded from adjusted operating profit as they distort the performance of the Group.

Table of Contents

Adjusted operating profit enables management to more easily track the underlying operational performance of the Group. A reconciliation of operating profit to adjusted operating profit for continuing operations is included in the tables below:

	Year Ended December 31, 2014						
£m	**North America**	**Core**	**Growth**	**PRH**	**Continuing**	**Discontinued**	**Total**
Sales	2,906	910	724		4,540	343	4,883
	64%	*20%*	*16%*		*100%*		
Total operating profit	336	100	(103)	15	348	325	673
	97%	*29%*	*(30%)*	*4%*	*100%*		
Add back:							
Other net gains and losses	(2)				(2)	(273)	(275)
Acquisition costs	2	1	3		6		6
Intangible charges	108	21	132	54	315	3	318
Adjusted operating profit: continuing operations	444	122	32	69	667		667
Adjusted operating profit: discontinued operations						55	55
Total adjusted operating profit	444	122	32	69	667	55	722
	61%	*17%*	*4%*	*10%*	*92%*	*8%*	*100%*

	Year Ended December 31, 2013						
£m	**North America**	**Core**	**Growth**	**PRH**	**Continuing**	**Discontinued**	**Total**
Sales	3,008	1,008	712		4,728	962	5,690
	64%	*21%*	*15%*		*100%*		
Total operating profit	358	58	(5)	20	431	79	510
	83%	*13%*	*(1%)*	*5%*	*100%*		
Add back:							
Other net gains and losses		16			16		16
Acquisition costs	2	3	7		12		12
Intangible charges	104	26	33	30	193	5	198
Adjusted operating profit: continuing operations							
Adjusted operating profit: discontinued operations						84	84
Total adjusted operating profit	464	103	35	50	652	84	736
	63%	*14%*	*5%*	*7%*	*89%*	*11%*	*100%*

North America

North America sales declined by £102m, or 3%, from £3,008m in 2013, to £2,906m in 2014 and adjusted operating profit decreased by £20m, or 4%, from £464m in 2013 to £444m in 2014. The decline in headline terms was a result of currency movements due to the strengthening of sterling against the US dollar. At constant exchange and after taking account of the contribution from acquisitions, sales grew by 2% and adjusted profits by 3% reflecting revenue mix, lower returns provision, reduced US pension costs and lower restructuring charges.

In our statutory results, we recognized a £38m loss on disposal of our 5% stake in Nook Media and a £40m gain on the disposal of our stakes in Safari Books Online and CourseSmart.

Table of Contents

Overall adjusted operating margins in the North America business were consistent in 2014 at 15.3% compared to 15.4% in 2013.

North America School

In school, good growth in Connections Education, our virtual schools business, was offset by declines in our State Assessments business due to the impact of legislative change in Texas and California, and in courseware due to some loss of market share, revenue deferral on blended programs and softness in the Open Territories.

Connections Education served over 62,000 Full Time Equivalent students in 2014 through full-time virtual and blended programs, up more than 15% from 2013. Three new full-time virtual public schools were launched in 2014 and an additional one will launch in 2015. At full-time virtual schools supported by Connections Education, virtual students consistently outperform their virtual school peers on state standardized tests. Students at College Park Academy, a blended school in Maryland using the Connections Education curriculum, scored significantly higher than their in-state peers in reading and math in the Maryland School Assessment (MSA) for 6th and 7th Grades.

In State and National Assessments, high stakes online test volumes grew strongly, up 40% on 2013 to 11 million, as customers transitioned to computer-based testing. Paper-based high stakes test volumes declined 17% to 32 million, in part due to the growth of computer-based testing, but also the impact of legislative changes in Texas and California. We were awarded contract to administer Partnership for Assessment of Readiness for College and Careers (PARCC) assessments in 11 states and extended our contracts to administer Virginia Standards of Learning (SOL) Assessments and the Maryland High School Assessment. We will continue to administer the Florida Comprehensive Assessment Test (FCAT) until summer 2016.

Clinical Assessment grew strongly, benefiting from the launch of the fifth edition of the Wechsler Intelligence Scale for Children (WISC-V) and strong growth in Q-Interactive, where early studies are showing good improvements in mental health professional productivity and student engagement levels.

Courseware revenues declined due to the impact of revenue deferrals from blended digital programs and a loss of market share, with a weaker performance in Grades 6-8 Science and Math in Texas, and Grades 6-12 Literature and Grades 6-8 Math in Florida only partly offset by a stronger performance in K-6 Math in Texas, Grades 6-12 Social Studies in Tennessee and Grades K-6 Math in California. We won an estimated 25% of the total new adoptions market (of $910m in 2014). enVisionMATH, which now has the largest installed base of elementary students in the US, continues to drive significant improvements in student computation and problem solving.

North America Higher Education

In Higher Education, total college enrolments fell by 1.3%. Career enrolments in two-year public (community) and four-year-for-profit colleges declined 3%, with rising employment rates and regulatory change affecting the for-profit and developmental learning sectors.

Courseware grew modestly, primarily due to market share gains, continued growth in digital courseware registrations, a stronger new edition cycle and less pronounced seasonality. MyLab registrations in North America grew 3% to almost 11 million. Lecturer generated case studies indicate that the use of MyLab programs, as part of a broader course redesign, can support improvements in student test scores. We launched REVEL, which combines trusted content with interactive videos, quizzes, a mobile user interface, study tools, assignment calendar and performance dashboard for 17 humanities and social sciences subjects. The launch of REVEL is the first of numerous product lines taking advantage of our new cloud-based mobile-ready, and data analytics capabilities. New editions launched in 2014 included Tro, *The Structures and Properties of Chemistry*; Acemoglu, Laibson and List, *Economics*; and Pearson *Writer*, an application built for mobile devices that helps

students in developing writing skills. We published a range of digital titles for The Boy Scouts of America and implemented a new digital curriculum incorporating enhanced Merit Badge programs in subjects including Robotics, Digital Technology and First Aid for the organization s 2.7 million youth members.

Pearson On Line Services, where we run fully online undergraduate and graduate learning programs and earn certain revenues based on the success of the students and the institution, grew course enrolments by 22% during the year with continued strong growth in programs at Arizona State University Online and University of Florida Online. We signed new programs with Bradley University, to create five online graduate degree programs in nursing and counselling, and University of Texas at Austin, Dana Center where we are partnering for the web delivery of math courses for its New Mathways Project (NMP), which will become part of a state-wide reform initiative in a collaboration between Dana Center and the Texas Association of Community Colleges. We expanded our collaboration with the American Health Information Management Association (AHIMA) to administer its online education business, which serves AHIMA s 71,000 members including 10,000 higher education students each year. We now provide our learning management system hosting 100 courses based on AHIMA content; technical support; a next generation Virtual Lab Product; and are launching a Coding Basics course combining AHIMA and Pearson content.

North America Professional

At VUE, global test volumes grew 9% year-on-year to almost 13 million boosted by continued growth in IT, State Regulatory and Professional certifications. New contracts include a deal to administer the Microsoft Certified Professional (MCP) Program globally, which significantly expands our existing partnership with Microsoft through Certiport s Microsoft Office Specialist (MOS) and Microsoft Technology Associate (MTA) exams.

Core

Sales in our Core markets decreased by £98m, or 10%, from £1,008m in 2013 to £910m in 2014 while adjusted operating profit increased by £19m, or 19%, from £103m in 2013 to £122m in 2014. At constant exchange and after taking account of the contribution from acquisitions there was decline in sales of 6%. At constant exchange and after taking account of the contribution from acquisitions there was growth in profits of 24% driven by the benefits of restructuring actions taken over the last two years in all markets. Overall adjusted operating margins in the Core markets increased from 10.2% in 2013 to 13.4% in 2014.

Core School

In the UK, qualifications have been impacted by government policy, where changes to accountability measures and a shift to end of course assessments in GCSE have led to a 21% decline in BTECs and 11% decline in General Qualifications in the year. We marked almost four million National Curriculum Tests (NCT), up 24% on 2013. Our contract to administer the NCT was extended to 2017. More than 4,600 schools, with almost 850,000 children, now subscribe to at least one of the Bug Club services, our primary school blended reading program.

In Australia, we benefited from a stronger adoption year and the launch of the locally standardized version of the Wechsler Pre and Primary Scales of Intelligence (fourth edition). In Italy, we gained share in both primary and secondary with new titles combined with professional development and online cross-curricula support. In primary, we developed Top Secret and adapted Our Discovery Island English Language Learning programs. In secondary, we extended our market leadership in the Humanities.

Revenues declined significantly in our partner markets due to challenging market conditions in Africa and Scandinavia and with the move to a distributor model in certain markets. We disposed of our local schools lists in the Caribbean as we continue to focus on our largest global geographic opportunities.

Table of Contents

Core Higher Education

In the UK, our courseware revenues declined, primarily due to enrolment contraction following policy changes in the vocational markets. We continue to invest to build Pearson College and graduated our first 32 students during the year. Pearson College was one of only four private colleges to pass Quality Assurance Agency review the first time.

In Australia, courseware revenues grew modestly benefiting from growth in core subjects, such as Biology, and direct-to-institution sales of digital learning products offset by our exit from vocational publishing. Monash Online, our collaboration with Monash University, continues to show good growth and will launch additional courses in the second half of 2015. In addition we collaborated with another leading university in Australia to provide course development, recruitment, enrolment, and student support services for post-graduate courses.

Core Professional

At VUE, test volumes grew strongly following the successful launch of a new contract with CPA Australia to deliver Professional exams and continued good growth in the UK Driving Theory test volumes. We will continue to deliver our UK contract to administer the Driving Theory test for DVSA until September 2016. VUE entered into ten year partnerships with the Chartered Institute of Management Accountants (CIMA) and the Association of Chartered Certified Accountants (ACCA) in the UK to transform a selection of their exams from pen and paper to computer-based testing.

Growth

Growth sales increased by £12m, or 2%, to £724m in 2014 from £712m in 2013. Adjusted operating profit decreased by £3m or 9% to £32m in 2014, from £35m in 2013. This reflected a benefit from the acquisition of Grupo Multi offset by a slower adoption year in South Africa, launch costs associated with our new vocational colleges and a contract provision in Saudi Arabia, and weaker revenues and restructuring costs in Brazil.

In our statutory results we wrote down the balance sheet value of our Indian business by £77m largely reflecting the reduced value of online tutoring which was primarily focused on the US market.

Overall adjusted operating margins in the Growth markets were lower at 4.4% in 2014 compared to 4.9% in 2013.

Growth School

In South Africa we performed well, competitively maintaining our market share of the School textbook market, but volumes declined significantly to more normal levels following a large adoption year, and significant share gains, in 2013.

In Brazil, enrolments in our sistemas were down 3% to 481,000 with growth in our public sistemas (NAME) offset by declines in our private sistemas as we combined our three sales forces into one. 72% of the municipalities that adopted NAME for lower secondary education showed improvement in their IDEB score, Brazil s federally established measure of educational quality.

Growth Higher Education

In South Africa student enrolments in CTI/MGI our private network of higher education institutions, grew by 15% to 13,400 across 13 campuses.

In Mexico, our fully accredited online university partnership, UTEL, increased the number of students enrolled from under 5,000 last year to more than 9,000 in 2014 as a result of improved consumer marketing efforts and better student retention.

Table of Contents

In India, higher education revenues declined due to higher levels of returns.

Growth Professional

In Pearson English, good growth in direct delivery in China and inside services in Brazil due to the acquisition of Grupo Multi was partly offset by declines in courseware in Brazil and Mexico. Global student registrations for MyEnglishLab grew 15% to more than 460,000 with strong growth in Latin America.

We launched the Global Scale of English, a new global standard for scoring English language proficiency on a precise, numeric, universal scale for businesses, governments and academic institutions. The scale is being embedded into all Pearson English products and services.

In China, English direct delivery enrolments grew at both Wall Street English (WSE), up 2% to 66,000 and Global Education, up 7% to 117,000. To support long-term growth, we consolidated our ERP systems in China and deployed a Salesforce.com CRM system in WSE. We divested our online vocational training operations.

In Brazil, we completed the acquisition of Grupo Multi, the largest provider of private language schools in Brazil. We successfully integrated the business despite challenging market conditions and disruption caused by the World Cup and Presidential elections.

Penguin Random House

In the twelve months to December 31, 2014 our share of Penguin Random House adjusted operating profits were £69m, compared with the six months from July 1, 2013 to December 31, 2013 of £50m.

Pearson owns 47% of Penguin Random House. Penguin Random House was reported post-tax for the full year in 2014 compared to only the second half in 2013 following the combination of Penguin with Random House on July 1, 2013, which resulted in a £7m reduction in the contribution to operating income with an equal benefit to our tax charge.

Penguin Random House performed well in 2014, benefiting particularly from a strong publishing performance in Children s around the world and multi-million-copy film and television tie ins.

The US business published 760 *New York Times* print and ebook bestsellers in 2014 (2013 full year pro forma: 790), enjoying exceptional success in children s publishing with John Green s *The Fault in Our Stars* (29 weeks at number one on the *New York Times* bestsellers list and nearly eight million copies sold) and four million copies of his backlist titles, tie-in titles from Disney s *Frozen* film (more than 17 million copies sold), Dashner s *The Maze Runner,* Forman s *If I Stay* and continued strong sales of LEGO® movie tie-in titles. Notable Adult titles included Grisham s *Gray Mountain*, Child s *Personal*, Monk Kidd s *The Invention of Wings*, Follett s *Edge of Eternity,* Bush s *41:A Portrait of My Father,* along with strong film and television tie-ins such as Flynn s *Gone Girl*, Hillenbrand s *Unbroken,* and Martins *Song of Fire and Ice* novels.

The UK business published 206 *Sunday Times* bestsellers (2013 full year pro forma: 207), also enjoying outstanding sales of John Green, along with the continued strength of Kinney s *Wimpy Kid* franchise. Key Adult titles included Brown s *Inferno,* Oliver s *Jamie s Comfort Food* and *Girl Online* by YouTube sensation Zoella, which became the fastest-selling debut UK novel ever.

Liquidity and capital resources

Cash flows and financing

Net cash generated from operations decreased by £186m (or 26%) to £518m in 2015 from £704m in 2014 reflecting the impact of lower sales, higher returns in US Higher Education and increased debtor days, primarily in North America. Net cash generated from operations increased by £20m (or 3%) to £704m in 2014 from £684m

Table of Contents

in 2013 reflecting some stabilization in the underlying trading environment with some offset from continued product investment. Cash spend on restructuring was level with 2013. The average working capital to sales ratio increased to 15.4% in 2015 from 12.3% in 2014 and 13.4% in 2013 reflecting the disposal of businesses with a lower working capital profile, higher returns, increased debtor days, increased product development investment, lower incentive accruals in 2015 and lower sales. Average working capital is the average month end balance in the year of inventory (including pre-publication), receivables and payables (including deferred revenue).

Net interest paid in 2015 was lower than 2014 at £51m reflecting lower interest on bonds (following repayments), lower average net debt and higher interest income on cash balances held in emerging markets. Net interest paid in 2014 was level with 2013 at £73m with higher average net debt levels and debt issue costs offset by currency translation gains.

Capital expenditure on property, plant and equipment and software intangibles was £247m in 2015, £182m in 2014 and £182m in 2013. The increase in 2015 was entirely due to investment in software and technology platforms as the Group sought to harmonize and expand its technology capabilities.

The acquisition of subsidiaries, joint ventures and associates accounted for a cash outflow of £20m in 2015 against £460m in 2014 and £58m in 2013. There were no major acquisitions in 2015. The major acquisition in 2014 was of Grupo Multi for £437m. There were no major acquisitions in 2013, with the cash outflow relating to various minor acquisitions and costs associated with prior period acquisitions.

The sale of subsidiaries and associates produced a net cash inflow of £1,409m in 2015 compared to an inflow of £366m in 2014 and an outflow of £130m in 2013. The cash inflow in 2015 relates to the proceeds on the sale of the *Financial Times* of £858m, the proceeds on the sale of The Economist Group of £377m and proceeds on the sale of PowerSchool £222m. The cash inflow in 2014 primarily relates to the proceeds on sale of Mergermarket of £375m, less associated costs. The cash outflow in 2013 primarily relates to the cash disposed with Penguin upon formation of Penguin Random House.

The cash outflow from financing of £364m in 2015 reflects a further 7% increase in the dividend, the repayment of a £300m Sterling bond, offset in part by the proceeds from the issue of a 500m Euro note. The cash outflow from financing of £534m in 2014 reflects a 7% increase in the dividend, the repayment of a $400m US dollar bond and a £250m sterling bond, offset in part by proceeds from the issue of a 500m Euro note. The cash outflow from financing of £395m in 2013 reflects a 7% increase in the dividend, the repayment of a $350m US Dollar note during the year and the buy-out of various non-controlling interests, with some offset from the proceeds of a $500m US Dollar note issued in the year.

Capital resources

Our borrowings fluctuate by season due to the effect of the school year on the working capital requirements in the educational materials business. Assuming no acquisitions or disposals, our maximum level of net debt normally occurs in July, and our minimum level of net debt normally occurs in December. Based on a review of historical trends in working capital requirements and of forecast monthly balance sheets for the next 12 months, we believe that we have sufficient funds available for the Group s present requirements, with an appropriate level of headroom given our portfolio of businesses and current plans. Our ability to expand and grow our business in accordance with current plans and to meet long-term capital requirements beyond this 12-month period will depend on many factors, including the rate, if any, at which our cash flow changes and the availability of public and private debt and equity financing, including our ability to secure bank lines of credit. We cannot be certain that additional financing, if required, will be available on terms favorable to us, if at all.

At December 31, 2015, our net debt was £654m compared to net debt of £1,639m at December 31, 2014 reflecting the business disposals completed during 2015. Net debt is defined as all short-term, medium-term and long-term borrowing (including finance leases), less all cash, cash equivalents and liquid resources. Cash equivalents comprise short-term deposits with a maturity of up to 90 days, while liquid resources comprise short-

Table of Contents

term deposits with maturities of more than 90 days and other marketable instruments which are readily realizable and held on a short-term basis. Total Short-term, medium-term and long-term borrowing amounted to £2,330m at December 31, 2015, compared to £2,225m at December 31, 2014 reflecting repayment of a £300m Sterling bond, offset by the issue of a 500m Euro note and exchange movements (primarily the strengthening of the US dollar against Sterling). At December 31, 2015, total cash and liquid resources were £1,703m, compared to £530m at December 31, 2014. This increase reflects the proceeds from the business disposals completed during 2015.

Contractual obligations

The following table summarizes the maturity of our borrowings, our obligations under non-cancelable leases, and pension funding obligations, exclusive of anticipated interest payments. Due to the variability of future interest payments, these have been excluded from the table below.

	At December 31, 2015				
	Total £m	**Less than one year £m**	**One to two years £m**	**Two to five years £m**	**After five years £m**
Gross borrowings:					
Bank loans, overdrafts and commercial paper	38	38			
Bonds	2,284	240		621	1,423
Finance lease obligations	8	4	3	1	
Operating lease obligations	1,391	164	146	396	685
UK Pension funding obligations	90	90			
Total	3,811	536	149	1,018	2,108

At December 31, 2015 the Group had capital commitments for fixed assets, including finance leases already under contract, of £8m (2014: £13m). There are contingent liabilities in respect of indemnities, warranties and guarantees in relation to former subsidiaries and in respect of guarantees in relation to subsidiaries and associates. In addition there are contingent liabilities in respect of legal and royalty claims. None of these claims or guarantees is expected to result in a material gain or loss.

In 2014, the Group negotiated a new $1,750m committed revolving credit facility with an initial maturity date of August 2019. During 2015, the Group extended the maturity date of this facility by 1 year to August 2020. The facility requires the Group to pay an annual commitment fee of 0.1225%, payable quarterly, on the unused amount of the facility.

Off-Balance sheet arrangements

The Group does not have any off-balance sheet arrangements, as defined by the SEC for the purposes of From 20-F, that have or are reasonably likely to have a material current or future effect on the Group s financial position or results of operations.

Borrowings

The Group finances its operations by a mixture of cash flows from operations, short-term borrowings from banks and commercial paper markets, and longer term loans from banks and capital markets.

We have in place a committed revolving credit facility of $1.75bn, which matures in August 2020. At December 31, 2015, the full $1.75bn was available under this facility. This credit facility contains two key covenants measured for each 12 month period ending June 30 and December 31:

We must maintain the ratio of our profit before interest, tax and amortization to our net interest payable at no less than 3:1; and

Table of Contents

We must maintain the ratio of our rolling 12 month average net debt to our EBITDA, which we explain below, at no more than 4:1.

EBITDA refers to earnings before interest, taxes, depreciation and amortization. We are currently in compliance with these covenants.

See note 18 of Item 18. Financial Statements for information on our longer term loans from banks and capital markets.

Treasury policy

Our treasury policy is described in note 19 of Item 18. Financial Statements . For a more detailed discussion of our borrowing and use of derivatives, see Item 11. Quantitative and Qualitative Disclosures about Market Risk .

Related parties

There were no significant or unusual related party transactions in 2015, 2014 or 2013. Refer to note 36 in Item 18. Financial Statements .

Accounting principles

For a description of our principal accounting policies used refer to note 1 in Item 18. Financial Statements .

Table of Contents

ITEM 6. ***DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES***
Directors and senior management

We are managed by a board of directors and a chief executive who reports to the board and manages through an executive committee. We refer to the board of directors, the chairman of the board of directors and the executive committee as our senior management .

The following table sets forth information concerning directors, as of February 29, 2016.

Name	Age	Position
Sidney Taurel	67	Chairman
John Fallon	53	Chief Executive
Elizabeth Corley, CBE	59	Non-executive Director
Vivienne Cox, CBE	56	Senior Independent Director
Josh Lewis	53	Non-executive Director
Linda Lorimer	63	Non-executive Director
Harish Manwani	62	Non-executive Director
Tim Score	55	Non-executive Director
Lincoln Wallen	55	Non-executive Director
Coram Williams	42	Chief Financial Officer

Sidney Taurel

Appointed January 1, 2016. Chairman of the nomination committee and member of the remuneration committee.

Sidney has over 40 years of experience in business and finance, and is currently a board director and chairman of the Compensation Committee at IBM Corporation. He is also a director at McGraw Hill Financial, Inc., a role from which he will step down during 2016. Sidney is senior advisor at global investment bank Moelis & Co and an advisory board member at pharmaceutical firms Takeda Pharmaceutical and Almirall. He was chief executive officer of global pharmaceutical firm Eli Lilly and Company from 1998 until 2008, chairman of the business from 1999 until 2008, and has been chairman emeritus since 2009. 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 Honor.

John Fallon

Appointed October 3, 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 and a member of the Council of the University of Hull.

Elizabeth Corley, CBE

Appointed May 1, 2014. Chairman of the remuneration committee and member of the nomination committee.

Table of Contents

Elizabeth is non-executive vice chair of Allianz Global Investors, where she was chief executive officer from 2005 to 2016. She was previously at Merrill Lynch Investment Managers (formerly Mercury Asset Management) and Coopers & Lybrand. Elizabeth is acting-chair of the FICC Markets Standards Board, a member of the ESMA stakeholder group and an advisory council member of TheCityUK. She is a non-executive director of BAE Systems plc and the Financial Reporting Council. In addition, she is a member of FEAM s management committee, the CFA Future of Finance Council, the Supervisory Board of Euler SA, a council member of the City of London IRSG and a member of the Committee of 200. She is a fellow of the CFA and the Royal Society of Arts and is also a crime fiction author.

Vivienne Cox, CBE

Appointed on January 1, 2012. Chairman of the reputation & responsibility committee and member of the audit, nomination and remuneration committees.

Vivienne has wide experience in energy, natural resources and business innovation. She worked for BP plc for 28 years, in Britain and Continental Europe, in posts including executive vice president and chief executive of BP s gas, power and renewables business and its alternative energy unit. She is non-executive director of Stena International and chairman of the supervisory board of Vallourec, which supplies tubular systems for the energy industry. She is also lead independent director at the UK Department for International Development. Vivienne was appointed Commander of the Order of the British Empire (CBE) in the 2016 New Year Honours for services to the UK Economy and Sustainability.

Josh Lewis

Appointed on March 1, 2011. Member of the nomination, remuneration and reputation & responsibility committees.

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

Linda Lorimer

Appointed July 1, 2013. Member of the audit, nomination and reputation & responsibility committees.

Linda has a deep background in education strategy, administration and public affairs. She is senior counsellor to the president and provost of Yale University and until recently served as vice president for Global & Strategic Initiatives at Yale, where her duties included oversight of Yale s Office of International Affairs and Office of Digital Dissemination. Over a 30-year career in higher education, she has been responsible for many of Yale s administrative services including the university s public communications, alumni relations and Office of Sustainability. Previously, Linda served as president of Randolph-Macon Woman s College in Virginia and was chair of the board of the Association of American Colleges and Universities. She has served on the boards of several public companies, including as presiding director of the McGraw-Hill Companies.

Harish Manwani

Appointed October 1, 2013. Member of the nomination and reputation & responsibility committees.

Harish has an extensive background in emerging markets and senior experience in a successful global organization. He was previously chief operating officer of consumer products company Unilever, having joined

Table of Contents

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.

Tim Score

Appointed January 1, 2015. Chairman of the audit committee and member of the nomination and remuneration committees.

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, a position he held 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. 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, BTR plc and others.

Lincoln Wallen

Appointed January 1, 2016. Member of the nomination committee.

Lincoln is chief technology officer for DreamWorks Animation, the global family entertainment company, a position he has held since 2012, having joined the company as head of research and development in 2008. Prior to this, Lincoln served as chief technology officer for the mobile business of Electronic Arts, Inc., a leading interactive entertainment software company. He has held senior positions at Criterion Software, MathEngine plc and is a non-executive director of the Smith Institute for Industrial Mathematics & System Engineering. Lincoln is also an advisory board member of Hewlett Packard Enterprise and a member of the STEM Advisory Committee of the National Academy foundation. Lincoln was formerly a lecturer and reader in computation at the University of Oxford.

Coram Williams

Appointed August 1, 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 and 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. Coram trained at Arthur Andersen, and subsequently worked in both the auditing and consulting practices of the firm.

The following table sets forth information concerning the executive committee, as of February 29, 2016

Name	Position
Sir Michael Barber	Chief Education Advisor
Tim Bozik	President, Global Products
Rod Bristow	President, Core Markets
Gio Giovannelli	President, Growth Markets
Albert Hitchcock	Chief Technology and Operations Officer
Kate James	Chief Corporate Affairs Officer
Don Kilburn	President, North America
Bob Whelan	President, Pearson Assessments
Melinda Wolfe	Chief Human Resources Officer

Table of Contents

Sir Michael Barber

Sir Michael is Chief Education Advisor at Pearson and is a leading authority on education systems and reform. He leads Pearson s worldwide program of research into education policy and efficacy, advising on and supporting the development of products and services that deliver efficacy and build on research findings. He leads Pearson s strategy for developing innovative educational models for low-income families in the developing world. Sir Michael is a Distinguished Visiting Fellow at Harvard and holds an honorary doctorate from the University of Exeter. His publications include Oceans of Innovation and An Avalanche is Coming.

Tim Bozik

Tim is President, Global Products and has extensive knowledge of all aspects of higher education as well experience in moving Pearson towards being a more digital, data and services-led business. Tim joined Pearson in 1983 as a sales representative and has since held several leadership roles in product development and general management, including his most recent post as chief executive of US higher education. His work has included a focus on the role of technology, data and analytics to improve access, achievement and affordability.

Rod Bristow

Rod is President, Core Markets and has wide-ranging expertise in K-12 schools, higher and professional education, assessment, qualifications, and learning technology having been involved in education throughout his career. He was previously the President of Pearson UK. Rod is a Fellow of the Royal Society of Arts, a former President of the Publishers Association, a trustee of the Education and Employers Taskforce and a member of the President s Committee of the Confederation of British Industry.

Gio Giovannelli

Gio is President, Growth Markets having joined Pearson as Managing Director of Pearson Brazil. Gio was previously CEO of Grupo Multi, Brazil s leading English language learning business, which was acquired by Pearson in December 2013. Prior to Multi, he held CEO positions in Brazil across a number of sectors, including energy, mining and HR services. Gio is a Board member of Natura (cosmetics and beauty products) and CVC (travel and vacation operator), both listed in the Sao Paulo Stock Exchange BOVESPA. Gio earned his undergraduate degree in Italy s Bocconi University, holds a Ph.D. in Economics from the American University in Washington DC and is an OPM graduate of Harvard Business School.

Albert Hitchcock

Albert joined Pearson in March 2014 as Chief Information Officer. He leads the IT organization across Pearson globally and has overall responsibility for implementing the group s technology strategy to enable competitive advantage. He previously held the position of Group Chief Information Officer at Vodafone and prior to this was Global CIO at Nortel. Albert is a Fellow of the Institute of Engineering and Technology and a Chartered Engineer.

Kate James

Kate joined Pearson in January 2014 as Chief Corporate Affairs Officer. She has a background in international government relations, corporate communications, brand management and sustainability. Prior to joining Pearson, Kate was Chief Communications Officer at the Bill & Melinda Gates Foundation. Kate is a member of the board of Vital Voices.

Don Kilburn

Don is President, North America and has broad product-service experience in Higher Ed and K-12. He is responsible for accelerating shift-to-services and digital and transforming North American business by putting

Table of Contents

learner outcomes at the center of Pearson. Previously, he was vice chairman of Pearson Higher Education North America and chief executive of Pearson Learning Solutions. Don joined Pearson in 1998 and has extensive general-manager experience in a variety of companies including Viacom and Xerox.

Bob Whelan

Bob is President, Pearson Assessments and has significant expertise in assessment and growing businesses. As president and chief executive officer of Pearson VUE since January 2000, Bob led Pearson s growth as a global leader in computer-based assessments. He now leads Pearson s combined assessments businesses including K12 and clinical assessment as well as Pearson VUE. Bob received his BA from the University of Alabama in finance and economics.

Melinda Wolfe

Melinda is Chief Human Resources Officer, having joined Pearson in September 2013. Her extensive human resources expertise includes business alignment, talent management, succession planning, diversity, leadership, change management, culture, employee engagement, team building, health and wellness and non-profit leadership. Melinda previously worked in Human Resources at Bloomberg LP and served as an adjunct professor at Columbia University s School of International and Public Affairs, on Mayor Bloomberg s Commission on Women as well as Planned Parenthood of NTC, the National Council for Research on Women, Auburn Seminary, the Dalton School and the advisory boards of Barnard, Duke University and Washington University.

Compensation of senior management

It is the role of the remuneration committee (the committee) to approve the remuneration and benefits packages of the executive directors and other members of the Pearson Executive.

The principal duties of the remuneration committee (the committee) are to:

a. Determine and regularly review the remuneration policy for the executive directors, the presidents of the principal geographic markets and lines of business and other members of the Pearson executive who report directly to the CEO (Executive Management). This policy includes base salary, annual and long-term incentives, pension arrangements, any other benefits and termination of employment.

b. 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.

c. Approve the design of, and determine targets for, any performance-related pay plans operated by the company and approve the total payments to be made under such plans.

d. Review the design of the company s long-term incentive and other share plans for approval by the board and shareholders.

e. Advise and decide on general and specific arrangements in connection with the termination of employment of executive directors.

f. Review and approve corporate goals and objectives relevant to CEO remuneration and evaluate the CEO s performance in light of those goals and objectives.

g. Have delegated responsibility for determining the remuneration and benefits package of the chairman of the board.

h. Appoint and set the terms of engagement for any remuneration consultants who advise the committee and monitor the cost of such advice.

Table of Contents

The committee also takes note of the remuneration arrangements for the company s senior leadership group representing approximately 100 executives and managers.

Remuneration policy

Our starting point continues to be that total remuneration should reward both short and long-term results, delivering competitive rewards for target performance, but outstanding rewards for exceptional performance.

Total remuneration is made up of fixed and performance-linked elements, with each element supporting different objectives. Base salary helps to recruit, reward and retain people and reflects competitive market level, role, skills, experience and individual contribution. Allowances and benefits help to recruit and retain people and reflect the local competitive market. Retirement benefits help to recruit and retain people and recognize their long-term commitment to the company. Annual incentives motivate the achievement of annual strategic goals and personal objectives, provide focus on key financial metrics and reward individual contribution to the success of the company. Long-term incentives help to recruit, reward and retain people, drive long-term earnings, share price growth and value creation, align interests of executives and shareholders, encourage long-term shareholding and commitment to the company and link management s long-term reward and wealth to corporate performance in a flexible way.

For benchmarking purposes, we review remuneration by reference to different comparator groups. We look at survey data from: select UK human capital-intensive businesses and UK and US media convergence companies with a focus on media, information services and technology (and cross-referenced with FTSE 100 companies with significant international exposure). These companies are of a range of sizes relative to Pearson, but the method our independent advisers, Willis Towers Watson, use to make comparisons on remuneration takes this variation in size into account. We also look at publicly disclosed and proxy data for global media convergence comparators with a focus on media and technology. We use these companies because they represent the wider executive talent pool from which we might expect to recruit externally and the pay market to which we might be vulnerable if our remuneration was not competitive.

Consistent with its policy, the committee places considerable emphasis on the performance-linked elements i.e. annual and long-term incentives. The committee will continue to review the mix of fixed and performance-linked remuneration on an annual basis, consistent with its overall philosophy.

Base salary

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

Allowances and benefits

Allowances and benefits include *inter alia* cash allowances and non-cash benefits such as health, welfare and car benefits. Allowances and benefits do not form part of pensionable earnings. The provision and level of allowances and benefits are competitive and appropriate in the context of the market.

Retirement benefits

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

Under the Money Purchase 2003 section of the Pearson Group Pension Plan in the UK, normal retirement is age 62 but, subject to company consent, retirement is currently possible from age 55 or earlier in the event of

ill-health. During service, the company and the employee make contributions into a pension fund. Company contributions amount to up to 16% of pensionable salary (double the amount of the employee contribution, which is limited according to certain age bands). Account balances are used to provide benefits at retirement. Pensions for a member s spouse, dependent children and/or nominated financial dependents are payable on death.

Under the 401(k) plan in the US, which is a defined contribution plan, account balances will be used to provide benefits at retirement. Company contributions amount to 100% of the first 3% of eligible compensation contributed by the employee and 50% of the next 3%, plus a basic annual company contribution of 1.25% of eligible compensation. Pearson Inc. Pension Plan participants who were at least age 40 at December 31, 2001 can receive an additional 0.5% 1.5% of pay. In the event of death before retirement, the account balances will be used to provide benefits for designated beneficiaries.

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

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

In the US, the defined benefit Pearson Inc. Pension Plan provides a lump sum benefit that is convertible to an annuity on retirement. The lump sum benefit accrued at an age dependent percentage of capped compensation until December 31, 2001 when further benefit accruals ceased for most employees. Employees who satisfied criteria of age and service as of November 30, 1998 continue to earn benefits under an alternative formula that provides for 1.5% of final average earnings, adjusted for US Social Security. The benefit paid to these employees is the maximum of the lump sum benefit converted to an annuity and the benefit earned under the alternative final average earnings formula.

Members of the Pearson Group Pension Plan who joined after May 1989 are subject to an upper limit of earnings that can be used for pension purposes, known as the earnings cap. This limit was abolished by the Finance Act 2004. However the Pearson Group Pension Plan has retained its own cap , which will increase annually in line with the UK Government s Index of Retail Prices (All Items). The cap was £145,800 effective April 6, 2014, and £149,400 effective April 6, 2015, and £150,600 effective April 6, 2016.

As a result of the UK Government s A-Day changes effective from April 2006, UK executive directors and other members of the Pearson Group Pension Plan who are, or become, affected by the lifetime allowance are provided with a cash supplement as an alternative to further accrual of pension benefits on a basis that is broadly cost neutral to the company. Effective from April 6, 2011, the annual allowance (i.e. the maximum amount of pension saving that benefits from tax relief each year) was reduced from £255,000 to £50,000. Since April 6, 2012, the lifetime allowance (i.e. the maximum amount of pension and/or lump sum that can benefit from tax relief) has been £1.5m and was reduced to £1.25m on April 6, 2014.

Table of Contents

The pension entitlements of each director are as follows:

John Fallon	Member of the Pearson Group Pension Plan. His pension accrual rate is 1/30th of pensionable salary per annum, restricted to the plan earnings cap. Until April 2006, the company also contributed to a Funded Unapproved Retirement Benefits Scheme (FURBS) on his behalf. Since April 2006, he has received a taxable and non-pensionable cash supplement in replacement of the FURBS.
Coram Williams	Pearson Group Pension Plan Accrual rate of 1/60th of pensionable salary per annum, subject to the Plan earnings cap.
Robin Freestone (stepped down August 1, 2015)	Member of the Money Purchase 2003 section of the Pearson Group Pension Plan. Company contributions are 16% of pensionable salary per annum, restricted to the plan earnings cap. Until April 2006, the company also contributed to a Funded Unapproved Retirement Benefits Scheme (FURBS) on his behalf. Since April 2006, he has received a taxable and non-pensionable cash supplement in replacement of the FURBS.

Annual incentives

The purpose of annual incentives is to motivate the achievement of annual strategic goals and personal objectives, provide a focus on key financial metrics, and reward individual contribution to the success of the company.

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

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

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

The committee also reserves the right as a form of malus to adjust payments before they are made if special circumstances exist that warrant this, such as financial misstatement, individual misconduct or reputational damage to the company. The committee also reserves, in the same special circumstances, a right to reclaim or claw back payments or awards that have already been made.

Annual incentives will not exceed 200% of base salary.

For the chief executive, the individual maximum opportunity that will apply for 2016 is 180% of base salary (which is the same as applied for 2015).

For other executive directors and other members of the Pearson Executive, individual incentive opportunities take into account their membership of that committee and the relative contribution of their businesses or roles to the company s overall goals. The individual maximum opportunity that will apply for 2016 varies by individual but will be no more than 170% of base salary.

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

Table of Contents

The committee has the discretion to select the performance measures, targets and relative weightings from year to year to ensure continuing alignment with strategy and to ensure targets are sufficiently stretching. The committee establishes a threshold below which no pay-out is achieved and a maximum at or above which the annual incentive pays out in full.

For 2015, the funding of annual incentives was related to the performance against targets for Pearson s adjusted earnings per share, sales, and operating cash flow.

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

Long-term incentives

The purpose of long-term incentives is to help to recruit, reward and retain, drive long-term earnings, share price growth and value creation, align the interests of executives and shareholders, encourage long-term shareholding and commitment to the company, and link management s long-term reward and wealth to corporate performance in a flexible way.

Awards of restricted shares are made on an annual basis.

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

For performance-related awards for members of the Pearson Executive, performance will continue to be tested over 3 years and 75% of the vested shares will continue to be released at that point. Starting with awards made in 2014, there is a mandatory restriction on participants ability to dispose of the 75% of the vested shares (other than to meet personal tax liabilities) for a further 2 years. Furthermore, participants rights to the release of the 25% of the vested shares are subject to continued employment over the same period.

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

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

The long-term incentive plan also provides for the grant of stock options. Whilst it is not the committee s intention to grant stock options in 2016 or the foreseeable future, the committee believes that it should retain the flexibility of granting stock options in addition to, or instead of, restricted stock awards in the right circumstances. Any decision by the committee to grant stock options in the future would take account of best practice prevailing at the time. The committee would consult with shareholders before granting stock options to executive directors.

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

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

Table of Contents

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

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

We set the level of individual awards by taking into account:

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

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

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

Awards are normally subject to the achievement of targets for growth in earnings per share, return on invested capital and relative total shareholder return.

All employees (including executive directors) are also eligible to participate in savings-related share acquisition programs in the UK, US and rest of world, which are not subject to any performance conditions.

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.

Shareholding policy

Executive directors are expected to build up a substantial shareholding in the company in line with the policy of encouraging widespread employee ownership. Shares that count towards these guidelines include any shares held unencumbered by the executive, their spouse and/or dependent children plus any shares vested but held pending release under a restricted share plan. In 2014, the target holding was increased to 300% of salary for the chief executive and 200% of salary for the other executive directors. Mandatory guidelines were also extended to other members of the Pearson Executive at 100% of salary. Details of individual directors shareholding are set out at the end of this section.

Service agreements

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

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

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

58

Table of Contents

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

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

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

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

awards that are subject to performance conditions will stay in force as if the participant had not ceased employment and shall vest on the original vesting date

awards that are not subject to a performance condition will be released on cessation of employment

the number of shares that are released shall be prorated for the period of the participant s service in the restricted period (although the committee may in its absolute discretion waive or vary the prorating)

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

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

Executive directors non-executive directorships

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

Where executive directors served as non-executive directors elsewhere, they either waived or did not receive fees.

Chairman s and non-executive directors remuneration

The committee s policy is that the chairman s pay should be set at a level that is competitive with those of chairmen in similar positions in comparable companies. He is not entitled to any annual or long-term incentive, retirement or other employee benefits.

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

59

Table of Contents

The chairman s and non-executive directors fees were last reviewed in 2014 and increased with effect from May 1, 2014 with a commitment to review again in 2017. Fees for the non-executive directors were last increased with effect from May 1, 2014.

The structure of non-executive directors fees is as follows:

	With effect from May 1, 2014
Non-executive director	£ 70,000
Chairmanship of audit committee	£ 27,500
Chairmanship of remuneration committee	£ 22,000
Chairmanship of reputation and responsibility committee	£ 10,000
Membership of audit committee	£ 15,000
Membership of remuneration committee	£ 10,000
Membership of reputation and responsibility committee	£ 5,000
Senior independent director	£ 22,000

Notes:

(1) The fee paid to the chairman remains unchanged at £500,000.
(2) A minimum of 25% of the basic fee is paid in Pearson shares that the non-executive directors have committed to retain for the period of their directorships.
(3) Non-executive directors serve Pearson under letters of appointment and do not have service contracts. There is no entitlement to compensation on the termination of their directorships.

Remuneration of senior management

The remuneration received by executive directors in respect of the financial year ending December 31, 2015 was as follows:

	Base Salary/ Fees £000	Allowances & Benefits(1) £000	Annual Incentives £000	Long-term Incentives £000	Retirement Benefits £000	Total £000
Chairman						
Glen Moreno	500					500
Executive directors						
John Fallon	776	62	0	54	371	1,263
Coram Williams	258	0	0	0	18	276
Robin Freestone (stepped down August 1, 2015)	417	13	0	41	126	597
Senior management as a group	**1,951**	**75**	**0**	**95**	**515**	**2,636**

Notes:

(1) Benefits include company car, car allowance, private use of a driver, healthcare, additional life cover and long-term disability insurance.
(2) Figures for Coram Williams and Robin Freestone relate to full period of employment in 2015; for Coram commencing 1 July 2015, and for Robin ending 30 September 2015. Note that Coram became an executive director and Robin stepped down as an executive director on 1 August 2015.
(3) Glen Moreno stepped down on 31 December 2015.

60

Table of Contents

Share options for senior management

This table sets forth for each director the number of share options held as of December 31, 2015 as well as the exercise price, rounded to the nearest whole pence/cent, and the range of expiration dates of these options.

Director	Number of Options	Exercise Price	Earliest Exercise Date	Expiry Date
John Fallon	1,109	811.2p	08/01/17	02/01/18
Robin Freestone	1,109	811.2p	08/01/17	02/01/18

Notes:

(1) The share option awards made in 2010 to John Fallon in respect of 1,930 shares and 2012 to Robin Freestone in respect of 990 shares vested and became exercisable in the year and were exercised on 3 August 2015.
(2) No variations to the terms and conditions of share options were made during the year.
(3) The acquisition of shares under the worldwide save for shares plan is not subject to a performance condition.
(4) All share options that become exercisable during the year are included in the single figure of total remuneration for that year. The value included in the single figure of total remuneration is the number of options multiplied by the difference between the discounted option price and the market value on the earliest exercise date. Share options that became exercisable in the 2015 are included in the single figure of total remuneration for 2015 based on the share price on 1 August 2015 of 1,203p.
(5) The market price on December 31, 2015 was 736.0p per share and the range during the year was 695.0p to 1,508.0p.

Share ownership of senior management

The table overleaf shows the number of ordinary shares and conditional shares held by directors and their connected persons as at December 31, 2015.

Ordinary shares include both ordinary shares listed on the London Stock Exchange and American Depositary Receipts (ADRs) listed on the New York Stock Exchange. The figures include both shares and ADRs acquired by individuals investing part of their own after-tax annual bonus in Pearson shares under the annual bonus share matching plan.

Conditional shares means shares which have vested but remain held subject to continuing employment for a pre-defined holding period.

61

Table of Contents

Additional information with respect to share options held by, and bonus awards for, these persons is set out above in Remuneration of Senior Management and Share Options of Senior Management . The total number of ordinary shares held by senior management as of December 31, 2015 was 503,066.

As at 31 December 2015	Ordinary shares(1)	Conditional Shares
Glen Moreno	210,000	
Sidney Taurel		
John Fallon	293,056	
Coram Williams	10	
Tim Score	849	
Elizabeth Corley	1,267	
Vivienne Cox	2,938	
Josh Lewis	7,740	
Linda Lorimer	2,675	
Lincoln Wallen		
Harish Manwani	2,571	

Notes:

(1) Ordinary shares include both ordinary shares listed on the London Stock Exchange and American Depositary Receipts (ADRs) listed on the New York Stock Exchange. The figures include both shares and ADRs acquired by individuals investing part of their own after-tax annual bonus in Pearson shares under the annual bonus share matching plan.
(2) The register of directors interests (which is open to inspection during normal office hours) contains full details of directors shareholdings and options to subscribe for shares. The market price on December 31, 2015 was 736.0p per share and the range during the year was 695.0p to 1,508.0p.
(3) Ordinary shares do not include any shares vested but held pending release under a restricted share plan.
(4) On 29 February 2016, Coram Williams purchased 5,000 shares and on 2 March 2016, Sidney Taurel purchased 50,000 shares.
(5) Sidney Taurel and Lincoln Wallen were appointed as directors on 1 January 2016. Glen Moreno left Pearson on 31 December 2015.

The total remuneration of the executive committee is set out in the table below:

All figures in £ millions	2015
Short-term employee benefits	**7**
Retirement benefits	**1**
Share-based payment costs	**1**
Total	**9**

Employee share ownership plans

In 1998, we introduced a worldwide save for shares plan. Under this plan, our employees around the world have the option to 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 commencement of the employee s participation in the plan.

In 2014, shareholders approved the renewal and extension of the life of the UK plan by a further ten years, until 2024 and the renewal of the directors authority to continue to operate equivalent arrangements for non-UK employees. As part of this renewal, the savings limit for the UK HMRC-approved part of the plan (which forms the basis of the plan in the rest of the world outside the US) was increased from £250 to £500 per month.

In the United States, this plan operates as a stock purchase plan under Section 423 of the US Internal Revenue Code of 1986. This plan was introduced in 2000 following Pearson s listing on the New York Stock

62

Table of Contents

Exchange. Under it, participants save a portion of their monthly salary over six month periods, at the end of which they have the option to purchase ADRs with their accumulated funds at a purchase price equal to 85% of the lower of the market price prevailing at the beginning or end of the period. The maximum employee contribution under the plan is $1,000 per month.

Board practices

Our board currently comprises the chairman, two executive directors and seven non-executive directors. Our articles of association provide that at every annual general meeting, one-third of the board of directors, or the number nearest to one-third, shall retire from office. The directors to retire each year are the directors who have been longest in office since their last election or appointment. A retiring director is eligible for re-election. If at any annual general meeting, the place of a retiring director is not filled, the retiring director, if willing, is deemed to have been re-elected, unless at or prior to such meeting it is expressly resolved not to fill the vacated office, or unless a resolution for the re-election of that director has been put to the meeting and lost. Our articles of association also provide that every director be subject to re-appointment by shareholders at the next annual general meeting following their appointment.

However in accordance with the UK Corporate Governance Code, the board has resolved that all directors should offer themselves for re-election on an annual basis at the company s annual general meeting. Accordingly, all of the directors will offer themselves for re-election, (or re-appointment in the case of directors who were appointed since the last meeting), at the forthcoming annual general meeting on April 29, 2016.

Pearson is listed on the New York Stock Exchange (NYSE). As a listed non-US issuer, we are required to comply with some of the NYSE s corporate governance rules, and otherwise must disclose on our website any significant ways in which our corporate governance practices differ from those followed by US companies under the NYSE listing standards. At this time, the Company believes that it is in compliance in all material respects with all the NYSE rules except that the Nomination Committee is not composed entirely of independent directors, and that it is the full board, not the Nomination Committee, that develops and recommends corporate governance principles.

The board of directors has established the following formal committees, all of which report to the board. Each committee has its own written terms of reference setting out its authority and duties. These can be found on our website (www.pearson.com/ governance).

Audit committee

This committee provides the board with a vehicle to appraise our financial management and reporting and to assess the integrity of our accounting procedures and financial controls. Tim Score chairs this committee and its other members are Vivienne Cox and Linda Lorimer. Lincoln Wallen will join the committee on March 1, 2016. Tim Score is also the designated audit committee financial expert within the meaning of the applicable rules and regulations of the US Securities and Exchange Commission. Our internal and external auditors have direct access to the committee to raise any matter of concern and to report the results of work directed by the committee.

Remuneration committee

This committee meets regularly to decide the remuneration and benefits of the executive directors and the executive committee. The committee also recommends the chairman s remuneration to the board of directors for its decision and reviews management development and succession plans. Elizabeth Corley chairs this committee and its other members are Vivienne Cox, Josh Lewis, Tim Score and Sidney Taurel.

Nomination committee

This committee meets from time to time as necessary to consider the appointment of new directors. The committee is chaired by Sidney Taurel and comprises all of the non-executive directors.

Table of Contents

Reputation and responsibility committee

This committee meets regularly to oversee Pearson s strategy and plans to build and protect its corporate reputation. It provides advice and guidance to management on these plans. Vivienne Cox chairs this committee and its other members are Josh Lewis, Linda Lorimer and Harish Manwani.

Employees

The average number of persons employed by us in continuing operations during each of the three fiscal years ended 2015 were as follows:

37,265 in fiscal 2015,

38,654 in fiscal 2014, and

39,886 in fiscal 2013.

We, through our subsidiaries, have entered into collective bargaining agreements with employees in various locations. Our management has no reason to believe that we would not be able to renegotiate any such agreements on satisfactory terms. We encourage employees to contribute actively to the business in the context of their particular job roles and believe that the relations with our employees are generally good.

The table set forth below shows for 2015, 2014 and 2013 the average number of persons employed in each of our segments.

Average number employed	2015	2014	2013
North America	19,951	20,927	21,856
Core	5,936	6,139	7,075
Growth	11,114	11,406	10,768
Other	264	182	187
Continuing operations	**37,265**	**38,654**	**39,886**

The average number employed in discontinued operations was 2,282 in 2015, 2,295 in 2014, and 5,821 in 2013.

ITEM 7. ***MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS***

As at February 29, 2016, the company had been notified under the Financial Conduct Authority s Disclosure and Transparency Rules of the following significant voting rights in its shares:

Name of shareholder	Number of ordinary shares held	% of outstanding ordinary shares represented by number of shares held
Schroders plc	42,151,560	5.13%
BlackRock, Inc.	42,201,515	5.14%

The shareholders listed above have no special voting rights.

On February 29, 2016, record holders with registered addresses in the United States held 36,106,012 ADRs, which represented 4.4% of our outstanding ordinary shares. Some of these ADRs are held by nominees and so these numbers may not accurately represent the number of beneficial owners in the United States.

Loans and equity advanced to joint ventures and associates during the year and as at December 31, 2015 are shown in note 12 in Item 18. Financial Statements. Dividends receivable from joint ventures and associates are set out in note 12 in Item 18. Financial Statements . There were no other related party transactions in 2015.

Table of Contents

ITEM 8. ***FINANCIAL INFORMATION***

The financial statements filed as part of this Annual Report are included on pages F-1 through F-71 hereof.

Other than those events described in note 37 in Item 18. Financial Statements of this Form 20-F and seasonal fluctuations in borrowings, there has been no significant change to our financial condition or results of operations since December 31, 2015. Our borrowings fluctuate by season due to the effect of the school year on the working capital requirements of the educational book business. Assuming no acquisitions or disposals, our maximum level of net debt normally occurs in July, and our minimum level of net debt normally occurs in December.

Our policy with respect to dividend distributions is described in response to Item 3. Key Information above.

See Item 4. Information on the Company Legal Proceedings for information with respect to legal proceedings to which we may be subject from time to time.

ITEM 9. ***THE OFFER AND LISTING***

The principal trading market for our ordinary shares is the London Stock Exchange. Our ordinary shares also trade in the United States in the form of ADSs evidenced by ADRs under a sponsored ADR facility with The Bank of New York Mellon, as depositary. We established this facility in March 1995 and most recently amended it in August 2014 in connection with our New York Stock Exchange listing. Each ADS represents one ordinary share.

The ADSs trade on the New York Stock Exchange under the symbol PSO .

Table of Contents

The following table sets forth the highest and lowest middle market quotations, which represent the average of closing bid and asked prices, for the ordinary shares, as derived from the Daily Official List of the London Stock Exchange and the average daily trading volume on the London Stock Exchange:

on an annual basis for our five most recent fiscal years,

on a quarterly basis for our most recent quarter and two most recent fiscal years, and

on a monthly basis for the six most recent months.

Reference period	Ordinary shares High	Low	Average daily trading volume
	(In pence)		(Ordinary shares)
Five most recent fiscal years			
2015	1508	695	2,928,500
2014	1341	998	2,499,900
2013	1365	1119	2,065,900
2012	1294	1111	2,174,000
2011	1222	983	2,012,900
Most recent quarter and two most recent fiscal years			
2015 Fourth quarter	1224	695	3,376,500
Third quarter	1275	1074	2,849,300
Second quarter	1471	1205	2,673,500
First quarter	1508	1140	2,802,000
2014 Fourth quarter	1241	1113	2,255,400
Third quarter	1240	1087	2,242,500
Second quarter	1175	1008	2,424,400
First quarter	1341	998	3,086,800
Most recent six months			
February 2016	859	719.5	3,337,500
January 2016	789	657.5	4,341,200
December 2015	823.5	695	2,764,700
November 2015	867.5	765	3,714,000
October 2015	1224	861.5	3,638,200
September 2015	1161	1082	2,225,900

ITEM 10. ***ADDITIONAL INFORMATION***

Articles of association

We summarize below the material provisions of our articles of association, as amended, which have been filed as an exhibit to our annual report on Form 20-F for the year ended December 31, 2015. The summary below is qualified entirely by reference to the Articles of Association. We have multiple business objectives and purposes and are authorized to do such things as the board may consider fit to further our interests or incidental or conducive to the attainment of our objectives and purposes.

Directors powers

Our business shall be managed by the board of directors and the board may exercise all such of our powers as are not required by law or by the Articles of Association or by any directions given by the Company by special resolution, to be exercised in a general meeting.

66

Table of Contents

Interested directors

For the purposes of section 175 of the Companies Act 2006 the board may authorize any matter proposed to it which would, if not so authorized, involve a breach of duty by a Director under that section, including, without limitation, any matter which relates to a situation in which a Director has, or can have, an interest which conflicts, or possibly may conflict, with the interests of the Company. Any such authorization will be effective only if:

(a) any requirement as to quorum at the meeting at which the matter is considered is met without counting the Director in question or any other interested Director; and

(b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.

The board may (whether at the time of the giving of the authorization or subsequently) make any such authorization subject to any limits or conditions it expressly imposes but such authorization is otherwise given to the fullest extent permitted. The board may vary or terminate any such authorization at any time.

Provided that he has disclosed to the board the nature and extent of his interest, a Director notwithstanding his office:

(a) may be a party to, or otherwise interested in, any transaction or arrangement with the Company or in which the Company is otherwise (directly or indirectly) interested;

(b) may act by himself or his firm in a professional capacity for the Company (otherwise than as auditor) and he or his firm shall be entitled to remuneration for professional services as if he were not a Director;

(c) may be a director or other officer of, or employed by, or a party to a transaction or arrangement with, or otherwise interested in, any body corporate in which the Company is otherwise (directly or indirectly) interested.

A Director shall not, by reason of his office, be accountable to the Company for any remuneration or other benefit which he derives from any office or employment or from any transaction or arrangement or from any interest in any body corporate:

(a) the acceptance, entry into or existence of which has been approved by the board (subject, in any such case, to any limits or conditions to which such approval was subject); or

(b) which he is permitted to hold or enter into by virtue of paragraph (a), (b) or (c) above;

nor shall the receipt of any such remuneration or other benefit constitute a breach of his duty under section 176 of the Act.

A Director shall be under no duty to the Company with respect to any information which he obtains or has obtained otherwise than as a Director of the Company and in respect of which he owes a duty of confidentiality to another person. However, to the extent that his relationship with that other person gives rise to a conflict of interest or possible conflict of interest, which has been approved by the board: the Director shall not be in breach of the general duties he owes to the Company by virtue of sections 171 to 177 of the Act because he fails:

(a) to disclose any such information to the board or to any Director or other officer or employee of the Company; and/or

(b) to use or apply any such information in performing his duties as a Director of the Company.

67

Table of Contents

Where the existence of a Director s relationship with another person has been approved by the board and his relationship with that person gives rise to a conflict of interest or possible conflict of interest, the Director shall not be in breach of the general duties he owes to the Company by virtue of sections 171 to 177 of the Act because he:

(a) absents himself from meetings of the board at which any matter relating to the conflict of interest or possible conflict of interest will or may be discussed or from the discussion of any such matter at a meeting or otherwise; and/or

(b) makes arrangements not to receive documents and information relating to any matter which gives rise to the conflict of interest or possible conflict of interest sent or supplied by the Company and/or for such documents and information to be received and read by a professional adviser, for so long as he reasonably believes such conflict of interest or possible conflict of interest subsists.

Except as stated below, a Director shall not vote in respect of any contract or arrangement or any other proposal whatsoever in which he has an interest which is, to his knowledge, a material interest, otherwise than by virtue of his interests in shares or debentures or other securities of or otherwise in or through the Company. A Director shall not be counted in the quorum at a meeting of the Board in relation to any resolution on which he is debarred from voting.

Notwithstanding the foregoing, a Director will be entitled to vote, and be counted in the quorum, on any resolution concerning any of the following matters:

the giving of any guarantee, security or indemnity in respect of money lent or obligations incurred by him or by any other person at the request of or for the benefit of the Company or any of its subsidiaries;

the giving of any guarantee, security or indemnity to a third party in respect of a debt or obligation of the Company or any of its subsidiaries for which he himself has assumed responsibility in whole or in part and whether alone or jointly with others under a guarantee or indemnity or by the giving of security;

any proposal relating to the Company or any of its subsidiary undertakings where it is offering securities in which offer a Director is or may be entitled to participate as a holder of securities or in the underwriting or sub-underwriting of which a Director is to participate;

any proposal relating to another company in which he and any persons connected with him do not to his knowledge hold an interest in shares (as that term is used in sections 820 to 825 of the Companies Act 2006) representing one per cent or more of either any class of the equity share capital, or the voting rights, in such company;

any proposal relating to an arrangement for the benefit of the employees of the Company or any of its subsidiary undertakings which does not award him any privilege or benefit not generally awarded to the employees to whom such arrangement relates; and

any proposal concerning insurance that we propose to maintain or purchase for the benefit of directors or for the benefit of persons, including Directors.

Where proposals are under consideration concerning the appointment of two or more Directors to offices or employment with us or any company in which we are interested, these proposals may be divided and considered separately and each of these directors, if not prohibited from voting under the provisions of the eighth paragraph before this one, will be entitled to vote and be counted in the quorum with respect to each resolution except that concerning his or her own appointment.

Borrowing powers

The board of Directors may exercise all powers to borrow money and to mortgage or charge our undertaking, property and uncalled capital and to issue debentures and other securities, whether outright or as

68

Table of Contents

collateral security for any of our or any third party s debts, liabilities or obligations. The board of directors must restrict the borrowings in order to secure that the aggregate amount of undischarged monies borrowed by us (and any of our subsidiaries), but excluding any intra-group debts, shall not at any time (without the previous sanction of the Company in the form of an ordinary resolution) exceed a sum equal to twice the aggregate of the adjusted capital and reserves.

Other provisions relating to directors

Under the articles of association, directors are paid out of our funds for their services as we may from time to time determine by ordinary resolution and, in the case of non-executive directors, up to an aggregate of £750,000 or such other amounts as resolved by the shareholders at a general meeting. Any Director who is not an Executive Director and who performs special services which in the opinion of the Board are outside the scope of the ordinary duties of a Director, may be paid such extra remuneration by way of additional fee, salary, commission or otherwise as the Board may determine in accordance with our remuneration policy. Under the articles of association, Directors currently are not required to hold any share qualification. However, our remuneration policy mandates a shareholding guideline for executive directors which they are expected to build towards over a specified period.

Annual general meetings

Pursuant to the Companies Act 2006, the Company must hold an annual general meeting (AGM) (within six months beginning with the day following its accounting reference date) at a place and time determined by the board. The following matters are usually considered at an annual general meeting:

- approving final dividends;
- consideration of the accounts and balance sheet;
- ordinary reports of the board of directors and auditors and any other documents required to be annexed to the balance sheet;
- as holders of ordinary shares vote for the election of one-third of the members of the board of directors at every annual general meeting, the appointment or election of directors in the place of those retiring by rotation or otherwise. Notwithstanding the provisions of the Articles, the board has resolved that all directors should offer themselves for re-election annually, in accordance with the UK Corporate Governance Code;
- appointment or reappointment of, and determination of the remuneration of, the auditors; and
- the renewal, limitation, extension, variation or grant of any authority to the board in relation to the allotment of securities.

The board may call a general meeting whenever it thinks fit. If at any time there are not within the United Kingdom sufficient directors capable of acting to form a quorum, any director or any two members may convene a general meeting in the same manner as nearly as possible as that in which meetings may be convened by the board.

No business shall be dealt with at any general meeting unless a quorum is present when the meeting proceeds to business. Three members present in person and entitled to vote shall be a quorum for all purposes. A corporation being a member shall be deemed to be personally present if represented by its duly authorized representative.

If a quorum for a meeting convened at the request of shareholders is not present within fifteen minutes of the appointed time, the meeting will be dissolved. In any other case, the general meeting will be adjourned to the same day in the next week, at the same time and place, or to a time and place that the chairman fixes. If at that rescheduled meeting a quorum is not present within fifteen minutes from the time appointed for holding the

Table of Contents

meeting, the shareholders present in person or by proxy will be a quorum. The chairman or, in his absence, the deputy chairman or any other director nominated by the board, will preside as chairman at every general meeting. If no director is present at the general meeting or no director consents to act as chairman, the shareholders present shall elect one of their number to be chairman of the meeting.

Share Certificates

Every person whose name is entered as a member in the Company s Register of Members shall be entitled to one certificate in respect of each class of shares held(the law regarding this does not apply to stock exchange nominees). Subject to the terms of issue of the shares, certificates are issued following allotment or receipt of the form of transfer bearing the appropriate stamp duty by our registrar, Equiniti, Aspect House, Spencer Road, Lancing, West Sussex, BN99 6DA, United Kingdom, telephone number +44 121-415-7062.

Share capital

Any share may be issued with such preferred, deferred or other special rights or other restrictions as may be determined by way of a shareholders vote in general meeting. Subject to the Companies Act 2006, any shares may be issued which are to be redeemed or are liable to be redeemed at the option of the Company or the shareholders.

There are no provisions in the Articles of Association which discriminate against any existing or prospective shareholder as a result of such shareholder owning a substantial number of shares.

Subject to the terms of the shares which have been issued, the directors may from time to time make calls upon the shareholders in respect of any moneys unpaid on their shares, provided that (subject to the terms of the shares so issued) no call on any share shall be payable at less than fourteen clear days from the last call. The directors may, if they see fit, receive from any shareholder willing to advance the same, all and any part of the moneys uncalled and unpaid upon any shares held by him.

Changes in capital

We may from time to time, by ordinary resolution subject to the Companies Act 2006:

- consolidate and divide all or any of our share capital into shares of a larger nominal amount than its existing shares; or
- sub-divide all of or any of our existing shares into shares of smaller nominal amounts.

We may, from time to time increase our share capital by allotting new shares in accordance with the prescribed threshold authorized by shareholders at the last annual general meeting and subject to the consents and procedures required by the Companies Act 2006, may by special resolution reduce our share capital.

Voting rights

Every holder of ordinary shares present in person at a meeting of shareholders has one vote on a vote taken by a show of hands. On a poll, every holder of ordinary shares who is present in person or by proxy has one vote for every ordinary share of which he or she is the holder. Voting at any meeting of shareholders is by a show of hands unless a poll is properly demanded before the declaration of the results of a show of hands. A poll may be demanded by:

- the chairman of the meeting;
- at least three shareholders present in person or by proxy and entitled to vote;

any shareholder or shareholders present in person or by proxy representing not less than one-tenth of the total voting rights of all shareholders having the right to vote at the meeting; or

Table of Contents

any shareholder or shareholders present in person or by proxy holding shares conferring a right to vote at the meeting being shares on which the aggregate sum paid up is equal to not less than one-tenth of the total sum paid up on all shares conferring that right.

Dividends

Holders of ordinary shares are entitled to receive dividends out of our profits that are available by law for distribution, as we may declare by ordinary resolution, subject to the terms of issue thereof. However, no dividends may be declared in excess of an amount recommended by the board of directors. The board may pay interim dividends on the shares of any class as it deems fit. We may invest or otherwise use all dividends left unclaimed for six months after having been declared for our benefit, until claimed. All dividends unclaimed for a period of twelve years after having been declared will be forfeited and revert to us.

The directors may, with the sanction of an ordinary resolution of the shareholders, offer any holders of ordinary shares the right to elect to receive ordinary shares credited as fully paid, in whole or in part, instead of cash in respect of such dividend.

The directors may deduct from any dividend payable to any shareholder all sums of money (if any) presently payable by that shareholder to us on account of calls or otherwise in relation to our shares.

Liquidation rights

In the event of our liquidation, after payment of all liabilities, our remaining assets would be used to repay the holders of ordinary shares the amount they paid for their ordinary shares. Any balance would be divided among the holders of ordinary shares in proportion to the nominal amount of the ordinary shares held by them.

Other provisions of the articles of association

Whenever our capital is divided into different classes of shares, the special rights attached to any class may, unless otherwise provided by the terms of the issue of the shares of that class, be varied or abrogated, either with the written consent of the holders of three-fourths of the issued shares of the class or with the sanction of a special resolution passed at a separate meeting of these holders. In the event that a shareholder or other person appearing to the board of directors to be interested in ordinary shares fails to comply with a notice requiring him or her to provide information with respect to their interest in voting shares pursuant to section 793 of the Companies Act 2006, we may serve that shareholder with a notice of default. After service of a default notice, that shareholder shall not be entitled to attend or vote at any general meeting or at a separate meeting of holders of a class of shares or on a poll until he or she has complied in full with our information request.

If the shares described in the default notice represent at least one-fourth of 1% in nominal value of the issued ordinary shares, then the default notice may additionally direct that in respect of those shares:

- we will not pay dividends (or issue shares in lieu of dividends); and

- we will not register transfers of shares unless the shareholder is not himself in default as regards supplying the information requested and the transfer, when presented for registration, is in such form as the board of directors may require to the effect that after due and careful inquiry, the shareholder is satisfied that no person in default is interested in any of the ordinary shares which are being transferred or the transfer is an approved transfer, as defined in our articles of association.

No provision of our articles of association expressly governs the ordinary share ownership threshold above which shareholder ownership must be disclosed. Under the Disclosure and Transparency Rules of the Financial Conduct Authority, any person who acquires, either alone or, in specified circumstances, with others an interest in our voting share capital equal to or in excess of 3% comes under an obligation to disclose prescribed

Table of Contents

particulars to us in respect of those ordinary shares. A disclosure obligation also arises where a person s notifiable interests fall below 3%, or where, at or above 3%, the percentage of our voting share capital in which a person has a notifiable interest increases or decreases by 1% or more.

Limitations affecting holders of ordinary shares or ADSs

Under English law and our memorandum and articles of association, persons who are neither UK residents nor UK nationals may freely hold, vote and transfer ordinary shares in the same manner as UK residents or nationals.

With respect to the items discussed above, applicable UK law is not materially different from applicable US law.

Material contracts

Pearson has not entered into any contracts outside the ordinary course of business during the two year period immediately preceding the date of this annual report. The Trust Deed entered into in 2014 with respect to 500.0 million aggregate principal amount of 1.875% guaranteed notes due 2021 and the Trust Deed entered into in 2015 with respect to 500.0 million aggregate principal amount of 1.375% guaranteed notes due 2025, in each case, issued by a subsidiary and guaranteed by Pearson, are filed as Exhibits 2.9 and 2.10 of this report, respectively.

Executive employment contracts

We have entered into agreements with each of our executive directors pursuant to which such executive director is employed by us. These agreements describe the duties of such executive director and the compensation to be paid by us. See Item 6. Directors, Senior Management and Employees Compensation of Senior Management .

It is the company s policy that the company may terminate the executive directors service agreements by giving no more than 12 months notice. As an alternative, the company may at its discretion pay in lieu of that notice. Payment-in-lieu of notice may be made in equal monthly installments from the date of termination to the end of any unexpired notice period. In the case of the CEO, payment-in-lieu of notice in installments may also be subject to mitigation and reduced taking into account earnings from alternative employment. For executive directors, pay in lieu of notice comprises 100% of the annual salary at the date of termination and the annual cost to the company of providing pension and all other benefits. In limited circumstances, in addition to making a full payment in lieu of notice, the company may permit an executive director to stay employed after the announcement of his or her departure for a limited period to ensure an effective hand-over and/or allow time for a successor to be appointed. The company may, depending on the circumstances of the termination, determine that it will not pay the director in lieu of notice and may instead terminate a director s contract in breach and make a damages payment, taking into account as appropriate he director s ability to mitigate his or her loss.

Exchange controls

There are no UK government laws, decrees, regulations or other legislation which restrict or which may affect the import or export of capital, including the availability of cash and cash equivalents for use by us or the remittance of dividends, interest or other payments to nonresident holders of our securities, except as otherwise described under Tax Considerations below.

Table of Contents

Tax considerations

The following is a discussion of the material US federal income tax considerations and UK tax considerations arising from the acquisition, ownership and disposition of ordinary shares and ADSs by a US holder. A US holder is:

- an individual citizen or resident of the US, or
- a corporation created or organized in or under the laws of the US or any of its political subdivisions, or
- an estate or trust the income of which is subject to US federal income taxation regardless of its source.

This discussion deals only with ordinary shares and ADSs that are held as capital assets by a US holder, and does not address tax considerations applicable to US holders that may be subject to special tax rules, such as:

- dealers or traders in securities or currencies,
- financial institutions or other US holders that treat income in respect of the ordinary shares or ADSs as financial services income,
- insurance companies,
- tax-exempt entities,
- persons acquiring shares or ADSs in connection with employment,
- US holders that hold the ordinary shares or ADSs as a part of a straddle or conversion transaction or other arrangement involving more than one position,
- US holders that own, or are deemed for US tax purposes to own, 10% or more of the total combined voting power of all classes of our voting stock,
- US holders that have a principal place of business or tax home outside the United States, or
- US holders whose functional currency is not the US dollar.

For US federal income tax purposes, holders of ADSs will be treated as the owners of the ordinary shares represented by those ADSs. In practice, HM Revenue & Customs (HMRC) will also regard holders of ADSs as the beneficial owners of the ordinary shares represented by those ADSs, although case law has cast some doubt on this. The discussion below assumes that HMRC s position is followed.

In addition, the following discussion assumes that The Bank of New York Mellon will perform its obligations as depositary in accordance with the terms of the depositary agreement and any related agreements.

Because US and UK tax consequences may differ from one holder to the next, the discussion set out below does not purport to describe all of the tax considerations that may be relevant to you and your particular situation. Accordingly, you are advised to consult your own tax advisor as to the US federal, state and local, UK and other, including foreign, tax consequences of investing in the ordinary shares or ADSs. Except where otherwise indicated, the statements of US and UK tax law set out below are based on the laws, interpretations and tax authority practice in force or applicable as of February 29, 2016, being the last practicable date before the date of this Annual Report, and are subject to any changes occurring after that date, possibly with retroactive effect.

UK income taxation of distributions

The UK does not impose dividend withholding tax on dividends paid by the Company.

A US holder that is not resident in the UK for UK tax purposes and does not carry on a trade, profession or vocation in the UK through a branch or agency (or in the case of a company a permanent establishment) to which the ordinary shares or ADSs are attributable will not generally be liable to pay UK tax on dividends paid by the Company.

Table of Contents

US income taxation of distributions

Distributions that we make with respect to the ordinary shares or ADSs, other than distributions in liquidation and distributions in redemption of stock that are treated as exchanges, will be taxed to US holders as ordinary dividend income to the extent that the distributions do not exceed our current and accumulated earnings and profits. The amount of any distribution will equal the amount of the cash distribution. Distributions, if any, in excess of our current and accumulated earnings and profits will constitute a non-taxable return of capital to a US holder and will be applied against and reduce the US holder s tax basis in its ordinary shares or ADSs. To the extent that these distributions exceed the tax basis of the US holder in its ordinary shares or ADSs, the excess generally will be treated as capital gain.

Dividends that we pay will not be eligible for the dividends received deduction generally allowed to US corporations under Section 243 of the Code.

In the case of distributions in pounds, the amount of the distributions generally will equal the US dollar value of the pounds distributed, determined by reference to the spot currency exchange rate on the date of receipt of the distribution by the US holder in the case of shares or by The Bank of New York Mellon in the case of ADSs, regardless of whether the US holder reports income on a cash basis or an accrual basis. The US holder will realize separate foreign currency gain or loss only to the extent that this gain or loss arises on the actual disposition of pounds received. For US holders claiming tax credits on a cash basis, taxes withheld from the distribution are translated into US dollars at the spot rate on the date of the distribution; for US holders claiming tax credits on an accrual basis, taxes withheld from the distribution are translated into US dollars at the average rate for the taxable year.

A distribution by the Company to noncorporate shareholders will be taxed as net capital gain at a maximum rate of 20%, provided certain holding periods are met, to the extent such distribution is treated as a dividend under US federal income tax principles. In addition, a 3.8% Medicare tax will generally be imposed on the net investment income, which generally would include distributions treated as dividends under US federal income tax principles, of noncorporate taxpayers whose adjusted gross income exceeds a threshold amount.

UK taxation of capital gains

A US holder that is not resident in the UK for UK tax purposes and who does not carry on a trade, profession or vocation in the UK through a branch or agency (or in the case of a company a permanent establishment) to which the ordinary shares or ADSs are attributable will not generally be liable for UK taxation on capital gains or eligible for relief for allowable losses, realized on the sale or other disposal of the ordinary shares or ADSs.

A US holder who is an individual who has been resident for tax purposes in the UK but who ceases to be so resident or becomes regarded as resident outside the UK for the purposes of any double tax treaty (Treaty Non-resident) and continues to not be resident in the UK, or continues to be Treaty Non-resident, for a period of five years or less (or, for departures before 6 April 2013, ceases to be resident or ordinarily resident or becomes Treaty Non-resident for a period of less than five tax years) and who disposes of his ordinary shares or ADSs during that period may also be liable on his return to the UK to UK tax on capital gains, subject to any available exemption or relief, even though he is not resident in the UK, or is Treaty Non-resident, at the time of the disposal.

US income taxation of capital gains

Upon a sale or exchange of ordinary shares or ADSs to a person other than Pearson, a US holder will recognize gain or loss in an amount equal to the difference between the amount realized on the sale or exchange and the US holder s adjusted tax basis in the ordinary shares or ADSs. Any gain or loss recognized will be capital gain or loss and will be long-term capital gain or loss if the US holder has held the ordinary shares or ADSs for

more than one year. Long-term capital gain of a noncorporate US holder is generally taxed at a maximum rate of 20%. In addition, a 3.8% Medicare tax will generally be imposed on the net investment income, which generally would include capital gains, of noncorporate taxpayers whose adjusted gross income exceeds a threshold amount.

Gain or loss realized by a US holder on the sale or exchange of ordinary shares or ADSs generally will be treated as US-source gain or loss for US foreign tax credit purposes.

Estate and gift tax

The current Estate and Gift Tax Convention, or the Convention, between the US and the UK generally relieves from UK Inheritance Tax (the equivalent of US Estate and Gift Tax) the transfer of ordinary shares or of ADSs where the transferor is domiciled in the US for the purposes of the Convention. This relief will not apply if the ordinary shares or ADSs are part of the business property of an individual s permanent establishment in the UK or pertain to the fixed base in the UK of a person providing independent personal services. If no relief is given under the Convention, inheritance tax may be charged on death and also on the amount by which the value of an individual s estate is reduced as a result of any transfer made by way of gift or other gratuitous or undervalue transfer, in general within seven years of death, and in certain other circumstances. In the unusual case where ordinary shares or ADSs are subject to both UK Inheritance Tax and US Estate or Gift Tax, the Convention generally provides for tax paid in the UK to be credited against tax payable in the US or for tax paid in the US to be credited against tax payable in the UK based on priority rules set forth in the Convention.

Stamp duty

No stamp duty or stamp duty reserve tax (SDRT) will generally be payable in the UK on the purchase or transfer of an ADS, provided that the ADS, and any separate instrument or written agreement of transfer, remain at all times outside the UK and that the instrument or written agreement of transfer is not executed in the UK. Subject to the following paragraph, UK legislation does however provide for SDRT or (in the case of transfers) stamp duty to be chargeable at the rate of 1.5% of the amount or value of the consideration or, in some circumstances, the value of the ordinary shares (rounded up to the next multiple of £5 in the case of stamp duty), where ordinary shares are issued or transferred to a person whose business is or includes issuing depositary receipts, or to a nominee or agent for such a person, or issued or transferred to a person whose business is or includes the provision of clearance services or to a nominee or agent for such a person. Following litigation, HM Revenue & Customs (HMRC) has accepted that it will no longer seek to apply the 1.5% SDRT charge when new shares are issued to a clearance service or depositary receipt system on the basis that the charge is not compatible with EU law. HMRC s view is that the 1.5% SDRT or stamp duty charge will continue to apply to transfers of shares into a clearance service or depositary receipt system, unless they are an integral part of an issue of share capital. This view is currently being challenged in further litigation. **Accordingly, specific professional advice should be sought before paying the 1.5% SDRT or stamp duty charge in any circumstances.**

A transfer for value of the underlying ordinary shares will generally be subject to either stamp duty or SDRT, normally at the rate of 0.5% of the amount or value of the consideration (rounded up to the next multiple of £5 in the case of stamp duty). A transfer of ordinary shares from a nominee to its beneficial owner, including the transfer of underlying ordinary shares from the Depositary to an ADS holder, under which no beneficial interest passes will not be subject to stamp duty or SDRT.

Close company status

We believe that the close company provisions of the UK Corporation Tax Act 2010 do not apply to us.

Documents on display

Copies of our Memorandum and Articles of Association and filed as exhibits to this Annual Report and certain other documents referred to in this Annual Report are available for inspection at our registered office at 80 Strand, London WC2R 0RL (c/o the Company Secretary), or, in the US, at the registered office of Pearson Inc. at 330 Hudson Street, New York, New York, during usual business hours upon reasonable prior request.

Table of Contents

ITEM 11. ***QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***
Introduction

Our principal market risks are changes in interest rates and currency exchange rates. Following an evaluation of these positions, we selectively enter into derivative financial instruments to manage our risk exposure. For this purpose, we primarily use interest rate swaps, interest rate caps and collars, forward rate agreements, currency swaps and forward foreign exchange contracts. Managing market risks is the responsibility of the chief financial officer, who acts pursuant to policies approved by the board of directors. The Audit Committee receives regular reports on our treasury activities.

We have a policy of not undertaking any speculative transactions, and we do not hold our derivative and other financial instruments for trading purposes.

We have formulated policies for hedging exposures to interest rate and foreign exchange risk, and have used derivatives to ensure compliance with these policies. Although a proportion of our derivative contracts were transacted without regard to existing IFRS requirements on hedge accounting, during 2015 and 2014 we qualified for hedge accounting under IFRS on a number of our key derivative contracts.

The following discussion addresses market risk only and does not present other risks that we face in the normal course of business, including country risk, credit risk and legal risk.

Interest rates

The Group s financial exposure to interest rates arises primarily from its borrowings. The Group manages its exposure by borrowing at fixed and variable rates of interest, and by entering into derivative transactions. Objectives approved by the board concerning the proportion of debt outstanding at fixed rates govern the use of these financial instruments.

The Group s objectives are applied to core net debt, which is measured at the year-end and comprises borrowings net of cash and other liquid funds. Our objective is to maintain a proportion of forecast core net debt in fixed or capped form for the next four years, subject to a maximum of 65% and a minimum that starts at 40% and falls by 10% each year.

The principal method of hedging interest rate risk is to enter into an agreement with a bank counterparty to pay a fixed rate and receive a variable rate, known as a swap. Under interest rate swaps, the Group agrees with other parties to exchange, at specified intervals, the difference between fixed-rate and variable-rate amounts calculated by reference to an agreed notional principal amount. The majority of the Group s swap contracts are US dollar denominated, and some of them have deferred start dates, in order to maintain the desired risk profile as other contracts mature. The variable rates received are normally based on three-month or six-month LIBOR, and the dates on which these rates are set do not necessarily exactly match those of the hedged borrowings. Management believes that our portfolio of these types of swaps is an efficient hedge of our portfolio of variable rate borrowings.

In addition, from time to time, the Group issues bonds or other capital market instruments to refinance existing debt. To avoid the fixed rate on a single transaction unduly influencing our overall net interest expense, our typical practice has been to enter into a related derivative contract effectively converting the interest rate profile of the bond transaction to a variable interest rate. In some cases, the bond issue is denominated in a different currency to the Group s desired borrowing risk profile and the Group enters into a related cross currency interest rate swap in order to maintain this risk profile, which is predominantly borrowings denominated in US dollars.

The Group s accounting objective in its use of interest rate derivatives is to minimize the impact on the income statement of changes in the mark-to-market value of its derivative portfolio as a whole. It uses duration

calculations to estimate the sensitivity of the derivatives to movements in market rates. The Group also identifies which derivatives are eligible for fair value hedge accounting (which reduces significantly the income statement impact of changes in the market value of a derivative). The Group then divides the total portfolio between hedge-accounted and pooled segments, so that the expected movement on the pooled segment is minimized.

Currency exchange rates

Although the Group is based in the UK, it has significant investments in overseas operations. The most significant currency in which the Group trades is the US dollar.

The Group s policy is to align approximately the currency composition of its core net borrowings with its forecast operating profit before depreciation and amortization. This policy aims to soften the impact of changes in foreign exchange rates on consolidated interest cover and earnings. This policy applies only to currencies that account for more than 15% of group operating profit, which currently only includes the US dollar. However, the Group still borrows small amounts in other currencies, typically for seasonal working capital needs. In addition, the Group s policy does not require existing currency debt to be terminated to match declines in that currency s share of Group operating profit. Also, the chief financial officer may request the inclusion of currencies that account for less than 15% of Group operating profit before depreciation and amortization in the above hedging process. Only one hedging transaction, denominated in South African rand, has been undertaken under that authority. The South African rand transaction matured in 2014.

At December 31, 2015 the Group s net borrowings/(cash) in our main currencies (taking into account the effect of cross currency rate swaps) were: US dollar £1,345m and sterling £(385)m.

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

Investments in overseas operations are consolidated for accounting purposes by translating values in one currency to another currency, in particular from US dollars to sterling. Fluctuations in currency exchange rates affect the currency values recorded in our accounts, although they do not give rise to any realized gain or loss, nor to any currency cash flows.

The Group is also exposed to currency exchange rates in its cash transactions and its investments in overseas operations. Cash transactions typically for purchases, sales, interest or dividends require cash conversions between currencies. Fluctuations in currency exchange rates affect the cash amounts that the Group pays or receives.

Forward foreign exchange contracts

The Group sometimes uses forward foreign exchange contracts where a specific major project or forecasted cash flow, including acquisitions and disposals, arises from a business decision that has used a specific foreign exchange rate. The Group s policy is to effect routine transactional conversions between currencies, for example to collect receivables or settle payables, at the relevant spot exchange rate.

The Group seeks to offset purchases and sales in the same currency, even if they do not occur simultaneously. In addition, its debt and cash portfolios management gives rise to temporary currency shortfalls and surpluses. Both of these activities require using short-dated foreign exchange swaps between currencies.

Table of Contents

Although the Group prepares its consolidated financial statements in sterling, significant sums have been invested in overseas assets, particularly in the US. Therefore, fluctuations in currency exchange rates, particularly between the US dollar and sterling, and to a lesser extent between the euro and sterling, are likely to affect shareholders funds and other accounting values.

Derivatives

Under IFRS, the Group is required to record all derivative instruments on the balance sheet at fair value. Derivatives not classified as hedges are adjusted to fair value through earnings. Changes in the fair value of derivatives that the Group has designated and that qualify as effective hedges are either recorded in reserves or are offset in earnings by the corresponding movement in the fair value of the underlying hedged item. Any ineffective portion of derivatives that are classified as hedges is immediately recognized in earnings.

In 2015 and 2014 the Group met the prescribed designation requirements and hedge effectiveness tests under IFRS for some of its derivative contracts. As a result, the movements in the fair value of the effective portion of fair value hedges and net investment hedges have been offset in earnings and reserves respectively by the corresponding movement in the fair value of the underlying hedged item.

In line with the Group s treasury policy, none of these instruments were considered trading instruments and each instrument was transacted solely to match an underlying financial exposure.

Quantitative information about market risk

The sensitivity of the Group s derivative portfolio to changes in interest rates is found in note 19 of Item 18. Financial Statements .

ITEM 12. ***DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES***
AMERICAN DEPOSITARY SHARES

Fees paid by ADR holders

Our ordinary shares trade in the United States under a sponsored ADR facility with The Bank of New York Mellon as depositary.

The depositary collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal, or from intermediaries acting for them. The depositary collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depositary may collect its annual fee for depositary services by deductions from cash distributions or by directly billing investors or by charging the book-entry system accounts of participants acting for them. The depositary may generally refuse to provide fee-attracting services until its fees for those services are paid.

Table of Contents

The following table summarizes various fees currently charged by The Bank of New York Mellon:

Person depositing or withdrawing shares must pay to the depositary:	**For:**
$5.00 (or less) per 100 ADSs (or portion of 100 ADSs)	Issuance of ADSs, including issuances resulting from a distribution of shares or rights or other property
	Cancellation of ADSs for the purpose of withdrawal, including if the deposit agreement terminates
$.05 (or less) per ADS	Any cash distribution to ADS registered holders
A fee equivalent to the fee that would be payable if securities distributed had been shares and the shares had been deposited for issuance of ADSs	Distribution of securities by the depositary to ADS registered holders of deposited securities
$.05 (or less) per ADS per calendar year	Depositary services
Registration of transfer fees	Transfer and registration of shares on the share register to or from the name of the depositary or its agent when shares are deposited or withdrawn
Expenses of the depositary	Cable, telex and facsimile transmissions (when expressly provided in the deposit agreement)
	Converting foreign currency to US dollars
Taxes and other governmental charges the depositary or the custodian have to pay on any ADS or share underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes	As necessary
Any charges incurred by the depositary or its agents for servicing the deposited securities	As necessary

Fees incurred in past annual period and fees to be paid in the future

The Company received payments from the depositary with respect to 2015 of $350,000 for standard out-of-pocket maintenance costs for the ADRs (consisting of the expenses of postage and envelopes for mailing the annual and interim financial of reports, printing and distributing dividend cheques, electronic filing of US Federal tax information, mailing required the forms, stationery, postage, facsimile and telephone calls), any applicable performance indicators relating to the ADR facility, underwriting fees and legal fees.

The depositary has agreed to reimburse the Company for expenses they incur that are related to establishment and maintenance expenses of the ADS program. The depositary has agreed to reimburse the Company for its continuing annual stock exchange listing fees. The depositary has also agreed to pay the standard out-of-pocket maintenance costs for the ADRs, which consists of the expenses of postage and envelopes for mailing annual and interim financial reports, printing and distributing dividend cheques, electronic filing of US Federal tax information, mailing required tax forms, stationery, postage, facsimile and telephone calls. It has also agreed to reimburse the Company annually for certain investor relationship programs or special investor relations promotional activities. In certain instances, the depositary has agreed to provide additional payments to the Company based on any applicable performance indicators relating to the ADR facility. There are limits on the amount of expenses for which the depositary will reimburse the Company, but the amount of reimbursement available to the Company is not necessarily tied to the amount of fees the depositary collects from investors.

Table of Contents

The depositary collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal, or from intermediaries acting for them. The depositary collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depositary may collect its annual fee for depositary services by deduction from cash distributions or by directly billing investors or by charging the book-entry system accounts of participants acting for them. The depositary may generally refuse to provide fee-attracting services until its fees for those services are paid.

Table of Contents

PART II

ITEM 13. ***DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES***
None.

ITEM 14. ***MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS***
None.

ITEM 15. ***CONTROLS AND PROCEDURES***
Disclosure controls and procedures

An evaluation of the effectiveness our disclosure controls and procedures as of December 31, 2015 was carried out by management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures (as defined in Rules 13a- 15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were effective as at December 31, 2015 at a reasonable assurance level. A controls system, no matter how well designed and operated, cannot provide absolute assurance to achieve its objectives.

Management s annual report on internal control over financial reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Internal control over financial reporting is a process designed by, or under the supervision of, our Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, and effected by the Company board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Management has assessed the effectiveness of internal control over financial reporting as of December 31, 2015 based on the framework in *Internal Control Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, management has concluded that the Company s internal control over financial reporting was effective as a December 31, 2015 based on criteria in *Internal Control Integrated Framework* (2013) issued by the COSO.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has audited the effectiveness of the Company s internal control over financial reporting as of December 31, 2015, as stated in their report which appears on page F-2.

Change in internal control over financial reporting

During the period covered by this Annual Report on Form 20-F, the Company has made no changes to its internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 16A.***AUDIT COMMITTEE FINANCIAL EXPERT***
The members of the Board of Directors of Pearson plc have determined that Tim Score is an audit committee financial expert within the meaning of the applicable rules and regulations of the US Securities and Exchange Commission.

Table of Contents

ITEM 16B. ***CODE OF ETHICS***

Pearson has adopted a code of ethics (the Pearson code of conduct) which applies to all employees including the chief executive officer and chief financial officer and other senior financial management. This code of ethics is available on our website (www.pearson.com/code-of-conduct.html). The information on our website is not incorporated by reference into this report.

ITEM 16C. ***PRINCIPAL ACCOUNTANT FEES AND SERVICES***

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

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

Pre-approved non-audit services can be authorized by the chief financial officer up to £100,000 per project, subject to a cumulative limit of £500,000 per annum;

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

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

Services provided by PwC above these limits and all other allowable non-audit services, such as due diligence, irrespective of value, must be approved by the audit committee. Where appropriate, services will be tendered prior to awarding this work to the auditor.

The following table sets forth remuneration paid to PwC for 2014 and 2015:

Auditors Remuneration	**2015 £m**	**2014 £m**
Audit fees	6	7
Tax fees	1	1
All other fees	3	1

Audit fees include £35,000 (2014: £35,000) of audit fees relating to the audit of the parent company.

Fees for the audit of the effectiveness of the Group s internal control over financial reporting are allocated to audit fees paid.

Tax services include services related to tax compliance and advisory services.

ITEM 16D. ***EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES***

Not applicable.

Table of Contents

ITEM 16E. ***PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASES***

Period	Total number of shares purchased	Average price paid per share	Total number of units purchased as part of publicly announced plans or programs	Maximum number of shares that may yet be purchased under the plans or programs
February 1, 2013 February 28, 2013	1,000,000	£ 11.64	N/A	N/A
April 1, 2013 April 30, 2013	1,000,000	£ 11.53	N/A	N/A
June 1, 2013 June 30, 2013	1,972,725	£ 11.61	N/A	N/A
September 1, 2013 September 30, 2013	139,192	£ 12.57	N/A	N/A
April 1, 2014 April 30, 2014	906,892	£ 10.18	N/A	N/A
July 1, 2015 July 31, 2015	1,974,362	£ 11.81	N/A	N/A

Purchases of shares were made to satisfy obligations under Pearson employee share award programs. All purchases were made in open-market transactions. None of the foregoing share purchases was made as part of a publicly announced plan or program.

ITEM 16F. ***CHANGE IN REGISTRANT S CERTIFYING AUDITOR***

Not applicable.

ITEM 16G. ***CORPORATE GOVERNANCE***

Pearson is listed on the New York Stock Exchange (NYSE). As a listed non-US issuer, we are required to comply with some of the NYSE s corporate governance rules, and otherwise must disclose on our website any significant ways in which our corporate governance practices differ from those followed by US companies under the NYSE listing standards. At this time, the Company believes that it is in compliance in all material respects with all the NYSE rules except that the Nomination Committee is not composed entirely of independent directors, and that it is the full board, not the Nomination Committee, that develops and recommends corporate governance principles.

ITEM 16H. ***MINE SAFETY DISCLOSURE***

Not applicable.

Table of Contents

PART III

ITEM 17. ***FINANCIAL STATEMENTS***
Not applicable.

ITEM 18. ***FINANCIAL STATEMENTS***
The financial statements filed as part of this Annual Report are included on pages F-1 through F-71 hereof.

ITEM 19. ***EXHIBITS***

1.1	Articles of Association of Pearson plc. ¥
2.1	Indenture dated June 23, 2003 between Pearson plc and The Bank of New York, as trustee *
2.2	Indenture dated May 6, 2008 among Pearson Dollar Finance Two plc, as the Issuer, Pearson plc, Guarantor, and The Bank of New York, as trustee, Paying Agent and Calculation Agent. ¥
2.3	Indenture dated May 17, 2010 between Pearson Funding Two plc, as the Issuer, Pearson plc, Guarantor, and The Bank of New York Mellon, as trustee, Paying Agent and Calculation Agent. l
2.4	Indenture dated May 8, 2012 between Pearson Funding Four plc, as the Issuer, Pearson plc, Guarantor, and The Bank of New York Mellon, as trustee, Paying Agent and Calculation Agent. f
2.5	Indenture dated May 8, 2013 between Pearson Funding Five plc, as the Issuer, Pearson plc, Guarantor, and The Bank of New York Mellon, as trustee, Paying Agent and Calculation Agent. q
2.6	Trust Deed dated May 19, 2014 between Pearson Funding Five plc, as the Issuer, Pearson plc, Guarantor, and The Law Debenture Trust Corporation P.L.C, as trustee. ¥
2.7	Trust Deed dated May 6, 2015 between Pearson Funding Five plc, as the Issuer, Pearson plc, Guarantor, and The Law Debenture Trust Corporation P.L.C, as trustee.
8.1	List of Significant Subsidiaries.
12.1	Certification of Chief Executive Officer.
12.2	Certification of Chief Financial Officer.
13.1	Certification of Chief Executive Officer.
13.2	Certification of Chief Financial Officer.
15	Consent of PricewaterhouseCoopers LLP.

* Incorporated by reference from the Form 20-F of Pearson plc for the year ended December 31, 2003 and filed May 7, 2004.
l Incorporated by reference from the Form 20-F of Pearson plc for the year ended December 31, 2010 and filed March 25, 2011.
f Incorporated by reference from the Form 20-F of Pearson plc for the year ended December 31, 2012 and filed March 22, 2013.
q Incorporated by reference from the Form 20-F of Pearson plc for the year ended December 31, 2013 and filed March 27, 2014.
¥ Incorporated by reference from the Form 20-F of Pearson plc for the year ended December 31, 2014 and filed March 26, 2015.

Table of Contents

FINANCIAL STATEMENTS: CONTENTS

Report of Independent Registered Public Accounting Firm	F-2
Consolidated Income Statement for the year ended December 31, 2015, 2014 and 2013	F-3
Consolidated Statement of Comprehensive Income for the year ended December 31, 2015, 2014 and 2013	F-4
Consolidated Balance Sheet as at December 31, 2015 and 2014	F-5
Consolidated Statement of Changes in Equity for the year ended December 31, 2015, 2014 and 2013	F-7
Consolidated Cash Flow Statement for the year ended December 31, 2015, 2014 and 2013	F-9
Notes to the Consolidated Financial Statements	F-10

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Pearson plc

In our opinion, the accompanying consolidated balance sheets and the related consolidated income statements, statements of comprehensive income, statements of changes in equity and cash flow statements present fairly in all material respects, the financial position of Pearson plc and its subsidiaries at December 31, 2015 and December 31, 2014 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2015, in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board and in conformity with International Financial Reporting Standards as adopted by the European Union. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in Internal Control Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Annual Report on Internal Control Over Financial Reporting appearing under Item 15 of this Form 20-F. Our responsibility is to express opinions on these financial statements and on the Group s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States) and International Standards on Auditing. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control base on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/PricewaterhouseCoopers LLP

London

United Kingdom

March 23, 2016

Table of Contents

Consolidated income statement

Year ended 31 December 2015

All figures in £ millions	Notes	**2015**	2014 restated	2013 restated
Sales	2	**4,468**	4,540	4,728
Cost of goods sold	4	**(1,981)**	(2,021)	(2,123)
Gross profit		**2,487**	2,519	2,605
Operating expenses	4	**(2,094)**	(2,125)	(2,202)
Impairment of intangible assets	11	**(849)**	(77)	
Share of results of joint ventures and associates	12	**52**	31	28
Operating (loss)/profit	2	**(404)**	348	431
Finance costs	6	**(100)**	(140)	(110)
Finance income	6	**71**	47	37
(Loss)/profit before tax		**(433)**	255	358
Income tax	7	**81**	(56)	(88)
(Loss)/profit for the year from continuing operations		**(352)**	199	270
Profit for the year from discontinued operations	3	**1,175**	271	269
Profit for the year		**823**	470	539
Attributable to:				
Equity holders of the company		**823**	471	538
Non-controlling interest			(1)	1
Earnings per share for profit from continuing and discontinued operations attributable to equity holders of the company during the year (expressed in pence per share)				
basic	8	**101.2p**	58.1p	66.6p
diluted	8	**101.2p**	58.0p	66.5p
(Loss)/earnings per share for (loss)/profit from continuing operations attributable to equity holders of the company during the year (expressed in pence per share)				
basic	8	**(43.3)p**	24.7p	33.3p
diluted	8	**(43.3)p**	24.6p	33.3p

Table of Contents

Consolidated statement of comprehensive income

Year ended 31 December 2015

All figures in £ millions	Notes	**2015**	2014	2013
Profit for the year		**823**	470	539
Items that may be reclassified to the income statement				
Net exchange differences on translation of foreign operations Group		**(85)**	150	(206)
Net exchange differences on translation of foreign operations associates		**16**	25	(11)
Currency translation adjustment disposed Group		**(10)**	(2)	(18)
Attributable tax	7	**5**	(6)	6
Items that are not reclassified to the income statement				
Remeasurement of retirement benefit obligations Group	25	**110**	23	79
Remeasurement of retirement benefit obligations associates		**8**	(15)	
Attributable tax	7	**(24)**	(1)	(23)
Other comprehensive income for the year		**20**	174	(173)
Total comprehensive income for the year		**843**	644	366
Attributable to:				
Equity holders of the company		**845**	645	369
Non-controlling interest		**(2)**	(1)	(3)

F-4

Table of Contents

Consolidated balance sheet

As at 31 December 2015

All figures in £ millions	Notes	2015	2014
Assets			
Non-current assets			
Property, plant and equipment	10	**320**	334
Intangible assets	11	**5,164**	6,310
Investments in joint ventures and associates	12	**1,103**	1,118
Deferred income tax assets	13	**276**	295
Financial assets derivative financial instruments	16	**78**	90
Retirement benefit assets	25	**337**	190
Other financial assets	15	**143**	54
Trade and other receivables	22	**115**	82
		7,536	8,473
Current assets			
Intangible assets pre-publication	20	**841**	820
Inventories	21	**211**	224
Trade and other receivables	22	**1,284**	1,310
Financial assets derivative financial instruments	16	**32**	24
Financial assets marketable securities	14	**28**	16
Cash and cash equivalents (excluding overdrafts)	17	**1,703**	530
		4,099	2,924
Total assets		**11,635**	11,397
Liabilities			
Non-current liabilities			
Financial liabilities borrowings	18	**(2,048)**	(1,883)
Financial liabilities derivative financial instruments	16	**(136)**	(73)
Deferred income tax liabilities	13	**(560)**	(714)
Retirement benefit obligations	25	**(139)**	(163)
Provisions for other liabilities and charges	23	**(71)**	(82)
Other liabilities	24	**(356)**	(310)
		(3,310)	(3,225)
Current liabilities			
Trade and other liabilities	24	**(1,390)**	(1,601)
Financial liabilities borrowings	18	**(282)**	(342)
Financial liabilities derivative financial instruments	16	**(29)**	(1)
Current income tax liabilities		**(164)**	(190)
Provisions for other liabilities and charges	23	**(42)**	(53)
		(1,907)	(2,187)
Total liabilities		**(5,217)**	(5,412)
Net assets		**6,418**	5,985

F-5

Table of Contents

All figures in £ millions	Notes	**2015**	2014
Equity			
Share capital	27	**205**	205
Share premium	27	**2,590**	2,579
Treasury shares	28	**(72)**	(75)
Translation reserve		**(7)**	70
Retained earnings		**3,698**	3,200
Total equity attributable to equity holders of the company		**6,414**	5,979
Non-controlling interest		**4**	6
Total equity		**6,418**	5,985

These financial statements have been approved for issue by the board of directors on 4 March 2016 and signed on its behalf by

Coram Williams Chief financial officer

F-6

Table of Contents

Consolidated statement of changes in equity

Year ended 31 December 2015

All figures in £ millions	**Share capital**	**Share premium**	**Treasury shares**	**Translation reserve**	**Retained earnings**	**Total**	**Non-controlling interest**	**Total equity**
	Equity attributable to equity holders of the company							
At 1 January 2015	**205**	**2,579**	**(75)**	**70**	**3,200**	**5,979**	**6**	**5,985**
Profit for the year					**823**	**823**		**823**
Other comprehensive income				**(77)**	**99**	**22**	**(2)**	**20**
Total comprehensive income				**(77)**	**922**	**845**	**(2)**	**843**
Equity-settled transactions					**26**	**26**		**26**
Tax on equity-settled transactions					**(1)**	**(1)**		**(1)**
Issue of ordinary shares under share option schemes		**11**				**11**		**11**
Purchase of treasury shares			**(23)**			**(23)**		**(23)**
Release of treasury shares			**26**		**(26)**			
Changes in non-controlling interest								
Dividends					**(423)**	**(423)**		**(423)**
At 31 December 2015	**205**	**2,590**	**(72)**	**(7)**	**3,698**	**6,414**	**4**	**6,418**

All figures in £ millions	Share capital	Share premium	Treasury shares	Translation reserve	Retained earnings	Total	Non-controlling interest	Total equity
	Equity attributable to equity holders of the company							
At 1 January 2014	205	2,568	(98)	(103)	3,128	5,700	6	5,706
Profit for the year					471	471	(1)	470
Other comprehensive income				173	1	174		174
Total comprehensive income				173	472	645	(1)	644
Equity-settled transactions					32	32		32
Tax on equity-settled transactions					(3)	(3)		(3)
Issue of ordinary shares under share option schemes		11				11		11
Purchase of treasury shares			(9)			(9)		(9)
Release of treasury shares			32		(32)			
Changes in non-controlling interest							2	2
Dividends					(397)	(397)	(1)	(398)
At 31 December 2014	205	2,579	(75)	70	3,200	5,979	6	5,985

Table of Contents

All figures in £ millions	Share capital	Share premium	Treasury shares	Translation reserve	Retained earnings	Total	Non-controlling interest	Total equity
	Equity attributable to equity holders of the company							
At 1 January 2013	204	2,555	(103)	128	2,902	5,686	24	5,710
Profit for the year					538	538	1	539
Other comprehensive expense				(231)	62	(169)	(4)	(173)
Total comprehensive income				(231)	600	369	(3)	366
Equity-settled transactions					37	37		37
Tax on equity-settled transactions								
Issue of ordinary shares under share option schemes	1	13				14		14
Purchase of treasury shares			(47)			(47)		(47)
Release of treasury shares			52		(52)			
Changes in non-controlling interest					13	13	(15)	(2)
Dividends					(372)	(372)		(372)
At 31 December 2013	205	2,568	(98)	(103)	3,128	5,700	6	5,706

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. Changes in non-controlling interest in 2014 relate to the disposal of a non-controlling interest in a Chinese business.

Table of Contents

Consolidated cash flow statement

Year ended 31 December 2015

All figures in £ millions	Notes	2015	2014	2013
Cash flows from operating activities				
Net cash generated from operations	32	**518**	704	684
Interest paid		**(75)**	(86)	(82)
Tax paid		**(232)**	(163)	(246)
Net cash generated from operating activities		**211**	455	356
Cash flows from investing activities				
Acquisition of subsidiaries, net of cash acquired	30	**(9)**	(448)	(48)
Acquisition of joint ventures and associates		**(11)**	(12)	(10)
Purchase of investments		**(7)**	(3)	(64)
Purchase of property, plant and equipment		**(86)**	(75)	(118)
Purchase of intangible assets		**(161)**	(107)	(64)
Disposal of subsidiaries, net of cash disposed	31	**1,030**	327	(132)
Proceeds from sale of associates		**379**	39	2
Proceeds from sale of investments		**13**	9	2
Proceeds from sale of property, plant and equipment	32	**2**	9	28
Proceeds from sale of intangible assets		**1**	2	2
Proceeds from sale of liquid resources		**17**	12	13
Loans repaid by/(advanced to) related parties		**7**	(10)	(44)
Loans advanced			(2)	(5)
Investment in liquid resources		**(29)**	(22)	(14)
Interest received		**24**	13	9
Dividends received from joint ventures and associates		**162**	120	64
Net cash received from/(used in) investing activities		**1,332**	(148)	(379)
Cash flows from financing activities				
Proceeds from issue of ordinary shares	27	**11**	11	14
Purchase of treasury shares	28	**(23)**	(9)	(47)
Proceeds from borrowings		**372**	404	319
Repayment of borrowings		**(300)**	(538)	(225)
Finance lease principal payments		**(1)**	(4)	(8)
Dividends paid to company s shareholders	9	**(423)**	(397)	(372)
Dividends paid to non-controlling interest			(1)	
Purchase of non-controlling interest	33			(76)
Net cash used in financing activities		**(364)**	(534)	(395)
Effects of exchange rate changes on cash and cash equivalents		**(19)**	(2)	21
Net increase/(decrease) in cash and cash equivalents		**1,160**	(229)	(397)
Cash and cash equivalents at beginning of year		**511**	740	1,137
Cash and cash equivalents at end of year	17	**1,671**	511	740

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

Table of Contents

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, assessents 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 4 March 2016.

1. Accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below.

a. Basis of preparation

These consolidated financial statements have been prepared on the going concern basis and in accordance with International Financial Reporting Standards (IFRS) and IFRS Interpretations Committee interpretations as adopted by the European Union (EU) and with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. In respect of the accounting standards applicable to the Group there is no difference between EU-adopted and IASB-adopted IFRS.

These consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of financial assets and liabilities (including derivative financial instruments) to fair value through profit or loss.

The prior year financial statements have been restated to reflect the classification of FT Group as a discontinued operation.

1. Interpretations and amendments to published standards effective 2015 The following amendments and interpretations were adopted in 2015:
Amendments to IAS 19 Employee Benefits: Defined Benefit Plans Employee Contributions

Amendments to IFRS 2 Share based Payment: Definition of vesting conditions

Amendments to IFRS 3 Business Combinations: Accounting for contingent consideration in a business combination and scope exemptions for joint ventures

Amendments to IFRS 8 Operating Segments: Aggregation of operating segments and reconciliation of segment assets to entity s assets

Amendments to IAS 24 Related Party Disclosures: Key management personnel

Amendments to IFRS 13 Fair Value Measurement: Short term receivables and payables

The adoption of these new pronouncements from 1 January 2015 does not have a material impact on the consolidated financial statements.

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

a. Basis of preparation continued

2. Standards, interpretations and amendments to published standards that are not yet effective The Group has not early adopted the following new pronouncements that are not yet effective:

IFRS 9 Financial Instruments , effective for annual reporting periods beginning on or after 1 January 2018. The new standard details the requirements for the classification, measurement and recognition of financial assets and liabilities. The Group is yet to assess the full impact of IFRS 9.

IFRS 15 Revenue from Contracts with Customers , effective for annual reporting periods beginning on or after 1 January 2018. The new standard specifies how and when an entity will recognise revenue, and requires more detailed disclosure. Adoption of the new standard is likely to have an impact on the Group and management is currently assessing the impact.

IFRS 16 Leases , effective for annual reporting periods beginning on or after 1 January 2019. The new standard details the requirements for the classification, measurement and recognition of lease arrangements. Adoption of the new standard is likely to have an impact on the Group and management is currently assessing the impact.

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). Management are currently evaluating these proposals and although the proposals have not yet been finalised, it should be noted that the current draft, if adopted, may restrict the Group s ability to recognise a pension asset in respect of pension surpluses in its UK defined benefit pension plan.

In addition, the current draft may require certain elements of committed minimum funding contributions to be recognised as a liability on the balance sheet.

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

Consolidation: Business combinations determination of fair values

Intangible assets: Goodwill

Intangible assets: Pre-publication assets

Taxation

Revenue recognition

Employee benefits: Pensions

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.

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

b. Consolidation continued

Identifiable assets and contingent assets acquired and identifiable liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. 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 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.

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.

4. Joint ventures and associates Joint ventures are entities in which the Group holds an interest on a long-term basis and has rights to the net assets through contractually agreed sharing of control. Associates are entities over which the Group has significant influence but not the power to control the financial and operating policies, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in joint ventures and associates are accounted for by the equity method and are initially recognised at the fair value of consideration transferred.

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.

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

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 intercompany 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 $1.53 (2014: $1.65) and the year end rate was $1.47 (2014: $1.56).

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.

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

e. Intangible assets

1. Goodwill For the acquisition of subsidiaries made on or after 1 January 2010, goodwill represents the excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition date fair value of any previous equity interest in the acquiree over the fair value of the identifiable net assets acquired. For the acquisition of subsidiaries made from the date of transition to IFRS to 31 December 2009, goodwill represents the excess of the cost of an acquisition over the fair value of the Group s share of the net identifiable assets acquired. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisition of associates and joint ventures represents the excess of the cost of an acquisition over the fair value of the Group s share of the net identifiable assets acquired. Goodwill on acquisitions of associates and joint ventures is included in investments in associates and joint ventures.

Goodwill is tested 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 and significant management judgement. A description of the key assumptions and sensitivities is included in note 11. Goodwill is allocated to aggregated cash-generating units for the purpose of impairment testing. The allocation is made to those aggregated cash-generating units that are expected to benefit from the business combination in which the goodwill arose.

Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

IFRS 3 Business Combinations has not been applied retrospectively to business combinations before the date of transition to IFRS.

2. Acquired software Software separately acquired for internal use is capitalised at cost. Software acquired in material business combinations is capitalised at its fair value as determined by an independent valuer. Acquired software is amortised on a straight-line basis over its estimated useful life of between three and eight years.

3. Internally developed software Internal and external costs incurred during the preliminary stage of developing computer software for internal use are expensed as incurred. Internal and external costs incurred to develop computer software for internal use during the application development stage are capitalised if the Group expects economic benefits from the development. Capitalisation in the application development stage begins once the Group can reliably measure the expenditure attributable to the software development and has demonstrated its intention to complete and use the software. Internally developed software is amortised on a straight-line basis over its estimated useful life of between three and eight years.

4. Acquired intangible assets Acquired intangible assets include customer lists, 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 life cycle of the title, with a higher proportion of the amortisation taken in the earlier years.

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

e. Intangible assets continued

The investment in pre-publication assets has been disclosed as part of cash generated from operations in the cash flow statement (see note 32).

The assessment of the recoverability of pre-publication assets and the determination of the amortisation profile involve a significant degree of judgement based on historical trends and management estimation of future potential sales. An incorrect amortisation profile could result in excess amounts being carried forward as intangible assets that would otherwise have been written off to the income statement in an earlier period.

Reviews are performed regularly to estimate recoverability of pre-publication assets. The carrying amount of pre-publication assets is set out in note 20.

f. Other financial assets

Other financial assets, designated as available for sale investments, are non-derivative financial assets measured at estimated fair value. Changes in the fair value are recorded in equity in the fair value reserve. On the subsequent disposal of the asset, the net fair value gains or losses are taken to the income statement.

g. Inventories

Inventories are stated at the lower of cost and net realisable value. Cost is determined using the first in first out (FIFO) method. The cost of finished goods and work in progress comprises raw materials, direct labour, other direct costs and related production overheads. Net realisable value is the estimated selling price in the ordinary course of business, less estimated costs necessary to make the sale. Provisions are made for slow moving and obsolete stock.

h. Royalty advances

Advances of royalties to authors are included within trade and other receivables when the advance is paid less any provision required to adjust the advance to its net realisable value. The realisable value of royalty advances relies on a degree of management judgement in determining the profitability of individual author contracts. If the estimated realisable value of author contracts is overstated, this will have an adverse effect on operating profits as these excess amounts will be written off.

The recoverability of royalty advances is based upon an annual detailed management review of the age of the advance, the future sales projections for new authors and prior sales history of repeat authors.

The royalty advance is expensed at the contracted or effective royalty rate as the related revenues are earned. Royalty advances which will be consumed within one year are held in current assets. Royalty advances which will be consumed after one year are held in non-current assets.

i. Cash and cash equivalents

Cash and cash equivalents in the cash flow statement include cash in hand, deposits held on call with banks, other short-term highly liquid investments with original maturities of three months or less, and bank overdrafts. Bank overdrafts are included in borrowings in current liabilities in the balance sheet.

Short-term deposits and marketable securities with maturities of greater than three months do not qualify as cash and cash equivalents. Movements on these financial instruments are classified as cash flows from financing

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

i. Cash and cash equivalents continued

activities in the cash flow statement where these amounts are used to offset the borrowings of the Group or as cash flows from investing activities where these amounts are held to generate an investment return.

j. Share capital

Ordinary shares are classified as equity.

Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

Where any Group company purchases the company s equity share capital (treasury shares) the consideration paid, including any directly attributable incremental costs, net of income taxes, is deducted from equity attributable to the company s equity holders until the shares are cancelled, reissued or disposed of. Where such shares are subsequently sold or reissued, any consideration received, net of any directly attributable transaction costs and the related income tax effects, is included in equity attributable to the company s equity holders.

k. Borrowings

Borrowings are recognised initially at fair value, which is proceeds received net of transaction costs incurred. Borrowings are subsequently stated at amortised cost with any difference between the proceeds (net of transaction costs) and the redemption value being recognised in the income statement over the period of the borrowings using the effective interest method. Accrued interest is included as part of borrowings. Where a debt instrument is in a fair value hedging relationship, an adjustment is made to its carrying value in the income statement to reflect the hedged risk. Interest on borrowings is expensed in the income statement as incurred.

l. Derivative financial instruments

Derivatives are recognised at fair value and remeasured at each balance sheet date. The fair value of derivatives is determined by using market data and the use of established estimation techniques such as discounted cash flow and option valuation models. The Group designates certain of the derivative instruments within its portfolio to be hedges of the fair value of its bonds (fair value hedges) or hedges of net investments in foreign operations (net investment hedges).

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

The effective portion of changes in the fair value of derivatives that are designated and qualify as net investment hedges are recognised in other comprehensive income. Gains and losses accumulated in equity are included in the income statement when the corresponding foreign operation is disposed of. Gains or losses relating to the ineffective portion are recognised immediately in finance income or finance costs in the income statement.

Certain derivatives do not qualify or are not designated as hedging instruments. Such derivatives are classified at fair value and any movement in their fair value is recognised immediately in finance income or finance costs in the income statement.

m. Taxation

Current tax is recognised on the amounts expected to be paid or recovered under the tax rates and laws that have been enacted or substantively enacted at the balance sheet date.

F-16

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

m. Taxation continued

Deferred income tax is provided, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts. Deferred income tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred tax asset is realised or the deferred income tax liability is settled.

Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred income tax is provided in respect of the undistributed earnings of subsidiaries other than where it is intended that those undistributed earnings will not be remitted in the foreseeable future.

Current and deferred tax are recognised in the income statement, except when the tax relates to items charged or credited directly to equity or other comprehensive income, in which case the tax is also recognised in equity or other comprehensive income.

The Group is subject to income taxes in numerous jurisdictions. Significant judgement is required in determining the estimates in relation to the worldwide provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. The Group recognises liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

Deferred tax assets and liabilities require management judgement in determining the amounts to be recognised. In particular, significant judgement is used when assessing the extent to which deferred tax assets should be recognised with consideration given to the timing and level of future taxable income together with any future tax planning strategies.

n. Employee benefits

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.

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.

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

n. Employee benefits continued

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 at fair value. 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.

Revenue from the sale of books is recognised when title passes. A provision for anticipated returns is made based primarily on historical return rates. If these estimates do not reflect actual returns in future periods then revenues could be understated or overstated for a particular period.

F-18

Notes to the consolidated financial statements continued

1. Accounting policies continued

p. Revenue recognition continued

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 license.

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.

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.

Circulation and advertising revenue is recognised when the newspaper or other publication is published. Subscription revenue is recognised on a straight-line basis over the life of the subscription.

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.

Table of Contents

Notes to the consolidated financial statements continued

1. Accounting policies continued

q. Leases continued

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases by the lessee. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

r. Dividends

Dividends are recorded in the Group s financial statements in the period in which they are approved by the company s shareholders.

s. 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).

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 (PRH) associate.

The chief operating decision-maker is the Pearson Executive.

Continuing operations:

North America School, Higher Education and Professional businesses in US and Canada.

Growth School, Higher Education and Professional businesses in emerging markets which are investment priorities, including Brazil, China, India and South Africa.

Core School, Higher Education and Professional businesses in more mature markets including UK, Australia and Italy.

The results of the FT Group segment (to 30 November 2015) and Mergermarket (to 4 February 2014) are shown as discontinued in the relevant periods.

Table of Contents

Notes to the consolidated financial statements continued

2. Segment information continued

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

					2015			
All figures in £ millions	**Notes**	**North America**	**Core**	**Growth**	**PRH**	**Corporate**	**Discontinued operations**	**Group**
Continuing operations								
Sales		**2,940**	**836**	**692**				**4,468**
Operating (loss)/profit		**113**	**30**	**(595)**	**48**			**(404)**
Finance costs	6							**(100)**
Finance income	6							**71**
Loss before tax								**(433)**
Income tax	7							**81**
Loss for the year from continuing operations								**(352)**
Segment assets		**6,399**	**1,573**	**719**		**1,841**		**10,532**
Joint ventures	12	**1**		**3**				**4**
Associates	12		**6**		**1,093**			**1,099**
Total assets		**6,400**	**1,579**	**722**	**1,093**	**1,841**		**11,635**
Other segment items								
Share of results of joint ventures and associates	12	**(9)**		**(3)**	**64**		**16**	**68**
Capital expenditure	10, 11	**85**	**33**	**110**			**15**	**243**
Pre-publication investment	20	**218**	**63**	**66**				**347**
Depreciation	10	**42**	**9**	**18**			**6**	**75**
Amortisation	11, 20	**338**	**95**	**109**			**15**	**557**
Impairment	11	**282**	**37**	**530**				**849**

Table of Contents

Notes to the consolidated financial statements continued

2. Segment information continued

		2014 restated						
All figures in £ millions	Notes	North America	Core	Growth	PRH	Corporate	Discontinued operations	Group
Continuing operations								
Sales		2,906	910	724				4,540
Operating profit/(loss)		336	100	(103)	15			348
Finance costs	6							(140)
Finance income	6							47
Profit before tax								255
Income tax	7							(56)
Profit for the year from continuing operations								199
Segment assets		6,580	1,426	1,394		660	219	10,279
Joint ventures	12	1		3			9	13
Associates	12	1	8		1,095		1	1,105
Total assets		6,582	1,434	1,397	1,095	660	229	11,397
Other segment items								
Share of results of joint ventures and associates	12		(1)	(3)	35		20	51
Capital expenditure	10, 11	97	32	49			16	194
Pre-publication investment	20	209	77	72				358
Depreciation	10	41	10	16			7	74
Amortisation	11, 20	306	99	121			16	542
Impairment	11			77				77

		2013 restated						
All figures in £ millions	Notes	North America	Core	Growth	PRH	Corporate	Discontinued operations	Group
Continuing operations								
Sales		3,008	1,008	712				4,728
Operating profit/(loss)		358	58	(5)	20			431
Finance costs	6							(110)
Finance income	6							37
Profit before tax								358
Income tax	7							(88)
Profit for the year from continuing operations								270
Other segment items								
Share of results of joint ventures and associates		1		(4)	31		26	54
Depreciation	10	45	12	16			9	82

Amortisation	285	131	103	16	535
Impairment					

Table of Contents

Notes to the consolidated financial statements continued

2. Segment information continued

There were no material inter-segment sales in 2013, 2014 or 2015.

Both operating profit and adjusted operating profit in 2015 are stated after the following restructuring charges: North America £24m (2014: £37m, 2013: £77m); Core £nil (2014: £21m, 2013: £49m); Growth £11m, (2014: £6m, 2013: £36m); Penguin Random House £12m (2014: £19m, 2013: £nil).

Corporate costs are allocated to business segments including discontinued operations on an appropriate basis depending on the nature of the cost; therefore the segment result is equal to the Group operating profit. Segment assets consist of property, plant and equipment, intangible assets, inventories, receivables, deferred taxation and other financial assets and exclude cash and cash equivalents and derivative assets. Corporate assets comprise cash and cash equivalents, marketable securities and derivative financial instruments. Capital expenditure comprises additions to property, plant and equipment and software (see notes 10 and 11).

Property, plant and equipment and intangible assets acquired through business combination were £1m (2014: £263m) (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. School Systems includes PowerSchool and Family Education Network, both of which were disposed during 2015.

	2015			
All figures in £ millions	**North America**	**Core**	**Growth**	**Group**
Courseware				
School Courseware	**406**	**186**	**104**	**696**
Higher Education Courseware	**1,207**	**96**	**55**	**1,358**
English Courseware	**22**	**84**	**79**	**185**
	1,635	**366**	**238**	**2,239**
Assessments				
School and Higher Education Assessments	**420**	**301**	**15**	**736**
Clinical Assessments	**126**	**32**		**158**
Professional Certification	**269**	**82**	**36**	**387**
	815	**415**	**51**	**1,281**
Services				
School Services	**209**	**1**	**47**	**257**
Higher Education Services	**223**	**26**	**70**	**319**
English Services	**18**	**28**	**286**	**332**
School Systems	**40**			**40**
	490	**55**	**403**	**948**
Total	**2,940**	**836**	**692**	**4,468**

F-23

Table of Contents

Notes to the consolidated financial statements continued

2. Segment information continued

	2014 restated			
All figures in £ millions	North America	Core	Growth	Group
Courseware				
School Courseware	389	214	120	723
Higher Education Courseware	1,179	114	66	1,359
English Courseware	22	92	75	189
	1,590	420	261	2,271
Assessments				
School and Higher Education Assessments	416	312	14	742
Clinical Assessments	115	34		149
Professional Certification	228	93	19	340
	759	439	33	1,231
Services				
School Services	253		56	309
Higher Education Services	215	22	90	327
English Services	20	29	284	333
School Systems	69			69
	557	51	430	1,038
Total	2,906	910	724	4,540

	2013 restated			
All figures in £ millions	North America	Core	Growth	Group
Courseware				
School Courseware	467	233	167	867
Higher Education Courseware	1,180	138	66	1,384
English Courseware	23	105	83	211
	1,670	476	316	2,462
Assessments				
School and Higher Education Assessments	452	375	7	834
Clinical Assessments	150			150
Professional Certification	221	82	24	327
	823	457	31	1,311
Services				
School Services	239	6	79	324

Higher Education Services	167	23	83	273
English Services	22	46	203	271
School Systems	87			87
	515	75	365	955
Total	3,008	1,008	712	4,728

F-24

Table of Contents

Notes to the consolidated financial statements continued

2. Segment information continued

The Group operates in the following main geographic areas:

	Sales			Non-current assets	
All figures in £ millions	**2015**	2014 restated	2013 restated	**2015**	2014
Continuing operations					
UK	**421**	444	476	**991**	1,056
Other European countries	**246**	281	299	**121**	180
US	**2,800**	2,762	2,852	**5,000**	5,243
Canada	**107**	109	128	**235**	288
Asia Pacific	**590**	565	588	**211**	416
Other countries	**304**	379	385	**144**	661
Total continuing	**4,468**	4,540	4,728	**6,702**	7,844
Discontinued operations					
UK	**134**	170	270		
Other European countries	**64**	66	116		
US	**72**	68	430		
Canada	**2**	1	24		
Asia Pacific	**35**	34	110		
Other countries	**5**	4	12		
Total discontinued	**312**	343	962		
Total	**4,780**	4,883	5,690	**6,702**	7,844

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.

Table of Contents

Notes to the consolidated financial statements continued

3. Discontinued operations

Discontinued operations relate to FT Group, Penguin and Mergermarket. An analysis of the results and cash flows of discontinued operations is as follows:

	2015		2014 restated				2013 restated			
All figures in £ millions	**FT Group**	**Total**	Penguin	Mergermarket	FT Group	Total	Penguin	Mergermarket	FT Group	Total
Sales	**312**	**312**		9	334	343	513	108	341	962
Operating profit	**48**	**48**		2	50	52	28	24	27	79
Finance income/(costs)							1		(3)	(2)
Profit before tax	**48**	**48**		2	50	52	29	24	24	77
Income tax	**(8)**	**(8)**		(1)	(7)	(8)	(9)	(9)	1	(17)
Profit after tax	**40**	**40**		1	43	44	20	15	25	60
Profit on disposal of Penguin			29			29	202			202
Attributable tax benefit							15			15
Profit on disposal of The Economist	**473**	**473**								
Profit on disposal of Financial Times	**711**	**711**								
Attributable tax expense	**(49)**	**(49)**								
Mergermarket transaction costs								(8)		(8)
Profit on disposal of Mergermarket				244		244				
Attributable tax expense				(46)		(46)				
Profit for the year from discontinued operations	**1,175**	**1,175**	29	199	43	271	237	7	25	269
Operating cash flows	**31**	**31**		2	24	26	36	22	17	75
Investing cash flows	**3**	**3**			(5)	(5)	(6)	(2)	2	(6)
Financing cash flows							(8)	(29)		(37)
Total cash flows	**34**	**34**		2	19	21	22	(9)	19	32

Included within the cost of disposal of Penguin in 2013 are amounts in respect of the settlement of litigation related to the agency arrangement for eBooks. Also included in cost of disposal for Penguin for 2013 was a provision for amounts payable to Bertelsmann upon settlement of the transfer of Penguin s UK past service pension liabilities to the new PRH venture. During 2014, it was decided that this transfer would not go ahead as planned and the costs have been credited back in the £29m gain reported against the disposal in 2014.

Table of Contents

Notes to the consolidated financial statements continued

4. Operating expenses

All figures in £ millions	2015	2014 restated	2013 restated
By function:			
Cost of goods sold	**1,981**	2,021	2,123
Operating expenses			
Distribution costs	**80**	84	88
Selling, marketing and product development costs	**895**	931	995
Administrative and other expenses	**1,195**	1,168	1,056
Restructuring costs	**35**	64	162
Other net gains and losses	**(13)**	(2)	16
Other income	**(98)**	(120)	(115)
Total net operating expenses	**2,094**	2,125	2,202
Impairment of intangible assets	**849**	77	
Total	**4,924**	4,223	4,325

Included in other income is service fee income from Penguin Random House of £16m (2014: £41m, 2013: £28m). Included in administrative and other expenses are research and efficacy costs of £33m (2014: £22m, 2013: £5m). In addition to the restructuring costs shown above there were restructuring costs in Penguin Random House of £12m (2014: £19m, 2013: £nil) and in discontinued operations of £nil (2014: £1m, 2013: £14m).

All figures in £ millions	Notes	2015	2014 restated	2013 restated
By nature:				
Royalties expensed		**249**	242	256
Other product costs		**566**	620	663
Employee benefit expense	5	**1,742**	1,832	1,938
Contract labour		**182**	183	190
Employee related expense		**127**	136	167
Promotional costs		**163**	149	148
Depreciation of property, plant and equipment	10	**69**	67	73
Amortisation of intangible assets pre-publication	20	**281**	292	308
Amortisation of intangible assets software	11	**61**	51	48
Amortisation of intangible assets other	11	**199**	184	163
Impairment of intangible assets	11	**849**	77	
Property and facilities		**219**	204	213
Technology and communications		**153**	123	88
Professional and outsourced services		**262**	253	245
Other general and administrative costs		**132**	121	104
Capitalised costs		**(219)**	(195)	(193)
Acquisition costs			6	12
Other net gains and losses		**(13)**	(2)	16
Other income		**(98)**	(120)	(114)

Total	**4,924**	4,223	4,325

Included in other net gains and losses within continuing operations in 2015 in the North America segment is the profit on disposal of PowerSchool of £30m, net of small losses on other investments. In the Core segment the loss on disposal relates to adjustments to prior year disposals.

Table of Contents

Notes to the consolidated financial statements continued

4. Operating expenses continued

Included in other net gains and losses in continuing operations in 2014 are gains on the sale of joint venture interests in Safari Books Online and CourseSmart (£40m) and a loss on disposal of an investment in Nook Media (£38m).

Included in other net gains and losses in 2013 is a loss on the disposal of the Japanese school and local publishing assets.

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

All figures in £ millions	2015	2014	2013
The audit of parent company and consolidated financial statements	4	5	4
The audit of the company s subsidiaries	2	2	2
Total audit fees	6	7	6
Other assurance services	2	1	1
Other non-audit services	1		
Total other services	3	1	1
Tax compliance services	1	1	2
Tax advisory services			2
Total tax services	1	1	4
Total non-audit services	4	2	5
Total	10	9	11

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

All figures in £ millions	2015	2014	2013
Group audit fees including fees for attestation under section 404 of the Sarbanes-Oxley Act	6	7	6
Non-audit fees	4	2	5
Total	10	9	11

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 in 2015 are amounts related to carve out audits for disposals of £1m.

5. Employee information

All figures in £ millions	Notes	2015

			2014 restated	2013 restated
Employee benefit expense				
Wages and salaries (including termination benefits and restructuring costs)		**1,507**	1,607	1,697
Social security costs		**124**	122	124
Share-based payment costs	26	**26**	32	37
Retirement benefits defined contribution plans	25	**66**	61	58
Retirement benefits defined benefit plans	25	**19**	21	22
Other post-retirement benefits	25		(11)	
Total		**1,742**	1,832	1,938

F-28

Table of Contents

Notes to the consolidated financial statements continued

5. Employee information continued

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

Average number employed	2015	2014 restated	2013 restated
Employee numbers			
North America	**19,951**	20,927	21,856
Core	**5,936**	6,139	7,075
Growth	**11,114**	11,406	10,768
Other	**264**	182	187
Continuing operations	**37,265**	38,654	39,886

The employee benefit expense relating to discontinued operations was £132m (2014: £151m, 2013: £330m) and the average number employed was 2,282 (2014: 2,295, 2013: 5,821).

6. Net finance costs

All figures in £ millions	Notes	2015	2014 restated	2013 restated
Interest payable		**(61)**	(81)	(81)
Net finance costs in respect of retirement benefits				(3)
Net foreign exchange losses		**(36)**	(53)	
Finance cost of put options, deferred consideration associated with acquisitions and other interest charges related to transactions				(9)
Derivatives not in hedging relationships		**(3)**	(6)	(17)
Finance costs		**(100)**	(140)	(110)
Interest receivable		**15**	17	10
Net finance income in respect of retirement benefits	25	**4**	1	
Net foreign exchange gains		**43**	17	22
Financial instruments in a hedging relationship				1
Derivatives not in hedging relationships		**9**	12	4
Finance income		**71**	47	37
Net finance costs		**(29)**	(93)	(73)
Analysed as:				
Net interest payable		**(46)**	(64)	(71)
Other net finance income/(costs)		**17**	(29)	(2)
Total net finance costs		**(29)**	(93)	(73)

Included in interest receivable is £1m (2014: £1m, 2013: £nil) of interest receivable from related parties. There was a net movement of £nil on fair value hedges in 2015 (2014: £nil, 2013: net gain of £1m), comprising a gain of £22m (2014: loss of £27m, 2013: gain of £95m) on the underlying bonds, offset by a loss of £22m (2014: gain of £27m, 2013: loss of £94m) on the related derivative financial instruments.

Table of Contents

Notes to the consolidated financial statements continued

7. Income tax

All figures in £ millions	Notes	2015	2014 restated	2013 restated
Current tax				
Charge in respect of current year		**(155)**	(96)	(130)
Adjustments in respect of prior years		**42**	30	(7)
Total current tax charge		**(113)**	(66)	(137)
Deferred tax				
In respect of temporary differences		**185**	8	14
Other adjustments in respect of prior years		**9**	2	35
Total deferred tax credit	13	**194**	10	49
Total tax credit/(charge)		**81**	(56)	(88)

The adjustments in respect of prior years in 2015, 2014 and 2013 mainly relate to changes in estimates arising from uncertain tax positions following agreement of historical tax positions.

The tax on the Group s (loss)/profit before tax differs from the theoretical amount that would arise using the UK tax rate as follows:

All figures in £ millions	2015	2014 restated	2013 restated
(Loss)/profit before tax	**(433)**	255	358
Tax calculated at UK rate (2015: 20.25%, 2014: 21.5%)	**88**	(55)	(84)
Effect of overseas tax rates	**52**	(10)	(13)
Joint venture and associate income reported net of tax	**10**	7	7
Net expense not subject to tax	**(66)**	(11)	(14)
Gains and losses on sale of businesses not subject to tax	**(32)**		(6)
Unutilised tax losses	**(22)**	(19)	(7)
Utilisation of previously unrecognised tax losses and credits			1
Adjustments in respect of prior years	**51**	32	28
Total tax credit/(charge)	**81**	(56)	(88)
UK	**(25)**		(14)
Overseas	**106**	(56)	(74)
Total tax credit/(charge)	**81**	(56)	(88)
Tax rate reflected in earnings	**18.7%**	22.0%	24.6%

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

All figures in £ millions	**2015**	2014	2013
Net exchange differences on translation of foreign operations	**5**	(6)	6
Remeasurement of retirement benefit obligations	**(24)**	(1)	(23)
	(19)	(7)	(17)

A tax charge of £1m (2014: tax charge £3m, 2013: tax charge £nil) relating to share-based payments has been recognised directly in equity.

Table of Contents

Notes to the consolidated financial statements continued

8. Earnings per share

Basic

Basic earnings per share is calculated by dividing the profit attributable to equity shareholders of the company by the weighted average number of ordinary shares in issue during the year, excluding ordinary shares purchased by the company and held as treasury shares.

Diluted

Diluted earnings per share is calculated by adjusting the weighted average number of ordinary shares to take account of all dilutive potential ordinary shares and adjusting the profit attributable, if applicable, to account for any tax consequences that might arise from conversion of those shares.

All figures in £ millions	Notes	2015	2014 restated	2013 restated
(Loss)/profit for the year from continuing operations		**(352)**	199	270
Non-controlling interest			1	(1)
Earnings from continuing operations		**(352)**	200	269
Profit for the year from discontinued operations	3	**1,175**	271	269
Earnings		**823**	471	538
Weighted average number of shares (millions)		**813.3**	810.9	807.8
Effect of dilutive share options (millions)			1.0	1.1
Weighted average number of shares (millions) for diluted earnings		**813.3**	811.9	808.9
Earnings per share from continuing and discontinued operations				
Basic		**101.2p**	58.1p	66.6p
Diluted		**101.2p**	58.0p	66.5p
(Loss)/earnings per share from continuing operations				
Basic		**(43.3)p**	24.7p	33.3p
Diluted		**(43.3)p**	24.6p	33.3p
Earnings per share from discontinued operations				
Basic		**144.5p**	33.4p	33.3p
Diluted		**144.5p**	33.4p	33.3p

9. Dividends

All figures in £ millions	2015	2014	2013
Final paid in respect of prior year 34.0p (2014: 32.0p, 2013: 30.0p)	**277**	259	242
Interim paid in respect of current year 18.0p (2014: 17.0p, 2013: 16.0p)	**146**	138	130
	423	397	372

The directors are proposing a final dividend in respect of the financial year ended 31 December 2015 of 34.0p per share which will absorb an estimated £277m of shareholders funds. It will be paid on 6 May 2016 to shareholders who are on the register of members on 8 April 2016. These financial statements do not reflect this dividend.

Table of Contents

Notes to the consolidated financial statements continued

10. Property, plant and equipment

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Cost				
At 1 January 2014	375	568	32	975
Exchange differences	11	17		28
Additions	10	58	19	87
Disposals	(9)	(46)	(2)	(57)
Acquisition through business combination		2		2
Disposal through business disposal		(1)		(1)
Reclassifications	1	3	(4)	
Transfer to software			(16)	(16)
At 31 December 2014	388	601	29	1,018
Exchange differences	**8**	**10**	**1**	**19**
Additions	**15**	**42**	**25**	**82**
Disposals	**(20)**	**(86)**		**(106)**
Acquisition through business combination				
Disposal through business disposal	**(48)**	**(76)**		**(124)**
Reclassifications	**16**	**17**	**(33)**	
At 31 December 2015	**359**	**508**	**22**	**889**

All figures in £ millions	Land and buildings	Plant and equipment	Assets in course of construction	Total
Depreciation				
At 1 January 2014	(210)	(423)		(633)
Exchange differences	(7)	(15)		(22)
Charge for the year	(23)	(51)		(74)
Disposals	9	36		45
At 31 December 2014	(231)	(453)		(684)
Exchange differences	**(5)**	**(12)**		**(17)**
Charge for the year	**(22)**	**(53)**		**(75)**
Disposals	**18**	**82**		**100**
Disposal through business disposal	**48**	**59**		**107**
At 31 December 2015	**(192)**	**(377)**		**(569)**
Carrying amounts				
At 1 January 2014	165	145	32	342
At 31 December 2014	157	148	29	334

At 31 December 2015	**167**	**131**	**22**	**320**

Depreciation expense of £19m (2014: £16m, 2013: £24m) has been included in the income statement in cost of goods sold and £50m (2014: £51m, 2013: £49m) in operating expenses. In 2015 £6m (2014: £7m, 2013: £9m) relates to discontinued operations.

The Group leases certain equipment under a number of finance lease agreements. The net carrying amount of leased plant and equipment included within property, plant and equipment was £8m (2014: £13m).

Table of Contents

Notes to the consolidated financial statements continued

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 2014	4,666	469	855	237	198	398	6,823
Exchange differences	198	17	34	5		14	268
Impairment	(67)						(67)
Additions internal development		54					54
Additions purchased		53					53
Disposals		(7)					(7)
Acquisition through business combination	238		5	69		186	498
Disposal through business disposal	(5)	(5)		(3)	(1)		(14)
Transfer from PPE		16					16
At 31 December 2014	5,030	597	894	308	197	598	7,624
Exchange differences	**105**	**17**	**25**	**(17)**	**(7)**	**(40)**	**83**
Impairment	**(826)**						**(826)**
Additions internal development		**125**					**125**
Additions purchased		**36**					**36**
Disposals		**(18)**		**(4)**	**(10)**	**(29)**	**(61)**
Acquisition through business combination						**1**	**1**
Disposal through business disposal	**(175)**	**(138)**	**(59)**	**(6)**		**(21)**	**(399)**
At 31 December 2015	**4,134**	**619**	**860**	**281**	**180**	**509**	**6,583**

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 2014		(316)	(249)	(93)	(148)	(216)	(1,022)
Exchange differences		(13)	(11)	(3)		(12)	(39)
Impairment			(6)	(2)		(2)	(10)
Charge for the year		(63)	(83)	(25)	(12)	(67)	(250)
Disposals		5					5
Disposal through business disposal		1		1			2
At 31 December 2014		(386)	(349)	(122)	(160)	(297)	(1,314)
Exchange differences		**(14)**	**(8)**	**1**	**6**	**(6)**	**(21)**
Impairment			**(13)**	**(1)**	**(9)**		**(23)**
Charge for the year		**(74)**	**(99)**	**(40)**	**(10)**	**(53)**	**(276)**

Disposals		**18**		**4**	**10**	**29**	**61**
Disposal through business disposal		**99**	**39**	**3**		**13**	**154**
At 31 December 2015		**(357)**	**(430)**	**(155)**	**(163)**	**(314)**	**(1,419)**
Carrying amounts							
At 1 January 2014	4,666	153	606	144	50	182	5,801
At 31 December 2014	5,030	211	545	186	37	301	6,310
At 31 December 2015	**4,134**	**262**	**430**	**126**	**17**	**195**	**5,164**

Table of Contents

Notes to the consolidated financial statements continued

11. Intangible assets continued

Goodwill

The goodwill carrying value of £4,134m relates to acquisitions completed after 1 January 1998. Prior to 1 January 1998 all goodwill was written off to reserves on the date of acquisition. For acquisitions completed between 1 January 1998 and 31 December 2002 no value was ascribed to intangibles other than goodwill and the goodwill on each acquisition was amortised over a period of up to 20 years. On adoption of IFRS on 1 January 2003, the Group chose not to restate the goodwill balance and at that date the balance was frozen (i.e. amortisation ceased). If goodwill had been restated then a significant value would have been ascribed to other intangible assets, which would be subject to amortisation, and the carrying value of goodwill would be significantly lower. For acquisitions completed after 1 January 2003 value has been ascribed to other intangible assets which are amortised.

Other intangible assets

Other intangibles acquired include content, technology and software rights.

Intangible assets are valued separately for each acquisition and the primary method of valuation used is the discounted cash flow method. The majority of acquired intangibles are amortised using 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 £13m (2014: £12m, 2013: £15m) is included in the income statement in cost of goods sold and £248m (2014: £222m, 2013: £196m) in operating expenses. In 2015, £16m (2014: £15m, 2013: £16m) of amortisation relates to discontinued operations.

The range of useful economic lives for each major class of intangible asset (excluding goodwill and software) is shown below:

Class of intangible asset	2015 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	2015 One to five years	Six to ten years	More than ten years	Total
Class of intangible asset				
Acquired customer lists, contracts and relationships	**268**	**122**	**40**	**430**
Acquired trademarks and brands	**56**	**47**	**23**	**126**
Acquired publishing rights	**15**	**2**		**17**
Other intangibles acquired	**146**	**43**	**6**	**195**

Table of Contents

Notes to the consolidated financial statements continued

11. Intangible assets continued

Impairment tests for cash-generating units (CGUs) containing goodwill

Impairment tests have been carried out where appropriate as described below.

Following a reorganisation of the business effective 1 January 2014 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 carrying value of the goodwill in each of the CGUs, after the impact of impairments, is summarised below:

All figures in £ millions	2015	2014
North America	**3,155**	3,422
Core	**635**	618
Growth (includes Brazil, China, India and South Africa)		612
Pearson VUE	**344**	327
Financial Times Group		51
Total	**4,134**	5,030

The recoverable amount of each aggregated cash generating unit (CGU) is based on fair value less costs of disposal or value in use calculations as appropriate. 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.

Following significant economic and market deterioration in the Group s operations in emerging markets and ongoing cyclical and policy-related pressures in the Group s mature market operations, management s expectations of future returns were revised down in the course of 2015. It was determined during the impairment review that the fair value less costs of disposal of the Growth, North America and Core CGUs no longer supported the carrying value of the goodwill. An impairment of £507m was booked in respect of the Group s Growth operations, representing impairments of £269m in the Brazil CGU, £181m in the China CGU, £48m in the South Africa CGU and £9m in the Other Growth CGU, thereby bringing the carrying value of goodwill in those CGUs down to £nil. Impairments of £10m and £13m were also booked in respect of other acquired intangibles in the South Africa and Other Growth CGUs respectively, bringing their carrying value down to £nil. Impairments of £282m and £37m were also booked in respect of the North America and Core CGUs respectively, bringing the carrying value of the goodwill in those CGUs down to fair value less costs of disposal. Fair value less costs of disposal was determined using post-tax discount rates of 17.4% for Brazil, 11.0% for China, 13.6% for South Africa, 12.8% for Other Growth, 8.6% for North America and 8.7% for Core. Following the above impairments, the recoverable amounts of the Growth, North America and Core CGUs are £350m, £4,750m and £926m respectively.

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

Table of Contents

Notes to the consolidated financial statements continued

11. Intangible assets continued

Key assumptions continued

CGU. The average post-tax discount rates range from 7.2% to 17.4%. 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% (2014: 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 5.0% and 8.5% 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 factors include USA and UK college enrolment rates, assessment growth rates, the success of new product launches, growth rates and economic conditions in emerging markets and the rate of growth in new services businesses. The five-year sales forecasts use average nominal growth rates between 1.1% and 1.6% for mature markets and between 0.1% and 5.6% 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 global restructuring programme planned in 2016.

Cash conversion Cash conversion is the ratio of operating cash flow to operating profit. Management forecasts cash conversion rates based on historical experience, adjusted for the impact of product investment priorities and the shift to digital and service based business.

Sensitivities

The Group s impairment review is sensitive to a change in assumptions used, most notably the discount rates and the perpetuity growth rates. As the carrying value of goodwill in the Growth market CGUs has been written down to £nil, the value of other intangible assets in Brazil and China is sensitive to any increase in discount rates or reduction in perpetuity growth rates. In the North America and Core CGUs goodwill has been written down to fair value less costs of disposal and any further increase in discount rates or reduction in perpetuity growth rates would give rise to further impairment. A 0.1% increase in discount rates would cause the fair value less costs of disposal of the Brazil, China, North America and Core CGUs to reduce by £3m, £5m, £120m and £25m respectively. A 0.1% reduction in perpetuity growth rates would cause the fair value less costs of disposal of the Brazil, China, North America and Core CGUs to reduce by £2m, £5m, £100m and £21m respectively. All CGUs which have been written down to fair value less costs of disposal are 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 £29m in the Growth CGUs, £241m in the North America CGU and £62m in the Core CGU.

Table of Contents

Notes to the consolidated financial statements continued

11. Intangible assets continued

2014 impairment tests

In 2014 following deterioration in the market conditions for the Group s online tutoring business based in India, it was determined in the course of the impairment review that the value in use of the India CGU no longer supported the carrying value of the goodwill in that CGU. An impairment of £67m was booked, thereby bringing the carrying value of goodwill in the India CGU down to £nil. An impairment of £10m was also booked in respect of other acquired intangibles in that CGU, bringing their carrying value to £nil. The India CGU incorporates all the Group s trading operations in India. A pre-tax discount rate of 13.6% was used to determine the value in use of the India CGU. No previous assessment had been made of the value in use of that CGU as the Group s India operations, prior to the 1 January 2014 reorganisation, were previously part of a larger Emerging Markets aggregated CGU.

12. Investments in joint ventures and associates

The amounts recognised in the balance sheet are as follows:

All figures in £ millions	2015	2014
Associates	**1,099**	1,105
Joint ventures	**4**	13
Total	**1,103**	1,118

The amounts recognised in the income statement are as follows:

All figures in £ millions	2015	2014
Associates	**72**	54
Joint ventures	**(4)**	(3)
Total	**68**	51

Included within the 2015 results are discontinued operations consisting of £17m profit from associates (2014: £21m profit) and £1m loss from joint ventures (2014: £1m loss). For further information on discontinued operations and the profit on sale of associates and joint ventures, see notes 3 and 31.

Investment in associates

On 16 October 2015, the Group sold 39% of its 50% stake in The Economist (see note 31 for further information). As at 31 December 2015, the Group holds an 11% stake in The Economist which has been classified as an Other financial asset (see note 15).

The Group has the following material associates:

	Principal place of business	Ownership interest	Nature of relationship	Measurement method

Penguin Random House Ltd	UK/Global	47%	See below	Equity
Penguin Random House LLC	US	47%	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. The shareholder agreement includes

Table of Contents

Notes to the consolidated financial statements continued

12. Investments in joint ventures and associates continued

Investment in associates continued

protection 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. Penguin Random House does not have a quoted market price.

The summarised financial information of the material associates is detailed below:

	2015		2014	
All figures in £ millions	**Penguin Random House**	**The Economist**	Penguin Random House	The Economist
Assets				
Current assets	**1,354**		1,355	110
Non-current assets	**1,244**		1,429	166
Liabilities				
Current liabilities	**(1,034)**		(1,113)	(190)
Non-current liabilities	**(358)**		(424)	(86)
Net assets	**1,206**		1,247	
Sales	**2,453**	**276**	2,416	320
Profit from continuing operations	**136**		74	
Profit from discontinued operations		**34**		42
Other comprehensive income/(expense)	**51**		42	(20)
Total comprehensive income	**187**	**34**	116	22
Dividends received from associate	**142**	**20**	95	21

The information above reflects the amounts presented in the financial statements of the associates, adjusted for fair value and similar adjustments. Amounts presented for The Economist cover the period up until the date of the partial disposal. 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.

Table of Contents

Notes to the consolidated financial statements continued

12. Investments in joint ventures and associates continued

Investment in associates continued

A reconciliation of the summarised financial information to the carrying value of the material associates is shown below:

	2015		2014	
All figures in £ millions	**Penguin Random House**	**The Economist**	Penguin Random House	The Economist
Opening net assets	**1,247**		1,232	16
Exchange differences	**(1)**		(1)	
Profit for the period	**136**	**34**	74	42
Other comprehensive income/(expense)	**51**		42	(20)
Dividends, net of tax paid	**(229)**	**(40)**	(100)	(42)
Additions	**2**			
Distribution from associate in excess of carrying value				4
Reversal of distribution from associate in excess of carrying value		**(3)**		
Disposal		**9**		
Closing net assets	**1,206**		1,247	
Share of net assets	**567**		586	
Goodwill	**526**		509	
Carrying value of associate	**1,093**		1,095	

Information on other individually immaterial associates is detailed below:

All figures in £ millions	**2015**	2014
Loss from continuing operations	**(9)**	(2)
Other comprehensive income		
Total comprehensive expense	**(9)**	(2)

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 2015 was £47m (2014: £54m). The loans are provided under a working capital facility and fluctuate during the year. The loan outstanding at 31 December 2015 was repaid in its entirety in January 2016.

The Group also has a current asset receivable of £27m (2014: £41m) from Penguin Random House arising from the provision of services. Included in other income (note 4) is £16m (2014: £41m) of service fees.

Investment in joint ventures

Information on joint ventures, all of which are individually immaterial, is detailed below:

All figures in £ millions	**2015**	2014
Loss from continuing operations	**(3)**	(3)
Loss from discontinued operations	**(1)**	
Other comprehensive income		
Total comprehensive expense	**(4)**	(3)

Table of Contents

Notes to the consolidated financial statements continued

13. Deferred income tax

All figures in £ millions	2015	2014
Deferred income tax assets	**276**	295
Deferred income tax liabilities	**(560)**	(714)
Net deferred income tax	**(284)**	(419)

Substantially all of the deferred income tax assets are expected to be recovered after more than one year.

Deferred income tax assets and liabilities may be offset when there is a legally enforceable right to offset current income tax assets against current income tax liabilities and when the deferred income taxes relate to the same fiscal authority. At 31 December 2015 the Group has unrecognised deferred income tax assets of £nil (2014: £4m) in respect of UK losses, £11m (2014: £14m) in respect of US losses and approximately £70m (2014: £44m) in respect of losses in other territories. The US losses relate to state taxes and therefore have expiry periods of between five and 20 years.

The recognition of the deferred income tax assets is supported by management s forecasts of the future profitability of the relevant business units.

The movement on the net deferred income tax account is as follows:

All figures in £ millions	Notes	2015	2014
At beginning of year		**(419)**	(362)
Exchange differences		**(26)**	(22)
Income statement benefit	7	**196**	10
Disposal through business disposal		**1**	(1)
Tax charge to other comprehensive income or equity		**(36)**	(18)
Transfer to current tax			(26)
At end of year		**(284)**	(419)

Included in the income statement above for 2015 is a £2m benefit (2014: £nil) relating to discontinued operations.

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	Other	Total
Deferred income tax assets					
At 1 January 2014	15	39	42	154	250
Exchange differences	1	2	4	5	12
Acquisition through business combination	2				2
Income statement benefit	10	3	7	35	55
Tax benefit/(charge) to other comprehensive income or equity			10	(7)	3
Transfer to current tax				(26)	(26)

Disposal through business disposal			(1)		(1)
At 31 December 2014	28	44	62	161	295
Exchange differences	**5**	**3**	**4**	**9**	**21**
Income statement charge	**(14)**	**(4)**	**(3)**	**(15)**	**(36)**
Tax charge to other comprehensive income or equity			**(4)**		**(4)**
At 31 December 2015	**19**	**43**	**59**	**155**	**276**

Table of Contents

Notes to the consolidated financial statements continued

13. Deferred income tax continued

Other deferred income tax assets include temporary differences on goodwill, deferred income, share-based payments, inventory and other provisions.

All figures in £ millions	Goodwill and intangibles		Other	Total
Deferred income tax liabilities				
At 1 January 2014	(584)		(28)	(612)
Exchange differences	(30)		(4)	(34)
Acquisition through business combination	(2)			(2)
Income statement benefit/(charge)	18 line; FONT-SIZE: 10pt; FONT-FAMILY: times new roman">	(6,150)		
Cash dividends paid	(5,612)		(5,606)	(5,587)
Repurchase of stock	(121)		(904)	(1,359)
Proceeds from exercise of stock options	474		219	295
Net cash provided by (used in) financing activities	11,065		10,976	(18,385)
Net (Decrease) Increase in Cash and Cash Equivalents	(155)		5,794	(7,820)
Cash and Cash Equivalents at Beginning of Period	24,098		18,304	26,124
Cash and Cash Equivalents at End of Period	$ 23,943		$24,098	$18,304

The accompanying notes are an integral part of the consolidated financial statements.

43

Table of Contents

American National Bankshares Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2009, 2008, and 2007

Note 1 – Summary of Significant Accounting Policies

Nature of Operations and Consolidation

The consolidated financial statements include the accounts of American National Bankshares Inc. and its wholly owned subsidiary, American National Bank and Trust Company (collectively referred to as the "Company"). American National Bank and Trust Company (the "Bank") offers a wide variety of retail, commercial, secondary market mortgage lending, and trust and investment services, which also include non-deposit products such as mutual funds and insurance policies.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, valuation of foreclosed real estate, deferred taxes, other than temporary impairment of investments, and fair value estimates.

In April 2006, AMNB Statutory Trust I, a Delaware statutory trust (the "Trust") and a wholly owned subsidiary of the Company was formed for the purpose of issuing preferred securities (the "Trust Preferred Securities") in a private placement pursuant to an applicable exemption from registration. Proceeds from the securities were used to fund the acquisition of Community First Financial Corporation that occurred in April 2006. Refer to Note 12 for further details concerning this variable interest entity.

All significant inter-company transactions and accounts are eliminated in consolidation, with the exception of the Trust, as detailed in Note 12.

Cash and Cash Equivalents

Cash includes cash on hand and cash with correspondent banks. Cash equivalents are short-term, highly liquid investments that are readily convertible to cash with original maturities of three months or less and are subject to an insignificant risk of change in value. Cash and cash equivalents are carried at cost.

Securities

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings, though the Company has not and currently does not maintain a trading portfolio. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Prior to the adoption of the recent accounting guidance on April 1, 2009, management considered, in determining whether other-than-temporary impairment existed, (1) the length of time and the extent to which the fair value had been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Effective April 1, 2009, the Company adopted new accounting guidance related to recognition and presentation of other-than-temporary impairment. This recent accounting guidance amends the recognition guidance for other-than-temporary impairments of debt securities and expands the financial statement disclosures for other-than-temporary impairment losses on debt and equity securities. The recent guidance replaced the “intent and ability” indication in prior guidance by specifying that (1) if a company does not have the intent to sell a debt security prior to recovery and (2) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment should be amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

Table of Contents

For equity securities, when the Company has decided to sell an impaired available-for-sale security and the entity does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made.

Due to the nature and restrictions placed on the Company's investment in common stock of the Federal Home Loan Bank of Atlanta ("FHLB") and the Federal Reserve Bank of Richmond, these securities have been classified as restricted equity securities and carried at cost.

Loans Held for Sale

Secondary market mortgage loans are designated as held for sale at the time of their origination. These loans are pre-sold with servicing released and the Company does not retain any interest after the loans are sold. These loans consist primarily of fixed-rate, single-family residential mortgage loans which meet the underwriting characteristics of certain government-sponsored enterprises (conforming loans). In addition, the Company requires a firm purchase commitment from a permanent investor before a loan can be committed, thus limiting interest rate risk. Loans held for sale are carried at the lower of cost or fair value. Gains on sales of loans are recognized at the loan closing date and are included in noninterest income.

Derivative Loan Commitments

The Company enters into mortgage loan commitments whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. Loan commitments that are derivatives are recognized at fair value on the consolidated balance sheets with net changes in their fair values recorded in other expenses. Derivative loan commitments resulted in $3,000 in expense for 2009, $9,000 in income for 2008, and $21,000 in expense for 2007.

The period of time between issuance of a loan commitment and sale of the loan generally ranges from 30 to 60 days. The Company protects itself from changes in interest rates through the use of best efforts forward delivery contracts, by committing to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed the interest rate risk on the loan. As a result, the Company is not generally exposed to significant losses nor will it realize significant gains related to its rate lock commitments due to changes in interest rates. The correlation between the rate lock commitments and the best efforts contracts is very high due to their similarity.

The market value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded in stand-alone markets. The Company determines the fair value of rate lock commitments and best efforts contracts by measuring the change in the estimated value of the underlying assets while taking into consideration the probability that the loan will be funded.

Loans

The Company makes mortgage, commercial, and consumer loans. A substantial portion of the loan portfolio is secured by real estate. The ability of the Company's debtors to honor their contracts is dependent upon the real estate and general economic conditions in the Company's market area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balance adjusted for the allowance for loan losses, and any

deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

45

The accrual of interest on loans is generally discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Loans are typically charged off when the loan is 120 days past due, unless secured and in process of collection. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

Interest accrued but not collected for loans that are placed on nonaccrual status or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash basis or cost recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Substandard and doubtful risk graded commercial, commercial real estate, and construction loans equal to or greater than $100,000 on an unsecured basis, and equal to or greater than $250,000 on a secured basis are reviewed for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment and establishing a specific allowance include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, commercial real estate, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Generally, large groups of smaller balance homogeneous loans are collectively evaluated for impairment. The Company's policy for recognizing interest income on impaired loans is consistent with its nonaccrual policy.

Accounting for Certain Loans or Debt Securities Acquired in a Transfer

The Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") requires acquired loans to be recorded at fair value and prohibits carrying over valuation allowances in the initial accounting for acquired impaired loans. Loans carried at fair value, mortgage loans held for sale, and loans to borrowers in good standing under revolving credit agreements are excluded from the accounting guidance. The yield that may be accreted is limited to the excess of the undiscounted expected cash flows over the investor's initial investment in the loan. The excess of the contractual cash flows over expected cash flows may not be recognized as an adjustment of yield. Subsequent increases in cash flows expected to be collected are recognized prospectively through an adjustment of the loan's yield over its remaining life. Decreases in expected cash flows are recognized as impairments. Refer to Note 5 for required disclosures.

Allowance for Loan Losses

The allowance for loan losses is management's estimate of probable credit losses that are inherent in the loan portfolio at the balance sheet date. Increases to the allowance are made by charges to the provision for loan losses, which is reflected in the Consolidated Statements of Income. Loan balances deemed to be uncollectible are charged-off against the allowance. Recoveries of previously charged-off amounts are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the loan portfolio in light of historical charge-off experience, the nature and volume of the loan portfolio,

and adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. The allowance for loan losses has two basic components: the formula allowance and the specific allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses along with various economic factors and, as a result, could differ from the loss incurred in the future. Allowance calculations for consumer loans are calculated on a product basis rather than by risk grade. The specific allowance uses various techniques to arrive at an estimate of loss for specifically identified impaired loans. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. Actual losses could be greater or less than the estimates.

Table of Contents

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost, less accumulated depreciation and amortization. Premises and equipment are depreciated over their estimated useful lives ranging from three years to thirty-nine years; leasehold improvements are amortized over the lives of the respective leases or the estimated useful lives of the improvements, whichever is less. Software is generally amortized over three years. Depreciation and amortization are recorded on the straight-line method.

Costs of maintenance and repairs are charged to expense as incurred. Costs of replacing structural parts of major units are considered individually and are expensed or capitalized as the facts dictate. Gains and losses on routine dispositions are reflected in current operations.

Goodwill and Intangible Assets

In accordance with current accounting guidance, goodwill is no longer subject to amortization over its estimated useful life, but is subject to at least an annual assessment for impairment by applying a fair value based test. Additionally, acquired intangible assets (such as core deposit intangibles) are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful lives. Intangible assets related to branch transactions continued to amortize. The cost of purchased deposit relationships and other intangible assets, based on independent valuation, are being amortized over their estimated lives ranging from 8.25 years to 10 years.

Trust Assets

Securities and other property held by the trust and investment services segment in a fiduciary or agency capacity are not assets of the Company and are not included in the accompanying consolidated financial statements.

Foreclosed Real Estate

Foreclosed real estate represents real estate that has been acquired through loan foreclosures or deeds received in lieu of loan payments. Generally, such properties are appraised at the time acquired, and are recorded at the lower of cost or fair value less estimated selling costs. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Income Taxes

The Company uses the balance sheet method to account for deferred income tax assets and liabilities. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being

realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Stock-Based Compensation

The accounting guidance requires companies to recognize compensation expense related to stock-based compensation awards, such as stock options and restricted stock, in their income statements over the period during which an employee is required to provide service in exchange for such award.

Earnings Per Share

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect the impact of additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company consist solely of outstanding stock options, and are determined using the treasury method.

Table of Contents

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income, although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and changes in the funded status of a defined benefit postretirement plan, are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of comprehensive income. The components of accumulated other comprehensive income (loss), net of tax, included in the equity section of the balance sheets are as follows (in thousands):

	December 31, 2009	December 31, 2008
Unrealized gains on securities available for sale	$ 2,700	$ 2,024
Unfunded pension liability	(1,591)	(3,391)
Total accumulated other comprehensive income (loss)	$ 1,109	$ (1,367)

Advertising and Marketing Costs

Advertising and marketing costs are expensed as incurred, and were $139,000, $203,000, and $300,000 in 2009, 2008, and 2007, respectively.

Reclassifications

Certain reclassifications have been made in prior years financial statements to conform to classifications used in the current year.

Recent Accounting Pronouncements

Effective July 1, 2009, the Company adopted new accounting guidance related to U.S. Generally Accepted Accounting Principles (“GAAP”) (FASB ASC 105). This guidance establishes Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) as the source of authoritative U.S GAAP recognized by FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. FASB ASC supersedes all existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in FASB ASC has become nonauthoritative. FASB will no longer issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates (ASUs), which will serve to update FASB ASC, provide background information about the guidance and provide the basis for conclusions on the changes to FASB ASC. FASB ASC is not intended to change U.S. GAAP or any requirements of the SEC. This guidance is effective for the Company as of December 31, 2009.

The Company adopted new guidance impacting FASB Topic 805: Business Combinations (Topic 805) on January 1, 2009. This guidance requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose to investors and other users all of the information needed to evaluate and understand the nature and financial effect of the business combination. The adoption of the new guidance did not have a material impact on the Company’s consolidated

financial statements.

In April 2009, the FASB issued new guidance impacting FASB Topic 805. This guidance addresses application issues raised by preparers, auditors, and members of the legal profession on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. This guidance was effective for business combinations entered into on or after January 1, 2009. This guidance did not have a material impact on the Company's consolidated financial statements.

In December 2008, the FASB issued new guidance impacting FASB Topic 715-20: Compensation Retirement Benefits – Defined Benefit Plans – General. The objectives of this guidance are to provide users of the financial statements with more detailed information related to the major categories of plan assets, the inputs and valuation techniques used to measure the fair value of plan assets and the effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period, as well as how investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies. The disclosures about plan assets required by this guidance are included in Note 18 of the Company's consolidated financial statements.

Table of Contents

In April 2009, the FASB issued new guidance impacting FASB Topic 820: Fair Value Measurements and Disclosures (Topic 820). This interpretation provides additional guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased. This also includes guidance on identifying circumstances that indicate a transaction is not orderly and requires additional disclosures of valuation inputs and techniques in interim periods and defines the major security types that are required to be disclosed. This guidance was effective for interim and annual periods ending after June 15, 2009, and should be applied prospectively. The adoption of the standard did not have a material impact on the Company’s consolidated financial statements.

In April 2009, the FASB issued new guidance impacting FASB Topic 320-10: Investments – Debt and Equity Securities. This guidance amends GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. This guidance was effective for interim and annual periods ending after June 15, 2009, with earlier adoption permitted for periods ending after March 15, 2009. The Company did not have any cumulative effect adjustment related to the adoption of this guidance.

In May 2009, the FASB issued new guidance impacting FASB Topic 855: Subsequent Events. This update provides guidance on management’s assessment of subsequent events that occur after the balance sheet date through the date that the financial statements are issued. This guidance is generally consistent with current accounting practice. In addition, it requires certain additional disclosures. This guidance was effective for periods ending after June 15, 2009 and had no impact on the Company’s consolidated financial statements.

In August 2009, the FASB issued new guidance impacting FASB Topic 820. This guidance is intended to reduce ambiguity in financial reporting when measuring the fair value of liabilities. This guidance was effective for the first reporting period (including interim periods) after issuance and had no impact on the Company’s consolidated financial statements.

In September 2009, the FASB issued new guidance impacting Topic 820. This creates a practical expedient to measure the fair value of an alternative investment that does not have a readily determinable fair value. This guidance also requires certain additional disclosures. This guidance is effective for interim and annual periods ending after December 15, 2009. The adoption of the new guidance did not have a material impact on its consolidated financial statements.

Accounting Standards Not Yet Effective

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as Statement of Financial Accounting Standards (“SFAS”) No. 166, Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140, was adopted into Codification in December 2009 through the issuance of Accounting Standards Update (“ASU”) 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement, if any, in transferred financial assets. The Company will adopt the new guidance in 2010 and is evaluating the impact it will have, if any, on its consolidated financial statements.

In June 2009, the FASB issued new guidance relating to the variable interest entities. The new guidance, which was issued as SFAS No. 167, Amendments to FASB Interpretation No. 46(R), was adopted into Codification in December 2009. The objective of the guidance is to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. SFAS No. 167

is effective as of January 1, 2010. The Company does not expect the adoption of the new guidance to have a material impact on its consolidated financial statements.

In October 2009, the FASB issued ASU 2009-15, Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing. ASU 2009-15 amends Subtopic 470-20 to expand accounting and reporting guidance for own-share lending arrangements issued in contemplation of convertible debt issuance. ASU 2009-15 is effective for fiscal years beginning on or after December 15, 2009 and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The Company does not expect the adoption of ASU 2009-15 to have a material impact on its consolidated financial statements.

Table of Contents

In January 2010, the FASB issued ASU 2010-01, Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash – a consensus of the FASB Emerging Issues Task Force. ASU 2010-01 clarifies that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in earnings per share (‘EPS”) prospectively and is not a stock dividend. ASU 2010-01 is effective for interim and annual periods ending on or after December 15, 2009 and should be applied on a retrospective basis. The Company does not expect the adoption of ASU 2010-01 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU 2010-02, Consolidation (Topic 810): Accounting and reporting for Decreases in Ownership of a Subsidiary – a Scope Clarification. ASU 2010-02 amends Subtopic 810-10 to address implementation issues related to changes in ownership provisions including clarifying the scope of the decrease in ownership and additional disclosures. ASU 2010-02 is effective beginning in the period that an entity adopts Statement 160. If an entity has previously adopted Statement 160, ASU 2010-02 is effective beginning in the first interim or annual reporting period ending on or after December 15, 2009 and should be applied retrospectively to the first period Statement 160 was adopted. The Company does not expect the adoption of ASU 2010-02 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU 2010-04, Accounting for Various Topics – Technical Corrections to SEC Paragraphs. ASU 2010-04 makes technical corrections to existing SEC guidance including the following topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements - subsequent events, use of residential method to value acquired assets other than goodwill, adjustments in assets and liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. The Company does not expect the adoption of ASU 2010-04 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU 2010-05, Compensation – Stock Compensation (Topic 718): Escrowed Share Arrangements and the Presumption of Compensation. ASU 2010-05 updates existing guidance to address the SEC staff’s views on overcoming the presumption that for certain shareholders escrowed share arrangements represent compensation. The Company does not expect the adoption of ASU 2010-05 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers’ disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The Company does not expect the adoption of ASU 2010-06 to have a material impact on its consolidated financial statements.

In February 2010, the FASB issued ASU 2010-08, Technical Corrections to Various Topics. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The Company does not expect the adoption of ASU 2010-08 to have a material impact on its consolidated financial statements.

Note 2 – Restrictions on Cash and Amounts Due From Banks

The Company is a member of the Federal Reserve System and is required to maintain certain levels of its cash and cash equivalents as reserves based on regulatory requirements. This reserve requirement was approximately $6,937,000 at December 31, 2009 and $7,795,000 at December 31, 2008.

The Company maintains cash accounts in other commercial banks. The amount on deposit with correspondent institutions at December 31, 2009 did not exceed the insurance limits of the Federal Deposit Insurance Corporation.

50

Table of Contents

Note 3 - Securities

The amortized cost and estimated fair value of investments in debt securities at December 31, 2009 and 2008 were as follows:

	December 31, 2009			
(in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Securities available for sale:				
Federal agencies & GSE	$ 81,279	$ 1,474	$ 7	$ 82,746
Mortgage-backed	41,365	1,535	310	42,590
State and municipal	58,035	1,442	181	59,296
Corporate	3,962	201	-	4,163
Total securities available for sale	184,641	4,652	498	188,795
Securities held to maturity:				
Mortgage-backed	199	14	-	213
State and municipal	6,330	220	-	6,550
Total securities held to maturity	6,529	234	-	6,763
Total securities	$ 191,170	$ 4,886	$ 498	$ 195,558

	December 31, 2008			
(in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Securities available for sale:				
Federal agencies & GSE	$ 43,331	$ 2,093	$ 8	$ 45,416
Mortgage-backed	45,139	1,040	496	45,683
State and municipal	36,726	653	74	37,305
Corporate	1,485	3	96	1,392
Total securities available for sale	126,681	3,789	674	129,796
Securities held to maturity:				
Mortgage-backed	254	10	-	264
State and municipal	6,867	261	1	7,127
Total securities held to maturity	7,121	271	1	7,391
Total securities	$ 133,802	$ 4,060	$ 675	$ 137,187

The amortized cost and estimated fair value of investments in securities at December 31, 2009, by contractual maturity, are shown in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Because mortgage-backed securities have both known principal repayment terms as well as unknown principal repayments due to potential borrower pre-payments, it is difficult to accurately predict the final maturity of these investments. Mortgage-backed securities are shown separately.

Table of Contents

(in thousands)	Available for Sale Amortized Cost	Available for Sale Estimated Fair Value	Held to Maturity Amortized Cost	Held to Maturity Estimated Fair Value
Due in one year or less	$ 39,053	$ 39,417	$ 1,406	$ 1,417
Due after on year through five years	61,364	63,158	1,448	1,500
Due after five years through ten years	25,695	26,279	3,476	3,633
Due after ten years	17,164	17,351	-	-
Mortgage-backed securities	41,365	42,590	199	213
	$ 184,641	$ 188,795	$ 6,529	$ 6,763

Gross realized gains and losses from the call of certain securities or the sale of securities available for sale were as follows (in thousands):

	For the Years Ended December 31, 2009	2008	2007
Realized gains	$ 3	$ 51	$ 135
Realized losses	-	(501)	-

Securities with a carrying value of approximately $115,444,000 and $90,683,000, at December 31, 2009 and 2008, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required by law.

Corporate bonds consist of investment grade debt securities, primarily issued by financial services companies.

Temporarily Impaired Securities

The following table shows estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2009. The reference point for determining when securities are in an unrealized loss position is month-end. Therefore, it is possible that a security's market value exceeded its amortized cost on other days during the past twelve-month period.

Available for sale and held to maturity securities that have been in a continuous unrealized loss position are as follows:

	Total		Less than 12 Months		12 Months or More	
(in thousands)	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
GSE debt securities	$ 28,918	$ 7	$ 28,918	$ 7	$ -	$ -
Mortgage-backed	7,294	95	7,294	95	-	-
Private label CMO's	2,151	215	-	-	2,151	215
State and municipal	7,420	181	6,991	145	429	36

Total	$ 45,783	$ 498	$ 43,203	$ 247	$ 2,580	$ 251

GSE debt securities. The unrealized losses on the five investments in GSEs ("government sponsored entities") were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2009.

52

Table of Contents

GSE residential mortgage-backed securities. The unrealized losses on the Company's investment in five GSE mortgage-backed securities were caused by interest rate increases. The Company purchased those investments at a discount relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company’s investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2009.

Private-Label Residential Mortgage-Backed Securities: The unrealized losses associated with four private residential collateralized mortgage obligations (“CMOs”) are primarily driven by higher projected collateral losses, wider credit spreads and changes in interest rates. We assess for credit impairment using a cash flow model. Based upon our assessment of the expected credit losses of the security given the performance of the underlying collateral compared to our credit enhancement, we expect to recover the entire amortized cost basis of these securities.

State and municipal securities: The unrealized losses on the 12 investments in state and municipal securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2009.

The Company’s investment in Federal Home Loan Bank (“FHLB”) stock totaled $2,812,000 at December 31, 2009. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock, other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. Despite the FHLB’s temporary suspension of repurchases of excess capital stock in 2009, the Company does not consider this investment to be other-than-temporarily impaired at December 31, 2009 and no impairment has been recognized. FHLB stock is shown in restricted stock on the balance sheet and is not a part of the available for sale securities portfolio.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities had been in a continuous unrealized loss position, at December 31, 2008.

	Total		Less than 12 Months		12 Months or More	
(in thousands)	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
GSE debt securities	$ 1,583	$ 8	$ 1,583	$ 8	$ -	$ -
Mortgage-backed	1,751	28	735	4	1,016	24
Private label CMO’s	2,733	468	2,733	468	-	-
State and municipal	3,581	75	3,581	75	-	-
Corporate	389	96	-	-	389	96
Total	$ 10,037	$ 675	$ 8,632	$ 555	$ 1,405	$ 120

Note 4 – Loans

Loans, excluding loans held for sale, were comprised of the following:

(in thousands)	December 31, 2009	December 31, 2008
Construction and land development	$ 40,371	$ 63,361
Commercial real estate	208,066	207,160
Residential real estate	121,639	136,480
Home equity	64,678	57,170
Total real estate	434,754	464,171
Commercial and industrial	86,312	98,546
Consumer	6,925	8,393
Total loans	$ 527,991	$ 571,110

Table of Contents

Net deferred loan costs included in the above loan categories are $177,000 for 2009 and $244,000 for 2008. Overdraft deposits were reclassified to consumer loans in the amount of $62,000 and $109,000 for 2009 and 2008, respectively.

The following is a summary of information pertaining to impaired and nonaccrual loans:

(in thousands)	December 31, 2009	December 31, 2008
Impaired loans with a valuation allowance	$ 1,284	$ 2,545
Impaired loans without a valuation allowance	2,540	647
Total impaired loans	$ 3,824	$ 3,192
Allowance provided for impaired loans, included in the allowance for loan losses	$ 796	$ 1,164
Nonaccrual loans excluded from the impaired loan disclosure	$ 1,885	$ 1,574

(in thousands)	Years Ended December 31, 2009	2008	2007
Average balance in impaired loans	$ 3,211	$ 4,829	$ 2,540
Interest income recognized on impaired loans	$ 124	$ 152	$ 262
Interest income recognized on nonaccrual loans	$ -	$ -	$ -
Loans past due 90 days and still accruing interest	$ -	$ -	$ -

No additional funds are committed to be advanced in connection with impaired loans.

Note 5 – Accounting for Certain Loans Acquired in a Transfer

The Company acquired loans pursuant to the acquisition of Community First Financial Corporation (“Community First”) in April 2006. In accordance with accounting guidance, at acquisition the Company reviewed each loan to determine whether there was evidence of deterioration of credit quality since origination and if it was probable that it would be unable to collect all amounts due according to the loan’s contractual terms. When both conditions existed,

the Company accounted for each loan individually, considered expected payments, and estimated the amount and timing of undiscounted expected principal, interest, and other cash flows (expected at acquisition) for each loan. The Company determined the excess of the loan's scheduled contractual principal and contractual interest payments over all cash flows expected at acquisition as an amount that should not be accreted into interest income (nonaccretable difference). The remaining amount, representing the excess of the loan's cash flows expected to be collected over the amount paid, is accreted into interest income over the remaining life of the loan (accretable yield).

Over the life of the loan, the Company continues to estimate cash flows expected to be collected. The Company evaluates at the balance sheet date whether the present value of its loans determined using the effective interest rates has decreased and if so, establishes a valuation allowance for the loan. Valuation allowances for acquired loans subject to FASB ASC 310-30-3 reflect only those losses incurred after acquisition – that is, the present value of cash flows expected at acquisition that are not expected to be collected. Valuation allowances are established only subsequent to acquisition of the loans. For loans that are not accounted for as debt securities, the present value of any subsequent increase in the loan's or pool's actual cash flows or cash flows expected to be collected is used first to reverse any existing valuation allowance for that loan. For any remaining increases in cash flows expected to be collected, the Company adjusts the amount of accretable yield recognized on a prospective basis over the loan's remaining life. The Company does not have any such loans that were accounted for as debt securities.

Loans that were acquired in the Community First acquisition, for which there was evidence of deterioration of credit quality since origination and for which it was probable that all contractually required payments would not be made, had an outstanding balance of $539,000 and a carrying amount $198,000 at December 31, 2009 and an outstanding balance of $665,000 and a carrying amount of $344,000 at December 31, 2008.

Table of Contents

The carrying amount of these loans is included in the balance sheet amount of loans receivable at December 31, 2009 and 2008. These loans are not included in the impaired loan amounts disclosed in Note 4.

(in thousands)	Accretable Yield
Balance at December 31, 2007	$ 111
Accretion	(20)
Disposals	(46)
Balance at December 31, 2008	45
Accretion	(14)
Balance at December 31, 2009	$ 31

Note 6 – Allowance for Loan Losses and Reserve for Unfunded Lending Commitments

Changes in the allowance for loan losses and the reserve for unfunded lending commitments for each of the years in the three-year period ended December 31, 2009, are presented below:

	Years Ended December 31,		
(in thousands)	2009	2008	2007
Allowance for Loan Losses			
Balance, beginning of year	$ 7,824	$ 7,395	$ 7,264
Provision for loan losses	1,662	1,620	403
Charge-offs	(1,601)	(1,564)	(515)
Recoveries	281	373	243
Balance, end of year	$ 8,166	$ 7,824	$ 7,395

	Years Ended December 31,		
	2009	2008	2007
Reserve for Unfunded Lending Commitments			
Balance, beginning of year	$ 475	$ 151	$ 123
Provision for unfunded commitments	-	324	28
Charge-offs	215	-	-
Balance, end of year	$ 260	$ 475	$ 151

The reserve for unfunded loan commitments is included in other liabilities.

Note 7 – Premises and Equipment

Major classifications of premises and equipment are summarized as follows:

(in thousands)	December 31,	
	2009	2008
Land	$ 4,455	$ 3,977

Buildings		17,399		15,686
Leasehold improvements		558		535
Furniture and equipment		13,524		12,497
		35,936		32,695
Accumulated depreciation		(16,741)		(15,566)
Premises and equipment, net	$	19,195	$	17,129

Depreciation expense for the years ended December 31, 2009, 2008, and 2007 was $1,201,000, $1,086,000 and $1,178,000, respectively.

55

Table of Contents

The Company has entered into operating leases for several of its branch and ATM facilities. The minimum annual rental payments under these leases at December 31, 2009 are as follows:

(in thousands) Year	Minimum Lease Payments
2010	$ 267
2011	139
2012	107
2013	68
2014 and after	6
	$ 587

Rent expense for the years ended December 31, 2009, 2008, and 2007 was $325,000, $329,000, and 353,000, respectively.

Note 8– Goodwill and Other Intangible Assets

In accordance with accounting guidance, goodwill is no longer subject to amortization, but is subject to at least an annual assessment for impairment by applying a fair value test. An annual fair value-based test was performed in 2009 that determined the market value of the Company's shares exceeded the consolidated carrying value, including goodwill; therefore, there has been no impairment recognized in the value of goodwill.

The changes in the carrying amount of goodwill for the year ended December 31, 2009, are as follows (in thousands):

	Amount
Balance as of January 1, 2009	$ 22,468
Goodwill recorded during year	-
Impairment losses	-
Balance as of December 31, 2009	$ 22,468

Core deposit intangibles resulting from the Community First acquisition in April 2006 were $3,112,000 and are being amortized over 99 months.

Goodwill and intangible assets are as follow (in thousands):

	Gross Carrying Value	Accumulated Amortization	Net Carrying Value
December 31, 2009			
Core deposit intangibles	$ 3,112	$ 1,414	$ 1,698
Goodwill	22,468	-	22,468

December 31, 2008			
Core deposit intangibles	$ 3,112	$ 1,037	$ 2,075
Goodwill	22,468	-	22,468

Amortization expense of core deposit intangibles for each of the years ended December 31, 2009, 2008, and 2007 totaled $377,000. As of December 31, 2009, the estimated future amortization expense of core deposit intangibles is as follows (in thousands):

Year	Amount
2010	$ 377
2011	377
2012	377
2013	377
2014	190

Table of Contents

Note 9 - Deposits

The aggregate amount of time deposits in denominations of $100,000 or more at December 31, 2009 and 2008 was $117,296,000 and $107,186,000, respectively.

At December 31, 2009, the scheduled maturities of certificates of deposits (included in "time" deposits on the Consolidated Balance Sheet) were as follows (in thousands):

Year	Amount
2010	$ 177,818
2011	46,351
2012	15,871
2013	23,154
2014	4,751
2015	141
	$ 268,086

Note 10 – Short-term Borrowings

Short-term borrowings consist of customer repurchase agreements, overnight borrowings from the FHLB, and Federal Funds purchased. Customer repurchase agreements are collateralized by securities of the U.S. Government or its agencies. They mature daily. The interest rates are generally fixed but may be changed at the discretion of the Company. The securities underlying these agreements remain under the Company's control. FHLB overnight borrowings contain floating interest rates that may change daily at the discretion of the FHLB. Federal Funds purchased are unsecured overnight borrowings from other financial institutions. Short-term borrowings consisted of the following as of December 31, 2009 and 2008 (in thousands):

	2009	2008
Customer repurchase agreements	$ 65,929	$ 51,741
FHLB overnight borrowings	-	7,850
	$ 65,929	$ 59,591

Note 11 – Long-term Borrowings

Under the terms of its collateral agreement with the FHLB, the Company provides a blanket lien covering all of its residential first mortgage loans, second mortgage loans and home equity lines of credit. In addition, the Company pledges as collateral its capital stock in the FHLB and deposits with the FHLB. The Company has a line of credit with the FHLB equal to 30% of the Company's assets, subject to the amount of collateral pledged. As of December 31, 2009, $92,789,000 in 1-4 family residential mortgage loans and $59,761,000 in home equity lines of credit were pledged under the blanket floating lien agreement which covers both short-term and long-term borrowings. Long-term borrowings consisted of the following fixed rate, long term advances as of December 31, 2009 and 2008 (in thousands):

Due by December 31	2009 Advance Amount	Weighted Average Rate	Due by December 31	2008 Advance Amount	Weighted Average Rate
2011	$ 8,000	2.93	2009	$ 5,000	5.26 %
2014	638	3.78	2011	8,000	2.93
	$ 8,638	2.99 %	2014	787	3.78
				$ 13,787	3.82 %

In the regular course of conducting its business, the Company takes deposits from political subdivisions of the Commonwealth of Virginia. At December 31, 2009, the Bank's public deposits totaled $60,041,000. The Company is required to provide collateral to secure the deposits that exceed the insurance coverage provided by the Federal Deposit Insurance Corporation. This collateral can be provided in the form of certain types of government or agency bonds or letters of credit from the FHLB. At year-end 2009, the Company had $40 million in letters of credit with the FHLB outstanding to provide collateral for such deposits.

Table of Contents

Note 12 – Trust Preferred Capital Notes

On April 7, 2006, AMNB Statutory Trust I, a Delaware statutory trust and a newly formed, wholly owned subsidiary of the Company, issued $20,000,000 of preferred securities in a private placement pursuant to an applicable exemption from registration. The Trust Preferred Securities mature on June 30, 2036, but may be redeemed at the Company's option beginning on June 30, 2011. The securities require quarterly distributions by the Trust to the holder of the Trust Preferred Securities at a fixed rate of 6.66%. Effective June 30, 2011, the rate will reset quarterly at the three-month LIBOR plus 1.35%. Distributions are cumulative and will accrue from the date of original issuance, but may be deferred by the Company from time to time for up to twenty consecutive quarterly periods. The Company has guaranteed the payment of all required distributions on the Trust Preferred Securities.

The proceeds of the Trust Preferred Securities received by the Trust, along with proceeds of $619,000 received by the Trust from the issuance of common securities by the Trust to the Company, were used to purchase $20,619,000 of the Company's junior subordinated debt securities (the "Trust Preferred Capital Notes"), issued pursuant to a Junior Subordinated Indenture entered into between the Company and Wilmington Trust Company, as trustee. The proceeds of the Trust Preferred Capital Notes were used to fund the cash portion of the merger consideration to the former shareholders of Community First in connection with the Company's acquisition of that company, and for general corporate purposes. In accordance with FASB ASC 810-10-15-14, the Corporation did not eliminate through consolidation the Corporation's $619,000 equity investment in AMNB Statutory Trust I. Instead, the Corporation reflected this equity investment in the "Accrued interest receivable and other assets" line item in the consolidated balance sheets.

Note 13 – Stock-Based Compensation

The Company's 1997 Stock Option Plan ("1997 Option Plan") provided for the granting of incentive and non-statutory options to employees on a periodic basis, at the discretion of the Board or a Board designated committee. The 1997 Option Plan authorized the issuance of up to 300,000 shares of common stock. There were no options granted since 2004, and, effective December 31, 2006, no further options may be granted under this plan.

The 2008 Stock Incentive Plan ("2008 Option Plan") was adopted by the Board of Directors of the Company on February 19, 2008 and approved by the stockholders on April 22, 2008. The 2008 Option Plan provides for the granting of restricted stock awards and incentive and non-statutory options to employees and directors on a periodic basis, at the discretion of the Board or a Board designated committee. The 2008 Option Plan authorizes the issuance of up to 500,000 shares of common stock. Accounting guidance requires that compensation cost relating to share-based payment transactions be recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued.

A summary of stock option transactions is as follows:

	Option Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at December 31, 2008	218,610	$ 20.31		
Granted	6,000	16.00		
Exercised	(32,307)	14.66		

Forfeited	(29,700)		19.67			
Outstanding at December 31, 2009	162,603	$	21.39	5.7 years	$	361
Exercisable at December 31, 2009	132,103	$	22.43	4.9 years	$	208

The aggregate intrinsic value of stock options in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2009. This amount changes based on changes in the market value of the Company's stock.

The total proceeds of the in-the-money options exercised during the year ended December 31, 2009, 2008, and 2007 was $474,000, $219,000 and $295,000, respectively. Total intrinsic value of options exercised during years ended December 31, 2009, 2008, and 2007 was $105,000, $51,000, and $110,000, respectively.

Table of Contents

As of December 31, 2009 and 2008, there was $127,000 and $176,000, respectively, in unrecognized compensation expense. There was no unrecognized compensation expense as of December 31, 2007. Compensation expense related to stock options was $62,000 in 2009, $59,000 in 2008, and $0 in 2007.

The following table summarizes information related to stock options outstanding on December 31, 2009:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Outstanding Options	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
16.00 to 20.00	79,776	7.1 yrs	$ 17.37	49,276	$ 17.68
20.01 to 25.00	44,200	4.8	24.45	44,200	24.45
25.01 to 26.20	38,627	3.8	26.18	38,627	26.18
	162,603	5.7 yrs	$ 21.39	132,103	$ 22.43

The fair value of each stock option granted in 2009 and 2008 was estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table:

	2009	2008
Dividend yield	5.75 %	5.41 %
Expected life in years	6.6	6.6
Expected volatility	17.90 %	18.10 %
Risk-free interest rate	3.61 %	1.77 %
Weighted average fair value per option granted	$ 4.63	$ 3.98

The expected volatility is based on historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on the Company’s history and expectation of dividend payouts.

Table of Contents

Note 14 – Income Taxes

The Company files income tax returns in the U.S. federal jurisdiction and the states of Virginia and North Carolina. With few exceptions, the Company is no longer subject to U.S. federal, state, and local income tax examinations by tax authorities for years prior to 2006.

The components of the Company's net deferred tax assets (liabilities) were as follows:

(in thousands)	December 31, 2009	December 31, 2008
Deferred tax assets:		
Allowance for loan losses	$ 2,858	$ 2,675
Nonaccrual loan interest	149	165
OREO valuation allowance	449	26
Deferred compensation	203	211
Allowance for off balance sheet items	91	166
Loans	177	373
Other	48	24
Total deferred tax assets	3,975	3,640
Deferred tax liabilities:		
Depreciation	799	1,005
Accretion of discounts on securities	43	33
Core deposit intangibles	594	508
Deferred loan fees	62	86
Net unrealized gains on securities	1,454	1,090
Prepaid pension expense	841	240
Pension liability	857	1,826
Other	52	52
Total deferred tax liabilities	4,702	4,840
Net deferred tax assets (liabilities)	$ (727)	$ (1,200)

The provision for income taxes consists of the following:

(in thousands)	Years Ended December 31, 2009	2008	2007
Taxes currently payable	$ 2,393	$ 2,490	$ 4,943
Deferred tax expense (benefit)	132	691	(67)
	$ 2,525	$ 3,181	$ 4,876

The effective tax rates differ from the statutory federal income tax rates due to the following items:

	Years Ended December 31, 2009	2008	2007
Federal statutory rate	34.0 %	34.1 %	34.4 %
Nontaxable interest income	(6.3)	(4.9)	(3.5)
Other	(0.7)	(0.8)	(1.0)
Effective rate	27.0 %	28.4 %	29.9 %

Note 15 – Earnings Per Share

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of potentially dilutive common stock. Potentially dilutive common stock had no effect on income available to common shareholders.

	Years Ended December 31,					
	2009		2008		2007	
	Shares	Per Share Amount	Shares	Per Share Amount	Shares	Per Share Amount
Basic earnings per share	6,097,810	$ 1.12	6,096,649	$ 1.32	6,139,095	$ 1.86
Effect of dilutive securities - stock options	5,085	-	8,505	(.01)	22,730	-
Diluted earnings per share	6,102,895	$ 1.12	6,105,154	$ 1.31	6,161,825	$ 1.86

Table of Contents

Stock options on common stock which were not included in computing diluted EPS in 2009, 2008, and 2007, because their effects were antidilutive averaged 102,669 shares, 118,640 shares, and 89,277 shares, respectively.

Note 16 – Off-Balance Sheet Activities

The Company is party to credit-related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheets. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if applicable, is based on management's credit evaluation of the customer.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

The following off-balance sheet financial instruments were outstanding whose contract amounts represent credit risk:

	December 31,	
(in thousands)	2009	2008
Commitments to extend credit	$ 133,692	$ 146,399
Standby letters of credit	2,624	2,858
Mortgage loan rate lock commitments	2,054	2,031

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. These commitments generally consist of unused portions of lines of credit issued to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

At December 31, 2009, the Company had entered into commitments, on a best-effort basis, to sell loans of approximately $4,544,000. These commitments include mortgage loan commitments and loans held for sale. Risks arise from the possible inability of counterparties to meet the terms of their contracts.

Note 17 – Related Party Loans

In the ordinary course of business, loans are granted to executive officers, directors, and their related entities. Management believes that all such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans to similar, unrelated borrowers, and do not involve more than a normal risk of collectability or present other unfavorable features. As of December 31, 2009, none of

these loans were restructured, past due, or on nonaccrual status.

An analysis of these loans for 2009 is as follows (in thousands):

Balance at December 31, 2008	$19,795
Additions	6,900
Repayments	(8,152)
Balance at December 31, 2009	$18,543

Table of Contents

Note 18 – Employee Benefit Plans

Defined Benefit Plan

Until December 31, 2009, the Company maintained a non-contributory defined benefit pension plan which covered substantially all employees who were 21 years of age or older and who had at least one year of service. The Company froze its pension plan to new participants and converted its pension plan to a cash balance plan effective December 31, 2009. Each year existing participants will receive, with some adjustments, income based on the yield of the ten year U.S. Treasury Note in December of the preceding year.

Previously, advanced funding was accomplished by using the actuarial cost method known as the collective aggregate cost method. Prior to 2008, the Company used October 31 as a measurement date to determine postretirement benefit obligations. The requirement to measure plan assets and benefit obligations as of the date of the employers' fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008.

Information pertaining to the activity in the plan is as follows:

(in thousands)	As of and for the Years Ended December 31,		
	2009	2008	2007
Change in Benefit Obligation:			
Projected benefit obligation at beginning of year	$ 9,582	$ 8,923	$ 7,038
Service cost	737	843	656
Interest cost	585	600	418
Actuarial loss (gain)	1,004	(627)	987
Benefits paid	(2,130)	(157)	(176)
Decrease in obligations due to curtailment	(964)	-	-
Projected benefit obligation at end of year	8,814	9,582	8,923
Change in Plan Assets:			
Fair value of plan assets at beginning of year	10,184	8,230	7,070
Actual return on plan assets	1,998	(2,888)	1,336
Employer contributions	-	5,000	-
Benefits paid	(964)	(158)	(176)
Fair value of plan assets at end of year	11,218	10,184	8,230
Funded Status at End of Year	$ 2,404	$ 602	$ (693)
Amounts Recognized in the Consolidated Balance Sheets			
Other assets (liabilities)	$ 2,404	$ 602	$ (693)
Amounts Recognized in Accumulated Other Comprehensive Income			
Net actuarial loss	$ 2,448	$ 5,205	$ 2,308
Prior service cost	-	13	12

Deferred income tax benefit	(857)	(1,827)	(812)
Amount recognized	$ 1,591	$ 3,391	$ 1,508
Components of Net Periodic Benefit Cost			
Service cost	$ 737	$ 723	$ 656
Interest cost	585	515	418
Expected return on plan assets	(812)	(657)	(564)
Amortization of prior service cost	13	(1)	(1)
Recognized net actuarial loss	445	112	150
Net periodic benefit cost	$ 968	$ 692	$ 659

A Adjustment to Retained Earnings Due to Change in Measurement Date			
Service cost	N/A	$ 121	N/A
Interest cost	N/A	86	N/A
Expected return on plan assets	N/A	(110)	N/A
Recognized net actuarial loss	N/A	18	N/A
Net periodic benefit cost	N/A	$ 115	N/A

Table of Contents

	As of and for the Years Ended December 31,		
	2009	2008	2007
Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive Income			
Net actuarial loss	$ (2,757)	$ 2,897	$ 65
Amortization of prior service cost	(13)	1	1
Total recognized in other comprehensive income	$ (2,770)	$ 2,898	$ 66
Total Recognized in Net Periodic Benefit Cost, Retained Earnings and Other Comprehensive Income	$ (1,802)	$ 3,705	$ 725

	2009	2008	2007
Weighted-Average Assumptions at End of Year			
Discount rate used for net periodic pension cost	6.00 %	6.00 %	6.00 %
Discount rate used for disclosure	5.00 %	6.00 %	6.00 %
Expected return on plan assets	8.00 %	8.00 %	8.00 %
Rate of compensation increase	4.00 %	4.00 %	4.00 %
N/A – not applicable			

The accumulated benefit obligation as of December 31, 2009, 2008, and 2007 was $8,814,000, $6,942,000, and $6,499,000, respectively.

The plan sponsor selected the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary. This rate was intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed, especially with respect to real rates of return (net of inflation), for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience that may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period in which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).

Below is a description of the plan's assets. The plan's weighted-average asset allocations by asset category are as follows:

Asset Category	December 31,	December 31, 2008

	2009			
Fixed Income	33.2	%	24.8	%
Equity	47.5		34.0	
Mutual Funds	6.5		5.5	
Cash and Accrued Income	12.8		35.7	
Total	100.0	%	100.0	%

The investment policy and strategy for plan assets can best be described as a growth and income strategy. Diversification is accomplished by limiting the holding of any one equity issuer to no more than 5% of total equities. Exchange traded funds are used to provide diversified exposure to the small capitalization and international equity markets. All fixed income investments are rated as investment grade, with the majority of these assets invested in corporate issues. The assets are managed by the Company's Trust and Investment Services Division. No derivatives are used to manage the assets. Equity securities do not include holdings in the Company.

Table of Contents

The fair value of the Company’s pension plan assets at December 31, 2009, by asset category, are as follows (in thousands):

		Fair Value Measurements at December 31, 2009 Using		
Asset Category	Balance as of December 31, 2009	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Cash	$ 1,406	$ 1,406	$ -	$ -
Fixed income securities				
Government sponsored entities	1,342	-	1,342	-
Corporate bonds & notes	2,090	-	2,090	-
Bank certificates of deposit	297	297	-	-
Mutual funds	713	-	713	
Equity securities				
U.S. companies	5,075	5,075	-	-
Foreign companies	253	253	-	-
Exchange traded funds	10	-	10	-
Accrued interest and dividends	32	32	-	-
	$ 11,218	$ 7,063	$ 4,155	$ -

Projected benefit payments for the years 2010 to 2019 are as follows (in thousands):

Year	Amount
2010	$ 892
2011	1,793
2012	679
2013	676
2014	1,182
2015-2019	2,525

401(k) Plan

The Company maintains a 401(k) savings plan that covers substantially all full-time employees of the Company. The Company matches a portion of the contribution made by employee participants after at least one year of service. The Company contributed $258,000, $263,000, and $273,000 to the 401(k) plan in 2009, 2008, and 2007, respectively. These amounts are included employee benefits expense for the respective years.

Deferred Compensation Arrangements

The Company maintains deferred compensation agreements with certain current and former employees providing for annual payments to each ranging from $25,000 to $50,000 per year for ten years upon their retirement. The liabilities under these agreements are being accrued over the officers' remaining periods of employment so that, on the date of their retirement, the then-present value of the annual payments would have been accrued. The expense for these agreements was $33,000, $33,000, and $55,000 for years 2009, 2008, and 2007, respectively.

Profit Sharing and Incentive Arrangements

The Company maintains a cash profit sharing plan for full-time employees based on the Company's performance and a cash incentive compensation plan for officers based on the Company's performance and individual officer goals. The total amount charged to salary expense for these plans was $176,000, $0, and $287,000 for the years 2009, 2008, and 2007, respectively.

Table of Contents

Note 19 – Fair Value Measurements

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Fair Value Measurements and Disclosures topic of FASB ASC, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The recent fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 – Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 – Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using

pricing models that consider observable market data (Level 2). Federal Reserve Bank of Richmond and Federal Home Loan Bank stocks are carried at cost since no ready market exists and there is no quoted market value. The Company is required to own stock in these entities as long as it is a member. Therefore, they have been excluded from the table below.

Table of Contents

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2009 (in thousands):

		Fair Value Measurements at December 31, 2009 Using		
Description	Balance as of December 31, 2009	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Securities available for sale	$ 188,795	$ -	$ 188,795	$ -

		Fair Value Measurements at December 31, 2008 Using		
Description	Balance as of December 31, 2008	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Securities available for sale	$ 129,796	$ -	$ 129,796	$ -

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Company to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

Loans held for sale: Loans held for sale are carried at estimated fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Company records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the year ended December 31, 2009. Gains and losses on the sale of loans are recorded within income from mortgage banking on the Consolidated Statements of Income.

Impaired loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price

of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Table of Contents

Other real estate owned: Certain assets such as other real estate owned (“OREO”) are measured at fair value less cost to sell. We believe that the fair value component in our valuation of OREO follows the provisions of accounting standards.

The following table summarizes the Company’s assets that were measured at fair value on a nonrecurring basis during the period (in thousands):

		Fair Value Measurements at December 31, 2009 Using		
Description	Balance as of December 31, 2009	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets				
Loans held for sale	$ 2,490	$ -	$ 2,490	$ -
Impaired loans, net of valuation allowance	488	-	488	-
Other real estate owned	3,414	-	3,414	-

		Fair Value Measurements at December 31, 2008 Using		
Description	Balance as of December 31, 2008	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets				
Loans held for sale	$ 1,764	$ -	$ 1,764	$ -
Impaired loans, net of valuation allowance	1,381	-	600	781
Other real estate owned	4,311	-	4,311	-

The estimated fair values, and related carrying or notional amounts, of the Company’s financial instruments are as follows:

	December 31, 2009		December 31, 2008	
(in thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and due from banks	$ 23,943	$ 23,943	$ 24,098	$ 24,098

Securities available for sale *		188,795		188,795		129,796		129,796
Securities held to maturity		6,529		6,673		7,121		7,391
Loans held for sale		2,490		2,490		1,764		1,764
Loans, net of allowance		519,825		528,631		563,286		575,970
Accrued interest receivable		3,268		3,268		3,110		3,110
Financial liabilities:								
Deposits	$	604,273	$	607,015	$	589,138	$	591,159
Repurchase agreements		65,929		65,929		51,741		51,741
Other borrowings		8,638		8,620		21,637		21,630
Trust preferred capital notes		20,619		20,640		20,619		18,258
Accrued interest payable		899		899		1,272		1,272
* - Excludes restricted stock								

67

Table of Contents

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

Cash and cash equivalents. The carrying amount is a reasonable estimate of fair value.

Securities. Fair values are based on quoted market prices or dealer quotes.

Loans held for sale. The carrying amount is a reasonable estimate of fair value.

Loans. For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans are estimated based upon discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Accrued interest receivable. The carrying amount is a reasonable estimate of fair value.

Deposits. The fair value of demand deposits, savings deposits, and money market deposits equals the carrying value. The fair value of fixed-rate certificates of deposit is estimated by discounting the future cash flows using the current rates at which similar deposit instruments would be offered to depositors for the same remaining maturities.

Repurchase agreements. The carrying amount is a reasonable estimate of fair value.

Other borrowings. The fair values of long-term borrowings are estimated using discounted cash flow analyses based on the interest rates for similar types of borrowing arrangements.

Trust preferred capital notes. Fair value is calculated by discounting the future cash flows using the estimated current interest rates at which similar securities would be issued.

Accrued interest payable. The carrying amount is a reasonable estimate of fair value.

Off-balance sheet instruments. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2009 and 2008, the fair value of off balance sheet instruments was deemed immaterial, and therefore was not included in the table above. The various off-balance sheet instruments were discussed in Note 16.

The Company assumes interest rate risk (the risk that interest rates will change) in its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rates change and that change may be either favorable or unfavorable to the Company.

Table of Contents

Note 20 – Dividend Restrictions and Regulatory Capital

The approval of the Comptroller of the Currency is required if the total of all dividends declared by a national bank in any calendar year exceeds the bank's net income, as defined, for that year combined with its retained net income for the preceding two calendar years. Under this formula, the Bank can distribute as dividends to Company, without the approval of the Comptroller of the Currency, $3,540,000 as of December 31, 2009.

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company’s and the Bank’s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are subject to qualitative judgments by the regulators concerning components, risk weighting, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Under the guidelines, total capital is defined as core (“Tier I”) capital and supplementary (“Tier II”) capital. The Company’s Tier I capital consists primarily of shareholders' equity and trust preferred capital notes less intangibles, while Tier II capital also includes the allowance for loan losses subject to certain limits. The definition of assets has been modified to include items on and off the balance sheet, with each item being assigned a "risk-weight" for the determination of the ratio of capital to risk-adjusted assets. Management believes, as of December 31, 2009 and 2008, that the Company met the requirements to be considered “well capitalized.” As of September 30, 2009, the most recent notification from the Federal Deposit Insurance Corporation categorized the Company as well capitalized under the regulatory framework for prompt corrective action.

The following table provides summary information regarding regulatory capital:

(in thousands)	Actual		Minimum Capital Requirement		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2009						
Total Capital						
Company	$ 108,325	18.82 %	$ 46,053	>8.0%		
Bank	97,860	17.00	46,051	>8.0	$ 57,564	>10.0%
Tier I Capital						
Company	101,114	17.56	23,026	>4.0		
Bank	91,572	15.91	23,025	>4.0	34,538	>6.0
Leverage Capital						
Company	101,114	12.81	31,584	>4.0		
Bank	91,572	11.61	31,536	>4.0	39,420	>5.0

December 31, 2008						
Total Capital						
Company	$ 106,573	17.92 %	$ 47,576	>8.0%		
Bank	91,686	15.42	47,565	>8.0	$ 59,457	>10.0%
Tier I Capital						
Company	99,124	16.67	23,788	>4.0		
Bank	85,144	14.32	23,783	>4.0	35,674	>6.0
Leverage Capital						
Company	99,124	13.04	30,408	>4.0		
Bank	85,144	11.23	30,333	>4.0	37,916	>5.0

Table of Contents

Note 21 – Segment and Related Information

The Company has two reportable segments, community banking and trust and investment services.

Community banking involves making loans to and generating deposits from individuals and businesses. All assets and liabilities of the Company are allocated to community banking. Investment income from securities is also allocated to the community banking segment. Loan fee income, service charges from deposit accounts, and non-deposit fees such as automated teller machine fees and insurance commissions generate additional income for community banking.

Trust and investment services include estate planning, trust account administration, investment management, and retail brokerage. Investment management services include purchasing equity, fixed income, and mutual fund investments for customer accounts. The trust and investment services division receives fees for investment and administrative services.

Amounts shown in the "Other" column includes activities of American National Bankshares Inc. which are primarily debt service on trust preferred securities and corporate items. Intersegment eliminations primarily consist of American National Bankshares Inc.'s interest income on deposits held by its banking subsidiary.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Segment information as of and for the years ended December 31, 2009, 2008, and 2007, is shown in the following table:

2009 (in thousands)	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	$ 38,061	$ -	$ 260	$ (260)	$ 38,061
Interest expense	9,676	-	1,373	(260)	10,789
Noninterest income	3,614	3,338	91	-	7,043
Operating income before income taxes	8,504	2,179	(1,348)	-	9,335
Depreciation and amortization	1,560	16	2	-	1,578
Total assets	808,331	-	642	-	808,973
Capital expenditures	3,336	26	-	-	3,362

2008	Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	$ 42,836	$ -	$ 129	$ (93)	$ 42,872
Interest expense	14,559	-	1,373	(93)	15,839
Noninterest income	3,957	3,899	57	-	7,913
Operating income before income taxes	10,172	2,570	(1,540)	-	11,202
Depreciation and amortization	1,448	13	2	-	1,463

Total assets	788,435	-	749	-	789,184
Capital expenditures	5,423	25	-	-	5,448

	2007 Community Banking	Trust and Investment Services	Other	Intersegment Eliminations	Total
Interest income	$ 48,597	$ -	$ -	$ -	$ 48,597
Interest expense	17,997	-	1,373	-	19,370
Noninterest income	4,623	4,128	71	-	8,822
Operating income before income taxes	15,115	2,734	(1,529)	-	16,320
Depreciation and amortization	1,541	12	2	-	1,555
Total assets	771,518	-	770	-	772,288
Capital expenditures	2,087	18	-	-	2,105

70

Table of Contents

Note 22 – Parent Company Financial Information

Condensed Parent Company financial information is as follows (in thousands):

Condensed Balance Sheets	December 31, 2009	December 31, 2008
Cash	$ 9,094	$ 13,356
Investment in subsidiaries	116,847	108,320
Other assets	1,128	1,311
Total Assets	$ 127,069	$ 122,987
Trust preferred capital notes	$ 20,619	$ 20,619
Other liabilities	61	68
Shareholders' equity	106,389	102,300
Total Liabilities and Shareholders' Equity	$ 127,069	$ 122,987

Condensed Statements of Income	Years Ended December 31, 2009	2008	2007
Dividends from subsidiary	$ 1,650	$ 12,000	$ 12,000
Other income	351	150	86
Expenses	1,699	1,689	1,615
Income taxes (benefit)	(458)	(523)	(520)
Income before equity in undistributed earnings of subsidiary	760	10,984	10,991
Equity (deficit) in undistributed earnings of subsidiary	6,050	(2,963)	453
Net Income	$ 6,810	$ 8,021	$ 11,444

Condensed Statements of Cash Flows	Years Ended December 31, 2009	2008	2007
Cash provided by dividends received from subsidiary	$ 1,650	$ 12,000	$ 12,000
Cash used for payment of dividends	(5,612)	(5,606)	(5,587)
Cash used for repurchase of stock	(121)	(904)	(1,359)
Proceeds from exercise of options and stock compensation	536	219	295
Other	(715)	(972)	(1,182)
Net increase (decrease) in cash	$ (4,262)	$ 4,737	$ 4,167

Note 23 – Concentrations of Credit Risk

Substantially all the Company's loans are made within its market area, which includes Southern and Central Virginia and the northern portion of Central North Carolina. The ultimate collectability of the Company's loan portfolio and the ability to realize the value of any underlying collateral, if necessary, are impacted by the economic conditions of the market area.

Loans secured by real estate were $434,754,000, or 82% of the loan portfolio, at December 31, 2009, and $464,171,000, or 81% of the loan portfolio, at December 31, 2008. Loans secured by commercial real estate represented the largest portion of loans at $208,066,000 at December 31, 2009, and $207,160,000 at December 31, 2008, 39% and 36%, respectively of total loans. While there were no concentrations of loans to any individual, group of individuals, business, or industry that exceeded 10% of total loans at December 31, 2009 or 2008, loans to lessors of nonresidential buildings represented 13.9% of total loans at December 31, 2009 and 13.7% at December 31, 2008; the lessees and lessors are engaged in a variety of industries.

Table of Contents

Note 24 – Supplemental Cash Flow Information

(in thousands)	For the Years ended December 31, 2009	2008	2007
Supplemental Schedule of Cash and Cash Equivalents:			
Cash and due from banks	$ 13,250	$ 14,986	$ 18,155
Interest-bearing deposits in other banks	10,693	9,112	149
	$ 23,943	$ 24,098	$ 18,304
Supplemental Disclosure of Cash Flow Information:			
Cash paid for:			
Interest on deposits and borrowed funds	$ 11,162	$ 16,289	$ 19,332
Income taxes	2,835	2,936	3,790
Noncash investing and financing activities:			
Transfer of loans to other real estate owned	1,692	4,060	498
Unrealized gain (loss) on securities available for sale	1,039	1,474	2,723
Change in unfunded pension liability	(2,770)	2,898	66

Note 25 – Subsequent Events

In preparing these financial statements, the Company has evaluated events and transactions for potential recognition or disclosure through the date the financial statements were issued.

Table of Contents

PART IV

ITEM 15 – EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) (1) Financial Statements. See Item 8 for reference.
(a) (2) Financial Statement Schedules. All applicable financial statement schedules required under Regulation S-X have been included in the Notes to the Consolidated Financial Statements.
(a) (3) Exhibits. The exhibits required by Item 601 of Regulation S-K are listed below.

EXHIBIT INDEX

Exhibit #		Location
3.1	Amended and Restated Articles of Incorporation Dated August 20, 1997	Exhibit 4.1 on Form S-3 filed August 20, 1997
3.2	Amended Bylaws dated November 18, 2008	Exhibit 3.2 on Form 8-K filed November 19, 2008
10.1	Deferred Compensation Agreement between American National Bank and Trust Company, and Charles H. Majors dated December 31, 2008	Exhibit 10.1 on Form 10-K filed March 16, 2009
10.2	Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Charles H. Majors dated December 31, 2008	Exhibit 10.2 on Form 10-K filed March 16, 2009
10.3	Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and Jeffrey V. Haley dated December 31, 2008	Exhibit 10.3 on Form 10-K filed March 16, 2009
10.4	Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and R. Helm Dobbins dated December 31, 2008	Exhibit 10.4 on Form 10-K filed March 16, 2009
10.5	Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and	Exhibit 10.5 on Form 10-K filed March 16, 2009

	Dabney T. P. Gilliam, Jr. dated December 31, 2008	
10.6	Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and S. Cabell Dudley, Jr. dated December 31, 2008	Exhibit 10.6 on Form 10-K filed March 16, 2009
10.7	Executive Severance Agreement between American National Bankshares Inc., American National Bank and Trust Company, and William W. Traynham dated April 21, 2009	Exhibit 10.1 on Form 10-Q filed August 7, 2009
10.8	American National Bankshares Inc. 2008 Stock Incentive Plan	Exhibit 99.0 to Form S-8 filed on May 30, 2008
11.1	Refer to EPS calculation in the Notes to Financial Statements	Filed herewith
21.1	Subsidiaries of the registrant	Filed herewith
31.1	Section 302 Certification of Charles H. Majors, President and CEO	Filed herewith
31.2	Section 302 Certification of William W. Traynham, Senior Vice President and Chief Financial Officer	Filed herewith
32.1	Section 906 Certification of Charles H. Majors, President and CEO	Filed herewith
32.2	Section 906 Certification of William W. Traynham, Senior Vice President and Chief Financial Officer	Filed herewith

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

March 12, 2010 AMERICAN NATIONAL BANKSHARES INC.

By: /s/ Charles H. Majors
President and
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 12, 2010.

/s/ Charles H. Majors Charles H. Majors	President and Chief Executive Officer (principal executive officer)
/s/ Fred A. Blair Fred A. Blair	Director
/s/ Frank C. Crist, Jr. Frank C. Crist, Jr., D.D.S.	Director
/s/ Ben J. Davenport, Jr. Ben J. Davenport, Jr.	Director
/s/ H. Dan Davis H. Dan Davis	Director
/s/ Michael P. Haley Michael P. Haley	Director
/s/ Charles S. Harris Charles S. Harris	Director
/s/ Lester A. Hudson, Jr. Lester A. Hudson, Jr., Ph.D.	Director
/s/ E. Budge Kent, Jr. E. Budge Kent, Jr.	Director
/s/ Fred B. Leggett, Jr. Fred B. Leggett, Jr.	Director
/s/ Franklin W. Maddux Franklin W. Maddux, M.D.	Director

/s/ Martha W. Medley Martha W. Medley	Director
/s/ Claude B. Owen, Jr. Claude B. Owen, Jr.	Director
/s/ William W. Traynham William W. Traynham	Senior Vice President and Chief Financial Officer (principal accounting officer)