Operating and Financial Review

2004 overview

In 2004, we set out to achieve underlying progress on our three financial measures: adjusted earnings per share, free cash flow and return on invested capital. We are pleased to report that we made that progress, even in a weak market for the US school industry and a tough year for Penguin. We also made further efficiency gains and product investments, which have set the stage for significant progress in 2005 and beyond as our market conditions improve.

Pearson's sales rose 3% in 2004, with solid growth at Pearson Education and IDC. Adjusted operating profit increased 7%, with a 24% decline at Penguin being more than offset by good progress at our largest business, Pearson Education (up 5%) and a significant profit improvement at the FT Group (up 69%). Adjusted earnings per share of 30.0p (2003: 32.0p) were up 5% on an underlying basis, helped by this profit improvement and by lower tax and interest charges.

Our reported results were once again affected by currency movements. We earn approximately two-thirds of our sales in the US and the weakening of the dollar against the pound (£1:$1.83 in 2004 against £1:$1.63 in 2003) reduced our reported sales by £302m and our reported operating profit by £51m for our continuing businesses.

Our cash flow progressed with total free cash flow rising by £96m to £288m, representing a cash conversion rate of 93%. Average working capital:sales at Pearson Education and Penguin – our working capital users – improved by half a percentage point to 32.3%. Efficiency improvements more than offset an increase in product investment and the start-up of new contracts.

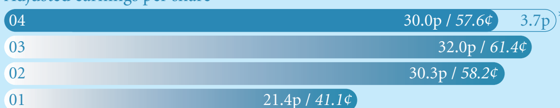
We ended the year with net debt of £1,206m, an 11% improvement on 2003.

Our statutory results also showed an improvement with operating profit rising 2% and statutory basic earnings per share increasing to 11.1p from 6.9p in 2003.

The board is proposing a dividend increase of 5% to 25.4p for the full year.

Rona Fairhead, *Chief financial officer*

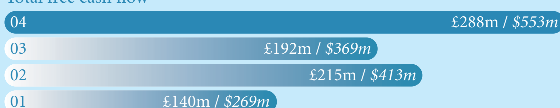
Adjusted earnings per share



Our progress We increased our adjusted eps by 5% on an underlying basis. Currency movements eroded our reported performance by 3.7p. In 2005 we expect strong earnings growth.

*Constant currency

Total free cash flow



Our progress Our cash improved by £96m, helped by the receipt of the TSA payment in December 2004. We expect our free cash flow to increase further in 2005.

Return on invested capital

Our progress Reported ROIC was a little lower than in 2003 at 6.2%, but it rose again on an underlying basis. This was the result of improvements in operating profit and working capital efficiency. We expect further improvement in ROIC in 2005.

*Constant currency

Pearson Education

Sales

Year	Sales
04	£2,356m / *$4,524m*
03	£2,451m / *$4,706m*
02	£2,756m / *$5,292m*
01	£2,604m / *$5,000m*
00	£2,090m / *$4,013m*

Adjusted operating profit

Year	Adjusted operating profit
04	£293m / *$563m*
03	£313m / *$601m*
02	£326m / *$626m*
01	£274m / *$526m*
00	£237m / *$455m*

Pearson Education had a strong year, growing sales by 4% and profits by 5% in spite of the weakest US new adoption market* for five years. Our School business increased profits by 2%, our US Higher Education business grew ahead of its industry and our Professional business increased profits by 30%.

School

Our School business ended the year with sales level with 2003 and profits up 2%. In a year when new adoption spending fell by some 40% to approximately $500m we led the new adoption market, taking a 27% share of this smaller new adoption opportunity – or 30% of the adoption opportunities we participated in. We benefited from our strength across a wide range of subjects and grade levels, with a decline in elementary sales (after particularly strong market share growth in 2003) mitigated by a strong performance in the secondary market. We returned to growth in the open territories and in supplementary publishing, helped by the restructuring actions we took in 2003 and by the sharp recovery in US state budgets. We also invested in major new programmes in reading, science, literature and social studies, which should help us capture a good share of a strong US School market over the next few years.

Our US School testing business benefited from the start-up of a number of new state contracts, including Texas, Ohio, Virginia and Washington. We continued to win new multi-year contracts, worth $150m, including Tennessee, New Jersey and California ahead of implementation of the No Child Left Behind Act testing requirements, which become mandatory in the school year starting in September 2005. Our digital learning businesses showed a further profit improvement on slightly lower sales and we continued to develop and sell new products which integrate our content, testing and technology in a more focused way. The decline in reported profits reflects the impact of dollar weakness and a full year contribution from Edexcel, which is loss-making in the first half.

*Note In the US, 20 'adoption' states buy textbooks and related programmes on a planned contract schedule or 'adoption cycle'. The level of spending varies from year to year with this schedule, depending on the number of adoptions in the largest states and subjects. In 'open territory' states, school districts or individual schools buy textbooks according to their own individual schedules rather than on a statewide basis.

Higher Education

Our Higher Education business grew sales by 4% and profits by 1%. In the US we grew faster than the market for the sixth straight year, up 4% while the industry without Pearson was up 2%, according to the Association of American Publishers. We saw particular strength in two-year career colleges, a fast-growing segment, with vocational programmes in allied health, technology and graphic arts, and elsewhere in maths and modern languages.

Our margins eased a little as we achieved 5% growth outside the US and continued to invest to make our technology central to the teaching and learning process. We rolled out our online learning platforms into new subject areas including economics, psychology and modern languages and by the end of the year almost three million US college students were following their courses through one of our online programmes. Our custom publishing business, which creates specific programmes built around the curricula of individual faculties or professors, grew very strongly. Pearson Custom has now increased its sales eight-fold over the past six years and we have introduced our first customised online resources for individual college courses.

Recognising concern over the rising cost of higher education, we also accelerated our strategy of making our content available to students in a wide range of different formats and price points through our Pearson Choices programme (www.pearsonchoices.com). Through SafariX, 350 of our leading textbooks are now available to students in a web-based format, at half the price of their traditional print counterparts.

Professional

Our Professional education business grew sales by 12% and profits by 30%. Pearson Government Solutions grew sales by 25%, with strong growth from add-ons to existing programmes. We also won some important new contracts, including multi-year contracts worth $500m from customers such as the US Department of Health and the London Borough of Southwark. Our Professional Testing business grew sales 31% as we benefited from the start-up of major new contracts although we continued to operate at a small loss as we invested in building up the infrastructure for our 150-strong UK test centre network. Markets remained tough for our technology publishing titles, where sales were 6% lower, but profits were broadly level as a result of further cost actions.

Our education businesses outside the US contributed a record $1.2bn in revenues. We saw a series of good performances across the spectrum of our publishing, testing and software. We won $200m of multi-year school testing contracts outside the US. Edexcel successfully introduced our testing technology into the UK, marking 1.3 million examination scripts on-screen in 2004. Our international English Language Teaching business grew well, helped by our biggest ever ELT investment. The new programme, *English Adventure*, has been developed for primary school age students using Disney characters, and has now been launched in five major ELT markets with a plan to go to over 50 in the next few years.

Pearson Education completed a number of small bolt-on acquisitions in the year. These included Knowledge Analytic Technologies, extending our capabilities in electronic school testing and marking; Causeway Press, strengthening our UK education publishing for schools and colleges; Altona Ed, a web-based student information system; and Dominie Press in Spanish language supplementary publishing.

Sales	2004 £m	*2004 $m*	2003 £m	*2003 $m*	Change – underlying %
School	1,118	*2,147*	1,176	*2,258*	–
Higher Education	731	*1,404*	772	*1,482*	4
Professional	507	*973*	503	*966*	12
Total	2,356	*4,524*	2,451	*4,706*	4
Adjusted operating profit					
School	117	*225*	127	*244*	2
Higher Education	133	*255*	148	*284*	1
Professional	43	*83*	38	*73*	30
Total	293	*563*	313	*601*	5

The Financial Times Group

Sales	
04	£777m / *$1,492m*
03	£757m / *$1,453m*
02	£726m / *$1,394m*
01	£801m / *$1,538m*
00	£844m / *$1,620m*

Adjusted operating profit	
04	£108m / *$207m*
03	£86m / *$165m*
02	£80m / *$154m*
01	£72m / *$138m*
00	£98m / *$188m*

The Financial Times Group increased sales by 3% and profits by 69% with another good year from IDC, a more stable business advertising environment and the benefit of cost actions taken in recent years.

The *Financial Times* achieved revenue growth for the first year since 2000 and reduced losses from £32m in 2003 to £9m, returning to profit in the seasonally strong fourth quarter. Sales increased 3% with advertising revenues up 2% and circulation revenues also ahead.

Advertising performance across categories and regions was mixed throughout the year. While the recruitment and luxury goods categories increased by more than 20%, the business-to-business and technology sectors showed few signs of recovery. In terms of geography, good growth in Europe and Asia offset a very weak US corporate advertising market. We continued to reduce the FT's cost base, which is now £110m or one-third lower than it was in 2000. At the same time, we invested in editorial initiatives, printing the FT in Australia – a first for any international daily newspaper publisher – and increasing the reach and number of our colour magazines, *FT Magazine* and *How To Spend It*. Average circulation for the year of 435,000 was 3% lower than the previous year, while FT.com has 76,000 paying subscribers and 3.7 million unique users. The FT's performance in international surveys of business readership in print and online remained strong.

Les Echos achieved sales growth of 4% and profits grew very strongly, despite a volatile advertising market. Average circulation grew 3% to 119,800, while competitors continued to see falling sales. FT Business also posted significant profit growth, with sales growth across all its main markets, and a continuing emphasis on cost management.

Profit from the FT's associates and joint ventures doubled in the year. Losses narrowed at *FT Deutschland* as circulation and advertising revenue both grew strongly. *FT Deutschland* reached the 100,000 copy sales mark in December, and circulation averaged 96,600 (+6%). The Economist Group again increased its operating profit, with *The Economist's* circulation passing the significant one million mark, with an average weekly circulation of 1,009,759. The Group also launched a new annual, *Intelligent Life*, as well the first Chinese language edition of *The World in 2005*.

Interactive Data Corporation (NYSE: IDC), our 61%-owned financial information business, increased sales by 3% and profits by 9%. FT Interactive Data and e-Signal performed well, particularly in the US, where we saw some signs of improvement in market conditions. Worldwide renewal rates among institutional clients remained at or above 95%. Demand for Interactive Data's value-added services remained strong, with the signing of our 100th customer for our Fair Value Information Service product in December. IDC had a first full year contribution from acquisitions made in 2003, ComStock and Hyperfeed Technologies, and acquired FutureSource in September to expand and complement e-Signal. The consolidation of seven US data centres into two facilities is on track for completion at the end of this year.

In December, we announced our intention to sell our shareholding in Recoletos, our 79%-owned Spanish media group, to Retos Cartera as part of a tender offer for all of Recoletos. Retos Cartera's tender offer was launched on 16 February 2005 and we accepted it on 25 February. In January 2005, we also accepted an offer from Dow Jones & Co. for our 22% stake in MarketWatch, bringing in proceeds of $101m.

Sales	2004 £m	*2004 $m*	2003 £m	*2003 $m*	Change – underlying %
FT Newspaper	208	*399*	203	*390*	3
Other FT publishing	110	*211*	112	*215*	5
IDC	269	*517*	273	*524*	3
Total continuing	587	*1,127*	588	*1,129*	3
Discontinued (Recoletos)	190	*365*	169	*324*	15
Total	777	*1,492*	757	*1,453*	6
Adjusted operating profit/(loss)					
FT Newspaper	(9)	*(17)*	(32)	*(62)*	72
Other FT publishing	11	*21*	6	*11*	61
Associates and joint ventures	6	*11*	3	*6*	100
IDC	78	*150*	81	*156*	9
Total continuing	86	*165*	58	*111*	69
Discontinued (Recoletos)	22	*42*	28	*54*	(18)
Total	108	*207*	86	*165*	39

The Penguin Group

Sales

Year	Sales
04	£786m / *$1,509m*
03	£840m / *$1,613m*
02	£838m / *$1,609m*
01	£820m / *$1,574m*
00	£755m / *$1,450m*

Adjusted operating profit

Year	Adjusted operating profit
04	£54m / *$104m*
03	£91m / *$175m*
02	£87m / *$167m*
01	£80m / *$154m*
00	£79m / *$152m*

Penguin had a difficult year, with flat sales and significantly lower profits, despite a successful publishing schedule. The single largest factor in the decline in reported operating profit was the weak dollar. Penguin makes approximately two-thirds of its sales in the US and the dollar's decline against sterling reduced Penguin's profits by £14m. The 24% decline in underlying operating profit was caused by a number of factors, including disruption to our UK distribution and weakness in the US consumer publishing market.

In the UK, our move to a new warehouse, to be shared between Penguin and Pearson Education, disrupted supply of our books and had a particular impact on backlist titles. Although we traded well in the second half, and shipped more books to our UK customers than in the previous year, we incurred some £9m of additional costs as we took special measures to deliver books, including the cost of running two warehouses, shipping books direct and additional marketing support. By the end of the year, we had eliminated the order backlog in the warehouse, and the new management team has continued to make good progress in the early part of 2005, successfully installing the new automated warehouse management system. We will continue to incur dual running costs until Pearson Education moves into the new warehouse, which is planned for the second half.

After a good start to the year, the US consumer publishing market deteriorated sharply in the second half and full-year industry sales were 1% lower than in 2003, according to the Association of American Publishers. The adult mass market segment, which accounts for approximately one-third of Penguin's US sales, was down 9% for the industry for the full year, and 13% in the second half. Penguin is planning for 2005 on the basis that tough market conditions continue and is adjusting its business and publishing programmes accordingly. We are taking actions to reduce costs, accelerating investment in successful new imprints, focusing publishing in premium market categories and finding new ways to sell high margin backlist titles.

Despite this, Penguin had another great publishing year. We benefited from our new imprint strategy, with a further four imprints publishing for the first time. Non-fiction performed particularly well, with a 40% increase in our titles on the *New York Times* bestseller list, including Lynne Truss's *Eats, Shoots & Leaves* (now with over one million copies in print), Ron Chernow's *Alexander Hamilton* and Maureen Dowd's *Bushworld*. Best-selling UK titles included Jamie Oliver's *Jamie's Dinners*, Sue Townsend's *Adrian Mole and the Weapons of Mass Destruction* and Gillian McKeith's *You Are What You Eat*.

	2004 £m	*2004 $m*	2003 £m	*2003 $m*	Change – underlying %
Sales	786	*1,509*	840	*1,613*	–
Adjusted operating profit	54	*104*	91	*175*	(24)

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	2004 £m	*2004 $m*	2003 £m	*2003 $m*
Adjusted operating profit	455	*874*	490	*941*
Goodwill amortisation	(224)	*(430)*	(264)	*(507)*
Non operating items	9	*17*	6	*12*
Net interest payable	(69)	*(133)*	(80)	*(154)*
Profit before taxation	171	*328*	152	*292*
Taxation	(62)	*(119)*	(75)	*(144)*
Profit after taxation	109	*209*	77	*148*
Equity and minority interests	(21)	*(40)*	(22)	*(42)*
Profit for the financial year	88	*169*	55	*106*
Dividends	(201)	*(386)*	(192)	*(369)*
Loss retained	(113)	*(217)*	(137)	*(263)*

Adjusted operating profit, on an underlying basis, was up 5% (up 7% for continuing businesses).

Statutory profit before tax was £171m, up £19m, largely as a result of lower goodwill amortisation and a reduced interest charge. The 20 cent weakening in the average US dollar rate against the pound (£1:$1.83 in 2004 against £1:$1.63 in 2003) reduced our reported operating profit.

Financial statements

Goodwill This is the final year of amortisation under UK GAAP, ahead of moving to International Financial Reporting Standards in 2005. The goodwill amortisation charge fell to £224m from £264m in 2003 as a result of the lower dollar exchange rate and the reduction in charges relating to fully amortised assets. There were no impairments in 2004.

Non operating items These reflected gains and losses on the sale or closure of businesses and on the disposal of fixed assets and investments. In 2004 we had profits on the sale of our stakes in Capella and Business.com, which were partially offset by small losses elsewhere.

Interest

Net operating interest fell by £11m to £69m, as an increase in floating interest rates was offset by a combination of lower levels of average net debt and a one-off credit of £9m for interest on a repayment of tax in France. The average three month LIBOR (weighted for the Group's borrowings in US dollars, euros and sterling) rose by 0.4%. We were partially protected from these increases by our treasury policy (see page 10), which put £736m of our year-end debt on a fixed rate basis. As a result, the Group's average net interest rate payable (excluding the £9m credit described above) rose by only 0.25%, to 5%.

Taxation The total tax charge for the year was £62m, representing a 36% rate on pre-tax profits of £171m. This was higher than the UK statutory rate of 30%; as in previous years, this was largely attributable to the fact that the goodwill amortisation charge in the profit and loss account was only partially eligible for tax relief. The total tax charge included credits of £48m relating to previous years; these reflected a combination of progress in settlements with the Revenue authorities and changes to deferred tax balances. The mix of profits between jurisdictions with different tax rates was also a relevant factor; the effect in 2004 was similar to that in 2003.

The tax rate on adjusted earnings reduced from 31.2% in 2003 to 30.3% in 2004, benefiting from prior year credits and the mix of profits.

Minority interests Minority interests were principally a 39% minority share in IDC and a 21% minority share in Recoletos.

Dividends The dividend payment of £201m which we are recommending in respect of 2004 represents 25.4p per share – a 5% increase on 2003. The dividend is covered 1.2 times by adjusted earnings and 1.4 times by free cash flow. We seek to maintain a balance between the requirements of our shareholders, including our many private shareholders, for a rising stream of dividend income and the reinvestment opportunities that we see across Pearson. This balance has been expressed in recent years as a commitment to increase our annual dividend faster than the prevailing rate of inflation while progressively reinvesting a higher proportion of our distributable earnings in our business.

Other financial items

Pensions Pearson operates a variety of pension schemes. Our UK fund is by far the largest and we also have some smaller defined benefit funds in the US and Canada. Outside the UK, most of our people operate 401K (essentially defined contribution) plans. The pension funding level is kept under regular review by the company and the Fund trustees. The scheme was valued as at 1 January 2004 and the next valuation will be at 1 January 2006. As a result of the 2004 valuation, the company agreed to increase contributions to £30m in respect of 2004; to £35m in 2005; and to £41m annually from 2006 to 2014.

Accounting disclosures and policies During 2004 we adopted UITF Abstract 38 'Accounting for ESOP trusts' and the revision of UITF Abstract 17 'Employee share schemes' were issued on 15 December 2003 and these revisions have been applied for the first time in 2004. Under UITF 38 own shares held in treasury or through an ESOP trust are recorded at cost and shown as a deduction in arriving at shareholders' funds. Previously these shares were recorded at cost less provision for impairment and shown as a fixed asset investment with impairment charges being taken to the profit and loss account. Under the revised UITF 17, employee share scheme charges to the profit and loss account are now always calculated as the intrinsic value of the award and spread over the performance period. The intrinsic value is the difference between the fair value of shares at the date of grant and the amount paid by the employee to exercise the rights to those shares irrespective of the cost of shares purchased to fund the award. The amendment to UITF 17 in respect of the calculation of share scheme charges has had no material effect on the profit and loss account.

Adoption of International Financial Reporting Standards (IFRS)

From 2005 onwards Pearson will be adopting IFRS in its consolidated financial statements in compliance with European Union regulation. This will lead to a number of changes in reported financial data, which will also be reflected in Pearson's comparative financial information for prior periods. Pearson has decided to adopt IFRS as at 1 January 2003 which will have the advantage of providing two years of comparative IFRS data.

The Group started its IFRS transition project in 2003. The project is governed by a steering committee chaired by the chief financial officer and regular updates are provided to the audit committee. The project has entailed a detailed assessment of the impacts of IFRS on Pearson accounting policies and reported results; system changes to capture additional data; training of staff critical to the Group's reporting process and definition of our IFRS communication strategy.

The work related to all project activities remains on track to provide an analysis of the full impact of the adoption of IFRS on the Group's audited 2003 and 2004 results and respective balance sheets. We plan to communicate the adjustments from UK GAAP to IFRS in April 2005.

Other than the format of presentation, there is no cash flow impact from the adoption of IFRS.

In the meantime we set out below a summary of the main areas of impact on the Group's operating profit together with indicative estimates of the related amounts:

1. Goodwill and other intangibles: Under IFRS 3, goodwill is no longer amortised and, instead, is assessed annually for impairment. Goodwill arising on acquisitions before 1 January 2003 will not be restated; other intangible assets arising from acquisitions after 1 January 2003 will be separately identified and amortised over their estimated useful economic lives, often over shorter periods than goodwill has previously been amortised.

As a result of this change, Pearson's operating profit will be increased by the amount of goodwill amortisation recorded under UK GAAP (amounting to £224m for 2004 and £264m in 2003) but reduced by the amortisation of other purchased intangible assets (estimated to be up to £10m in each of 2004 and 2003).

2. Share based payments: Under IFRS 2, the imputed fair value at the date of grant of restricted shares, SAYE schemes and share options issued to employees will be charged to operating profit over the relevant vesting period. This will result in a reduction in Pearson's reported operating profit, as the cost will be higher than that currently charged under UK GAAP. The UK GAAP charge is based upon the intrinsic value of the award being the difference between exercise price and grant price.

The impact is estimated to be between £15m and £25m in 2003 and 2004.

3. Employee benefits: Under IAS 19 pensions are charged to the profit and loss account using a different basis of accounting from SSAP 24. IAS 19 uses a balance sheet approach (similar to FRS 17) rather than determinations based on long-term actuarial assumptions. The profit and loss expense is determined using annually derived assumptions as to salary inflation, investment returns and discount rates, based on prevailing conditions at the start of the year. Any surplus or deficit on a deferred benefit scheme at the balance sheet date is recognised in the balance sheet. Where actual experience differs from the assumptions made, actuarial gains and losses will be recognised through the statement of recognised income and expense.

The adoption of IAS 19 is not anticipated to result in a significant change to operating profit compared to SSAP 24 for 2003 and 2004.

In addition to the above principal areas of impact, a number of other changes will arise upon transition to IFRS, for example, in relation to the treatment of software costs, deferred tax, dividends payable and certain balance sheet disclosures related to items such as pre-publication costs. We will report on these other adjustments including further details relating to the presentation and layout of the Group's IFRS income statement and balance sheet in our April announcement.

Going forward, Pearson has elected to adopt IAS 39 relating to financial instruments from 1 January 2005. Pearson uses derivative financial investments (as detailed below under our Treasury policy) to hedge certain interest rates and currency exposures. Accounting for derivative financial instruments in accordance with IAS 39 may result in increased volatility of earnings. However, Pearson has been tracking its key derivatives during 2004 and has put in place the required documentation to qualify for hedge accounting: where hedge accounting cannot be applied under IAS 39's prescriptive rules, change in this market value of financial investment will be reported through the profit and loss account. Given the adoption date, there will be no impact from this area in the 2003 or 2004 accounts.

A number of new IFRS standards were published in final form by the International Accounting Standards Board in the period between November 2003 and March 2004 which will be mandatory for Pearson in preparing the Group's first IFRS financial statements. As a large number of countries, including the United Kingdom, are simultaneously adopting the standards for the first time there is limited established practice on which to draw when forming opinions regarding IFRS interpretation and application. Therefore at this stage, the full financial effect of reporting under IFRS cannot be definitively quantified due to the possible amendment of interpretative guidance by the IASB and developing industry practice.

Managing our financial risks

This section explains the Group's approach to the management of financial risk.

Treasury policy The Group holds financial instruments for two principal purposes: to finance its operations and to manage the interest rate and currency risks arising from its operations and its sources of finance.

The Group finances its operations by a mixture of cash flows from operations, short-term borrowings from banks and commercial paper markets, and longer term loans from banks and capital markets. The Group borrows principally in US dollars, euros and sterling, at both floating and fixed rates of interest, using derivatives, where appropriate, to generate the desired effective currency profile and interest rate basis.

The derivatives used for this purpose are principally interest rate swaps, interest rate caps and collars, currency swaps and forward foreign exchange contracts. The main risks arising from the Group's financial instruments are interest rate risk, liquidity and refinancing risk, counterparty risk and foreign currency risk. These risks are managed by the chief financial officer under policies approved by the board, which are summarised below. These policies have remained unchanged, except as disclosed, since the beginning of 2003. A treasury committee of the board receives reports on the Group's treasury activities, policies and procedures, which are reviewed periodically by a group of external professional advisers. The treasury department is not a profit centre and its activities are subject to internal audit.

Interest rate risk The Group's exposure to interest rate fluctuations on its borrowings is managed by borrowing on a fixed rate basis and by entering into interest rate swaps, interest rate caps and forward rate agreements. Since October 2002 the Group's policy objective has been to set a target proportion of its forecast borrowings (taken at the year end, with cash netted against floating rate debt) to be hedged (i.e. fixed or capped) over the next four years within a 40% to 65% range. At the end of 2004 that ratio was 61%. A 1% change in the Group's variable rate US dollar, euro and sterling interest rates would have a £5m effect on profit before tax.

Liquidity and refinancing risk The Group's objective is to procure continuity of funding at a reasonable cost. To do this it seeks to arrange committed funding for a variety of maturities from a diversity of sources. The Group's policy objective has been that the weighted average maturity of its core gross borrowings (treating short-term advances as having the final maturity of the facilities available to refinance them) should be between three and 10 years. At the end of 2004 the average maturity of gross borrowings was six years and non-banks provided £1,650m (91%) of them (up from 4.9 years and 89% respectively at the beginning of the year). The Group believes that ready access to different funding markets also helps to reduce its liquidity risk, and that published credit ratings and published financial policies improve such access. All of the Group's credit ratings remained unchanged during the year. The long-term ratings are Baa1 from Moody's and BBB+ from Standard & Poor's, and the short-term ratings are P2 and A2 respectively. The Group strives to maintain a rating of at least BBB+/Baa1 over the long term. The Group will also continue to use internally a range of ratios to monitor and manage its finances. These include interest cover, net debt to operating profit, net debt to enterprise value and cash flow to debt measures. The Group also maintains undrawn committed borrowing facilities. At the end of 2004 these amounted to £641m and their weighted average maturity was 4.5 years.

Net borrowings fixed and floating rate

	2004		2003	
	£m	*$m*	£m	*$m*
Fixed rate	736	*1,413*	829	*1,592*
Floating rate	470	*902*	532	*1,021*
Total	1,206	*2,315*	1,361	*2,613*

Gross borrowings

	2004		2003	
	£m	*$m*	£m	*$m*
Bank debt	169	*324*	204	*391*
Bonds	1,650	*3,168*	1,718	*3,299*
Total	1,819	*3,492*	1,922	*3,690*

Gross borrowings by currency

	2004		2003	
	£m	*$m*	£m	*$m*
US dollar	1,332	*2,557*	1,427	*2,740*
Sterling	201	*386*	201	*386*
Euro	284	*545*	292	*560*
Other	2	*4*	2	*4*
Total	1,819	*3,492*	1,922	*3,690*

Counterparty risk The Group's risk of loss on deposits or derivative contracts with individual banks is managed in part through the use of counterparty limits. These limits, which take published credit limits (among other things) into account, are approved by the chief financial officer. In addition, for certain longer-dated, higher-value derivative contracts, specifically, a currency swap that transforms a major part of the 6.125% eurobonds due 2007 into a US dollar liability, the Group has entered into mark-to-market agreements whose effect is to reduce significantly the counterparty risk of the relevant transactions.

Currency risk Although the Group is based in the UK, it has its most significant investment in overseas operations. The most significant currency for the Group is the US dollar, followed by the euro and sterling. The Group's policy on routine transactional conversions between currencies (for example, the collection of receivables, and the settlement of payables or interest) remains that these should be affected at the relevant spot exchange rate. No unremitted profits are hedged with foreign exchange contracts as the company judges it inappropriate to hedge non-cash flow transnational exposure with cash flow instruments. However, the Group does seek to create a 'natural hedge' through its policy of aligning approximately the currency composition of its core borrowings in US dollars, euros and sterling with the split between those currencies of its forecast operating profit. This policy aims to dampen the impact of changes in foreign exchange rates on consolidated interest cover and earnings. Long-term core borrowing is limited to these three major currencies. However, the Group still borrows small amounts in other currencies, typically for seasonal working capital needs. At the year end the split of aggregate net borrowings in its three core currencies was US dollar 88%, euro 7% and sterling 5%.

	£m	$m
Cash inflow		
Operating cash flow	422	*810*
Disposals	42	*81*
New equity	4	*8*
Cash outflow		
Purchase of own shares	(10)	*(19)*
Integration costs	(4)	*(8)*
Interest, tax, dividends and other	(328)	*(630)*
Acquisitions	(46)	*(88)*
Opening net debt	(1,361)	*(2,613)*
Exchange differences on opening net debt	75	*144*
Closing net debt	(1,206)	*(2,315)*

Note Net debt excludes finance leases.