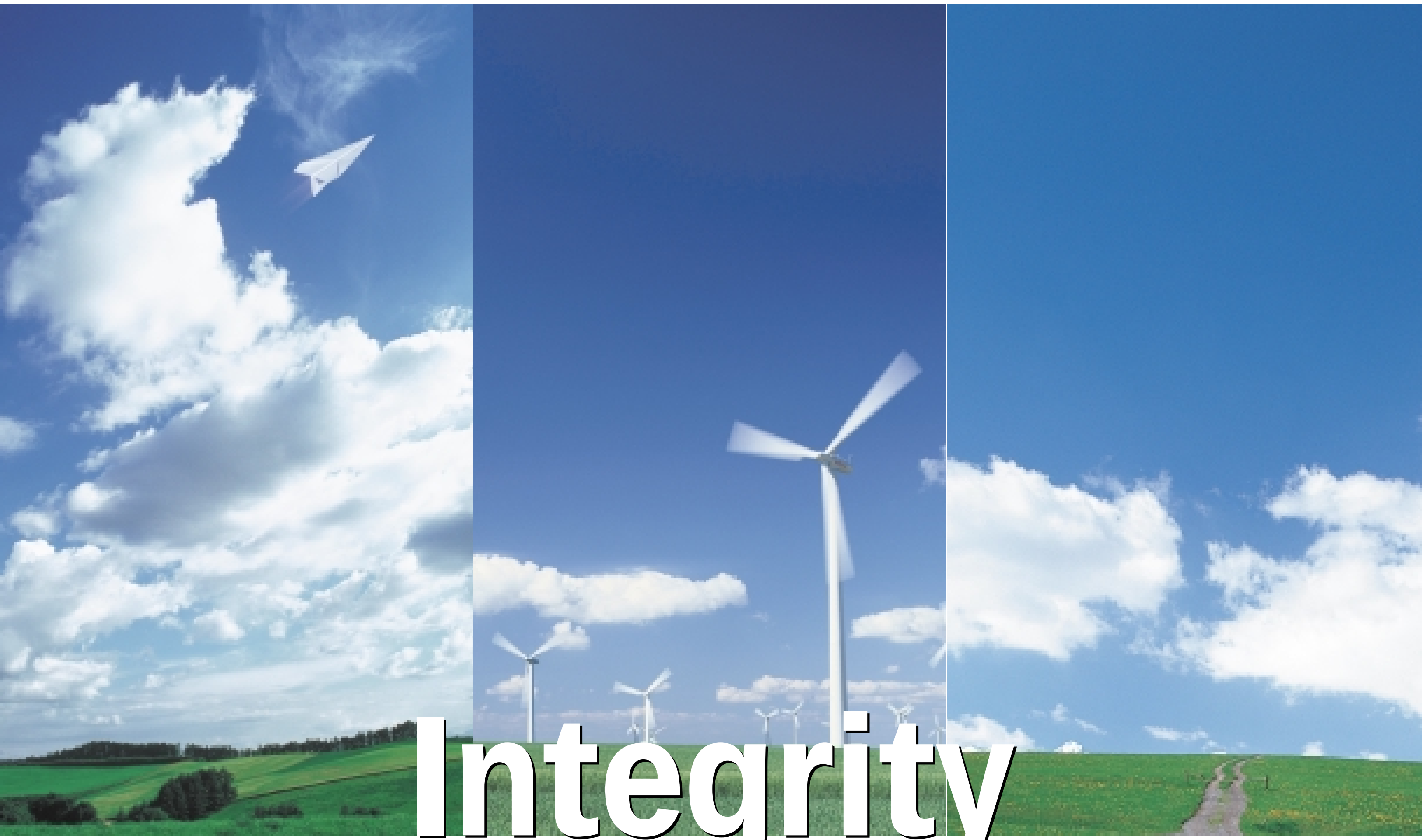
Annual Report 2004

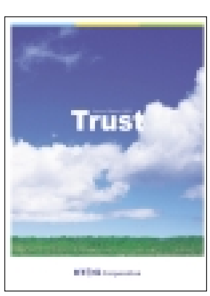


Integrity

TRANSPARENT I EFFICIENT I SUSTAINABLE

KT&G Corporation

CONTENTS



Through the quality of our products, our commitment to ethical corporate governance, and our progressive corporate culture, at KT&G we are forging trusting partnerships with customers, shareholders, and employees.Through the quality of our products, our commitment to ethical corporate governance, and our progressive corporate culture, at KT&G we are forging trusting partnerships with customers, shareholders, and employees.

PROFILE

KT&G was founded in 1899 as the Korean Imperial Household's exclusive agent for tobacco and ginseng. During the twentieth century, the Company became a household name in Korea as the nation's sole tobacco and ginseng manufacturer and distributor.

The achievement of full privatization in 2002 marked KT&G's successful passage from state-owned monopoly to free-market competitor and signaled the beginning of a new era for the Company. Through modernization of its facilities, rationalization of its workforce, and restructuring of its management, the Company has improved business efficiency and has met the challenges of competing with overseas companies in the liberalized domestic market.

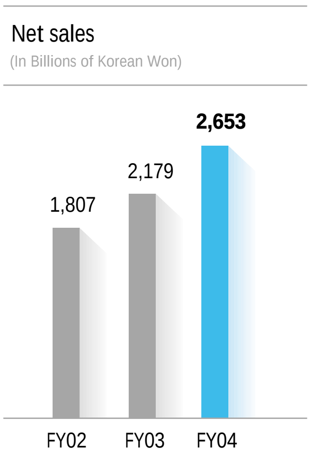
Today, KT&G maintains its dominance of the Korean tobacco market, enjoying a market share approaching 80%. It is also a rapidly emerging power in global markets, with a growing presence in China, the USA and Central and Southeast Asia.

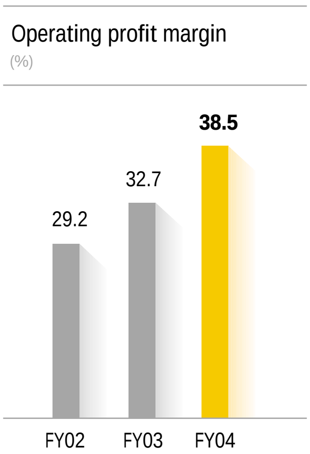
The Company's philosophy embraces customer satisfaction, shareholder value, and employee empowerment. Abiding by those principles, it is well on its way to attaining its goal of ranking among the tobacco industry's top five companies.

FINANCIAL HIGHLIGHTS

Key data KT&G Corporation	FY02	FY03	FY04
(In billions of Korean won)			
Net Sales	1,807	2,179	2,653
Gross profit	902	1,207	1,548
Operating profit	527	711	1,022
Net profit	347	460	472
(In billions of Korean won)			
Current assets	1,704	1,747	2,002
Fixed assets	2,062	2,140	1,883
Total assets	3,766	3,887	3,885
Current liabilities	742	487	535
Long-term liabilities	871	585	135
Total liabilities	1,614	1,072	671
Total stockholders' equity	2,152	2,815	3,214
(% YoY)			
Net Sales growth	6.2	20.6	21.8
Gross profit growth	21.6	33.9	28.2
Operating profit growth	17.3	35.0	43.6
Net profit growth	4.1	32.3	2.7
(%)			
Gross profit margin	49.9	55.4	58.3
Operating profit margin	29.2	32.7	38.5
Net profit margin	19.2	21.1	17.8
(Per share data)			
Diluted EPS (won)	2,092	3,307	2,981
Diluted PER (x)	7.8	6.3	10.4
Year-end stock price (won)	16,400	20,700	30,950

FINANCIAL HIGHLIGHTS





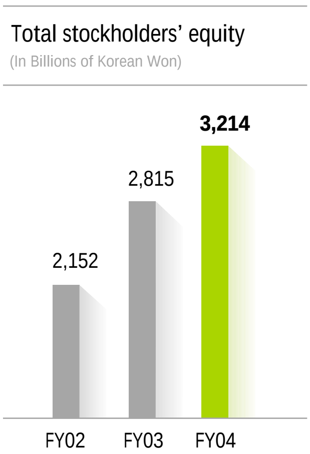
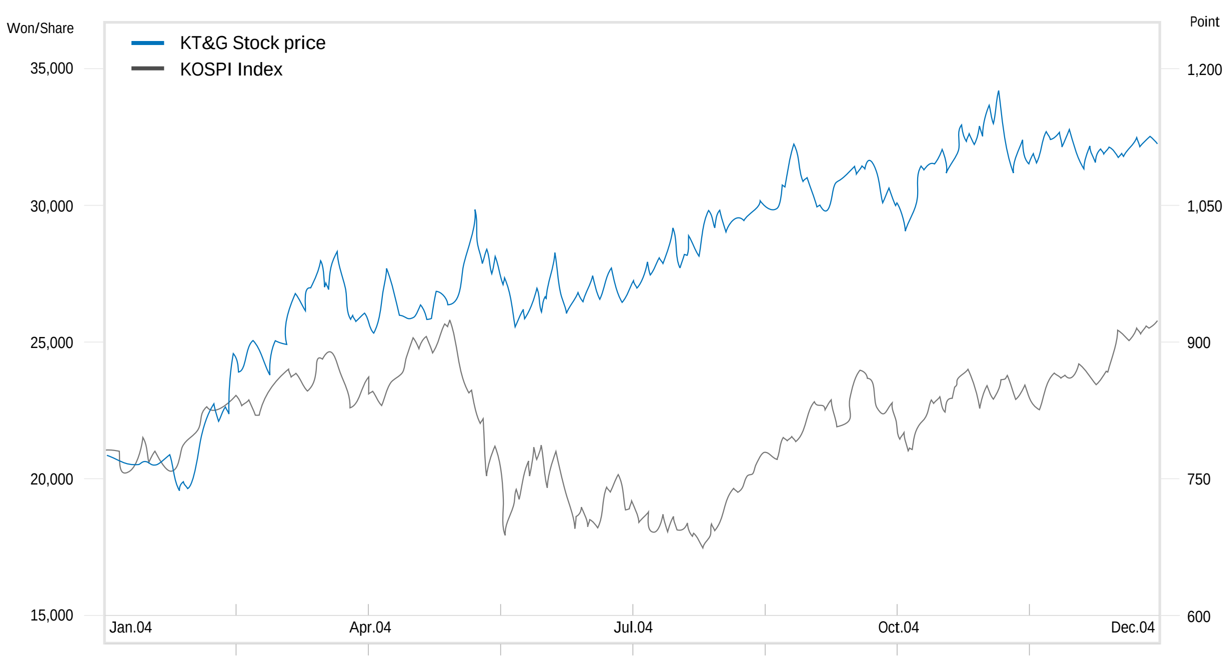


Chart of KT&G Stock price



MESSAGE FROM THE CEO

Dear our shareholders

An increase in tobacco taxes, tighter regulatory controls on smoking, and economic uncertainties made for a tough operating environment in 2004. In spite of those hurdles, KT&G grew sales by 21.8% year-on-year to a new record of KRW2,653.4 billion, and operating profit surpassed KRW1 trillion for the first time in our history.

We performed particularly well in the segment for low tar premium products, with achieving handsome top-line growth of 157.1% over the previous year.

Another notable feat in 2004 was that we started to recoup the losses in market share suffered in previous years. That recovery was underpinned by reinforced marketing, effective brand management, and timely launch of new products. We upheld our presence as a dominant force on home turf, with a near 80% market share.

We performed particularly well in the segment for low tar products, with prominent premium brands, such as Season, Raison, The One, Esse One and Esse Field, achieving handsome top-line growth of 157.1% over the previous year. We are pleased to say that KT&G remains the leader in the low tar market segment, which burgeoned by 177.2% in 2004 and accounted for 29.0% of total cigarette consumption in Korea.

Both quantitative and qualitative advances were made in our overseas operations. Export revenue increased by 10.6% year-on-year to KRW302.8 billion. As a percentage of total revenue, it dwindled by 1.2%p to 11.4%, but the dip was a temporary phenomenon sparked by stockpiling in the domestic market in throughout 2004 ahead of the tobacco tax hike.

As part of our strategy to nurture our overseas business, we have expanded our reach to new export destinations of China, Southeast Asia, the Americas and Russia. We have also strengthened our position in Central Asia and the Middle East where we have built a firm footing.

We continue to adhere to our policy of maximizing shareholder value, with dividend payout of KRW 1,600 per share decided for fiscal 2004. Last year, we acquired 16 million treasury shares, of which 13 million were retired, while the conversion of exchangeable bonds has removed a major uncertainty.

MESSAGE FROM THE CEO

Chairman & CEO
Young-kyoon Kwak

KT&G's sales grew by 21.8% year-on-year to a new record of KRW2,653.4 billion, and operating profit surpassed KRW1 trillion for the first time in our history.

To maintain our leadership status at home, we are proactively responding to changes and the latest trends with stronger and segmented marketing and the launch of new products.

With the Framework Convention for Tobacco Control outlined in 2005, we expect tighter regulations on smoking across the globe. Meanwhile, competition from multinational firms is increasing as they try to seize a bigger share of the Korean market.

KT&G continues to emphasize our leadership at home to secure a sturdy foundation for growth while simultaneously upgrading our business portfolio.

To maintain our leadership status at home, we are proactively responding to changes and the latest trends with stronger and segmented marketing and the launch of new products.

Turning overseas, our plan is to bolster exports of premium brands to enhance profitability and to elevate our brand power to assure solid growth in export revenues. Necessary steps will be taken to minimize exposure to foreign exchange fluctuations and regulatory risks.

In addition, along with facility rationalization, production automation, and labor productivity improvement, we have established solid manufacturing system and business infrastructure to meet diverse needs of our customers.

In addition to solidifying our core business, we will secure the foundation for long-term sustainable growth. While we actively seek new growth drivers, we will also carefully analyze any potential new business's prospects and the added value it will bring.

2004 Highlights

Kwak Young-kyoon takes office as CEO

The former director of the marketing headquarters Kwak Young-kyoon was appointed the new CEO at the 17th general shareholders' meeting. Upon taking office, he stated that KT&G will move forward based on the three basic principles of (1) trust and harmony, (2) open communication among all levels of the organization, and (3) independence and accountability.

Proclamation of Challenge & Vision 2008

KT&G unveiled its corporate vision of "maximizing corporate value and employee potential to leap forward as a leading global enterprise." Domestic tobacco operation was selected as the foundation for growth, overseas tobacco business chosen as the core strategic business, red ginseng adopted as the leading growth driver and pharmaceuticals as the future growth engine.

KT&G receives Corporate Social Contribution Award

KT&G is well recognized for its social contributions. The KT&G Social Welfare Foundation operates welfare halls for the elderly and volunteer service centers. Assistance for children battling leukemia and donation of wheelchairs and computers for patients suffering from rare disorders are a few examples of the ways in which we reach out to the wider community and give hope to those in need.

MESSAGE FROM THE CEO

In addition to solidifying our core business, we will secure the foundation for long-term sustainable growth.

Along with maintaining good corporate governance and pursuing transparency, we highly value ideas and suggestions from our all our stakeholders. We stay committed to enhancing corporate value and working for the best interest of our shareholders.

Seeking ways to enhance all aspects of our organization, from personnel management and production to corporate governance, is an ongoing mission at KT&G.

Chairman & CEO
Young-kyoon Kwak

Achieving record high sales and operating profit
KT&G further strengthened its presence in the domestic market, despite increased competition, and renewed sales and operating profit records in fiscal 2004. Domestic sales volume and revenue increased by 10.6% and 21.5% YoY, respectively, to 82.3 billion sticks and KRW2,284.7 billion. Operating profit surpassed the KRW1 trillion mark for the first in KT&G's history.

World-class corporate governance
KT&G has won numerous awards for high standards of corporate governance and was named the fourth most respected corporation in Korea. We have also been acknowledged for our environmentally friendly policy and selected one of the best companies to work for. Standard and Poor's raised KT&G one notch from CGS-7 to CGS-7+, an indication that our corporate governance is solid even based on international standards. Awards in the areas of marketing and corporate image attest to our success in creating a more modern and updated corporate identity.

Continued rollout of new products
Lumen was renewaled in January 2004, followed by the debut of Time Light in March, which extended our Time line of products. In May, the company also saw the launch of Zest, the first slide-type cigarette in Korea. The subsequent releases were Esse One and Esse Field, which expanded the Esse brand to five products. Vision was launched in December which gave KT&G a solid footing in the market for slim-type cigarettes.

TRANSPARENT

KT&G firmly believes good corporate governance that facilitates fair distribution of profits hold the key to sustaining growth in the long term. In addition, the management and the Board of Directors are well aware that ethical business practices, transparency, and innovation are essential for success.

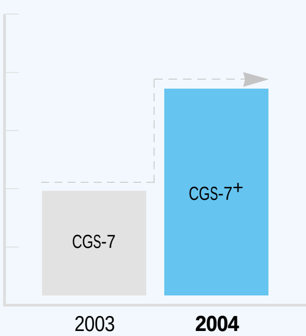
TRANSPARENT

TRANSPARENT

The Board of Directors plays a pivotal role in upholding sound corporate governance and shareholder democracy.

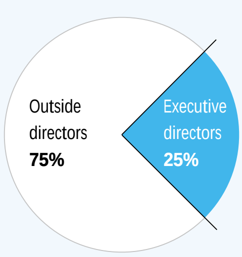
Nine of the twelve seats on the Board are filled by outside directors, and this structure assures that the Board is independent from the senior management and major shareholders.

S&P rating on Corporate governance



Standard and Poor's raised KT&G one notch from CGS-7 in 2003 to CGS-7+ in 2004, an indication that KT&G's corporate governance is solid based on international standards.

Percentage of Outside Directors on the Board
(%)



CORPORATE VISION

Maximizing both corporate value and employee potential to leap forward as a leading global enterprise is the management strategy driving KT&G. Domestic demand for cigarettes, which has accounted for the bulk of our revenues, is on the decline, competitive pressure is ever increasing, and regulations have become more stringent. To assure sustainable growth and profitability in the face of those adversities, we are working to enhance productivity and reinforce our business portfolio.

[Maximizing corporate value and employee potential to leap forward as a leading global enterprise]

Corporate Vision

- Domestic tobacco (Foundation for growth)
- Overseas tobacco (Core strategic business)
- Red ginseng (Leading growth driver)
- Pharmaceuticals (Future growth driver)

For our long-term business plans, we have decided on maintaining our emphasis on domestic cigarette sales as the foundation for growth, expansion into overseas tobacco markets as a core strategic business, red ginseng as the leading growth driver, and pharmaceuticals as our future growth engine.

To solidify our dominant position at home, we will reinforce marketing activities, further enhance brand power, rationalize production facilities, strengthen R&D and quality control, and innovate our raw material procurement system. With these endeavors, we aim to maintain stable revenue and profit generation in the domestic market.

Indigo A premium brand considered health and taste, Indigo introduced to the domestic market in April 2005.

We kept up our energetic pace of investor relation activities in 2004, with quarterly results conferences, numerous meetings with investors and analysts, including non-deal roadshows.

For our overseas operations, the focus is on strengthening our presence in export markets where we have already gained a foothold, exploring new markets with ample growth prospects, and building up our brand recognition.

Our lineup of red ginseng products, sold under the Cheon-Kwan-Jang brand, has emerged as an important growth driver. We are striving to expand our share of the domestic market and make greater inroads in overseas markets by continuing to improve all aspects of the business.

Our expansion into the pharmaceuticals field is an important part of our long-term growth strategy. Various efforts are being made to nurture this business and secure new products to achieve steady revenue streams and high profitability.

While KT&G recognizes the need to explore new opportunities, we will prudently and thoroughly analyze the growth potential and profitability prospects before venturing into new territory. Careful preparation will also be given to how a potential new business will add to our corporate value.

Under our long-term strategy, our growth path will take the following course: reinforce our core competencies for sustainable growth during 2005~2007, materialize growth opportunities during 2008~2010, and expand our presence on the global stage during 2011~2015.

In order to realize our objectives, we will adopt a value-based management system that allows for efficient allocation of resources and optimal investment. We remain committed to maintaining a pool of high-caliber personnel, adhering to high ethical standards, and pursuing transparent management. Taking that commitment to the next level, we will implement corporate social responsibility management. KT&G will spare no effort to remain an organization worthy of trust and respect.

CORPORATE GOVERNANCE

Board of Directors

75% of the Board is filled by outside directors

The Board of Directors plays a pivotal role in upholding sound corporate governance and shareholder democracy. Nine of the twelve seats on the Board are filled by outside directors, and this structure assures that the Board is independent from the senior management and major shareholders.

There is an audit committee, a performance/risk management committee, and a public interest/steering committee serving the Board, all of which are composed of experts in the relevant fields. In particular, executive directors are restricted from participating in the audit committee and agenda for which there is a potential conflict of interests with senior officers.

The Board has instituted several mechanisms to prevent moral hazard. First, the management contract scheme for the CEO ensures that decisions are not based on purely short-term gains. Second, incentive pay for the CEO is based on the outcome of performance evaluations. Third, if performance is not satisfactory, the Board has the authority to dismiss the CEO. To prevent unnecessary bureaucracy, the self-evaluation system for the Board was adopted in 2003. Under this scheme, senior outside directors lead the review of the Board's annual activities and those of the Board committees, and the outside directors conduct mutual evaluations.

Named the fourth most respected corporation in Korea

KT&G has emerged as an attractive investment for its high dividends, with the dividend yield holding steady at 5~6%. Our shareholder-oriented policy is also demonstrated by ongoing stock buybacks and cancellations. Outside directors are obligated to receive bonus pay in treasury stock, which keeps their interests aligned with those of the shareholders. Disposal of those shares is prohibited until they retire from their posts, thereby keeping the emphasis on long-term sustainability.

In recognition of our promotion of shareholder rights, management transparency, and appropriate distribution of profits, the Korea Stock Exchange selected KT&G as a company with superior corporate governance every year from 2002 to 2004. Standard and Poor's raised KT&G one notch from CGS-7 in 2003 to CGS-7+ in 2004, an indication that KT&G's corporate governance is also solid based on international standards. In June 2004, KT&G was ranked fourth among Korea's 30 most respected corporations by IBM BCS and Dong-a Ilbo.

Customized educational program for Board members

To help Board members keep abreast of latest developments in corporate governance, KT&G organizes seminars, at home or abroad, three times a year and arranges visits to our facilities for outside directors. The educational program for our Board members will be augmented by providing a regular forum in which various experts are invited to lead discussions on issues concerning the Board's roles and responsibilities.

We remain committed to maintaining a pool of high-caliber personnel, adhering to high ethical standards, and pursuing transparent management.

ZEST Korea's first slide-type cigarette, ZEST was introduced to the domestic market in May 2004.

SEASONS A regular-length premium brand with a distinctive sweet-spicy taste introduced to the domestic market in March 2002.

18th general shareholders' meeting

Lee Kwang-youl(director of marketing and sales headquarters) and Min Young-jin(director of overseas business headquarters) were named as standing directors in our 18th general shareholders' meeting. Seats left vacant by outside directors whose terms had expired were filled by Lee Kyung-jae (professor at Dongyang University), Cha Sun-gak (chairman of Ansan YMCA), and Kim Choong-sup (president of Korea Research Institute of Chemical Technology).

Outside directors who were re-appointed include Lee Man-woo (professor at Korea University), Soh Soon-moo (lawyer with law firm, Youlchon), Kim Byong-kyun (president of Daehan Investment & Securities), Kim Ki-ho (adviser for STX Co., Ltd.), Ahn Suck-kyo (professor at Hanyang University), and Kim Jin-Hyun (senior researcher at Korea International Trade Association).

Transparency

Corporate Governance Structure

KT&G firmly believes good corporate governance that facilitates fair distribution of profits hold the key to sustaining growth in the long term. In addition, the management and the Board of Directors are well aware that ethical business practices, transparency, and innovation are essential for success. That conviction is behind our governance structure, which clearly separates ownership and management.

Our Board is mostly comprised of outside directors to ensure independent decision-making. The Board are served by members with diverse backgrounds and expertise in their respective fields who bring a wealth of knowledge and assist the Board in various ways. To promote accountability, we have a contract system for the CEO, whose performance is evaluated by a committee composed exclusively of outside directors. KT&G gives full support to all members of the Board so they can concentrate their attention on raising corporate value.

Disclosure

We place great emphasis on accurate, timely and fair delivery of information to our shareholders, both existing and prospective. Corporate developments are clearly conveyed through our disclosures. We also provide disclosures in English to satisfy overseas investors' right to know.

Management Transparency

Our commitment to transparent management has not gone unnoticed. The Korea Listed Companies Association awarded KT&G in the audit category. We were given high marks for our audit committee, which is made up of only outside directors. In fact, KT&G has an independent audit department. Moreover, outside directors have the chance to speak directly with field managers without the presence of executive officers twice a year. An Internet reporting system provides a window for electronic filing of customer complaints and for reporting of wrongdoings.

In the first half of 2004 KT&G had the honor of being named the second most transparent corporation in Korea based on a survey by Economy21. The weekly publication based its decision upon a poll of 178 experts on corporate transparency conducted in February. KT&G earned high marks in most of the survey categories, such as reliability and accuracy of disclosures, and the top executive's commitment to transparent management.

Shareholder Relations

Investor Relations

We kept up our energetic pace of investor relation activities in 2004, with quarterly results conferences, numerous meetings with investors and analysts, including non-deal roadshows. We also communicated with prominent global institutional investors through conference calls. While conveying information about KT&G, our interaction with investors and analysts also allows us to gain insight on how we are perceived by the outside world. Updated information on corporate developments and operational results also can be accessed via our website.

Shareholder-oriented Policy

As part of efforts to maximize shareholder value, in september 2004, we acquired and have held treasury stock of three million shares. In addition three million shares were purchased and retired in October, followed by the equisition and the cancellation of another 10 million shares in December.

KT&G distributed total dividends of KRW237.2 billion for fiscal 2004, with the payout ratio at 50%. The combined amount of dividends and share repurchase was equivalent to 156% of net profit. Over the past three years, the figure has been around 121%.

Enhancing shareholder value will continue to be a top priority at KT&G, underpinned by stable profit generation. We will return wealth to our shareholders, taking into account our cash flows and the market conditions.

We will return wealth to our shareholders, taking into account our cash flows and the market conditions.

CIMA A fruit perfumed cigarette, CIMA was introduced to the domestic market in July 2001.

RAISON A mild-tasting, low tar premium brand introduced to the domestic market in August 2002.

EFFICIENT

EFFICIENT

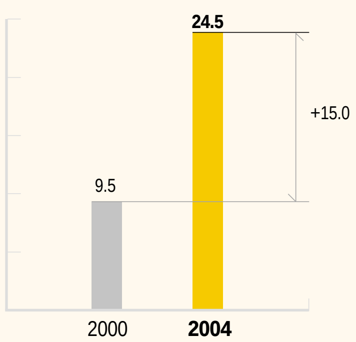
KT&G upheld its leadership position in the domestic market, with a 77.3% market share, by swiftly capitalizing on the shift towards low tar cigarettes.

Echoing the success of its domestic sales strategy, KT&G's shift towards premium brands has also driven improvement of average export price.

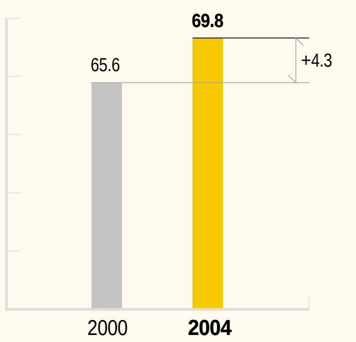
Efficient

KT&G continues to enhance manufacturing efficiency to prepare for the anticipated rise in overseas demand and favorable reception of its product offerings by overseas consumers. Continued efforts to improve on product quality, production efficiency and technology are an integral part of how we conduct our business.

KT&G's sales volume of low tar cigarettes
(billion of sticks)



KT&G's M/S in the premium cigarettes market (%)



KT&G prepared for the transition to a competitive market from 1998 by proceeding with rigorous restructuring and a rationalization program.

BUSINESS STRUCTURE

Business Efficiency

Reinventing our corporate image

Since the privatization in 2003, KT&G has been reinventing its image under a slogan that translates into "praising the imagination." With this initiative, we aspire to break away from our conservative image and forge a new identity as a dynamic, young and modern corporation. We highly value the imagination and potential of the young generation while adopting a future-oriented stance that embraces change.

The aforementioned campaign involved various programs and events such as a series of TV advertisements, the KT&G Summer Festival, and the Snow Festival. It enhanced the effectiveness of our rationalization program and push for more aggressive marketing.

Rationalization Program

KT&G prepared for the transition to a competitive market from 1998 by proceeding with rigorous restructuring and a rationalization program. Thanks to those endeavors, we generated record high sales and operating profit of respectively KRW2,653 billion and KRW1,022 billion in fiscal 2004, in spite of unfavorable market conditions.

In terms of domestic cigarette sales, our largest contributor of revenue, we managed to retain an overwhelming market share of nearly 80%. Combined domestic and export sales volume topped 113.3 billion sticks. Ongoing efforts to diversify our export markets resulted in export shipment of 31.1 billion sticks, and the rising export ratio is boosting top-line growth and enhancing profitability. Steady growth of our red ginseng product line and expansion into the pharmaceuticals market have also strengthened our profit base.

ESSE Lights Extra-long, super slim premium brand. ESSE Lights, a low tar version, was launched in December 2002.

ESSE field A tender and mild taste, ESSE field introduced to the domestic market in July 2004.

KT&G has been reinventing its image under a slogan that translates into "praising the imagination." With this initiative, we aspire to break away from our conservative image and forge a new identity as a dynamic, young and modern corporation.

Product Portfolio

Reinforcing R&D for better new product development

Highly talented research personnel and technological competence are prerequisites for making products that satisfy consumer tastes. With that in mind, we have redefined and revamped the R&D function at KT&G to better meet the markets' demands on us today.

In 2002, the Korea Ginseng and Tobacco Research Institute was renamed KT&G Central Research Institute. The system of research was restructured to allow more focused study on each area of specialty.

KT&G Central Research Institute is composed of four research centers: the tobacco research center strives to develop cigarettes functional cigarettes with special protective features: the ginseng research center is dedicated to creating red ginseng products and analyzing the medicinal properties of ginseng: the fuel research center conducts research on cultivation of tobacco and ginseng: and the analysis center examines tobacco products and the "pleasure sensation" they create. In March 2000, the analysis center was certified as a national testing body under the Korea Laboratory Accreditation Scheme, an event that raised its international credibility.

KT&G maintains a separate technology development unit to foster technological advances and engineering. The unit is constantly in contact with the marketing, production and raw material procurement departments to swiftly respond to their needs. The unit is composed of the product development team, production innovation team, process development team, and the technology planning team. Recently, a new team was added that focuses on products made from reconstituted tobacco.

We continue to make the best effort to develop new products and rationalize production facilities to meet the growing demand for premium cigarette brands and to satisfy diverse customer tastes.

New Product Development

▶ January 2004 Renewal of Lumen brand
relaunched with a milder taste and new design based on the phoenix motif

▶ March 2004 Launch of Time Light
a part of the Time line, along with Humming Time and Time

▶ April 2004 Renewal of Hanaro Light
a leading 100mm product with a mild taste and urbane image

▶ May 2004 Launch of Zest
Korea's first slide-type cigarette

▶ July 2004 Launch of Esse One and Esse Field
Esse line expanded to five products

▶ December 2004 Launch of Vision

a competitive slim-type brand

OPERATIONS

Domestic Sales

Despite more stringent regulations and fiercer competition, KT&G solidified its foothold in the domestic market and reaffirmed its long-term sustainability.

In 2004, market conditions turned unfavorable for the Company. In addition to greater competitive pressure, an increase in the tobacco excise tax resulted in a hike in cigarette prices. Even so, the Korean cigarette market expanded by 9.9% YoY to 106.5 billion sticks (or on up 12.7% YoY to KRW8,718.4 billion). The growth was led by the stockpiling running up to the price hike by KRW500 per pack effective from December, 30, 2004. Another driver was the rising preference for low tar cigarettes, which are mostly premium brands, triggered by heightened health awareness. As a portion of all cigarettes sold in Korea last year, the premium segment (i.e., brands priced over KRW1,800 per pack) comprised 75.3%, an expansion by 8.0%p over 2003.

KT&G upheld its leadership position in the domestic market, with a 77.3% market share, by swiftly capitalizing on the shift towards low tar cigarettes. Relative to the Company's total sales, products with tar below 3mg surged from 12.8% in 2003 to 29.8% in 2004, which leads to the growth of Korea's low tar market segment from 11.5% to 29.0%. As a result, our net revenue per pack improved to KRW555.2, which was 9.8% higher than in 2003.

Despite a tough operating climate, KT&G achieved sales volume of 82.3 billion sticks (+10.6% YoY) and revenue of KRW2,284.7 billion (+21.5% YoY). Last year marked a milestone, as operating profit broke above the KRW1 trillion mark for the first time.

We continue to make the best effort to develop new products and rationalize production facilities to meet the growing demand for premium cigarette brands and to satisfy diverse customer tastes.

ESSE One A premium brand considered health and taste, ESSE One introduced to the domestic market in July 2004.

VISION A new slim-type premium cigarette, VISION introduced to the domestic market in November 2004.

Competing tobacco companies have been fast penetrating the Korean cigarette market. But while their market share fell back slightly to 22.7% in 2004, KT&G expanded its share to 77.3%, up from the previous year's 76.7%. Enabling such an expansion was our timely response to the latest market trends and changing tastes of consumers. KT&G successfully tapped into the low tar market segment with the launch of premium brands, including the Esse line (Esse Field and Esse One) while maintaining an unrivalled hold on the market for slim-type cigarettes.

The competitors will likely take on a more aggressive stance, reshuffling their business structure and product portfolio. Our continued efforts to keep pace with market developments and enhance product quality should enable us to meet the challenge head-on.

Overseas Sales

Echoing the success of its domestic sales strategy, KT&G's shift towards premium brands has also driven improvement of average export price.

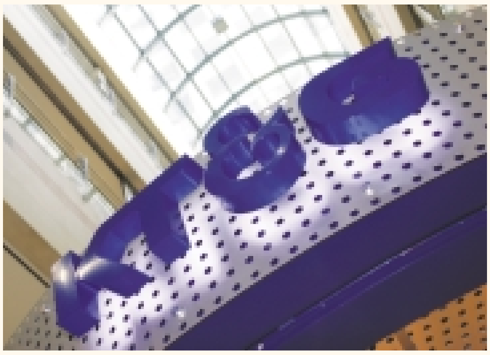
Building on its strong brand recognition in the Middle East and Central Asia, the Company successfully branched out into new markets. In 2004, export volume edged up only 0.5% YoY, but an increase in the average net selling price boosted export revenue by a solid 10.6% YoY.

Exports as a percentage of total sales slid by 1.2 percentage points in 2004 due to a temporary boost in domestic demand prior to the price hike induced by higher tobacco taxes. Nonetheless, it was also a year in which KT&G diversified its export destinations to the Americas, Southeast Asia, China and Russia while also reinforcing its status in the Middle East and Central Asia. The handsome strides made in the overseas markets were the results of KT&G's effective brand marketing of Esse, particularly in Russia, and localization of the Cima brand in Iran.

While we have moved forward in our overseas operations, we hope to achieve much more. KT&G plans to strengthen its presence in the key overseas markets with the launching of premium brands, reinforce the sales force in the US and China markets, and nurture our growing business in Russia and Southeast Asia. Necessary steps will be taken to minimize the risks associated with foreign exchange fluctuations and the local regulatory environment.

Manufacturing

KT&G continued with its facility rationalization in 2004. Such efforts bore fruit in the form of enhanced productivity and greater production efficiency.



The new plant in Yeongju was completed in 2003 at a cost of KRW238 billion and a building period of 30 months. The new state-of-the-art facility has equipped the Company with an annul production capacity of 22 billion sticks.

In addition, KT&G has implemented a systematic program of rationalization and has halted operations at four manufacturing plants in Daegu, Jeonju, Suwon and Chungju since 1999, which were growing obsolete. Of the manufacturing plants under the operation, two have now been modernized and the other two are in the modernization process. Along with the automation of production, labor productivity improved by an average of 12.4% over the past three years.

The tobacco business is capital-intensive and requires economies of scale. That is, production capacity has to be above a certain degree to ensure competitiveness. Presently, KT&G is capable of producing 145 billion sticks per year, which renders sufficient economies of scale to compete with global leading tobacco companies.

KT&G continues to enhance manufacturing efficiency to prepare for the anticipated rise in export sales demand and favorable reception of its product offerings by overseas consumers. Continued efforts to improve on product quality, production efficiency and technology are an integral part of how we conduct our business.

Labor Productivity (stick/man-hour)	FY02	FY03	FY04
	26,119	29,780	32,950

KT&G continued with its facility rationalization in 2004. Such efforts bore fruit in the form of enhanced productivity and greater production efficiency.

CLOUD9 KT&G's finest premium brand with carbon compound filter and unique package, launched in April 2003.

The One A mild-tasting, ultra-low tar premium brand introduced to the domestic market in September 2003.

SUSTAINABLE

SUSTAINABLE

All decisions and actions at KT&G are guided by our management philosophy of best serving our customers, faithfully fulfilling our social responsibilities, and pursuing what is in the best interest of all our stakeholders.

Sustainable

Korea's rapidly aging population has raised our interest in the welfare of the elderly. Other ways in which we serve the community include funding for medical research and medical assistance for patients suffering various disorders, operation of volunteer service centers, promotion of the arts, and many more. Our basic aim is to reach out and play our role as a responsible corporate citizen.

2004 Corporate
Social contribution Award
“Welfare of elderly”

Award the Bronze prize
for Great Workplace

KT&G received the 2004 Corporate Social Contribution Award in the category for “welfare of the elderly”.

ETHICAL MANAGEMENT

Code of Ethics

All decisions and actions at KT&G are guided by our management philosophy of best serving our customers, faithfully fulfilling our social responsibilities, and pursuing what is in the best interest of all our stakeholders. Those principles are reflected in our emphasis on integrity and trust, which we believe are key elements of a transparent and healthy enterprise. Our commitment to promoting fair and honest business practices is articulated in our Code of Ethics and Guidelines on Business Conduct formulated in February 2003.

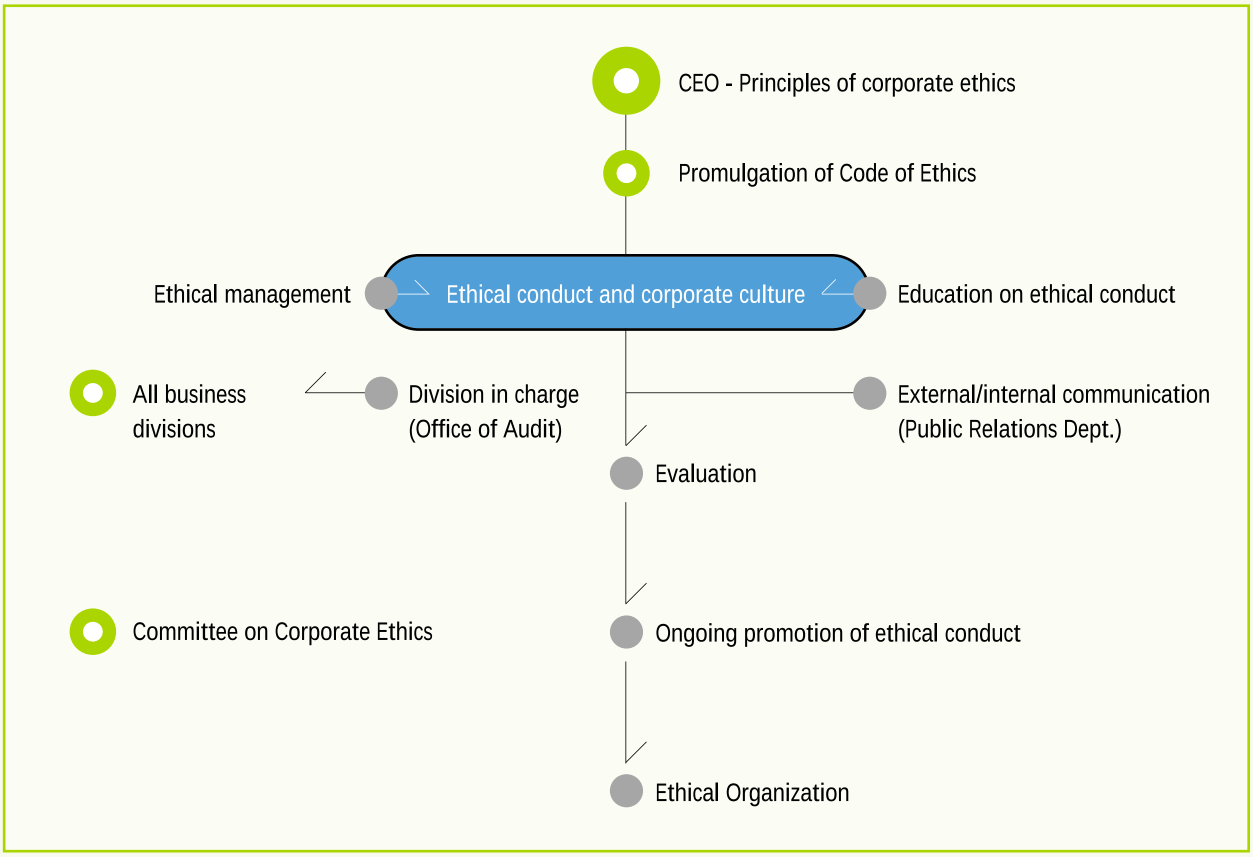
The ideas and spirit embodied in the Code of Ethics is communicated within the organization through a pledge on business conduct, which is taken by all members of KT&G. We also convey our dedication to the highest ethical standards to all our business partners. With active participation in related seminars and events and through exchanges with other corporations, we continue to seek ways to further raise our standards.

Our policies on business conduct were reinforced as of June 2004 in response to the growing importance of corporate ethics. We devised new regulations on employee obligations and officer/manager responsibilities, and a new provision relating to sharing corporate wealth with the community at large. Rules on unfair trade and those that govern dealings with contractors, suppliers and other business partners were strengthened.

Education on ethical conduct is available to new recruits to KT&G and sales personnel to help them fully understand our stance on this important issue. For other members of the organization, we have distributed a business conduct manual to guide them in their activities and decision-making. We have also prepared a

RAISON Menthol A clean and hub perfumed cigarette, RAISON Menthol introduced to the domestic market in October 2003.

We are also committed to supporting issues that are publicized to a lesser extent, such as preserving Korea's traditional arts and culture.



compilation of model cases of ethical behavior. The examples are classified into caring for the customer, building a better workplace, charitable works, supporting the regional community, and preserving the environment,

Promotion of good business ethics is a company-wide initiative. To provide motivation and heighten awareness, we have in place a system for awarding ethical behavior based on internal assessments. Constant evaluation and improvement of ethical standards is an inherent part of doing business at KT&G.

CORPORATE SOCIAL RESPONSIBILITY

Corporate Citizenship

KT&G Social Welfare Foundation

The KT&G Social Welfare Foundation was established in July 2003 in accordance with our policy of fulfilling our social responsibilities and sharing wealth with the wider community. Work is underway to enlarge the asset base of the Foundation and enhance its financial autonomy so as to broaden the scope of support and community involvement. Separate from the Foundation, KT&G itself also undertakes various activities to contribute to society.

Korea's rapidly aging population has raised our interest in the welfare of the elderly. Other ways in which we serve the community include funding for medical research and medical assistance for patients suffering various disorders, operation of volunteer service centers, promotion of the arts, and many more. Our basic aim is to reach out and play our role as a responsible corporate citizen.

There are 1,310 employees in 30 volunteer groups at KT&G who donate their time and effort to charitable works. In terms of financial assistance in 2004, the Company contributed KRW36 billion to the KT&G Social Welfare Foundation, while another KRW51.2 billion went towards a variety of causes such as the South Asia Tsunami relief and assistance for the underprivileged, among numerous others.

KT&G received the 2004 Corporate Social Contribution Award, jointly given by the Korea Economic Daily and the Open Management Research Institute, in the category for "welfare of the elderly." We were recognized for being the first Korean enterprise to operate facilities that cater to the elderly, offering a wide range of services such as meals, recreational programs and consultation. KT&G also makes contributions to 35 programs that serve senior citizens, especially those who are neglected.

Our involvement in a broad range of issues, from social welfare and health to the protection of minors, arts and sports, remains strong. We are also committed to supporting issues that are publicized to a lesser extent, such as preserving Korea's traditional arts and culture. We will maintain our relationships with various segments of the community and continue to widen the breadth and depth of our philanthropic activities.

Highlights of philanthropic activities in 2004

KT&G

- Assistance for 256 children suffering from leukemia over the past three years

Our involvement in a broad range of issues, from social welfare and health to the protection of minors, arts and sports, remains strong.

via the Korean Association for Children with Leukemia and Cancer

- Relief and medical supplies for Tsunami victims in Indonesia and South Asia

KT&G Social Welfare Foundation

- Care facilities for the elderly run in conjunction with regional governing bodies

- Educational program to foster professionals dedicated to treatment of Alzheimer's Disease

Promotion of the arts

- Sponsor of 2004 Seoul Performing Arts Festival - encompasses plays, dance, exhibitions, movies, mimes, etc.

- Sponsor of the 7th Seoul Fringe Festival - fosters creativity and imagination; 200 independent artists/groups in Korea and from five countries in Asia participated

- Organized KT&G Igloo Camping - an event featuring winter sports such as skiing, snowboarding, and curling

Promotion of sports

- KT&G Road Race Championship - Korea's premier motorcycle racing event held in Gangwon province

- Sponsor of the 2005 professional volleyball tournament - 2005 is the debut year

- KT&G Table Tennis Invitational, return match between Korea's Ryu Seung Min and China's Wang Hao

Labor-Management Relations

81% of employees express confidence in KT&G

In March 2004, KT&G conducted a survey to check employees' views on post-privatization KT&G in four areas: 1) employee attitude, 2) organizational culture, 3) external competitiveness, and 4) work motivation. Most of the survey participants said there were positive changes, such as more flexible communication, enhanced product competitiveness, and a more autonomous working environment. Many said KT&G has solid growth potential, while 81% praised the changes taking place at KT&G, and 91% said they were motivated to do their best.

Employees' confidence is the result of endeavors to promote KT&G as a global player. With our social contributions and service to community, we have not only improved the image of

KT&G among the public, but also boosted the morale of persons inside the organization.

The positive sentiment is also ascribed to the fact that the corporate vision and progress made are clearly conveyed to all of our stakeholders. Such communication ensures that everyone is striving for a common goal with a shared view.

Cooperative labor-management relations

The labor union at KT&G was established in 1954 and was renamed to Korea Tobacco and Ginseng Workers' Union in 1989. The number of union members stood at 4,044 as of the end of December 2004. Well aware of the importance of cooperative labor-management relations, the union has played a vital role in narrowing differences between the two sides while also working to enhance workers' welfare and improve the work setting.

Awarded the bronze prize for Great Workplace

In 2004, KT&G received the bronze prize for the Great Workplace Award, which is jointly sponsored by the Korea Economic Daily and ELTech Trust Management Institute. The Great Workplace Award was given to 15 companies in total last year based on whether employees think their organization is a good place to work. KT&G has been recognized as having all of the three essential factors for an optimal workplace, namely trust, pride and fun. We will work to sustain an environment in which everyone is motivated to live up to his/her full potential.

PRUDENT


RAISON
Indigo
ZEST
VISION
SEASONS
ONE
One/1
ESSE
field
CEO'S CHOICE
CIMA
THE 3D CLASS A CIGARETTES
CLOUD

PRUDENT

KT&G continued to lead the domestic cigarette market, along with an overwhelming share of the market segments for premium and low tar cigarettes. Proactive and creative marketing combined with continuous rollout of new products helped the Company expand domestic market share, even in the face of a more competitive environment.

MANAGEMENT'S DISCUSSION & ANALYSIS

(In billions of Korean won, except per share data)	2002	2003	2004	Change
Net sales	1,806.9	2,178.9	2,653.4	21.8%
Operating profit	527.1	711.5	1,021.6	43.6%
Net profit	347.4	459.7	472.3	2.7%
Total assets	3,766.3	3,887.0	3,885.0	-0.1%
Total liabilities	1,614.3	1,071.7	670.8	-37.4%
Total shareholders' equity	2,152.1	2,815.3	3,214.2	14.2%
Operating margin (%)	29.2	32.7	38.5	5.8%p
Return on equity (%)	14.6	18.5	15.7	-2.8%p
Interest-bearing debt to equity (%)	51.6	17.4	0.6	-16.7%p
Weighted-average number of shares outstanding (000's)	176,579	146,925	161,077	9.6%
Weighted-average number of common shares outstanding (000's)	146,989	123,428	148,391	20.2%
Earnings per share (won)	2,364	3,724	3,183	-14.5%
Diluted earnings per share (won) (2)	2,084	3,307	2,981	-9.9%
Average dividend per share (won)	1,400	1,600	1,600	0.0%
Year-end stock price (won)	16,400	20,700	30,950	49.5%
Year-end KOSPI index (point)	627.6	810.7	895.9	10.5%
Average net selling price (won/pack of 20 cigarettes)	441.4	505.6	555.2	9.8%
Domestic sales volume (in billions of cigarettes)	72.5	74.4	82.3	10.6%
Exports volume (in billions of cigarettes)	21.4	30.9	31.1	0.6%
Number of employees	4,635	4,564	4,264	-6.6%

The year 2004 was marked by numerous challenges. While the global economy managed to expand, skyrocketing oil prices and a weakening US dollar increased uncertainties. On the home front, the Korean economy remained in a slump amidst ever-falling interest rates, depressed consumer sentiment and heightened social tension.

Conditions surrounding the domestic cigarette market were not much better. The anti-smoking movement spread, competition intensified, and the government's decision to raise tobacco taxes led to a hike in cigarette prices. In spite of these obstacles, KT&G upheld its market dominance and reported its best ever sales and operating profit in fiscal 2004.

The Company continued to lead the domestic cigarette market, along with an overwhelming share of the market segments for premium and low tar cigarettes. Proactive and creative marketing combined with continuous rollout of new products helped the Company expand domestic market share, even in the face of a more competitive environment.

KT&G also made important strides in the global arena and

MANAGEMENT'S DISCUSSION & ANALYSIS

paved the way for steady growth in export revenue. The Company has a diversified range of exports markets spanning from the Middle East and Central Asia to the Americas, Southeast Asia, China and Russia.

Summary Income Statement (In billions of Korean won)	FY02	FY03	FY04
Net sales	1,807	2,179	2,653
Operating profit	527	711	1,022
Net profit	347	460	472
Earnings per share(Won)	2,364	3,724	3,183

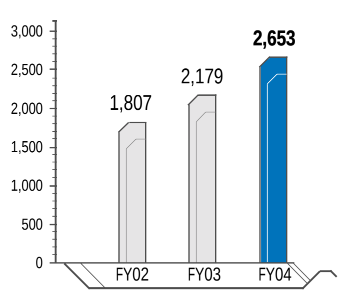
Sales

Net Sales (In billions of Korean won)	FY02	FY03	FY04
Net sales	1,807	2,179	**2,653**
Net sales growth	6.2%	20.6%	**21.8%**

Market leadership in low tar cigarettes, increased sales contribution of premium brands, and overseas expansion enabled KT&G to achieve strong sales performance in 2004. The boost in demand towards last year's end ahead of the price hike as of the end of 2004 also contributed to driving up net sales to a historic high of KRW2,653.4 billion, which represents impressive growth of 21.8% over the previous year, outpacing net sales growth of 20.6% YoY in 2003.

Net Sales

(In billions of Korean won)

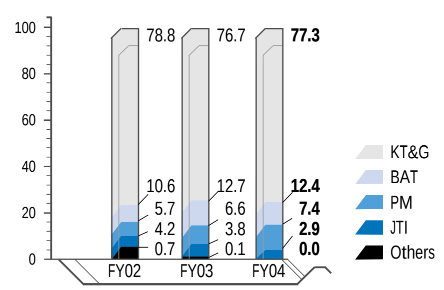


Robust top-line growth helped to bolster profits. Operating profit jumped 43.6% YoY to KRW1,021.6 billion, surpassing the KRW1 trillion mark for the first time in KT&G's history.

A key factor behind the remarkable performance was the gain in domestic market share, which had declined over the past several years. The Company had been losing its footing in the home market owing to softening demand for cigarettes and aggressive marketing by competitors. However, reinforcement of marketing capability, development of new products that cater to changing customer tastes, and sophisticated brand management helped the Company expand its market share to 77.3%, up by 0.6%p over the previous year.

Domestic Market Share

(%)



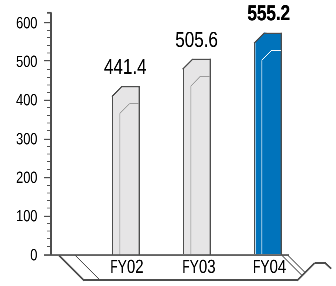
The shift towards low tar cigarettes has been a major growth driver for the cigarette market and for KT&G. Last year, demand for low tar products shot up 177.2% YoY, and they accounted for 29.0% of the overall cigarette market in Korea, as opposed to only 11.5% in 2003. For KT&G, sales volume of low tar brands surged 157.1% YoY to 24,515 million sticks, and those brands contributed 29.8% of total volume.

Status of KT&G's low-tar cigarette (million sticks, %)	FY02	FY03	FY04
Low-tar cigarette market	1,285	11,131	**30,859**
KT&G's low-tar cigarette sales	1,249	9,536	**24,515**
KT&G sales growth	225.6%	663.2%	**157.1%**
Volume contribution by low-tar cigarette	1.7%	12.8%	**29.8%**

The rising prominence of low tar products has been closely linked to the development of the premium brand market since a majority of the low tar products are premium brands. KT&G has benefited from the strong brand power of its premium low tar products such as Season, Raison, The One, Esse One, and Esse Field. In 2004, sales of premium brands accounted for 68.0% of KT&G's total sales, up by 10.6%p over 2003, whereas the share of regular and low-end brands continued to diminish. That shift pushed up the average net selling price of KT&G by 9.8% YoY to KRW555.2 per pack.

Average net selling price per pack

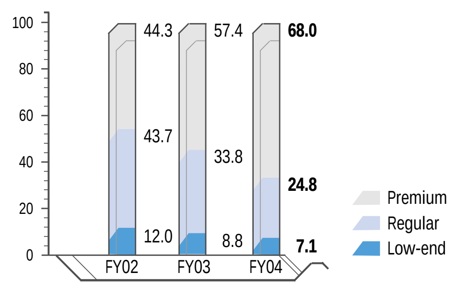
(Korean won per pack)



Strengthening overseas operations is a core element of our business strategy. Exports will serve as an important growth engine in the long term while also helping the Company overcome limitations of the domestic market. KT&G exported a total of KRW302.8 billion worth of cigarettes in 2004, an increase of 10.6% relative to 2003. Even so, exports as a percentage of total revenue fell by 1.2%p to 11.4%, which, we believe, was the result of a temporary jump in domestic sales towards the end of last year sparked by stockpiling ahead of the price hike.

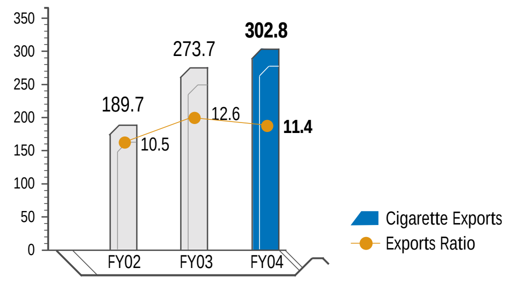
KT&G Brand Mix

(%)



Cigarette exports

(In billions of Korean won, %)



Export revenue by region (%)	FY02	FY03	FY04
Central Asia & the Middle East	80.4	84.1	**78.2**
America	16.9	12.7	**14.5**
China	1.1	1.3	**3.5**
Southeast Asia	1.1	1.5	**2.6**
Other	0.6	0.5	**1.1**

MANAGEMENT'S DISCUSSION & ANALYSIS

Since venturing into markets abroad, KT&G has made ceaseless efforts to develop new marketing techniques and products to appeal to local customers. Those efforts are largely behind the Company's solid performance in Central Asia and the Middle East, the two most important export markets to KT&G. In addition, KT&G has made inroads into markets with high growth potential such as China, Southeast Asia, Americas, and Russia. These newer markets accounted for a far larger portion of exports last year compared to 2003.

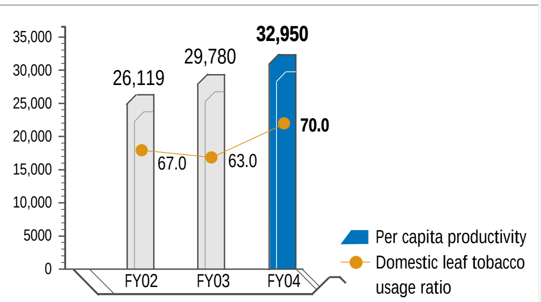
In the domestic market, the increase in tobacco taxes has raised concern of a potential reduction in demand. KT&G has taken various steps to address that concern: proceed with marketing to closer consumers, discontinue unprofitable brands, maximize operating efficiency, and improve labor productivity by modernizing production facilities. All these measures are ultimately intended to ensure sustained growth and high profitability.

Operating Costs and Expenses

COGS went up 13.8% YoY to KRW1,105.2 billion owing to: 1) expanded production amid volume growth, and 2) a rise in the usage portion of domestic leaf tobacco from 63.0% to 70.0%. Nevertheless, gross profit swelled 28.2% YoY to KRW1,548.2 billion. The gross profit margin improved by 2.9%p to 58.3%, expanding for the second year in a row, thanks to increased sales of premium brands and enhanced productivity. Production per man-hour rose by 10.6% YoY to 32,950 sticks.

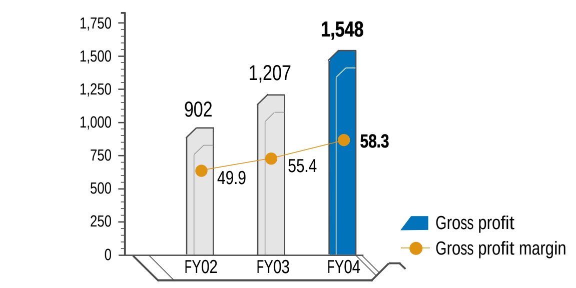
Cost of sales

(Cigarette/m/h, %)



Gross profit

(In billions of Korean won, %)



SG&A expense grew 6.2% YoY to KRW526.6 billion, or 19.8% of revenue, down by 3.0%p compared to a year earlier. The higher SG&A expense over 2003 is partly attributed to marketing expenses related to the launch of new brands such as Zest, Esse One, Esse Field, and Vision. Other reasons for the rise include increased overtime pay in the wake of brisk sales, more spending on ads and promotions for corporate image enhancement, and extensive domestic and overseas marketing activities.

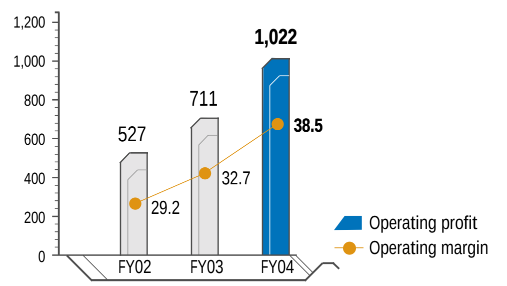
SG&A expenses breakdown (in billions of Korean won)	FY02	FY03	FY04
Salaries	154	169	182
Employee welfare	13	31	28
Advertising	76	135	153
Commissions	31	37	37
Depreciation	28	32	38
Others	73	91	89

The growth in labor expense including employee welfare costs slowed to 4.8% last year thanks to a wage freeze, and also because ESOP contribution remained at 2003's level. In 2003, labor expense including employee welfare costs soared almost 20% YoY. Although wages were frozen, salaries swelled due to the partial reassignment of manufacturing workers to the sales division, and performance-based incentive were granted to employees (ESOP contribution) for the first time as operating results surpassed the Company's targets.

Operating profit came in at KRW1,021.6 billion, ballooning 43.6% YoY and climbing above the KRW1 trillion mark. This memorable feat is ascribed to economies of scale realized from increased sales, enhanced productivity, and the growing profit contribution of premium brands. The operating profit margin expanded by 5.8%p to 38.5%.

Operating Profit

(In billions of Korean won, %)

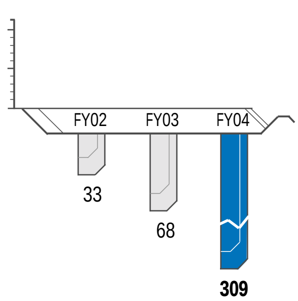


Non-operating Balance

Non-operating income shrank by 8% YoY to KRW169.7 billion, whereas non-operating expense surged 89.7% YoY to KRW478.2 billion. The combined effect was a deterioration of net non-operating expense to KRW308.5 billion.

Non-operating Balance (= non op income - non op expense)

(In billions of Korean won)



On a positive note, equity method gains from Korea Ginseng Corporation grew 9.5% YoY to KRW74.1 billion. This is also an indication of better predictability of non-operating items, going forward.

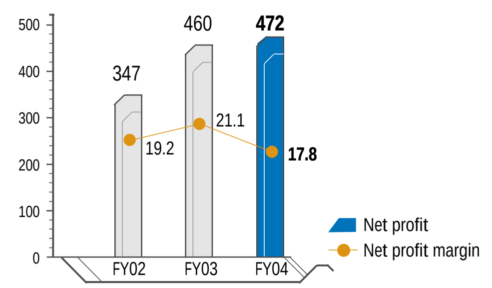
Loss on conversion of exchangeable bond which climbed 131.4% to KRW157.2 billion, was the main culprit behind the wider net non-operating expense. KT&G recorded losses of KRW100.2 billion and KRW57.0 billion, respectively, on conversion of overseas exchangeable bonds and domestic exchangeable bonds in 2004.

Earnings and Dividends

Net profit climbed to a historic high of KRW472.3 billion, an increase of 2.7% YoY. The growth rate was slightly lower than the 10.7% YoY increase in pre-tax profit to KRW713.1 billion owing to a sharp rise in taxes. The pre-tax profit margin slid by 2.7%p over the previous year to 26.9%, while the net profit margin was eroded by 3.3%p to 17.8%.

Net profit

(In billions of Korean won, %)

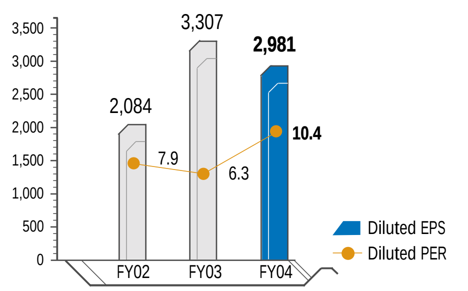


The conversion of domestic and overseas exchangeable bonds boosted the number of outstanding shares. The resultant dilution impact caused earnings per share to decrease 9.9% YoY from KRW3,307 in 2003 to KRW2,981 in 2004. For the same reason the price-to-earnings ratio rose from 6.3x to 10.4x (based on the 2004 closing share price of KRW30,950).

MANAGEMENT'S DISCUSSION & ANALYSIS

Diluted EPS and Diluted PER

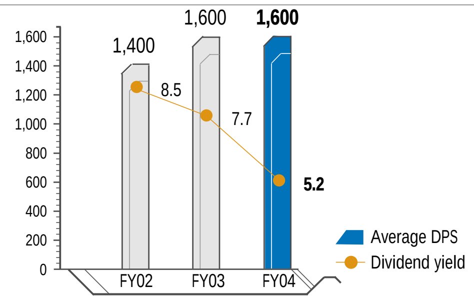
(in Korean won, X)



In keeping with our policy of maximizing shareholder value, the Company paid out attractive dividends of KRW1,600 per share for fiscal 2004, maintaining the previous year's level. The dividend yield, however, declined from 7.7% in 2003 to 5.2% in 2004 due to the 49.5% appreciation in share price. The Company remains firmly committed to returning profits to shareholders giving due consideration to market conditions and cash flows.

Dividend per share and Dividend yield

(in Korean won, %)



ANALYSIS OF FINANCIAL CONDITIONS

Summary Balance Sheet (in billions of Korean won)	FY02	FY03	FY04
Assets	3,766	3,887	3,885
Liabilities	1,614	1,072	671
Interest-bearing debt	1,110	489	20
Shareholders's equity	2,152	2,815	3,214
Book value per share (won)	12,188	19,162	19,955

The Company regards its healthy balance sheet and financial flexibility as a competitive advantage. This advantage is based on solid operating cash flow, discipline regarding working capital and capital expenditures, and the commitment to a fiscally responsible policy of maximizing shareholder value.

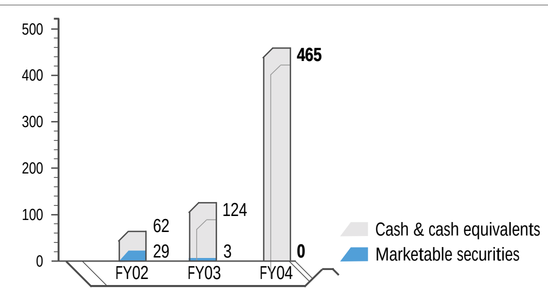
Total assets as of December 31, 2004, stood at KRW3,885.0 billion, down by 0.1% YoY, on the back of a sharp reduction in available for-sale securities from KRW364.6 billion in 2003 to KRW52.5 billion in 2004. Total liabilities decreased by KRW400.9 billion to KRW670.8 billion, following the conversion of domestic and overseas exchangeable bonds.

Cash and Working Capital

Cash and cash equivalents surged 275% YoY to KRW464.5 billion as a result of growing net profit, disposal of marketable securities, and efficient operating cash management. In particular, the full conversion of overseas exchangeable bonds gave the Company leeway to dispose of marketable securities that were held to prepare for possible redemption of those bonds.

Cash & marketable securities

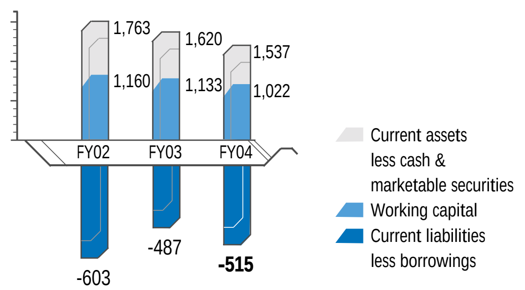
(In billions of Korean won)



Increased sales raised accounts receivable by KRW72.3 billion compared to 2003, while inventory dwindled by KRW137.6 billion. Accordingly, the working capital burden eased by 9.8% YoY, or KRW111.0 billion, to KRW1,022.3 billion, which in turn improved liquidity by a considerable degree.

Working Capital

(In billions of Korean won)



Fixed Assets

Fixed assets contracted by 12.0% YoY to KRW1,883.0 billion. Tangible assets increased marginally, while investment assets declined 31.5% YoY as the Company sold marketable securities, which were acquired to hedge for foreign exchange and interest rate fluctuations after issuance of overseas exchangeable bonds. When those bonds matured in 2004, all of the pertinent marketable securities were sold.

Fixed assets (in billions of Korean won)	FY02	FY03	FY04
Investment assets	923	972	666
Property, plant & equipment	1,138	1,166	1,215
Intangible assets	2	2	2

Debt Financing

Abundant operating cash flow and proceeds from the disposal of investment assets markedly expanded free cash flow. Simultaneously, conversion of exchangeable bonds sharply lowered interest-bearing liabilities. As a result, the debt-to-equity ratio fell from 17.4% in 2003 to 0.6% in 2004. KT&G further improved its financial health by paying down debt, which provides a sound foundation for enhancement of shareholder value.

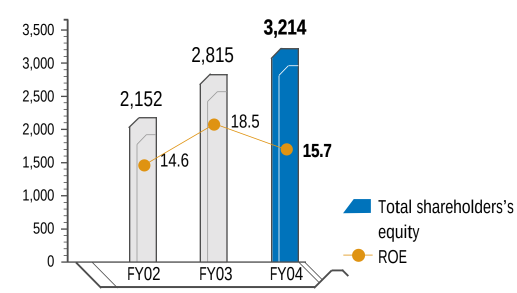
Borrowings & debt-to-equity ratio (in billions of Korean won, %)	FY02	FY03	FY04
Short-term borrowings	290	0	0
Exchangeable bonds	820	489	20
Interest-bearing debt to equity ratio	51.6	17.4	0.6

Shareholders' Equity

The conversion of exchangeable bonds (EBs) to 22,441,694 shares (7,241,960 shares for domestic EBs and 15,199,734 shares for overseas EBs) during last year led to a gain on disposal of treasury stock. That, in turn, bolstered the capital surplus from KRW81.1 billion at end-2003 to KRW277.3 billion at end-2004. Accordingly, total shareholder equity increased by 14.2% YoY to KRW3,214.2 billion. Net asset value per share improved by 6.6% YoY to KRW21,676, but there was a setback in return on equity from the previous year's 18.5% to 15.7% despite an increase in net profit.

Shareholders' equity

(In billions of Korean won, %)



ANALYSIS OF CASH FLOWS

Over the past several years, stable operating cash flow has provided the wherewithal to finance facility investment to secure future growth potential. At the same time, it also enabled KT&G to distribute dividends or repurchase stock to return profits to investors.

MANAGEMENT'S DISCUSSION & ANALYSIS

Summary Cash Flows Statements (in billions of Korean won)	FY02	FY03	FY04
Cash flows from operating activities	451	635	749
Cash flows from investing activities	(203)	(61)	87
Cash flows from financing activities	(229)	(508)	(619)

Cash Flows from Operating Activities

In 2004, net cash inflow from operating activities swelled by KRW113.6 billion to KRW748.7 billion. The boost is explained by expanded net profit, rising non-cash items such as depreciation and amortization, and reduced inventory assets in line with top-line growth.

Cash flows from operating activities (in billions of Korean won)	FY02	FY03	FY04
Net profit	347.4	459.7	472.3
Depreciation and amortization	79.7	87.4	103.4
Others	24.3	87.9	173.0

Cash Flows from Investing Activities

Net cash inflow from investing activities amounted to KRW87.5 billion, a vast improvement over the net outflow of KRW60.6 billion in 2003, as most of the holding of marketable securities were disposed of during the year. Using the free cash flow, KT&G acquired KRW123.9 billion in short-term financial goods.

Cash Flows from Financing Activities

Net cash outflow from financing activities magnified by KRW111.2 billion to KRW619.1 billion, which was the balance between cash inflow of KRW100.2 billion after disposal of treasury shares and cash outflow of KRW221.5 billion for dividend payment and KRW501.1 billion for share buyback.

Cash flows from financing activities (in billions of Korean won)	FY02	FY03	FY04
Borrowings & debentures	784.0	(289.6)	3.4
Dividend	(212.0)	(167.4)	(221.5)
Others	(801.2)	(50.9)	(400.9)

2005 BUSINESS OUTLOOK AND MANAGEMENT ISSUES

The climate is expected to remain unfavorable for the tobacco industry, with higher cigarette prices that reflect hiked tobacco taxes as well as tougher competition. However, KT&G is moving forward, fully prepared to take on the considerable demands before us in the year ahead.

The Korean cigarette market this year is forecast to contract to 82.7 billion sticks, down by 22.4% from 2004. Under that scenario, KT&G's net sales in 2005 should decrease by 9.4% YoY to KRW2,403.7 billion and operating profit, by 29.2% YoY to KRW723.5 billion. Owing in part to the temporary rise in demand ahead of the price hike in late 2004, this year we anticipate a steep reduction in sales volume of 21.6% YoY to 64.5 billion sticks and the net average selling price to inch down 0.7% to KRW551.4.

Although the market is likely to shrink, KT&G estimates to increase its share of the pie by 0.7%p to 78.0%. While sales is forecast to contract, net profit is expected to grow 8.0% YoY to KRW510.0 billion driven by substantial reduction in non-operating expenses. The net profit margin is forecast to improve to 21.2%.

KT&G is confident that it will remain the frontrunner in the domestic market for low tar and premium brands. Simultaneously, a proactive approach will be taken to solidify the Company's position in existing export markets and to penetrate into new markets. Also forming an important part of KT&G's strategy to assure sustainability is nurturing the red ginseng and pharmaceutical businesses as the future growth engines.

FINANCIAL STATEMENTS

Independent Auditors' Report

Based on a report originally issued in Korean

KPMG Samjong Accounting Corp.

10th floor, Star Tower
737 Yeoksam-dong, Gangnam-gu
Seoul 135-984,
Republic of Korea

Tel. 82-2-2112-0100
Fax. 82-2-2112-0101
www.kr.kpmg.com

The Board of Directors and Stockholders

KT&G Corporation:

We have audited the accompanying balance sheets of KT&G Corporation (the "Company") as of December 31, 2004 and 2003, and the related statements of income, appropriation of retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the Republic of Korea. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of KT&G Corporation as of December 31, 2004 and 2003, and the results of its operations, the changes in its retained earnings, and its cash flows for the years then ended in conformity with accounting principles generally accepted in the Republic of Korea.

The accompanying financial statements as of and for the year ended December 31, 2004 have been translated into United States dollars solely for the convenience of the reader and have been translated on the basis set forth in note 2(b) to the financial statements.

Without qualifying our opinion, we draw attention to the following:

As discussed in note 2(a) to the financial statements, accounting principles and auditing standards and their application in practice vary among countries. The accompanying financial statements are not intended to present the financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in countries other than the Republic of Korea.

In addition, the procedures and practices utilized in the Republic of Korea to audit such financial statements may differ from those generally accepted and applied in other countries. Accordingly, this report and the accompanying financial statements are for use by those knowledgeable about Korean accounting procedures and auditing standards and their application in practice.

FINANCIAL STATEMENTS

As discussed in note 2(a) to the financial statements, the Company adopted Statements of Korea Accounting Standards No. 10, No. 12 and No. 13, effective January 1, 2004, and Accounting Standard Application Opinion No. 04-1, effective April 1, 2004. Certain accounts of prior year's financial statements were reclassified to conform to the current year's presentation. These reclassifications did not result in any change to reported income or stockholders' equity.

As discussed in note 8 to the financial statements, the Company sells and purchases finished goods to and from related parties. The Company recorded sales of W102,178 million and purchases of W14,958 million in relation to the above transactions for the year ended December 31, 2004. As of December 31, 2004, W16,448 million and W1,835 million were due from and due to related parties, respectively.

As discussed in note 21 to the financial statements, the Company entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise by 2008 a fund with the target set at W410 billion to stabilize tobacco production. According to the agreement, the Company is to make up the deficiency if the fund balance should fall short of the target. The Company records a provision for the tobacco production stabilization fund deficiency based on the target amount. The amount contributed to the fund by the Company in 2004 amounted to W18,082 million, and the provision for the fund deficiency as of December 31, 2004 amounted to W37,671 million. In addition, effective December 30, 2004, the levy per pack of cigarettes, which was made for the purpose of raising the fund, was raised to 15 Korean Won from 10 Korean Won. However, the Company did not take into account the effect of this change in estimating the deficiency in case of falling short of the fund target owing to uncertainty as of the year-end as to the use of the 5 Korean Won increase per pack of cigarettes.

As discussed in note 21 to the financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of W407 million caused by smoking. The final outcome from these lawsuits cannot be estimated. Accordingly, no provisions have been made in the accompanying financial statements.

As discussed in note 18 to the financial statements, the Company reacquired and subsequently retired 13,000,000 shares of treasury stock in 2004. Accordingly, as of December 31, 2004, the number of the Company's shares issued decreased to 165,442,497 shares.

KPMG Samjong Accounting Corp.

Seoul, Korea

January 21, 2005

This report is effective as of January 21, 2005, the audit report date. Certain subsequent events or circumstances, which may occur between the audit report date and the time of reading this report, could have a material impact on the accompanying financial statements and notes thereto. Accordingly, the readers of the audit report should understand that there is possibility that the above audit report may have to be revised to reflect the impact of such subsequent event or circumstance, if any.

FINANCIAL STATEMENTS

Balance Sheets

December 31, 2004 and 2003

(In millions of Korean Won and thousands of United States dollars)

Assets	Won 2004		U.S. dollars(note 2(b)) 2004		2003	
Current assets:						
Cash and cash equivalents (notes 3 and 17)	₩	338,542	$	324,336	₩	121,486
Short-term financial instruments		126,000		120,713		2,095
Accounts receivable, net of allowance for doubtful accounts of ₩2,275 in 2004 and ₩1,544 in 2003 (notes 8 and 17)		225,196		215,746		152,905
Inventories (notes 4 and 12)		1,261,567		1,208,629		1,399,131
Other current assets (notes 5 and 17)		50,694		48,567		71,147
Total current assets		**2,001,999**		**1,917,991**		**1,746,764**
Available-for-sale securities (notes 6 and 17)		52,496		50,293		364,592
Investment securities under equity method (note 7)		401,340		384,499		338,925
Long-term loans receivable, net of allowance for doubtful accounts of ₩809 in 2004 and ₩747 in 2003 and present value discount of ₩33,514 in 2004 and ₩43,075 in 2003 (note 9)		80,077		76,717		73,978
Long-term loans to employees		84,967		81,402		119,624
Guarantee deposits		25,358		24,294		21,323
Long-term deposits in escrow fund, less allowance for doubtful accounts of W19,817 in 2004 and ₩17,137 in 2003 (note 17)		-		-		-
Property, plant and equipment, at cost (notes 10, 11 and 12)		1,808,734		1,732,836		1,723,564
Less accumulated depreciation		(593,909)		(568,988)		(557,889)
Net property, plant and equipment		**1,214,825**		**1,163,848**		**1,165,675**
Other assets (note 13)		23,950		22,945		56,164
Total assets	₩	**3,885,012**	$	**3,721,989**	₩	**3,887,045**

Continued;

FINANCIAL STATEMENTS

December 31, 2004 and 2003

(In millions of Korean Won and thousands of United States dollars, except share data)

Liabilities and Stockholders' Equity	Won 2004		U.S. dollars(note 2(b)) 2004		2003	
Current liabilities:						
Accounts payable (notes 8 and 17)	₩	13,846	$	13,265	₩	10,510
Value added tax payable		157,306		150,706		112,809
Advance receipts		34,318		32,878		38,448
Accrued expenses		27,511		26,356		16,422
Other payables		38,828		37,198		22,436
Tobacco excise taxes and dues payable		42,140		40,372		152,619
Income taxes payable		192,584		184,503		124,036
Current portion of exchangeable bonds (note 15)		20,142		19,296		-
Other current liabilities (notes 8, 14 and 17)		8,623		8,261		9,758
Total current liabilities		**535,298**		**512,835**		**487,038**
Exchangeable bonds (note 15)		-		-		488,604
Retirement and severance benefits (note 16)		46,399		44,452		40,597
Guarantee deposits received (note 8)		27,623		26,464		24,273
Deferred income tax liabilities (note 23)		23,804		22,805		11,611
Provision for loss on tobacco production stabilization fund (note 21)		37,671		36,090		19,589
Total liabilities		**670,795**		**642,646**		**1,071,712**
Stockholders' equity (note 18):						
Common stock of W 5,000 par value (note 1):						
Authorized - 800,000,000 shares						
Issued -165,442,497 shares						
Outstanding - 148,287,613 shares		954,959		914,887		954,959
Capital surplus (note 15)		277,331		265,694		81,140
Retained earnings (note 19)		2,355,656		2,256,807		2,517,044
Capital adjustments (note 20)		(373,729)		(358,045)		(737,810)
Total stockholders' equity		**3,214,217**		**3,079,343**		**2,815,333**
Commitments and contingencies (note 21)						
Total liabilities and stockholders' equity	₩	**3,885,012**	$	**3,721,989**	₩	**3,887,045**

See accompanying notes to financial statement.

Statements of Income

For the years ended December 31, 2004 and 2003

(In millions of Korean Won and thousands of United States dollars, except earnings per share)

	Won 2004		U.S. dollars(note 2(b)) 2004		2003	
Sales:						
Tobacco sales	₩	2,587,519	$	2,478,941	₩	2,154,316
Leaf tobacco sales		10,039		9,617		8,264
Other		55,827		53,485		16,296
		2,653,385		2,542,043		2,178,876
Cost of sales		1,105,231		1,058,853		971,507
Gross profit		1,548,154		1,483,190		1,207,369
Selling and administrative expenses (note 29)		526,578		504,481		495,912
Operating income		1,021,576		978,709		711,457
Other income (expense):						
Interest income		38,373		36,763		31,597
Interest expense		(11,566)		(11,080)		(40,982)
Loss on valuation of currency swaps, net (note 25)		-		-		(646)
Gain on valuation of interest rate swaps (note 25)		-		-		14,516
Loss on transactions of interest rate swaps		(698)		(669)		-
Loss on transactions of currency swaps		(9,051)		(8,671)		-
Rental income		9,662		9,256		10,427
Loss on valuation of inventories		-		-		(22,676)
Other bad debts expense		(28,317)		(27,129)		(18,503)
Loss on foreign currency transactions, net		(26,292)		(25,189)		(1,923)
Donations		(87,164)		(83,506)		(42,710)
Contribution to Tobacco Production Stabilization Fund (note 21)		(18,082)		(17,323)		(19,589)
Gain on valuation of investments using equity method (note 7)		73,297		70,221		66,289
Gain on sale of property, plant and equipment, net		4,917		4,711		9,488
Loss on redemption of exchangeable bonds, net (note 15)		(157,244)		(150,646)		(67,940)
Loss on prior period adjustments (note 26)		(13,908)		(13,324)		-
Additional income taxes for prior years		(86,337)		(82,714)		-
Other, net		3,904		3,739		15,152
		(308,506)		(295,561)		(67,500)
Income before income taxes		713,070		683,148		643,957
Income taxes (note 23)		240,770		230,667		184,256
Net income	₩	**472,300**	$	**452,481**	₩	**459,701**
Basic earnings per share in Won and US dollars (note 24)	₩	**3,183**	$	**3.05**	₩	**3,724**
Diluted earnings per share in Won and US dollars (note 24)	₩	**2,981**	$	**2.86**	₩	**3,307**

See accompanying notes to financial statement.

FINANCIAL STATEMENTS

Statements of Appropriation of Retained Earnings

For the years ended December 31, 2004 and 2003
(Date of Appropriation for 2004: March 18, 2005
Date of Appropriation for 2003: March 18, 2004)
(In millions of Korean Won and thousands of United States dollars)

	2004 Won		2004 U.S. dollars(note 2(b))		2003	
Unappropriated retained earnings:						
Balance at beginning of year	₩	230,219	$	220,559	₩	40,733
Retirement of treasury stock		(412,160)		(394,865)		(67,136)
Net income		472,300		452,481		459,701
Balance at end of year before appropriation		290,359		278,175		433,298
Transfer from voluntary reserves:						
Reserve for research and manpower development		12,038		11,533		17,889
Reserve for overseas business losses		-		-		194
Reserve for overseas market development		-		-		235
Reserve for energy saving facilities		-		-		131
Other appropriations		10,320		9,887		-
		22,358		21,420		18,449
Unappropriated retained earnings available for appropriation		312,717		299,595		451,747
Appropriation of retained earnings:						
Dividends - 32% on par value at 1,600 Won per share (note 27)		237,260		227,304		221,528
Reserve for research and manpower development		45,000		43,112		-
Reserve for losses on reissuance of treasury stock		26,646		25,528		-
		308,906		295,944		221,528
Unappropriated retained earnings to be carried over to subsequent year	₩	**3,811**	$	**3,651**	₩	**230,219**

See accompanying notes to financial statement.

Statements of Cash Flows

For the years ended December 31, 2004 and 2003

(In millions of Korean Won and thousands of United States dollars)

	Won 2004		U.S. dollars(note 2(b)) 2004		2003	
Cash flows from operating activities:						
Net income	₩	472,300	$	452,481	₩	459,701
Adjustments to reconcile net income to net cash provided by operating activities:						
Depreciation and amortization		103,415		99,075		87,443
Loss on valuation of inventories		8,877		8,504		22,676
Bad debts expense		730		700		357
Gain on valuation of trading securities		-		-		(26)
Gain on sale of trading securities, net		-		-		(5,994)
Amortization of discount on exchangeable bonds		8,003		7,677		22,084
Gain on valuation of investments using equity method		(73,297)		(70,221)		(66,289)
Loss on foreign currency transactions, net		5,846		5,602		81
Other bad debts expense		28,317		27,129		18,503
Provision for retirement and severance benefits		52,629		50,420		32,766
Gain on sale of property, plant and equipment, net		(4,917)		(4,711)		(9,488)
Impairment losses on property, plant and equipment		42		40		13,956
Amortization of present value discounts		(9,902)		(9,487)		(8,826)
Gain on valuation of short-term financial instruments		-		-		(38)
Gain on valuation of interest rate swaps		-		-		(14,516)
Loss on transactions of interest rate swaps		698		669		-
Loss on transactions of currency swaps		9,051		8,671		-
Loss on valuation of currency swaps		-		-		646
Contribution to Tobacco Production Stabilization Fund		18,082		17,323		19,589
Loss on redemption of exchangeable bonds, net		157,244		150,646		67,940
Loss on prior-period adjustments		13,908		13,324		-
Deferred income tax liabilities		18,069		17,310		22,912
Payments of retirement and severance benefits		(38,128)		(36,528)		(7,705)
Increase in deposit for severance benefit insurance		(8,699)		(8,334)		(12,013)
Changes in assets and liabilities:						
Accounts receivable		(76,509)		(73,299)		(35,196)
Inventories		128,686		123,286		18,072
Other current assets		12,411		12,190		9,624

Continued;

FINANCIAL STATEMENTS

For the years ended December 31, 2004 and 2003

(In millions of Korean Won and thousands of United States dollars)

	2004 Won		2004 U.S. dollars(note 2(b))		2003	
Accounts payable	₩	3,418	$	3,275	₩	(6,728)
Value added tax payable		44,498		42,631		16,919
Advance receipts		(4,130)		(3,957)		8,694
Accrued expenses		763		731		379
Other payables		16,392		15,704		(8,060)
Tobacco excise taxes and dues payable		(110,479)		(105,843)		(31,894)
Income taxes payable		(14,338)		(13,736)		30,415
Other current liabilities		(1,131)		(1,083)		775
Other, net		(13,179)		(12,625)		(11,605)
Net cash provided by operating activities		748,670		717,254		635,064
Cash flows from investing activities:						
Sale of available-for-sale securities		316,099		302,834		174
Sale of trading securities		198		189		33,759
Sale of investment securities under equity method		50,000		47,902		50,000
Purchases of trading securities		-		-		(1,372)
Purchases of available-for-sale securities		(3,617)		(3,466)		(29,283)
Purchases of investment securities under equity method		(40,284)		(38,594)		(8,903)
Purchases of property, plant & equipment		(166,004)		(159,040)		(155,605)
Purchases of intangible assets		(267)		(256)		(1,002)
Proceeds from long-term interest receivable		473		453		-
Proceeds from short-term deposits		(123,905)		(118,705)		4,681
Proceeds from sale of property, plant & equipment		18,953		18,158		29,078
Settlement of interest rate swaps		13,819		13,239		701
Settlement of currency swaps		(9,697)		(9,291)		(4,869)
Decrease in long-term loans to employees		27,661		26,504		3,868
Increase in guarantee deposits		(28,889)		(27,674)		(26,413)
Proceeds from long-term deposits in escrow fund		14,854		14,230		-
Increase in long-term deposits in escrow fund		(19,931)		(19,095)		(656)
Increase in other investments		(3,295)		(3,156)		(3,099)
Other, net		41,307		39,572		48,374
Net cash provided by (used in) investing activities		87,475		83,804		(60,567)

Continued;

For the years ended December 31, 2004 and 2003

(In millions of Korean Won and thousands of United States dollars)

	2004				2003	
	Won		U.S. dollars(note 2(b))			
Cash flows from Financing activities:						
Increase in guarantee deposits received	₩	3,350	$	3,209	₩	386
Reissuance of treasury stock		100,168		95,965		16,221
Reacquisition of treasury stock		(501,075)		(480,048)		(67,136)
Repayment of short-term borrowings		-		-		(290,000)
Redemption of exchangeable bonds		(4)		(4)		-
Payment of dividends		(221,528)		(212,232)		(167,395)
Net cash used in financing activities		(619,089)		(593,110)		(507,924)
Net increase in cash and cash equivalents		217,056		207,948		66,573
Cash and cash equivalents at beginning of year		121,486		116,388		54,913
Cash and cash equivalents at end of year	₩	338,542	$	324,336	₩	121,486

See accompanying notes to financial statement.

FINANCIAL STATEMENTS

Notes to Financial Statements

December 31, 2004 and 2003
(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(1) The Company

KT&G Corporation (the "Company"), which is engaged in manufacturing and selling tobacco, was established on April 1, 1987 as Korea Monopoly Corporation, a wholly-owned subsidiary of the Korean government, pursuant to the Korea Monopoly Corporation Act, in order to secure financing and to promote and develop, through efficient management, the monopoly business of red ginseng and tobacco. On April 1, 1989, the Company changed its name to Korea Tobacco and Ginseng Corporation pursuant to the Korea Tobacco and Ginseng Corporation Act. Also, pursuant to the Act on Management Reform and Privatization of Public Enterprises, proclaimed on August 28, 1997 and enforced on October 1, 1997, the Company was excluded from the application of the Act for the Management of Government Invested Enterprises. Accordingly, the Company became an entity existing and operating under the Commercial Code of Korea. The Korean government sold 28,650,000 shares of the Company to the public during 1999 and the Company listed its stock on the Korea Stock Exchange on October 8, 1999. On December 27, 2002, the Company changed its name again to KT&G Corporation from Korea Tobacco & Ginseng Corporation.

As of December 31, 2004, the Company has four manufacturing plants, including the Shin Tan Jin plant, and 14 local headquarters and 144 branches for the sale of tobacco throughout the country. Also, the Company has two plants for fabrication of leaf tobacco, including the Nam Won plant, and the Chun Ahn printing plant for the manufacturing of wrapping paper.

Pursuant to the Korean government's privatization program and management reorganization plan, on December 28, 1998, the stockholders approved a plan to separate into two companies by setting up a subsidiary for its red ginseng business segment effective January 1, 1999. The separation was accomplished by the Company's contribution of the assets and liabilities in the red ginseng business segment into a wholly-owned subsidiary, the Korea Ginseng Corporation.

On October 17, 2002 and October 31, 2001, the Company listed 35,816,658 and 45,400,000 Global Depositary Shares ("GDS") (each GDS representing the right to receive one-half share of common stock of the Company), respectively, on the Luxembourg Stock Exchange pursuant to the Korean government's privatization program.

The ownership of the Company's outstanding common stock at December 31, 2004 is held as follows:

Stockholder	Number of shares	Percentage of ownership
Industrial Bank of Korea	9,510,485	5.7%
Employee Stock Ownership Association	11,739,376	7.1%
Treasury stock	17,154,884	10.4%
Others	127,037,752	76.8%
	165,442,497	**100.0%**

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(2) Summary of Significant Accounting Policies and Basis of Presenting Financial Statements

(a) Basis of Presenting Financial Statements

The Company maintains its accounting records in Korean Won and prepares statutory financial statements in the Korean language (Hangul) in conformity with the accounting principles generally accepted in the Republic of Korea. Certain accounting principles applied by the Company that conform with financial accounting standards and accounting principles in the Republic of Korea may not conform with generally accepted accounting principles in other countries. Accordingly, these financial statements are intended for use only by those who are informed about Korean accounting principles and practices. The accompanying financial statements have been condensed, restructured and translated into English (with certain expanded descriptions) from the Korean language financial statements.

The accompanying financial statements include only the accounts of the Company, and do not include the accounts of any of its subsidiaries.

The Company adopted Statements of Korea Accounting Standards (SKAS) No. 10 (“Inventories”), No. 12 (“Construction - Type Contract”) and No. 13 (“Troubled Debt Restructuring”), effective January 1, 2004 and Accounting Standard Application Opinion No. 04-1, effective April 1, 2004. Certain accounts of prior year’s financial statements were reclassified to conform to the current year's presentation.

(b) Basis of Translating Financial Statements

The financial statements are expressed in Korean Won and, solely for the convenience of the reader, have been translated into U.S. dollars at the rate of ₩1,043.80 to US$1, the basic exchange rate on December 31, 2004. This translation should not be construed as a representation that any or all of the amounts shown could be converted into U.S. dollars at this or any other rate.

(c) Cash Equivalents

The Company considers short-term financial instruments with maturities of three-month or less at the acquisition date to be cash equivalents.

(d) Financial Instruments

Short-term financial instruments are financial instruments handled by financial institutions which are held for short-term cash management purposes or will mature within one year, including time deposits, installment savings deposits and restricted bank deposits.

(e) Allowance for Doubtful Accounts

Allowance for doubtful accounts is estimated based on an analysis of individual accounts and past experience of collection.

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(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(f) Inventories

Inventories are stated at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling cost. The cost of inventories is determined by the weighted-average method for finished goods, by-products and work-in-process; using the moving-average method for raw materials and supplies; and using the specific identification method for materials-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. Effective January 1, 2004, the Company adopted SKAS No. 10, "Inventories." Through 2003, a valuation loss which was incurred when the market value of inventory fell below its carrying amount was reported as a non-operating expense. In 2004, in accordance with SKAS No. 10, the Company included inventory valuation losses in cost of goods sold. Loss on valuation of inventories recognized amounted to ₩8,877 and ₩22,676 for the years ended December 31, 2004 and 2003, respectively.

(g) Investment in Securities

Upon acquisition, the Company classifies certain debt and equity securities into one of the three categories: held-to-maturity, available-for-sale, or trading securities. Investments in debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) are classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used to generate profit on short-term differences in price. Investments not classified as either held-to-maturity or trading securities are classified as available-for-sale securities.

Trading securities are carried at fair value, with unrealized holding gains and losses included in income. Available-for-sale securities are carried at fair value, with unrealized holding gains and losses reported as a capital adjustment. Investments in equity securities that do not have readily determinable fair values are stated at cost. Declines in value judged to be other-than-temporary on available-for-sale securities are charged to current results of operations. Investments in debt securities that are classified into held-to-maturity are reported at amortized cost at the balance sheet date and such amortization is included in interest income.

Marketable securities are at the quoted market prices as of the period end. Non-marketable debt securities are recorded at the fair values derived from the discounted cash flows by using an interest rate deemed to approximate the market interest rate. The market interest rate is determined by the issuers' credit rate announced by the accredited credit rating agencies in Korea. Money market funds are recorded at the fair value determined by the investment management companies.

Trading securities are classified as current assets, whereas available-for-sale securities and held-to-maturity securities are classified as long-term investments. However, available-for-sale securities whose maturity dates are due within one year from the balance sheet date or whose likelihood of being disposed of within one year from the balance sheet date is probable are classified as current assets. Likewise, held-to-maturity securities whose maturity dates are due within one year from the balance sheet date are classified as current assets.

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(h) Investment Securities under the Equity Method of Accounting

Investments in affiliated companies owned 20% or more or over which the Company has significant management control are stated at an amount as determined using the equity method.

Under the equity method of accounting, the Company's initial investment is recorded at cost and is subsequently increased to reflect the Company's share of the investee income and reduced to reflect the Company's share of the investee losses or dividends received. Any excess in the Company's acquisition cost over the Company's share of the investee's identifiable net assets is considered as goodwill and amortized by the straight-line method over the estimated useful life. The amortization of goodwill is recorded against the equity income of affiliates. When events or circumstances indicate that carrying amount may not be recoverable, the Company reviews the goodwill amount for any impairment.

Under the equity method of accounting, the Company does not record its share of loss of an affiliate company when such loss would make the Company's investment in such entity less than zero.

(i) Property, Plant and Equipment

Property, plant and equipment are stated at cost. Significant additions or improvements extending useful lives of assets are capitalized. However, normal maintenance and repairs are charged to expense as incurred.

Depreciation is computed by the straight-line method over estimated useful lives of the respective assets as follows:

	Useful lives (years)
Buildings	10 to 60
Structures	10 to 40
Machinery and equipment	10 to 12
Vehicles and other transportation equipment	4
Tools	4
Furniture and fixtures	4

Prior to January 1, 2003, the Company capitalized interest costs on all borrowings incurred prior to completion of the acquisitions, as part of the cost of qualifying assets. However, effective January 1, 2003, the Company adopted SKAS No. 7, "Capitalization of Financing Costs." In accordance with this standard, the Company elected to no longer capitalize interest costs. Accordingly, the Company recognizes interest costs and other financial charges on borrowings associated with the manufacture, purchase, or construction of property, plant and equipment as an expense in the period in which they are incurred.

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(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

The Company reviews for the impairment of property, plant and equipment, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss would be recognized when estimated undiscounted future net cash flows expected to result from the use of the asset and its eventual disposition are less than its carrying amount. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

(j) Intangible Assets

Intangible assets are stated at cost less accumulated amortization. Amortization is computed using the straight-line method over estimated useful lives, not to exceed 20 years, of the respective assets as follows:

	Estimated useful lives
Industrial rights	5 to 10
Water facility use rights	15

The Company reviews for the impairment of intangible assets, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

(k) Valuation of Receivables and Payables at Present Value

Receivables and payables arising from long-term installment transactions, long-term cash loans/borrowings and other similar loan/borrowing transactions are stated at present value. The difference between nominal value and present value is deducted directly from the nominal value of related receivables or payables and is amortized using the effective interest method. The amount amortized is included in interest expense or interest income.

(l) Retirement and Severance Benefits

Employees who have been with the Company for more than one year are entitled to lump-sum payments based on current rates of pay and length of service when they leave the Company. The Company's estimated liability under the plan which would be payable if all employees left on the balance sheet date is accrued in the accompanying balance sheets. A portion of the liability is covered by an employees' severance benefits trust where the employees have a vested interest in the deposit with the insurance company in trust. The deposit for severance benefits held in trust is, therefore, reflected in the accompanying balance sheets as a deduction from the liability for retirement and severance benefits.

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(m) Exchangeable Bonds

Effective January 1, 2003, the Company adopted SKAS No. 9, "Convertible Securities." When issuing convertible bonds or bonds with stock purchase warrants, the values of the conversion rights or stock warrants shall be recognized separately.

Considerations for conversion rights or stock warrants shall be measured by deducting the present value of ordinary or straight debt securities (redemption premium is included if applicable) from the gross proceeds of the convertible bonds or bonds with stock purchase warrants received at the date of issue. However, in the case of bonds with detachable stock warrants, considerations for such warrants shall be computed based on the fair values of the two core components - straight debt securities and detachable stock warrants.

However, convertible securities issued prior to first adopting new SKAS No. 9 are treated in accordance with the previous accounting standard and have not been restated. The Company recognizes interest expense on convertible notes and bonds with warrants as determined using the effective interest method, and amortization of redemption premium is recorded as a long-term accrued interest expense.

(n) Foreign Currency Translation

Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at the balance sheet date, with the resulting gains and losses recognized in current results of operations. Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at ₩1,043.80 to US$1, the rate of exchange on December 31, 2004 that is permitted by the Financial Accounting Standards. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated into Korean Won at the foreign exchange rate ruling at the date of the transaction.

(o) Discount on Debentures

Discount on debenture issued, which represents the difference between the face value and issuance price of debentures, is amortized using the effective interest method over the life of the debentures. The amount amortized is included in interest expense.

(p) Derivatives

Derivative instruments are presented as assets or liabilities valued principally at the fair value of rights or obligations associated with the derivative contracts. The unrealized gain or loss from derivative transactions is recognized in current operations.

However, for derivative instruments with the purpose of hedging the exposure to the variability of cash flows of a forecasted transaction, the hedge-effective portion of the derivative's gain or loss is deferred as a capital adjustment, a component of stockholders' equity. The deferred gain or loss will be adjusted to the related asset or liability resulted from the forecasted transaction, or adjusted to income when the forecasted transaction affects income statement. The ineffective portion of the gain or loss is charged or credited to current results of operations.

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(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

Forward foreign exchange contracts which have been made to hedge foreign exchange receivables and payables in the future are classified as forward foreign exchange contracts for hedging purposes. Unrealized gain or loss on forward foreign exchange contracts for hedging purposes are deferred as capital adjustment. The deferred gain or loss will be credited or charged to income when related foreign exchange receivables and payables are settled.

(q) Revenue Recognition

The Company recognizes revenue from the sale of goods when the goods are delivered. Revenue from other than the sale of goods is recognized when the Company's revenue earning activities have been substantially completed, the amount of revenue can be measured reliably, and it is probable that the economic benefits associated with the transaction will flow to the Company.

Revenue on contracts, regardless of whether long term or short term, is accounted for principally by the percentage-of-completion method, whereby income is recognized based on the estimated degree of completion of individual contracts.

(r) Income Taxes

Income tax on the income or loss for the year comprises current and deferred tax. Income tax is recognized in the statement of income except to the extent that it relates to items recognized directly to equity, in which case it is recognized in equity.

Deferred tax is provided using the asset and liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantially enacted at the balance sheet date.

A deferred tax asset is recognized only to the extent that it is probable that future taxable income will be available against which the unused tax losses and credits can be utilized. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

(s) Dividends Payable

Dividends are recorded when approved by the board of directors and shareholders.

(t) Prior Period Adjustments

Prior period adjustments resulting from other than fundamental errors are charged or credited to net income for the current period. The fundamental errors are defined as errors with such a significant effect on the financial statements for one or more prior periods that those financial statements can no longer be considered to have been reliable at the date of their issue. The prior period adjustments resulting from the fundamental errors are charged or credited to the beginning balance of retained income, and the financial statements of the prior year are restated.

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(u) Earnings Per Share

Earnings per common share are calculated by dividing net earnings by the weighted-average number of shares of common stock outstanding during each period.

(v) Contingent Liabilities

Contingent losses are generally recognized as a liability when probable and reasonably estimable.

(w) Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the Republic of Korea requires management to make estimates and assumptions that affect the amounts reported in the financial statements and related notes to financial statements. Actual results could differ from those estimates.

(3) Cash and Cash Equivalents

Cash and cash equivalents as of December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Cash on hand	₩	3,901	3,558
Passbook accounts		74,641	67,928
Time deposits		-	10,000
Money market fund		190,000	20,000
Repurchase agreement		70,000	20,000
	₩	**338,542**	**121,486**

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(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(4) Inventories

Inventories as of December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Finished goods, net of valuation loss reserve	₩	86,046	90,441
Work-in-process		6,772	11,164
Raw materials, net of valuation loss reserve		1,132,872	1,259,528
Supplies		17,249	18,845
By-products		2,872	1,778
Completed buildings		1,450	427
Sites for building lotting-out construction		4,406	5,026
Goods-in-transit		9,900	11,922
	₩	**1,261,567**	**1,399,131**

(5) Other Current Assets

Other current assets as of December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Accrued income	₩	3,907	3,195
Trading securities		-	2,893
Other receivables		9,753	20,127
Advance payments		9,995	13,265
Prepaid expenses		963	882
Short-term loans to employees		22,955	27,663
Current portion of long-term loans		3,121	3,122
	₩	**50,694**	**71,147**

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(6) Securities

Available-for-sale securities as of December 31, 2004 and 2003 are summarized as follows:

(a) Equity securities

Affiliate	Number of shares	Percentage of ownership	2004	2003
Yonhap Television News (YTN)	8,380,000	19.95%	₩ 10,098	12,067
Celltrion Inc. (preferred stock)	2,860,000	16.82%	18,866	18,866
Nexgen Biotechnologies, Inc.	100,000	16.22%	2,150	2,150
KT&G USA	100,000	100.00%	584	584
Cosmo Tobacco Co., Ltd.	480,000	40.00%	763	763
Innodis	110,000	19.64%	55	55
Oscotech, Inc.	230,770	5.18%	2,250	2,250
Rexhan	500,000	6.56%	2,359	2,359
Lifenza	29,047	13.01%	1,600	1,000
KT&G Hanbit Hyang Ryo, Inc.	1,134,000	51.04%	2,829	-
			₩ 41,554	**40,094**

Changes in unrealized gain for the year ended December 31, 2004 are summarized as follows:

	Amount
Beginning balance	₩ 6,965
Changes in unrealized gain	(1,969)
Net balance at end of year	**₩ 4,996**

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(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(b) Debt securities

	Interest rate per annum		2004	2003
Government and municipal bonds	3.00 ~ 9.70%	₩	9,343	9,440
Samsung Corporation	LIBOR + 1.95%		-	95,822
Woori Finance Holdings Co., Ltd.	LIBOR + 1.60%		-	88,637
Gibo Capital Co., Ltd.	6.55%		-	20,000
Hyundai Heavy Industries Co., Ltd.	7.67%		-	50,000
Hyundai Capital Co., Ltd.	7.33%		-	39,000
Crystal Genomics Co., Ltd.	3.00%		999	999
Yungjin Pharmacy Co., Ltd.	9.00%		-	20,000
MD Bioalpha	5.50%		600	600
		₩	**10,942**	**324,498**

(7) Affiliates' Equity Securities Accounted for Using Equity Method

(a) Affiliates' equity securities accounted for using the equity method of accounting for investments as of December 31, 2004 and 2003 are summarized as follows:

Affiliate	Number of shares	Percentage of ownership		2004	2003
Korea Ginseng Corporation	22,985,851	100.00%	₩	331,133	306,983
KT&G Turkey	9,900	99.00%		868	2,203
Tae-a Industry Co., Ltd.	150,000	100.00%		13,442	-
Buytheway Co., Ltd.	4,034,935	43.67%		22,744	23,039
Yungjin Pharmacy Co., Ltd.	53,148,564	57.34%		33,153	6,700
			₩	**401,340**	**338,925**

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(b) Details of changes in affiliates' equity securities accounted for using equity method after acquisition as of December 31, 2004 are as follows:

			Adjustments to				
			Retained Earnings				
Affiliate		Acquisition Cost	Prior to 2004	2004	Capital adjustment	Other	December 31, 2004
Korea Ginseng Corporation	₩	214,929	180,953	74,123	28	(138,900)	331,133
KT&G Turkey		2,203	-	-	-	(1,335)	868
Tae-a Industry Co., Ltd.		14,198	-	(756)	-	-	13,442
Buytheway Co., Ltd.		26,419	(3,275)	(400)	-	-	22,744
Yungjin Pharmacy Co., Ltd.		32,682	-	330	141	-	33,153
	₩	**290,431**	**177,678**	**73,297**	**169**	**(140,235)**	**401,340**

(8) Transactions and Balances with Related Companies

Significant transactions and account balances which occurred in the normal course of business with related companies as of and for the years ended December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Sales and other revenue:			
Korea Ginseng Corporation	₩	5,995	523
Buytheway Co., Ltd.		102,178	62,350
Yungjin Pharmacy Co., Ltd		14	-
Hanbit Hyang Ryo, Inc.		127	-
	₩	**108,314**	**62,873**
Purchase and other expenses:			
Korea Ginseng Corporation	₩	1,802	2,413
Buytheway Co., Ltd.		4,070	561
Tae-a Industry Co., Ltd.		11,181	-
KT&G Hanbit Hyang Ryo, Inc.		1,975	-
	₩	**19,028**	**2,974**

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(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

		2004	2003
Due from affiliates:			
Korea Ginseng Corporation	₩	15	-
Buytheway Co., Ltd.		14,979	6,559
Yungjin Pharmacy Co., Ltd		-	1,400
KT&G USA		205	205
KT&G Turkey		1,249	850
	₩	16,448	9,014
Due to affiliates:			
Korea Ginseng Corporation	₩	1,401	1,376
Buytheway Co., Ltd.		434	-
	₩	**1,835**	**1,376**

(9) Long-term Loans Receivable

Long-term loans receivable as of December 31, 2004 and 2003 are as follows:

Classification	Interest rate per annum	Maturity date		2004	2003
Loan to National Leaf Tobacco					
Growers Cooperative					
Federation in support of leaf					
tobacco cultivation (*)	0.7%	2007.11.20	₩	110,000	110,000
Loan to Korea Ginseng					
Cooperative Federation in		2002.12.21			
support of ginseng cultivation	1.5%	~ 2007.12.21		7,800	11,200
				117,800	121,200
Present value discount account (**)				(33,761)	(43,322)
Total present value				84,039	77,878
Current portion				(3,153)	(3,153)
Allowance for doubtful accounts				(809)	(747)
			₩	**80,077**	**73,978**

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(*) The National Agricultural Cooperative Federation guarantees the repayment of loans to the National Leaf Tobacco Growers Cooperative Federation in the same amount.

(**) The average market interest rates of three-year debentures at the time of loan origination, 14.01% and 9.70%, were used in calculating the present value of the loans to the National Leaf Tobacco Growers Cooperative Federation and the Korea Ginseng Cooperative Federation, respectively.

(10) Property, Plant and Equipment

Property, plant and equipment and related accumulated depreciation as of December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Land	₩	299,854	301,909
Buildings		576,759	571,821
Structures		41,511	40,972
Machinery and equipment		649,407	647,170
Vehicles and other transportation equipment		22,286	20,980
Tools		21,160	18,762
Furniture and fixtures		142,142	111,781
Construction-in-progress		55,249	9,807
Other tangible fixed assets		366	362
		1,808,734	1,723,564
Less: accumulated depreciation		(593,909)	(557,889)
	₩	**1,214,825**	**1,165,675**

(11) Officially Declared Value of Land

The officially declared value of land at December 31, 2004, as announced by the Minister of Construction and Transportation, is ₩1,007,446. The officially declared value, which is used for government purposes, is not intended to represent fair value.

(12) Insurance

Buildings, structures, machinery and inventories were insured against fire damage up to ₩769,477 as of December 31, 2004 with DongBu Insurance Co., Ltd. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

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(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(13) Other Assets

Other assets as of December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Long-term accrued interest	₩	23	155
Long-term loans to affiliates		1,454	817
Other investment assets		20,341	19,040
Currency swaps		-	10,930
Interest rate swaps		-	22,724
Intangible assets		2,132	2,498
	₩	**23,950**	**56,164**

(14) Other Current Liabilities

Other current liabilities as of December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Interest payable	₩	3	1,016
Withholdings		7,685	8,090
Unearned income		935	652
	₩	**8,623**	**9,758**

(15) Exchangeable Bonds

Exchangeable bonds as of December 31, 2004 and 2003 are as follows:

		2004	2003
The 1st overseas exchangeable bonds	₩	-	331,966
The 1st domestic exchangeable bonds		20,142	156,638
		20,142	488,604
Current portion		(20,142)	-
	₩	**-**	**488,604**

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(a) The 1st overseas exchangeable bonds

Issue date	Maturity date	Interest rate per annum		2004	2003
Oct. 31, 2001	Oct. 31, 2006	2 %	₩	-	317,466
Plus: long-term accrued expenses				-	18,284
Less: discount on issuance				-	(3,784)
			₩	**-**	**331,966**

The 1st overseas exchangeable bonds denominated in the US dollar are exchangeable for the Company's treasury stock at 20,886 Won per share, translated using a fixed exchange rate of US$ 1: ₩1,300.40 during the period from December 11, 2001 to October 20, 2006 at the option of the bondholders. Interest on such exchangeable bonds is payable at the end of each six-month period.

The bonds are to be redeemed on October 31, 2004 at 108.16% of their principal amount upon the request of the bondholders or any time after November 15, 2004 at the amount as agreed on bond issuance upon advance notice by the Company. For bonds neither exchanged nor redeemed, 114.26% of principal will be due in one lump sum on October 31, 2006.

For the year ended December 31, 2004, exchangeable bonds amounting to ₩317,463 were exchanged for 15,199,734 shares of treasury stock. In relation to the above transactions, the Company recognized loss on redemption of exchangeable bonds of ₩100,211 and gain on reissuance of treasury stock (a component of capital surplus) of ₩119,091.

(b) The 1st domestic exchangeable bonds

Issue date	Maturity date	Interest rate per annum		2004		2003
June 29, 2002	June 29, 2005	3%	₩	18,807	₩	147,861
Plus: long-term accrued expenses				1,347		9,228
Less: discount upon issuance				(12)		(451)
			₩	**20,142**	₩	**156,638**

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(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

The 1st domestic exchangeable bonds denominated in Won are exchangeable for the Company's treasury stock at 17,820 Won per share during the period from July 29, 2002 to May 30, 2005 at the option of the bondholders. Interest on such exchangeable bonds is payable at the end of each six- month period. For bonds not exchanged, 108.70% of principal will be due in one lump sum on September 29, 2005.

For the year ended December 31, 2004, exchangeable bonds amounting to ₩129,054 were exchanged for 7,241,960 shares of treasury stock. In relation to the above transactions, the Company recognized loss on redemption of exchangeable bonds of ₩57,033 and gain on reissuance of treasury stock (a component of capital surplus) of ₩54,787.

(16) Retirement and Severance Benefits

Changes in the retirement and severance benefits for the years ended December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Estimated severance liability at beginning of year	₩	94,885	69,824
Provision for retirement and severance benefits		52,629	32,766
Payments		(38,128)	(7,705)
Estimated severance liability at end of year		109,386	94,885
Severance benefits insurance deposit		(62,987)	(54,288)
Net balance at end of year	₩	**46,399**	**40,597**

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(17) Assets and Liabilities Denominated in Foreign Currencies

Details of assets and liabilities denominated in foreign currencies as of December 31, 2004 and 2003 are as follows:

(In thousands of JPY, HKD, EUR)

		Foreign currency		Won equivalent	
		2004	2003	2004	2003
assets:					
Cash and cash equivalents	USD	1,014	4,078	₩ 1,058	4,884
	JPY	1,829	-	19	-
	HKD	1,460	-	196	-
Trading securities	USD	-	1,996	-	2,391
Accounts receivable	USD	61,150	35,425	63,829	42,432
Available-for-sale securities	USD	-	153,998	-	184,459
Long-term deposits in escrow fund	USD	18,986	14,307	19,817	17,137
Accrued income	USD	-	719	-	861
Other receivables	USD	563	596	587	714
Total	USD	81,713	211,119		
	JPY	1,829	-		
	HKD	1,460	-	₩ 85,506	252,878
Liabilities:					
Accounts payable	USD	4,801	4,454	5,011	5,335
	EUR	1,128	956	1,605	1,436
	JPY	-	412	-	5
Interest payable	USD	-	827	-	991
Total	USD	4,801	5,281		
	EUR	1,128	956		
	JPY	-	412	₩ 6,616	7,767

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(18) Stockholders' Equity

Transactions in stockholders' equity accounts for the years ended December 31, 2004 and 2003 are summarized as follows:

	Common stock	Capital surplus	Retained earnings	Capital adjustments	Total
Balance at December 31, 2002	₩ 954,959	1,485	2,291,874	(1,096,259)	₩2,152,059
Net income	-	-	459,701	-	459,701
Unrealized gain on valuation of available-for-sale securities	-	-	-	587	587
Exchangeable bonds exchanged for treasury stock	-	75,815	-	313,447	389,262
Reissuance of treasury stock	-	3,840	(67,136)	44,415	(18,881)
Dividends	-	-	(167,395)	-	(167,395)
Balance at December 31, 2003	954,959	81,140	2,517,044	(737,810)	2,815,333
Net income	-	-	472,300	-	472,300
Unrealized gain on valuation of available-for sale securities	-	-	-	(1,969)	(1,969)
Unrealized gain on valuation of investments using equity method	-	-	-	169	169
Exchangeable bonds exchanged for treasury stock	-	173,878	-	386,368	560,246
Reissuance of treasury stock	-	22,313	-	68,428	90,741
Acquisition of treasury stock	-	-	-	(501,075)	(501,075)
Retirement of treasury stock(*)	-	-	(412,160)	412,160	-
Dividends	-	-	(221,528)	-	(221,528)
Balance at December 31, 2004	₩ 954,959	277,331	2,355,656	(373,729)	₩3,214,217

The Company reacquired 13,000,000 shares of treasury stock for ₩412,160 and retired those shares in 2004. Accordingly, as of December 31, 2004, the number of Company's shares issued decreased to 165,442,497 shares.

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(19) Retained Earnings

Retained earnings as of December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Legal reserve	₩	602,937	602,937
Reserve for business expansion		698,881	698,881
Reserve for business rationalization		12,851	12,851
Reserve for research and manpower development		18,308	36,196
Reserve for overseas business losses		-	194
Reserve for overseas market development		-	236
Reserve for energy saving facilities		-	131
Other appropriations		732,320	732,320
Unappropriated retained earnings at end of year		290,359	433,298
	₩	2,355,656	2,517,044

(a) Legal Reserve

The Korean Commercial Code requires the Company to appropriate as legal reserve an amount equal to at least 10% of cash dividends for each accounting period until the reserve equals 50% of stated capital. The legal reserve may be used to reduce a deficit or it may be transferred to common stock in connection with a free issue of shares.

(b) Reserve for Business Rationalization

Under the Special Tax Treatment Control Law, investment tax credit is allowed for certain investments. The Company was, however, required to appropriate from retained earnings the amount of tax benefits obtained and transfer such amount into a reserve for business rationalization.

Effective December 11, 2002, the Company is no longer required to establish a reserve for business rationalization despite tax benefits received for certain investments and, consequently, the existing balance is now regarded as a voluntary reserve.

(c) Reserve for Business Expansion

Under the old Korea Tobacco and Ginseng Corporation Act, the Company is required to appropriate at least 20% of net income to a reserve for business expansion until such reserve equals 50% of stated capital. This reserve may be used to reduce a future deficit or it may be transferred to common stock.

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(d) Other Reserves

Reserves for research and manpower development, overseas business losses, overseas market development, energy saving facilities and losses on reissuance of treasury stock were appropriated in order to utilize certain tax deductible benefits through the early recognition of future expenditures. These reserves are restored to retained earnings in accordance with the relevant tax laws. Such reserves are taken back into taxable income in the year of restoration. Reserves without specific purposes are restored to retained earnings by a resolution at a general meeting of stockholders.

(20) Capital Adjustments

Capital adjustments as of December 31, 2004 and 2003 are summarized as follows:

		2004	2003
Treasury stock	₩	(378,894)	(744,775)
Gain on valuation of available-for-sale securities		4,996	6,965
Gain on valuation of investments using equity method		169	-
	₩	(373,729)	(737,810)

(21) Commitments and Contingencies

The Company has entered into a purchase contract with the president of the National Leaf Tobacco Growers Cooperative Federation, who has been given powers of attorney from tobacco cultivators to sell their leaf tobacco. In addition, the Company has entrusted the Federation with training cultivators of raw material leaf tobacco and pays salaries to employees of the Federation in accordance with related laws.

Additionally, the Company entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise by 2008 a fund with the target set at ₩410,000 for the purpose of stabilizing tobacco production. Under the contract, the Company is obliged to make up the deficiency should the fund fall short of the target. The Company estimates the deficiency at the end of each period and records provision for the tobacco production stabilization fund based on the target amount. The provision for the fund deficiency for the year ended December 31, 2004 and 2003 amounts to ₩18,082 and ₩19,589, respectively, and the balance of the fund as of December 31, 2004 is ₩37,671. In addition, effective December 30, 2004, the levy per pack of cigarettes, which was made for the purpose of raising the fund, was raised to 15 Korean Won from 10 Korean Won. However, the Company did not take into account the effect of this change in estimating the deficiency in case of falling short of the fund target owing to uncertainty as of the year end as to the use of the 5 Korean Won increase per pack of cigarettes.

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

The Company recorded as a long-term deposit the amounts paid into the Escrow funds of State governments in the United States against potential litigation and damages relative to the tobacco exportation into the United States. The allowance for the long-term deposit is estimated based on the likelihood of recovery.

As of December 31, 2004, tobacco lawsuits claiming damages of ₩407 were filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligation to notify smokers of the potential health hazards of smoking. The final outcome of the litigation cannot be reasonably estimated. There are four additional lawsuits against the Company involving approximately ₩1,249. The amount of the liability the Company may ultimately have with respect to the litigation cannot be reasonably estimated as of December 31, 2004.

As of December 31, 2004, the Company has provided to the National Agricultural Cooperative Federation ("NACF") guarantees in the amount of ₩31,946 for the clients who made a financing agreement with NACF.

The Company has entered into Letter of Credit agreements with NACF and other banks on the limit set at USD 105,000.

As of December 31, 2004, the Company's accounts receivable arisen from export of cigarettes were insured against dishonor up to USD 25,100 by an export guaranty insurance with the Export-Import Bank of Korea.

(22) Building Lotting-out Construction Contracts

(a) Building lotting-out construction contracts as of December 31, 2004 are summarized as follows:

	Builder	Construction period	Location
Multi-purpose buildings in Dongdaemoon area	Ssang Yong Engineering & Construction	2002 ~ 2006	Seoul
Villa in Suwon	Samsung Corporation	2004 ~ 2005	Suwon

FINANCIAL STATEMENTS

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(b) Details of installment sales as of December 31, 2004 are summarized as follows:

	Expected contract amount	Confirmed contract amount	Recognized revenue: Prior to 2004	Recognized revenue: 2004	Unrecognized revenue
Multi-purpose buildings in Dongdaemoon area	₩ 161,401	149,780	16,270	49,209	₩ 95,922
Villa in Suwon	22,977	-	-	-	22,977
Total	₩ 184,378	149,780	16,270	49,209	₩ 118,899

(c) Cost of installment sales of store units for the years ended December 31, 2004 and 2003 are as follows:

	2004	2003
Outsourcing cost	₩ 16,361	4,484
Land:		
Beginning of year	5,026	5,061
End of year	(4,406)	(5,026)
Completed buildings:		
Beginning of year	427	296
End of year	(1,450)	(427)
Cost of sales of buildings	₩ 15,958	4,388

(d) Guarantees to secure performance of the building construction were summarized as follows:

	Provider	Amount
Multi-purpose buildings in Dongdaemoon area	Seoul Guarantee Insurance Co., Ltd.	₩ 12,918
Villa in Suwon	Korea Specialty Constructor Financial Cooperative	₩ 3,955

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(23) Income Taxes

(a) The Company is subject to a number of taxes based upon taxable income which result in the following normal rates:

Taxable income	Prior to 2005	Thereafter
Up to ₩100	16.5%	14.3%
Over ₩100	29.7%	27.5%

On December 9, 2003, the Korea government reduced the corporate income tax rate beginning in 2005. Specifically, effective from January 1, 2005, the income tax rate will be reduced from 29.7% to 27.5%.

(b) The components of income tax expense for the years ended December 31, 2004 and 2003 are summarized as follows:

	2004	2003
Current tax	₩ 206,710	161,344
Deferred tax	34,060	22,912
	₩ 240,770	184,256

(c) The provision for income taxes calculated using the normal tax rates differ from the actual provision for the years ended December 31, 2004 and 2003 for the following reasons:

	2004	2003
Provision for income taxes at normal tax rate	₩ 211,768	192,592
Tax effects of permanent differences, primarily additional income taxes for prior years	33,516	4,451
Tax credit	(8,116)	(13,936)
Other	3,602	1,149
Actual provision for income taxes	₩ 240,770	184,256

FINANCIAL STATEMENTS

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 33.8% and 28.6% in 2004 and 2003, respectively.

(d) The tax effects of temporary differences that result in significant portions of the deferred income tax assets and liabilities as of December 31, 2004 and 2003 are presented below:

		2004	2003
Deferred income tax assets:			
Provision for severance and retirement benefits	₩	22,016	15,676
Loss on valuation of inventories		4,654	6,349
Depreciation		5,609	2,608
Bad debts		5,827	4,879
Long-term accrued interest expense		370	7,703
Present value discounts		9,284	12,130
Provision for Tobacco Production Stabilization Fund		10,360	5,485
Other bad debts		6,603	3,832
Other		4,087	783
		68,810	59,445
Deferred income tax liabilities:			
Accrued income	₩	1,070	888
Deposit for severance and retirement benefits insurance		17,321	15,092
Reserve for research and manpower development		14,099	12,039
Investment securities under equity method		52,736	34,204
Interest rate swaps		-	6,470
Reserve for losses on reissuance of treasury stock		7,328	-
Other		60	2,363
		92,614	71,056
Net deferred tax liability	₩	(23,804)	(11,611)

(e) The Company has been imposed an additional income tax of ₩87,035 by the National Tax Service upon its tax review, and recorded ₩82,676 as additional income tax expense and ₩4,359 as a deferred income tax asset.

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(24) Earnings Per Share

Earnings per share for the years ended December 31, 2004 and 2003 are as follows:

(a) Basic earnings per share

	2004	2003
Net income per accompanying statements of income	₩ 472,300	459,701
Weighted-average number of common shares outstanding	148,391,341	123,427,573
Earnings per share in Korean Won	₩ 3,183	3,724

(b) Diluted earnings per share

If all exchangeable bonds were exchanged, shares of the Company's common stock so converted would be outstanding and the weighted-average number of common shares outstanding would be increased accordingly. Details of diluted earnings per share amounts are as follows:

	2004	2003
Net income per accompanying statement of income	₩ 472,300	459,701
Add: interest on exchangeable bonds, net of tax	7,808	26,214
Diluted net income	480,108	485,915
Weighted-average number of outstanding shares	161,077,325	146,925,222
Diluted net earnings per share in Korean Won	₩ 2,981	3,307

(25) Currency and Interest Rate Swap Contracts

The Company recognized loss on transaction of interest rate swaps of W698 and loss on transaction of currency swaps of W9,051 for the year ended December 31, 2004.

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(26) Prior Period Adjustments

Prior period adjustments resulting from other than fundamental errors are charged or credited to net income for the current period. The fundamental errors are defined as errors with such a significant effect on the financial statements for one or more prior periods that those financial statements can no longer be considered to have been reliable at the date of their issue. The prior period adjustments resulting from the fundamental errors are charged or credited to the beginning balance of retained earnings, and the financial statements of the prior year are restated.

Prior period adjustments for the year ended December 31, 2004 are summarized as follows:

	2003	2002	Total
Foreign currency swap	₩ (2,604)	₩ (8,972)	₩ (11,576)
Interest rate swap	(11,897)	3,689	(8,208)
	(14,501)	(5,283)	(19,784)
Tax effect	4,307	1,569	5,876
	₩ (10,194)	₩ (3,714)	₩ (13,908)

The above prior period adjustments are charged to net operations for the current period.

(27) Dividends

Details of dividends for the years ended December 31, 2004 and 2003 are as follows:

	2004	2003
Cash dividends	₩ 237,260	221,528
Net income	472,300	459,701
Dividends as a percentage of net income	50.24%	48.19%

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(28) Added Value

The components of manufacturing costs and selling and administrative expenses which are necessary in calculating added value for the years ended December 31, 2004 and 2003 are as follows:

	2004	2003
Wages and salaries	₩ 286,317	₩ 272,381
Provision for severance benefits	52,628	32,766
Employee welfare	50,149	55,502
Rent	7,621	2,455
Depreciation	103,414	87,444
Taxes and dues	13,375	11,903
	₩ 513,504	₩ 462,451

FINANCIAL STATEMENTS

(In millions of Korean Won and thousands of United States dollars, except where otherwise stated)

(29) Selling and Administrative Expenses

The details of selling and administrative expenses for the years ended December 31, 2004 and 2003 are as follows:

	2004	2003
Salaries	₩ 164,150	₩ 151,718
Provision for severance benefits	17,792	17,580
Welfare	28,265	31,259
Travel	3,998	4,721
Communications	3,471	3,390
Utilities	3,280	2,870
Taxes and dues	11,080	9,461
Supplies	2,847	2,212
Uniforms	88	1,141
Rent	2,953	2,370
Depreciation	37,741	32,150
Amortization	614	506
Repairs and maintenance	4,260	3,004
Vehicles	5,088	3,993
Insurance	474	395
Commissions	37,241	36,681
Transportation and warehousing	25,528	23,318
Entertainment	532	465
Conventions	1,862	1,331
Advertising	152,550	135,145
Training	6,597	5,926
Prizes and rewards	1,829	1,616
Cooperation	274	168
Normal research and development	9,634	20,364
Sample	2,911	3,061
Bad debts	730	357
Miscellaneous	789	710
	₩ 526,578	**₩ 495,912**

COMPANY INFORMATION

Board of Directors

- Young-kyoon Kwak
Chairman & CEO

- Kwang-youl Lee
Senior Managing Director of Marketing & Sales Headquarters

- Young-jin Min
Senior Managing Director of Overseas Business Headquarters

- Ki-ho Kim
Outside Director

- Byong-kyun Kim
Outside Director



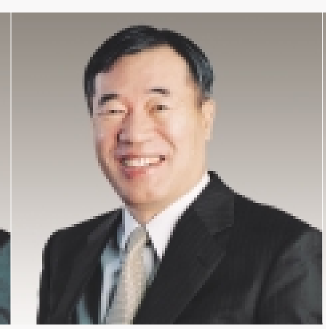

- Jin-hyun Kim
Outside Director

- Choong-sup Kim
Outside Director

- Soon-moo Soh
Outside Director

- Suck-kyo Ahn
Outside Director






- Kyung-jae Lee
Outside Director

- Man-woo Lee
Outside Director

- Sun-gak Cha
Outside Director



COMPANY INFORMATION

Organization Chart

- General Meeting of Shareholders
- Chairman & CEO
- Board of Directors
  - Audit Committee
  - Performance / Risk Management Committee
  - Public Interest / Steery Committee

- Planning & Coordination Office
  - Corporate Strategy Bureau
  - Corporate Policy Bureau
- Technology Development Office
  - Technology Development Bureau
  - Product Development Bureau
- Corporate Communication Office
- Auditing Office
- Secretary Office

- Marketing & Sales Headquarters
  - Marketing Bureau
  - Brand Management Bureau
- Overseas Business Headquarters
  - Export Bureau
  - Overseas Business Supporting Bureau
- Management & Administration Headquarters
  - Financing Bureau
  - Personnel Management Bureau
  - Management Supporting Bureau
  - Management Information Bureau
  - Emergency Planning Office

- Manufacturing Headquarters
  - Manufacturing Bureau
  - Quality Management Bureau
- Leaf Tobacco & Procurement Headquarters
  - Leaf Tobacco Management Bureau
  - Leaf Tobacco Production Bureau
  - Procurement Bureau
- Business Development Headquarters
  - Asset Development Bureau
  - New Business Development Bureau
- Central Research Institute
- Human Resources Development Institute

Directory & Network

Leaf Tobacco Processing
- Kimchon factory
- Namwon factory

Tobacco Manufacturing
- Shintanjin plant
- Wonju plant
- Kwangju plant
- Yeongju plant

Printing Plant
- Chonan plant

Sales
- Regional Headquarters : 14
- Branch Offices : 168

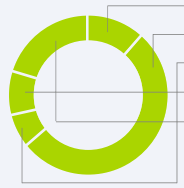
COMPANY INFORMATION

Investor Information

Capital Stock	KRW955 billion
Number of Authorized Shares	800,000,000
Number of Outstanding Common Shares	148,287,613
Stockholders' Equity	KRW3,214 billion
Number of Employees	4,264

Ownership Structure (%)

(End of 2004)



Treasury Stocks	10.4%
Foreign investors	59.8%
Industrial Bank of Korea	5.7%
Employees	7.1%
Others	17.0%

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