Korea Tomorrow & Global 2010 Annual Report

KT&G ON Shifting

KT&G Korea Tomorrow & Global

Contents

Profile

Righteousness

KT&G places priority on the interests of all shareholders and sound corporate governance to enhance shareholder value. With our commitment to corporate ethics and advanced governance structure, we have gained the trust of shareholders, investors and other stakeholders. As a "righteous company", KT&G observes social norms and interests and emphasizes accountability based on autonomy and creativity to pursue future-oriented management and maintain integrity.

Enlightenment

In a global market characterized by a fast changing business environment and increasing competition, KT&G is committed to ensuring transparency and efficiency. We have won recognition for our efforts from numerous agencies in Korea and abroad. At KT&G, change and innovation represent more than just the means to achieving our goals as an "enlightened company". By spurring change and innovation, we will foster a progressive and creative corporate culture.

Companionship

KT&G fulfills its social responsibilities with various initiatives including its welfare foundation, scholarship foundation and employee volunteer groups. As a "company that pursues companionship", we strive to deliver new value to customers, shareholders, employees and local communities. We also promote win-win relationships with suppliers and practice eco-friendly management. KT&G will create value and satisfaction for all stakeholders and embraces social norms and standards to contribute to the public good and meet its obligations to society and the environment.

KT&G pursues righteousness based on transparency, enlightenment through constant innovation, and companionship by fulfilling social responsibilities. We promote sustainability by maximizing value for all stakeholders

Financial Highlights

Operating Result

[in billions of KRW]

	2006	2007	2008	2009	2010
Net Sales	2,263	2,413	2,573	2,776	2,500
Operating Profit	714	814	1,046	947	925
Net Profit	650	661	850	745	931
Total Assets	3,668	4,200	4,614	4,788	5,254
Total Liabilities	623	1,064	1,159	935	916
Total Shareholders' Equity	3,046	3,136	3,454	3,853	4,338

Financial Result

[%, KRW]

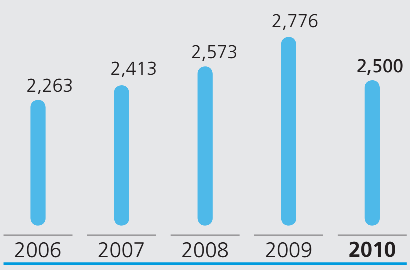
	2006	2007	2008	2009	2010
ROA	17.7	17.3	19.8	15.8	18.5
ROE	21.3	21.4	25.8	20.4	22.7
Operating profit margin	31.5	33.8	40.7	34.1	37.0
Net profit margin	28.7	27.4	33.0	26.8	37.2
EBITDA margin	36.9	39.4	41.0	34.8	41.7
EPS (KRW)	4,608	4,992	5,922	5,193	7,317
Payout ratio	49.2	51.5	40.3	47.8	41.0
DPS	2,400	2,600	2,800	2,800	3,000
Liabilities-to-equity ratio	20.4	26.6	33.6	24.3	21.1
Net debt-to-equity ratio	-	-	-	-	-

※ Figures for 2008~2011 are based on the Korean International Financial Reporting Standards (K-IFRS).

Stock Price

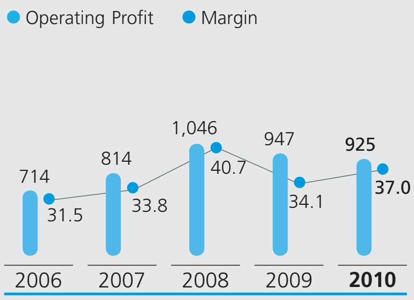
Net Sales

[in billions of KRW]



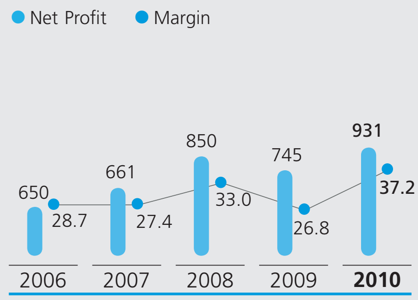
Operating Profit & Margin

[in billions of KRW, %]



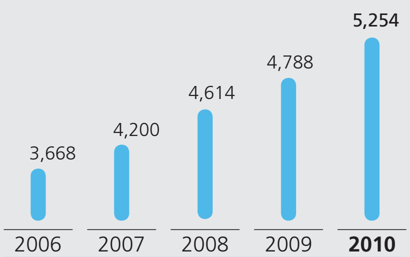
Net Profit & Margin

[in billions of KRW, %]



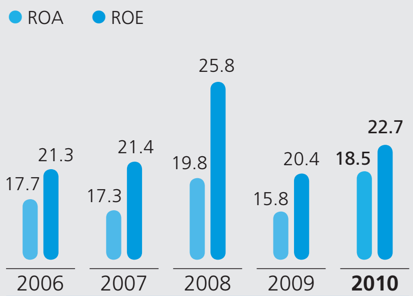
Total Assets

[in billions of KRW]



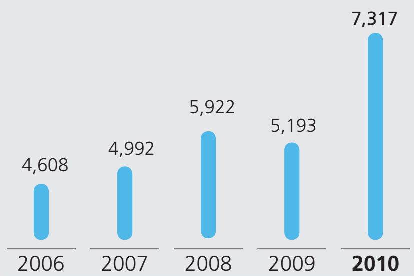
ROA & ROE

[%]



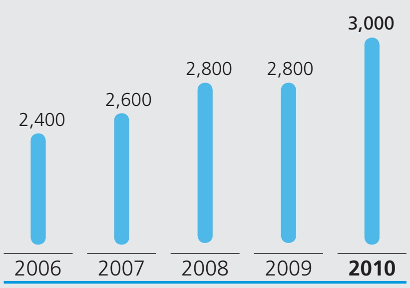
EPS

[in billions of KRW]



DPS

[KRW]

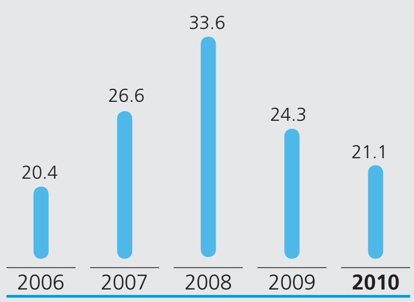


KOREA
TOMORROW
&
GLOBAL

2006~2010

Liabilities-to-equity Ratio

[%]



CEO's Message

We will make every effort to create and deliver satisfaction for all of our shareholders.

To the esteemed shareholders of KT&G,

On behalf of everyone at KT&G, I would like to begin by thanking all our shareholders for the support you showed us over the past year.

Amid increased economic uncertainty in 2010, KT&G continued with efforts to grow into a leading global company.

Upholding our principle of "looking far and ahead", we revamped our organizational and human resources structure, promoted meritocracy, and innovated the way we carry out our business activities to strengthen our fundamentals for sustained generation of profits.

In the domestic tobacco business, we upgraded our sales system and launched new products catering to diverse consumers' needs to bolster our competitive edge and recover market share.

In the overseas tobacco business, we reinforced our organization to explore new markets, completed our production factory in Russia, and introduced localized brands.

Our subsidiary Korea Ginseng Corp. (KGC) created new demand for red ginseng products through aggressive marketing including the launch of its second brand "Good Base". Reinforcement of global sales activities and pursuit of new overseas businesses laid the foundation for future growth.

We also focused on developing new growth engines such as health related businesses to pave the way for a promising future and reap greater fruit for the benefit of our shareholders.

For fiscal year 2010, KT&G recorded net sales of KRW2,499.9 billion, operating profit of KRW925.0 billion, and net profit of KRW931.1 billion.

A global economic slowdown, greater currency fluctuation and inflation are expected to create a tough business environment in 2011. Regardless of the hurdles, KT&G will make further strides to increase corporate value and grow into a global blue-chip company.

In the domestic tobacco business, we will pursue effective marketing, strengthen sales capabilities and nurture core brands to enhance profitability and market influence.

In the overseas tobacco business, we will solidify our position in key markets and aggressively explore new markets to bolster sales.

KGC will upgrade its red ginseng brands and concentrate on fostering its second brand. Efforts will also be made to expand direct overseas sales and evolve into a global red ginseng company.

The health related business carried out by KGC Life & Gin will be cultivated into a new growth driver by harnessing existing competences and making effective investments.

Additionally, KT&G will pursue long-term investments aimed at sustaining growth for stable generation of profits for shareholders.

With a positive attitude, ongoing innovation and creative ideas, all of us at KT&G will strive to maximize corporate value and enhance shareholders' interests.

We will make every effort to create and deliver satisfaction for all of our shareholders.

Thank you.

Chief Executive Officer **Young-jin Min**

2010 News & Issues

1. Young-jin Min Assumes Position of CEO of KT&G

Mr. Young-jin Min officially assumed the position of CEO at the shareholders meeting. In his inaugural address, Mr. Min revealed his intent to concentrate the company's growth potential to spearhead a new take-off. He said he would uphold "a consistent management philosophy and principles" under a clear vision. Under his leadership, KT&G took measures to strengthen the functions and roles of strategic departments and assigned young talent with drive, passion and an innovative mindset to frontline positions. The organizational reshuffle was intended to propel KT&G's growth into a leading global company.

2. New Organizational Structure and HR Innovation

KT&G reduced its organizational structure by 19% and proceeded with HR reform measures that more clearly delineate responsibility and authority. The decision-making process has been streamlined from four steps to three steps, while the number of departments has decreased from 287 to 233 by merging or abolishing 54 units. At the head office, a horizontal system of headquarters was set up to increase flexibility and accountability. KT&G also adopted an innovative HR system that transferred the CEO's HR decision-making powers to the lower levels.

3. Launch of Sangsang Friends

KT&G launched "Sangsang Friends" to promote "Sangsang Univ", an arts and culture community that spurs creativity among the young. About 900 college students applied to become Sangsang Friends after the recruitment drive began in April. Based on a review of the applicants' passion for arts and culture and their Internet activities, 205 students were chosen. This first group of Sangsang Friends carried out a wide range of online and offline activities from June to December.

4. European Premium Brand Davidoff Introduced in Korea

Based on a technology transfer from Europe-based ITG, KT&G produced and sold the world's first 84mm version of Davidoff Classic, a premium cigarette brand in Europe. The shorter product, as opposed to the usual 93mm Davidoff Classic cigarettes, was launched upon request from KT&G to cater to the preferences of Korean consumers. Made with high quality raw materials, the 84mm product offers a smooth and clean taste despite being a high-tar cigarette (tar content of 6.0mg and nicotine content of 0.6mg).

5. Completion of Esse Production Factory in Russia

KT&G's Russian production factory has commenced operation following a ceremony to mark its completion attended by KT&G executives and Russian government and industry officials. Featuring up-to-date facilities, the factory sits on a 103,421m^2 site in the Kaluga region near Moscow in Russia, the world's second largest tobacco market, and is equipped with lines for tobacco leaf processing and producing ultra slim products. With an annual capacity of 4.6 billion sticks, the factory will produce Esse Blue, Esse One, and Esse Menthol.

8. KT&G Scholarships Benefit Students of Diverse Ethnicities

The KT&G Scholarship Foundation was set up in June 2008 in line with "companionship", one of the core beliefs guiding KT&G. Among others, it provides scholarships to Korean and foreign students, hosts an essay contest, and supports humanities research. In August, 33 scholarship recipients gathered for the 2010 KT&G Scholarship Foundation camp. Bringing together Korean and international students, the camp promoted understanding of different cultures, friendships, and dreams for the future. Prior to the camp, a ceremony was held at KT&G Sangsang Madang where 25 students were presented with scholarship certificates for 2010.

6. Launch of KGC Life & Gin to Power New Growth

KGC Life & Gin was set up to lead the health food business, a new growth engine for KT&G. Established in June, it was formerly known as KGC Sales and was a subsidiary of KGC (KT&G's subsidiary) before becoming a subsidiary of KT&G. KGC Life & Gin was reborn as a company specializing in non-red ginseng health foods and lifestyle products after recruiting new talent and expanding its business scope. Its businesses are broadly classified into the four areas of a new-concept health franchise, oriental herb-based cosmetics, functional foods and door-to-door sales.

7. Award of Excellence in Corporate Governance

Korea Corporate Governance Service (KCGS) presented KT&G with the award of excellence in corporate governance in the KOSPI category at its 2010 awards ceremony. KT&G was recognized for practicing shareholder-oriented management through efforts to improve corporate governance. KT&G received the award of distinction for corporate governance in 2003 and the award of excellence for three consecutive years from 2004 before being inducted into the hall of fame of KCGS in 2007.

9. Award of Cultural Contribution

KT&G received the cultural contribution award (presented by the Minister of Culture, Sports and Tourism) at the 2010 Mecenat Awards jointly sponsored by Maeil Business Newspaper/ and the Korean Business Council for the Arts. KT&G was honored for supporting less popular arts and cultural pursuits and operating Sangsang Madang and Sangsang Art Hall, venues that support performing arts. Sangsang Madang is a multi-cultural space for amateur artists. Since its opening in 2007, the facility has uncovered the talents of some 2,000 young artists.

Value-up ON Shifting

KT&G

Vision & Strategy

Management Philosophy & Business Philosophy: Align our business vision, corporate image, brand, management system and philosophy, and business philosophy; "feel moment, fill life" for customers, shareholders, society and employees through products and services based on trust

CORPORATE VISION

Maximize value for customers, shareholders, society and employees

Stable and continued creation of corporate value

- Global tobacco company
- Global health company
- Leading domestic pharmaceutical company

Vision 2014

Feel Moment, Fill Life

"Through products and services based on trust, we will fulfill people's emotional sensitivities to create a better life."

- Tobacco (Stylish Life)
- Red Ginseng (Energetic Life)
- Health Foods (Well-being Life)
- Pharmaceuticals (Healthy Life)

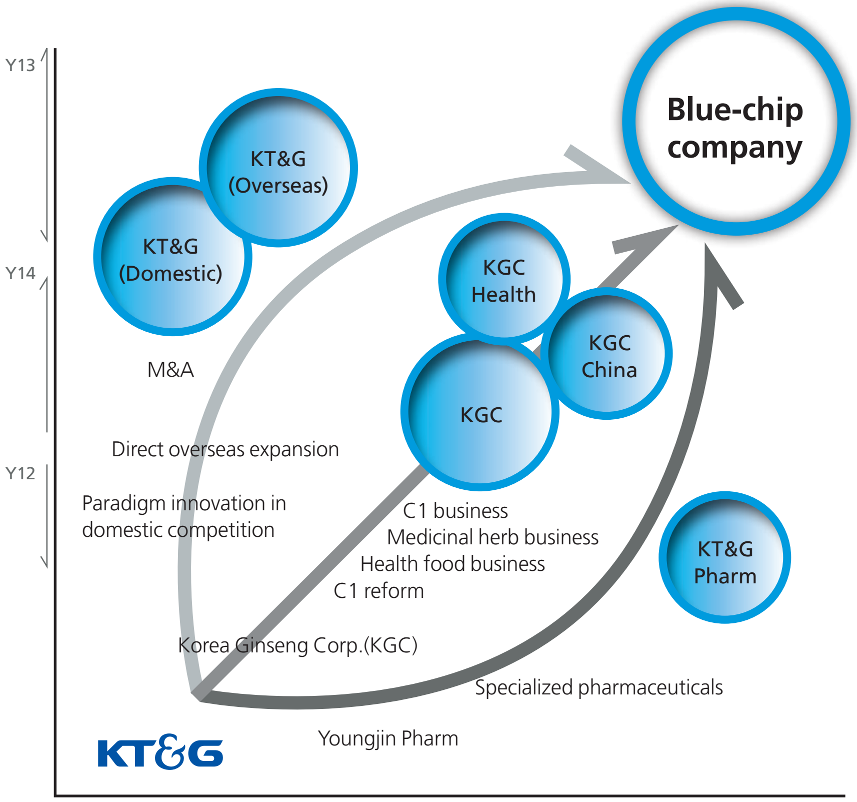
Business Philosophy

- Righteousness
- Enlightenment
- Companionship

Management Philosophy

KT&G's ultimate goal is to maximize value for customers, shareholders and all members of society. We have aligned our management philosophy, principles and vision accordingly and continue to make our best effort to realize our goal. In line with our three core beliefs of "righteousness," "enlightenment" and "companionship", we strive to deliver products and services that are based on trust and complete our "Feel Moment, Fill Life" vision by fulfilling the values of taste, vitality, well-being and health. Through this process, we are making strides toward becoming a global tobacco company, global health company and leading domestic pharmaceutical company while pursuing stable and continued creation of corporate value and growth into a global corporation.

2014 Vision: Construct a balanced business portfolio encompassing domestic and overseas tobacco businesses as well as health and functional foods to grow into a blue-chip company combining growth and profitability



KT&G aims to be a global blue-chip company by maximizing corporate value. Our domestic tobacco business will serve as a cash cow showing both stability and profitability. To this end, we will focus on consumer-oriented marketing, core brands and paradigm innovation in market competition. We will nurture the overseas tobacco business to fuel growth on the global stage by resolving business risks in key markets, pursuing M&A with local entities, and exploring new markets.

The red ginseng/health food business will serve as a core growth driver through domestic expansion, penetration into the Chinese market through the C1 business, and new pursuits involving medicinal herbs. Furthermore, we will pursue bold restructuring, R&D outsourcing and M&A to emerge as a specialist in biotech/pharmaceuticals.

BUSINESS STRATEGY

KT&G formulated a new vision of becoming a global blue-chip company by 2014. We have adopted three core strategies: rebuilding the business portfolio, maximizing value in each business segment, returning profits to shareholders. Additionally, we have classified our business portfolio into the three categories of tobacco, health and functional foods, and pharmaceuticals as detailed below.

For our domestic tobacco business, we will carry out consumer-oriented marketing and promote core brands. This will involve realigning the domestic brand portfolio to highlight strategic brands and establishing a brand-centered management system. Our intent is to induce a shift in the market's competition paradigm and to prop up stability and profitability.

Direct communication with consumers should allow accurate trend-reading and marketing focused on key customer groups. Regarding our overseas tobacco business, we will resolve business risks in key markets, pursue M&A with local companies and take other steps to aggressively expand into new markets and evolve into a global player. We will build a win-win system by forging strategic partnerships in key markets and redefining roles. In major markets and emerging markets like the US, China, Southeast Asia, Latin America and Africa, we will carry out preemptive investments. On the whole, we aim to recapture market share in Korea and achieve both growth and profits in overseas markets.

Strategy to Maximize Value of Tobacco Business

The red ginseng/health food business is being cultivated as a "core growth business" that will also fuel our evolution into a total health and functional foods company. To capitalize on fast growing demand for health and functional foods, we are conducting R&D into red ginseng and new ingredients and reviewing M&A possibilities.

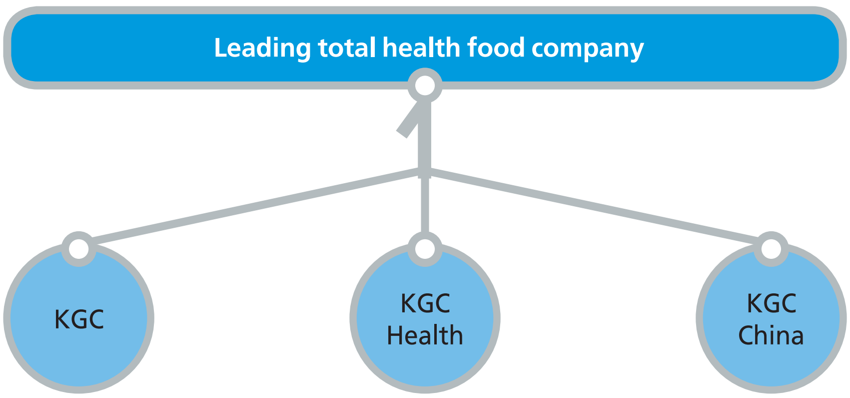
Based on R&D and high quality, we will grow our domestic red ginseng operations and expand into China through the C1 business. We will also foster new businesses such as new F/C, distribution of medicinal herbs, functional foods and Oriental herb-based cosmetics.

Since the red ginseng/health food business is related to public well-being, our priority will be on ensuring safety to garner consumers' trust. In addition, efforts will continue to promote Cheongkwanjang not only as the leading ginseng brand in Korea but as a prominent brand in overseas markets. In the pharmaceutical business, we will pursue bold restructuring and R&D outsourcing to increase corporate value and drive sustainable growth.

To boost our competitive edge, we will enhance sales productivity and maximize synergy with KGC and other subsidiaries. These measures should create a strong foundation for evolution into a bio-pharmaceuticals company. KT&G will maximize the competitive value of each business through bold execution of the mid/long-term plan and maintain a shareholder-oriented policy to increase value for shareholders. We will cultivate future growth engines to ensure continuity and create sustainable corporate value even in the face of uncertainty in the business environment.

We will try our best to reflect the value of KGC and other subsidiaries fully in the corporate value of KT&G. And to uphold our social responsibility and principle of "companionship", we will carry out social contribution activities via programs led by KT&G and the KT&G Welfare Foundation.

Strategy to Maximize Value of Health/Functional Food Business



Business Review

TOBACCO IN TURNING-UP

Product Line-up

KT&G offers a product portfolio of diverse brands and prices that appeal to ever changing customer preferences, spanning from "88 light" to "ESSE Golden Leaf Special Edition". Backed by ongoing R&D and market surveys, we continue to unveil new products and enhance the quality of existing products through renewal launches, which in turn allows us to maximize customer satisfaction and elevate our status in the domestic and overseas markets. In addition to taste and flavor, product concept and design play a crucial role in meeting customers' demands. With this understanding, we provide a wide range of superior products with distinctive concepts and designs.

Key Products

ESSE series

THE ONE series

RAISON series

ENTZ series

BOHEM CIGAR series

New Products

'Appealing to the eyes and taste' [ENTZ]

Brand name: ENTZ
Description: World's first compact, regular type cigarette
Line-up: 1.0mg / 3.5mg / 6mg
Launch date: December 8, 2010
Concept:
Projecting a lively and fun air, ENTZ is for people with a sense of passion. It has a refreshing and fruity scent, along with a colorful package design and unique typography. ENTZ is Korea's sole 84mm compact size product.

Featuring natural premium menthol [ESSE EDGE Menthol]

Brand name: ESSE EDGE Menthol
Description: Contains natural premium menthol
Launch date: October 13, 2010
Concept:
A product with a distinctive character. The use of premium natural menthol delivers a refreshing taste and flavor. The green motif symbolizes menthol and projects a youthful image. UV coating adds a flair of dynamic sophistication.

Traditional European premium cigarette [Davidoff]

Brand name: Davidoff
Description: Traditional European cigarette accentuating the finer details
Line-up: Classic/ Rich Blue
Launch date: June 9, 2010
Concept:
Features the unique Davidoff design and smooth and mellow blending. Rolling paper and packaging paper made with high quality materials with aluminum coating on the inside.

KT&G's deluxe premium cigarette [Bohem Cigar Master]

Brand name: Bohem Cigar Master
Description: Features cigar leaves from Cuba to deliver the unique flavor of cigar leaves
Line-up: 6mg
Launch date: December 8, 2010

[RAISON POP(17+3)]

Brand name: RAISON POP(17+3)
Description: 17 sticks of regular cigarettes +3 sticks of menthol cigarettes
Launch date: August 18, 2010
Concept:
Regular and menthol cigarettes in a single pack. First product in Korea to feature a window package. Product identity is highlighted through "17+3".

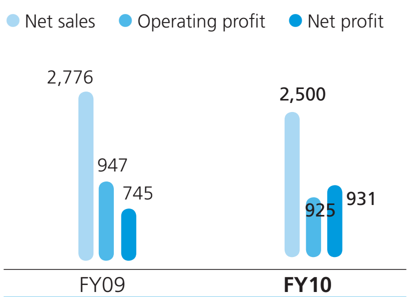
Operation Review

In 2010, total demand in Korean tobacco market significantly dropped due to irregular severe cold weather, etc.

Consequently, due to the drop of domstic tobacco and neal estate business sales, total net sales decreased by 10.0% to KRW2,499.9 billion and operating profit decreased by 2.3% to KRW925.0 billion. However, ongoing innovation in production and procurement and cost-saving measures resulted in net profit of KRW931.1 billion, an increase of 25.0% compared to the previous year.

Sales & Profit

[in billions of KRW]

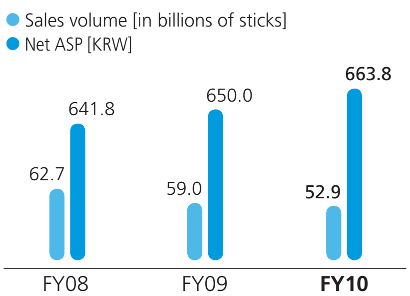


Domestic Business

Amid diversifying and globalizing smokers' needs and intensifying competition in the domestic market, KT&G made various efforts to strengthen brand power. We maintained our edge in the ultra-slim segment with the ESSE Golden Leaf renewal and expansion of the ESSE Special Gold and ESSE EDGE line-up. In the regular and high-tar market, we launched Davidoff. Other new product launches include Raison POP (Korea's first product featuring regular and menthol cigarettes in a single pack) and Bohem Cigar Master (contains cigar leaves). For more effective sales execution, we put greater focus on managing the market and key retail outlets. We also carried out organizational restructuring, redeployed personnel and realigned marketing resources for greater efficiency.

The sales proportion of Premium products rose by 1.5%p over the previous year, leading to a 2.1% boost in the net average selling price. However, we achieved 96.2% of our sales volume target (89.6% compared to the previous year) due to a contraction in overall demand.

Domestic Sales

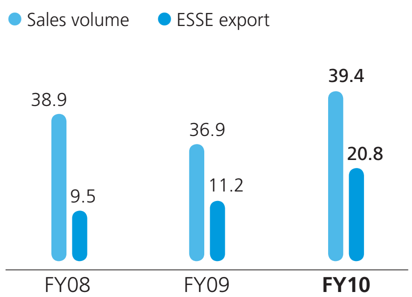


Overseas Business

Overseas sales volume expanded by 6.8% to 39.4 billion sticks while export revenue grew by 10.3% to KRW609.7 billion. Despite appreciation of the Korean currency, operating profit reached KRW193.3 billion. Under our marketing 4P strategy, we boosted advertising and promotional spending and expanded our distribution scope in key markets, namely the Middle East, Central Asia and CIS. We also pursued aggressive expansion in the Asia-Pacific market. Mid/high-priced brands as a percentage of total sales climbed by 20.3%p to 85.9%. The ESSE brand, our strategic brand for the global market, recorded export volume of 20.8 billion sticks, jumping by 85.5% over a year earlier.

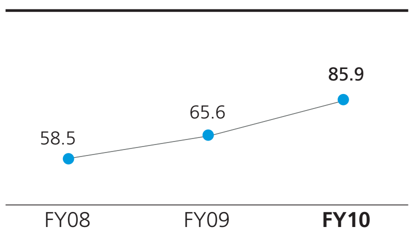
Overseas Export

[in billions of sticks]



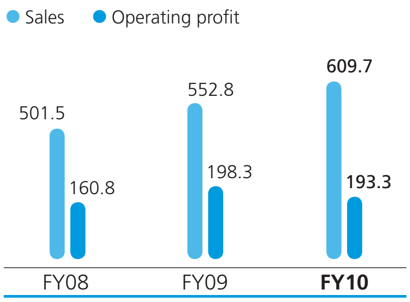
Mid/high Price Products as % of Total Sales

[%]



Sales & Profit

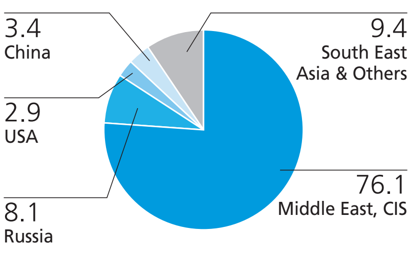
[in billions of KRW]



To sustain growth of the overseas business, we pursued investment projects in regions with strong potential. Our production factory in Russia was completed in October 2010 and we are taking steps to foster the CIS and Russian market. Future plans also include expansion of distribution channels in Southeast Asia, and entry into new markets in Europe, Africa and Latin America.

Exports by Region

[%]



Production and Procurement

Work innovation teams and employee learning clubs engaged in various activities to promote high quality and low cost. Job functions were redesigned to reduce the basic workforce and steps were taken to eliminate inefficiencies. As a result, labor productivity rose by 2.1% and manufacturing yield improved by 3.3%. Cost savings amounted to KRW24.1 billion. At the Shintanjin factory, we set up a factoring operating system to flexibly respond to changes in the business environment. We also set up SOP (Standard Operation Procedure) to assess and analyze leaf processing operations.

We reinforced quality assurance activities with an emphasis on taste. Quality manuals extending to overseas factories were prepared and distributed for more systematic quality control. Focused efforts to deal with the five main types of customer complaints lowered the number of complaints by 26%. We also took steps to identify factors that would enhance customer satisfaction.

To meet consumers' needs, we procured tobacco leaves and raw materials of superior quality. We have a portfolio of supplier nations to keep pace with trends in the global tobacco leaf market. We also uncovered new tariff-free providers. Accordingly, our average import price fell by $0.14/kg. To ensure stable procurement, we pursue local production projects and long-term supply contracts.

We also maintain a stable supply plan for raw materials other than tobacco leaf. In 2010, the average monthly inventory of raw materials dropped by 15%. During the year, efforts were made to replace imported raw materials with domestic counterparts and rationalize raw material standards in order to slash costs.

GINSENG ON GROWING

Operation Review

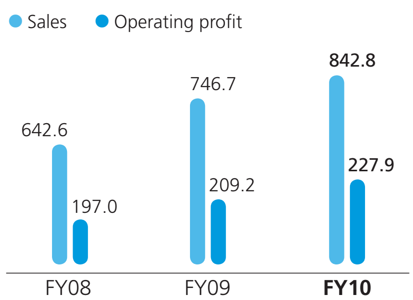
Despite intense competition and rising raw material prices, sales grew by 12.9% to KRW842.8 billion and operating profit by 8.9% to KRW227.9 billion. The growth was driven by expansion of the distribution channels, new product development, CRM concentration, aggressive marketing and cost saving measures.

Domestic sales grew by 13.7%, largely supported by expansion of the distribution channels such as franchise stores and department stores. CRM expansion drove up "purchasing members" by 12.4% to 1.09 million persons.

Overseas sales increased by 6.1%. The relatively slower growth was caused by appreciation of the Korean won and economic weakness in overseas markets like the US (reduction of about KRW500 million). However, future overseas sales will likely improve based on direct expansion through the Chinese subsidiary and favorable conditions in Japan's health and functional foods channels.

Sales & Profit

[in billions of KRW]



Financial Review
(Management's Discussion & Analysis)

KT&G's financial statements starting from fiscal year 2008 have been prepared based on the Korean International Financial Reporting Standards (K-IFRS), which the Company adopted as of January 1, 2009. The information in this section contains certain forward-looking statements regarding the Company's financial conditions, operating performance and business plans. Such forward-looking statements involve known and unknown risks, uncertainties and other factors not within control of the Company, which may cause the actual results or performance of the Company to be materially different from any future results or performance expressly stated or implied in the forward-looking statements.

KT&G does not assume responsibility on the accuracy or completeness of information contained or implied in this section, and statements on the past and future cannot be construed as the Company's promise or claims. The information herein is based on the Company's plans, estimations and projections as well as numerous assumptions regarding the political and economic environment in Korea and other countries in which the Company currently operates or will operate in the future. Such estimations and projections can alter due to the operating environment. Therefore, users of this report should take reasonable care when relying on the information contained herein. Estimations, plans and projections are based on conditions as of the day this report was prepared. KT&G does not bear responsibility of providing additional information on future events. The term "Company" used herein without any other qualifying description refers to "KT&G."

EXECUTIVE SUMMARY

The debt crisis in Europe and monetary tightening in China coupled with intense competition in the domestic and overseas tobacco markets and weak consumer sentiment created an unfavorable business climate in 2010. Against this backdrop, KT&G recorded sales of KRW2,499.9 billion from the tobacco and real estate business and operating profit of KRW925.0 billion, which represent year-on-year declines of 10.0% and 2.3% respectively. However, net profit increased by 25.0% to KRW931.1 billion, largely due to gains on disposal of available-for-sale financial assets (disposal of entire holding of Celltrion shares)

Selected Financial Data

[in billions of KRW]

	FY08	FY09	FY10	% YoY
Net sales	2,573	2,776	2,500	(10.0)
Gross profit	1,608	1,622	1,498	(7.6)
Operating profit	1,046	947	925	(2.3)
Net profit	850	745	931	25.0
Total assets	4,614	4,788	5,254	9.7
Total liabilities	1,159	935	916	(2.0)
Total shareholders' equity	3,454	3,853	4,338	12.6
Gross margin(%)	62.5	58.4	59.9	1.5%p
Operating margin(%)	40.7	34.1	37.0	2.9%p
Net margin(%)	33.0	26.8	37.2	10.4%p
EPS(KRW)	6,527	5,803	7,317	26.1
PER(X)	12.1	11.1	8.8	(20.7)
Stock Price(Year-end) (KRW)	79,100	64,400	64,700	(0.0)

OPERATING RESULT ANALYSIS

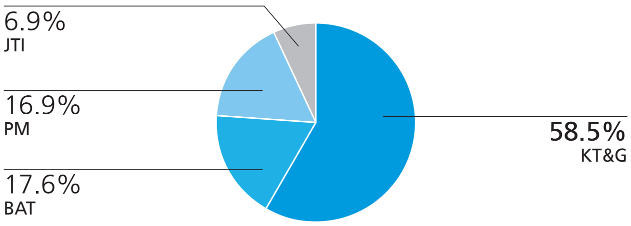
Summarized Statement of Income

[in billions of KRW]

	FY08	FY09	FY10
Net revenue	2,573	2,776	2,500
Gross profit	1,608	1,622	1,498
Operating profit	1,046	947	925
Net profit	850	745	931

Heightened health awareness and a shrinking smoking population has led to stagnant growth of the tobacco market. The operating climate is being further pressured by diversifying tobacco purchasing patterns, fierce competition with global tobacco companies and lingering uncertainties over the global economy. For generation of stable profits in this environment, KT&G is working to save costs on raw material procurement, raise the ASP by launching premium products and reinforce marketing. In 2010, sales decreased by 10.0% year-on-year to KRW2,499.9 billion but the gross profit margin and operating profit margin improved compared to 2009.

Domestic Market Share



Competitive pressure increased in 2010 as global tobacco firms persisted with aggressive marketing to gain market share and imported cigarette brands gained further popularity. Nevertheless, KT&G maintained its unrivaled domestic leadership with a 58.5% share of the market. However, PM and JTI strengthened their footing in Korea as they expanded market shares to 16.9% (up 2.5%p) and 6.9% (up 0.9%p) respectively. KT&G will continue with the strategic release of new products having differentiated quality and high added value and carry out innovative marketing activities to drive a paradigm shift in market competition while bolstering market share and profitability.

OPERATING REVENUES

KT&G at the Low-tar Segment

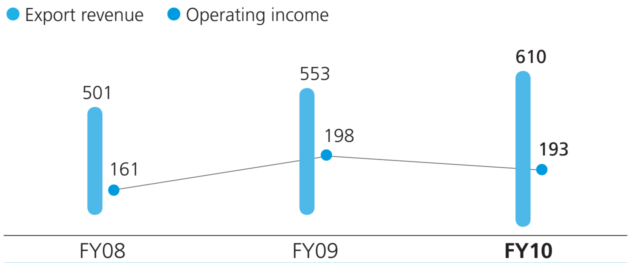
[in millions of sticks, %]

	FY08	FY09	FY10
Korea low-tar market	44,594	44,701	42,530
KT&G's low-tar sales	31,773	30,527	28,037
KT&G's low-tar sales ratio to KT&G total domestic sales (%)	50.7	51.7	53.0
Premium brand sales	42,907	41,390	37,889
Premium brand ratio to KT&G total domestic sales (%)	68.4	70.1	71.6

Consumers' preference for premium low-tar brands continued to rise in 2009. KT&G is the domestic leader in the premium low-tar segment with its brands ESSE, Raison and THE ONE. Low-tar brands accounted for 53.0% of KT&G's total sales in 2010 and the sales proportion of premium products climbed by 1.5%p to 71.6%. The steadily growing sales contribution from high-price products is a key factor in enhancing profitability at KT&G.

Exports

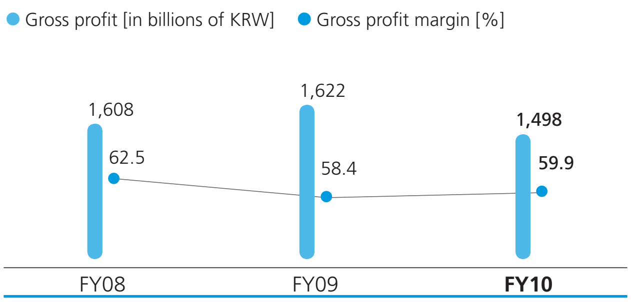
[in billions of KRW]



Greater health awareness and the subsequent slowdown in demand combined with intensifying competition suggest the domestic tobacco market has limited potential for future growth. To overcome this limitation, KT&G has been aggressively nurturing its overseas business and made meaningful advances in 2010. Thanks to expansion of distribution channels in the Middle East, Central Asia and CIS along with aggressive investment in the lucrative Asia-Pacific market, export revenue grew by 10.3% to KRW690.7 billion. In particular, KT&G boosted the sales proportion of mid/high-price brands with the launch of new products and its ESSE brand.

OPERATING PROFITABILITY

Gross Profit



In line with the decline in sales, gross profit decreased by 7.6% to KRW1,497.7 billion. In contrast, gross profit margin improved by 1.5%p. Diversification of supplier countries and long-term supply contracts lowered the average import price of tobacco leaf while production efficiency improved. Effective procurement of other raw materials, replacement of imported materials with domestic counterparts, and standardization of raw materials also helped to bolster the margin.

Operating Expenses Breakdown

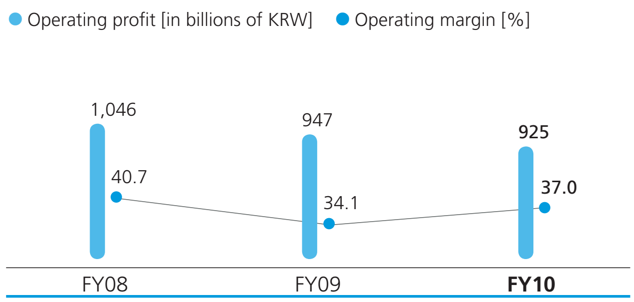
[in billions of KRW]

	FY08	FY09	FY10
Operating expenses	561	675	572
Other income	(108)	(51)	(130)
SG&A expenses	618	611	631
Employee welfare fund	15	10	9
Other expenses	38	105	62

A big jump in gains from the disposal of tangible assets coupled with effective management of SG&A expenses and foreign exchange exposure reduced operating expenses by 15.3% to KRW572.7 billion. Operating expenses as a percentage of sales slid by 1.2%p to 22.9%. All in all, KT&G maintained stable control over operating expenses.

OPERATING PROFITABILITY

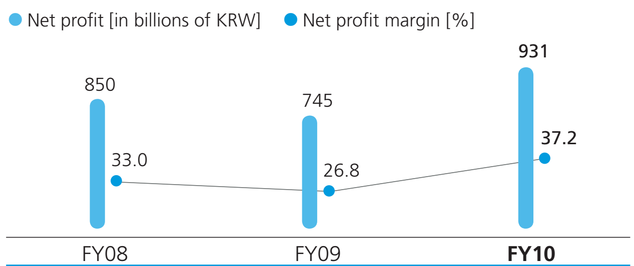
Operating Profit



Operating profit decreased relative to 2010 and reached KRW925.0 billion, but gains from foreign currency translation and tangible asset disposal raised the operating profit margin by 2.7%p.

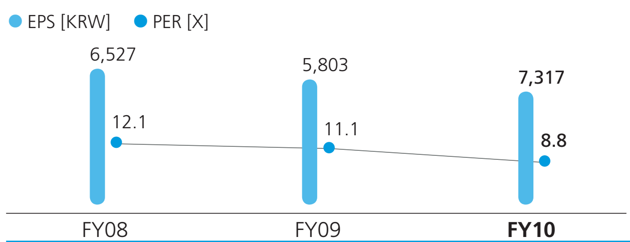
EARNINGS AND DIVIDENDS

Net Income



Although sales and operating profit decreased relative to 2009, interest income and disposal of available-for-sale financial assets led to a sharp increase in net financial gain. As a result, net profit grew by 25.0% to KRW931.1 billion.

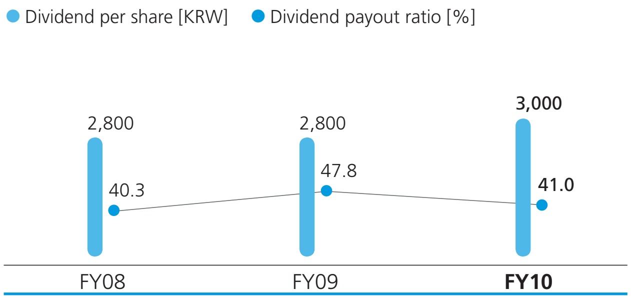
EPS & PER



Note) Based on the year-end closing share price

Earnings per share improved significantly in line with robust growth in net profit. The year-end closing share price inched up from KRW64,400 in 2009 to KRW64,700 in 2010. Consequently, the price-earnings ratio dropped from 11.1 to 8.8.

Dividend per Share & Dividend Yield



Note) Based on the year-end closing share price

For 2010, KT&G paid out a dividend of KRW3,000 per share, up by KRW 200 from the previous year. The dividend translates to a payout ratio of 41.0%. Based on the year-end closing share price of KRW64,700, the dividend yield was 4.64%. KT&G will maintain a high dividend policy to maximize shareholder value.

FINANCIAL CONDITION ANALYSIS

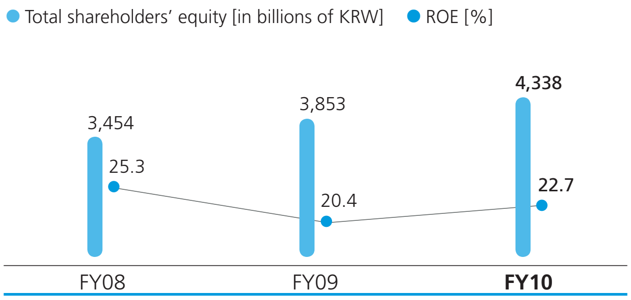
Summarized Statements of Financial Position

[in billions of KRW]

	FY08	FY09	FY10
Total assets	4,614	4,788	5,254
Total liabilities	1,159	935	916
Total shareholders' equity	3,454	3,853	4,338

Total assets increased by 9.7% to KRW5,253.8 billion. On the other hand, total liabilities decreased by 2.0% to KRW916.1 billion. Total liabilities have been steadily declining since 2008 underpinned by a healthy financial structure. A boost in retained earnings backed by robust net profit growth and effective management of reserves pushed up total shareholders' equity by 12.6% to KRW4,337.7 billion.

Return on Equity



Total shareholders' equity grew by 12.6% while net profit growth was higher at 25.0%. Accordingly, return on equity rose by 2.4%p to 22.7%.

CASH FLOW ANALYSIS

Summarized Statement of Cash Flow

[in billions of KRW]

	FY08	FY09	FY10
Cash flow from operating activities	603	748	716
Cash flow from investing activities	(92)	(102)	173
Cash flow from financing activities	(537)	(465)	(329)
Net increase(decrease) in cash and cash equivalents	(27)	181	560
Cash & cash equivalents at the end of year	88	269	829

Despite sharp growth in net profit, a reduction in working capital slightly lowered net cash flow from operating activities. Disposal of financial assets and non-current assets led to a net inflow of cash from investing activities. Net inflow from financing activities increased markedly to KRW560.0 billion owing to disposal of available-for-sale financial assets. At the end of 2010, cash and cash equivalents stood at KRW829.0 billion, up by 208.2% from a year earlier.

While generating stable cash flow from operating activities, KT&G has been making bold facility investments to enhance product competitiveness, deploying resources for product development, and making diverse efforts to cultivate future growth drivers. KT&G will continue to implement effective business activities based on a policy of selection and concentration to maximize corporate value.

2011 Business Plan & Outlook

The outlook for 2011 points to a slowdown in the domestic and global economy, rising interest rates, and appreciation of the Korean won. In addition, the issue of tobacco tax hikes and tighter regulations are likely to gain renewed spotlight. KT&G will respond flexibly to the changing macroeconomic environment and make thorough preparations to induce favorable changes in the business climate to strengthen growth and profitability and enhance corporate value. The following is an outline of our business plan for the year ahead.

Boosting the value of existing businesses

Domestic tobacco business: We will implement a customer-oriented strategy and secure a competitive edge in marketing to recapture market share and generate stable profits.

Overseas tobacco business: We will pursue an aggressive growth strategy that includes entry into new markets and localized marketing as well as alliances and M&A with overseas tobacco companies.

Red ginseng business: We will foster top-line growth and market expansion with our flagship brand Cheongkwanjang and brand diversification. By achieving an appropriate balance between overseas expansion and profitability, we will seek stable profit generation and pave the way for future growth.

Sustained growth via expansion into related businesses

Related to the health business, we will introduce new F/C, Oriental herb-based cosmetics, and medicinal herbs led by KGC Life & Gin. We will also pursue global M&A in the tobacco business and take steps to accelerate global expansion of the red ginseng business.

Financial strategy balancing investment for growth and shareholder return

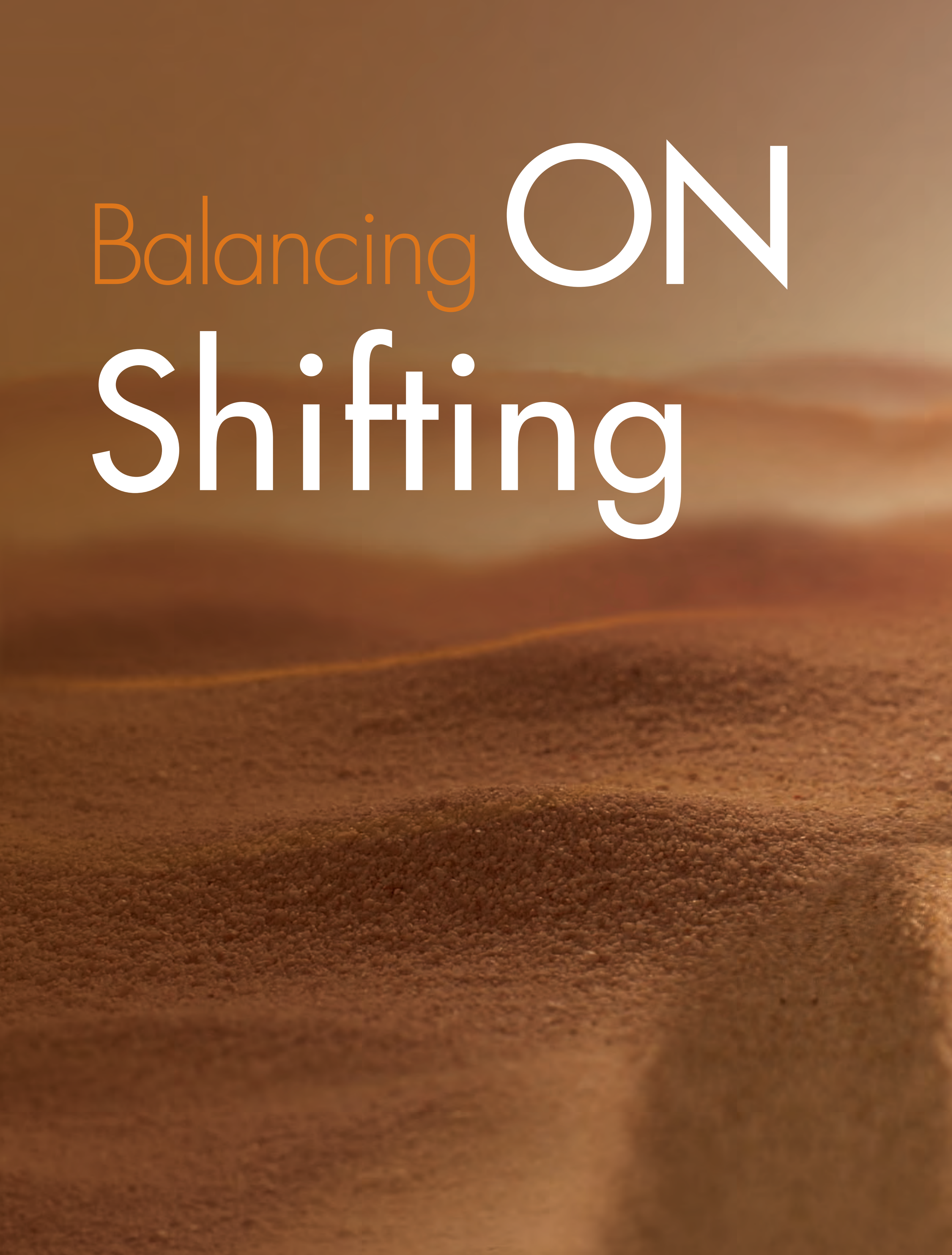
We will share the fruits of our business activities with shareholders and implement a financial strategy that enhances shareholder value. Through investments based on a long-term perspective, we will achieve sustainable growth and return profits to shareholders, maintaining high devidend policy.

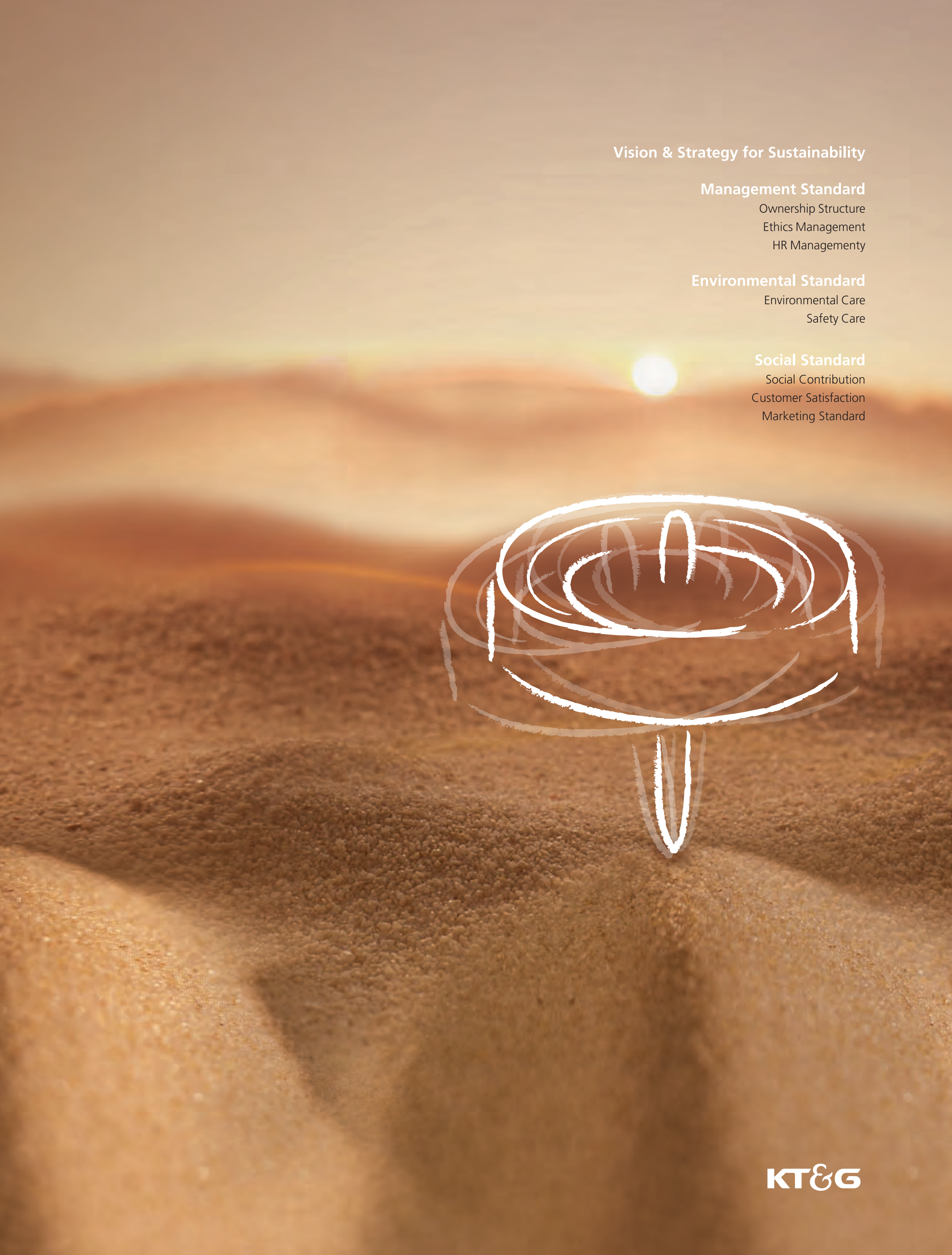
Management innovation and creative improvement for superior performance

We will foster a strong organization by instilling confidence among employees and innovating the way in which they carry out their duties. We will establish a platform for performance-oriented creativity and improvements while eliminating inefficiencies to achieve superior performance.


Korea Tomorrow & Global

Balancing ON Shifting





Vision & Strategy for Sustainability

Management Standard
Ownership Structure
Ethics Management
HR Managementy

Environmental Standard
Environmental Care
Safety Care

Social Standard
Social Contribution
Customer Satisfaction
Marketing Standard

KT&G

Vision & Strategy for Sustainability

Guided by the mission of "EVER-KT&G 2015", KT&G's sustainability management goal is to attain excellent economic performance; create economic, environmental and social values; and realize eco-friendliness.

Vision

Become a global blue-chip company through new value creation

Mission

E-Excellent **V**-Value-Creating **E**-Eco-Friendly **R**-Responsible

EVER - KT&G 2015

Strategy

	Economy	Society	Environment
Strategic direction	Enhance business competitiveness through value-orieanted reform	Improve win-win partnerships by fulfilling the role of corporate citizen	Build a green company by engaging in eco-friendly business activities
Strategic tasks	• Reinforce market competitiveness of core business • Strengthen innovation leadership activities • Improve corporate value through business diversification	• Maximize customer value • Maximize human resources value • Reinforce win-win partnerships	• Reinforce eco-friendly management system • Strengthen readiness to respond to environmental risks • Build eco-friendly corporate culture
Action	• Explore and select overseas markets • Reinforce competitiveness in the domestic market • Build infrastructure for sustainability management • Develop domestic and overseas network for sustainability management • Link with mid- to long-term master plan • Foster global leaders and experts • Maintain value-oriented business portfolio • Secure competencies for new	• Effectively enhance customer satisfaction • Reinforce employee welfare benefits • Strengthen link between performance and compensation • Boost health and safety system • Reinforce stakeholders' human network management • Oversee sustainability of the supply chain • Strengthen social contribution activities • Establish and announce business philosophy • Identify and respond to regulatory trends	• Reinforce eco-friendly management organization • Introduce and operate environmental management programs • Conduct systematic environmental training • Introduce and boost eco-efficiency of products • Increase green purchasing • Bolster climate change response system • Reinforce external environmental communication • Implement systematic environmental training

KT&G pursues growth into a global blue-chip company through the creation of new values. We are well aware of the need for sustainability management to ensure sustainable development of both business and society. To this end, we have adopted key strategic tasks. Our sustainability management goal is "EVER-KT&G 2015." E in Ever stands for "Excellent" economic performance; V for economic, environmental and social "Value-creating"; E for "Eco-friendly" company; and R for "Responsible" business that fulfils its social responsibility. "'EVER-KT&G 2015" demonstrates KT&G's firm commitment to sustainability in the areas of economy, environment and society through the year 2015

Ⓔ- **EXCELLENT** (economic)
Ⓥ- **VALUE-CREATING** (economic/social/environmental)
Ⓔ- **ECO-FRIENDLY** (environmental)
Ⓡ- **RESPONSIBLE** (social)

Management Standard

OWNERSHIP STRUCTURE

Corporate Governance

Business activities at KT&G are guided by the Board of Directors (BOD) and the CEO with the objective of maximizing value for the company and its people. Along with compliance to related laws, we maintain a system of efficient corporate governance through management accountability and transparent information disclosure led by an independent BOD. We strive to ensure balanced representation of the interests of our shareholders and other stakeholders.

Board of Directors

Comprising nine outside directors and one executive director, the BOD is the top decision-making body at KT&G. It is responsible for dealing with issues as set forth in the law and KT&G's articles of incorporation as well as in the BOD regulations. Outside directors represent diverse fields of expertise including the economy, finance and policy-making.

They oversee and decide on major business activities such as implementation of management contracts, investment in other entities, and new facility investment.

OWNERSHIP STRUCTURE

Outside Directors

Outside directors are provided with swift and accurate access to information necessary to carry out their duties. They are notified of board meetings at least three days in advance to ensure sufficient time to review items on the meeting agenda. Outside directors can visit business sites without the presence of senior executives twice a year. They are also allowed to own KT&G shares to promote greater participation in management and accountability. Moreover, outside directors hold more than two meetings annually in which senior executives are not in attendance.

Board Committees

To facilitate rational and swift decision-making, KT&G maintains four committees under the BOD: Strategy Committee, Evaluation and Compensation Committee (formerly Performance and Risk Management Committee), Audit Committee, Investment Committee. The Audit Committee is comprised entirely of outside directors to provide appropriate assistance and supervision to the top management and to ensure transparency and integrity of financial data.

Summarized Balance Sheet

	Composition	Role
Evaluation and Compensation Committee	4 outside directors	Decide on compensation and retirement pay for CEO and senior executives, conduct performance evaluations, etc.
Audit Committee	4 outside directors	Carry out audit functions as set forth in commercial law and related regulations
Investment Committee	3 outside directors, 1 executive director	Review major investment projects, risk management, etc.

Training for Director

KT&G provides outside directors with the opportunity for training necessary for their duties as well as issue briefings on business activities.

BOD Performance Evaluation

The BOD and each committee under the BOD carries out annual self-evaluations. In addition, the directors evaluate each other's performance on an annual basis. Evaluation reports are drawn up, sometimes with the help of outside experts if necessary.

General Shareholders' Meeting

The general shareholders' meeting is held within three months of the end of each fiscal year. Extraordinary meetings are held as necessary based on resolution of the BOD and laws. A shareholder council comprising not more than 15 shareholder representatives may be set up to ensure efficient meetings.

As indicated above, KT&G has made continued efforts for sound and transparent corporate governance. As a result, KT&G received the award of distinction for corporate governance in 2003, and subsequently, the award of excellence for three consecutive years from 2004 to 2006. In 2007, we were inducted into the hall of fame of the Korea Corporate Governance Service. We received the award of excellence once again in 2010.

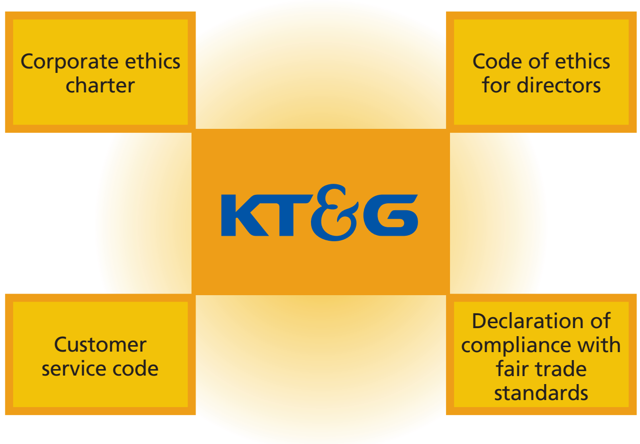
ETHICS MANAGEMENT

Foundation and Framework for Ethics Management

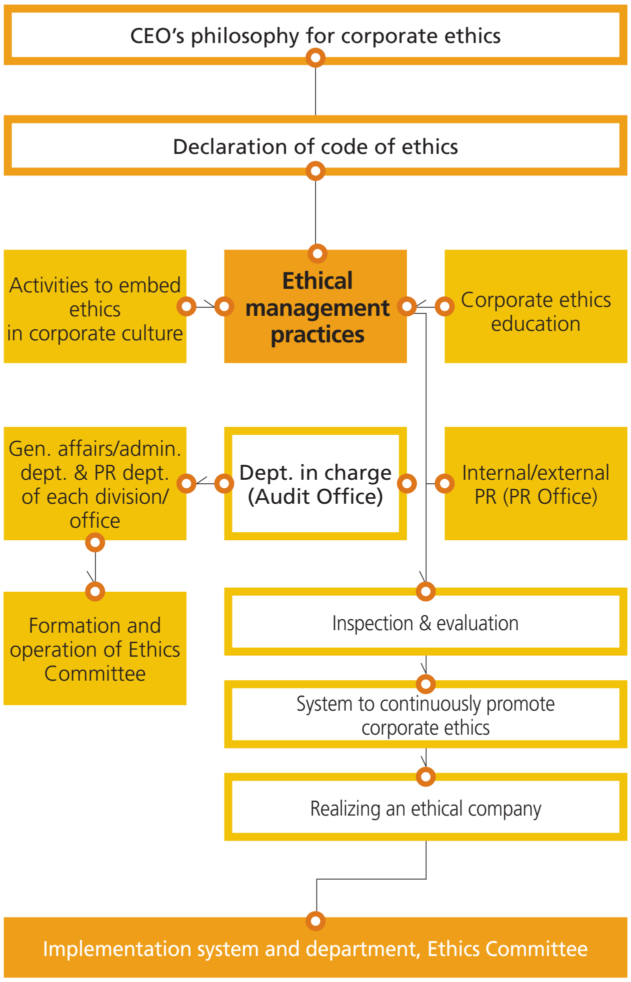
KT&G established the framework for ethics management in 2001 with the completion of its code of ethics, code of ethics for directors, and practical guidelines on corporate ethics. The framework also encompasses the corporate ethics charter, compliance program, and customer service code. The code of ethics and practical guidelines set forth details according to the categories of customers, society, environment, market, employees, suppliers and shareholders. Underpinned by ongoing reviews led by the Audit Office, KT&G received the Grand Prize at the 4th Korea Ethical Management Award in 2006.

With its commitment to transparent and ethical business practices, KT&G is presenting the model of an ethical enterprise that advances together with society. All new recruits are required to sign a pledge of ethics to ensure they understand the code of ethics and practical guidelines. We place emphasis on transparency and accountability across all business domains. We also expend efforts to promote ethics and transparency among BOD members and the BOD adopted the Code of Ethics for Outside Directors by the Korea Listed Companies' Association (KLCA).

Ethics Management System



Ethics Management Structure



KT&G encourages all employees to observe the code of ethics. Sound beliefs, judgment and conduct of the entire workforce are integral to fulfilling our corporate social responsibility.

Ethics Training Process

KT&G has developed training programs including online courses to promote voluntary commitment to ethical business practices among employees. The training centers on various scenarios that may unfold in the course of carrying out their work duties.

Summarized balance Sheet

Category	Educational contents
Overview of ethics management	1. What is ethics management?
	2. Background information and need for ethics management
	3. The 3Cs for the practice of corporate ethics
	4. Direction of ethics management – work and ethics
	5. History of KT&G's ethics management
KT&G code of ethics and practical guidelines	6. Compliance with laws, respect for free competition and market order
	7. Basic ethics of employees 1
	8. Basic ethics of employees 2
	9. Basic ethics of employees 3
	10. Basic responsibilities toward employees/ sound relationship with suppliers
	11. Practical guidelines for the code of ethics

HR MANAGEMENT

KT&G offers tailored programs to reinforce leadership and achieve business targets. We built the leadership pipeline to foster growth of leaders at various levels. The group training reinforces leaders' awareness of their roles and mindset. We also offer e-learning programs on new management and innovation techniques such as BSC (Balanced Score Card), MBO (Management by Objectives), Clientship, meeting innovation, and change management leadership.

Strategic HR Development

To assist employees with career development, KT&G has drawn up strategies for sharing values, change innovation, and learning support. From the time they join K&TG until their departure, employees can take advantage of education to achieve management objectives that takes into account the company's strategic direction and individual aspirations. We seek ways to ensure that education is applicable to actual work duties through various types of evaluations such as problem-solving according to course, position and job function.

We are upgrading e-learning courses on leadership, job specialization and global languages as well as training on duties related to workplace security. We also offer a program that helps employees prepare for life after retirement and further develop their careers.

Employee Welfare and Benefits

KT&G formulated its mid- to long-term welfare vision to enhance employees' quality of life and maximize corporate value. Numerous benefits are provided including allowances for infant care, kindergarten expenses, middle school and high school expenses, college scholarships, expenses for athletic meets, allowances for congratulations and condolences, housing loans, health exams, medical expenses, and use of recreational facilities. These benefits are available to both regular employees and contract workers.

Meanwhile, introduction of the ESOP system has contributed to building trust and cooperation between labor and management. Employee satisfaction levels have increased thanks to a flexible benefit plan that allows employees to choose from various benefits.

Additionally, KT&G runs a health management center for employees in five manufacturing factories as well as in the head office. Resident health managers take care of emergency patients, administer medications, and provide health advice. The centers also help improve the working environment and conduct health inspections. Moreover, continued efforts are being made to enhance the leave system to support employees' health and childbirth.

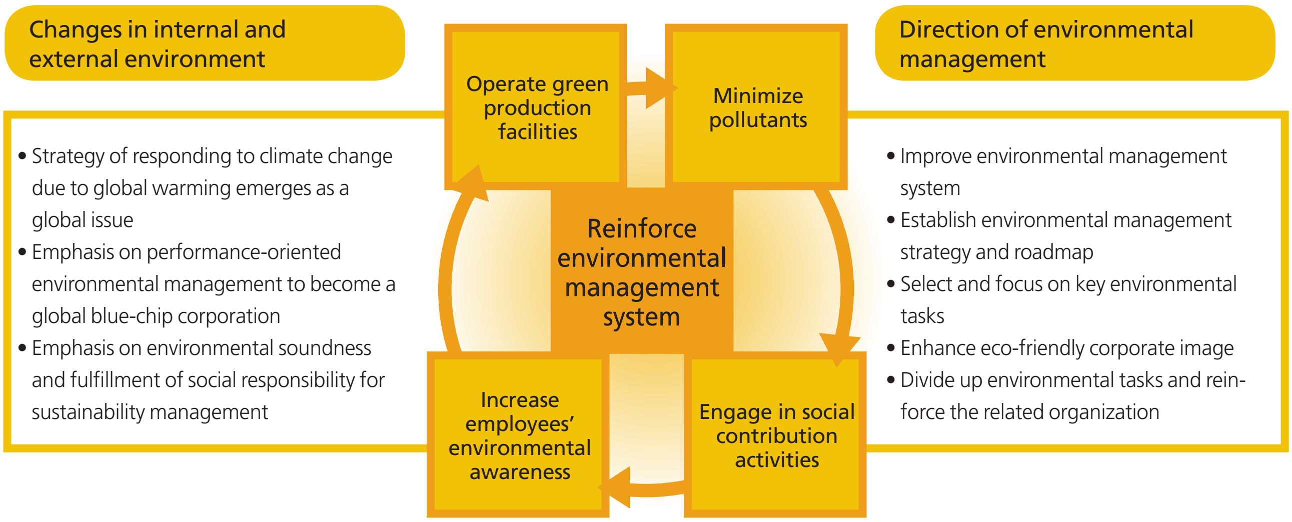
Defined Contribution Retirement Pension

In step with the shift in the financial market from "indirect" to "direct" financing, KT&G introduced the defined contribution (DC) retirement pension plan which allows employees to choose how their retirement funds, i.e., their long-term financial assets, are managed. The DC plan is available to employees who have signed on for the defined benefit plan but wish to switch to the DC plan.

Environmental Standard

ENVIRONMENTAL CARE

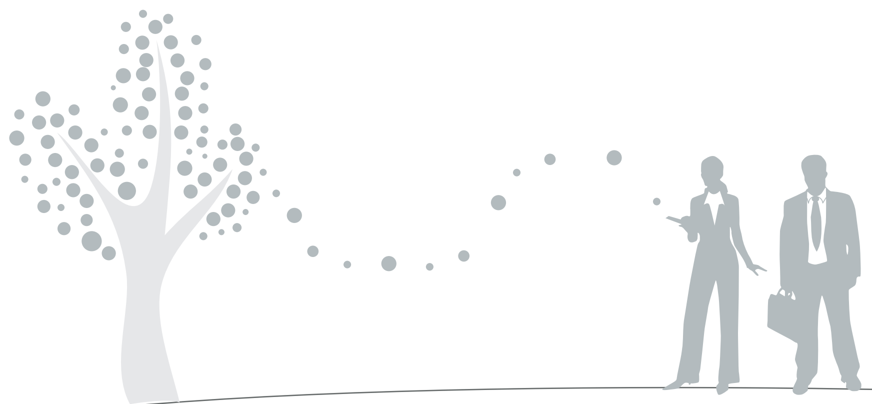
Environmental Management System



Overview of Environmental Management

Reflecting our commitment to sustainability and corporate stewardship, KT&G practices eco-friendly management by operating green production facilities, minimizing pollutants, raising employees' environmental awareness, and engaging in social contribution activities.

We are implementing viable strategies led by our mission and organization for environmental management. The head office is in charge of overall supervision while individual worksites concentrate on eliminating environmental risk factors and implementing green practices in everyday operations.



Environmental Management Roadmap

	Key short-term tasks (~ 2010)	Key long-term tasks (~ 2015)
Eco-friendly factory management	• Build system for inter-departmental cooperation on environmental management • Benchmark advanced companies • Sign agreement for Guidelines on Green Purchase with suppliers • Monitor environmental management, etc.	• Be designated as an environment-friendly enterprise • Raise the level of green purchase • Promote exchange with global leaders
Minimization of pollutants	• Improve efficiency of pollutant prevention facilities • Make aggressive environmental investments for rainwater prevention facilities • Monitor pollutant discharge of workplaces • Improve corporate image by eliminating grievances • Decrease waste generation and processing costs via site-by-site management, etc.	• Improve and evaluate environmental management capabilities of suppliers • Raise employees' understanding and implementation of the environmental management manual
Enhancement of employees' environmental awareness	• Provide environmental education • Have environmental staff attend legally required education programs and technical seminars • Have environmental staff benchmark corporate leaders in environmental management, etc.	• Enhance environmental awareness
Social contribution activities	• Come up with activities aligned with characteristics of the manufacturing sector • Cooperate with KT&G Welfare Foundation to develop programs to return wealth to society • Develop a bio-diversity protection program • Participate in local environmental activities and strengthen ties with stakeholders, etc.	• Engage in social contribution activities

Performance-Based Environmental Management System

For more comprehensive and systematic environmental activities, KT&G has stationed environmental personnel in the factory management departments of the production management office under the manufacturing headquarters since 2000. Then in June 2005, we set up an environmental department at each manufacturing factory. Regular workshops are held for environmental staff to promote information-sharing and reinforce environmental management at worksites. Currently, KT&G's four tobacco manufacturing factory have environmental management systems and obtained the ISO14001 certification. The leaf tobacco processing factory and the printing factory acquired the certification in 2008 and 2009, respectively. KT&G strives to come up with environmental strategies and action plans that go beyond compliance with related rules and guidelines.

Certification Status

Shintanjin Factory	Yeongju Factory	Wonju Factory	Gwangju Factory	Printing Factory	Leaf tobacco processing Factory
2005.06.08	2005.06.08	1999.09.13	2005.06.08	2008.11.12	2009.12.13

Environmental Management Organization and Tasks

Environmental tasks are divided into three categories. First, environmental management involves overall supervision of environmental facilities, related budget and expenses, and environmental grievances. Secondly, ISO management covers ISO9001 documents and establishment and revision of department operating standards. Lastly, environmental facility operations include the operation and maintenance of wastewater treatment facilities and air pollution prevention facilities which are performed by environmental engineers.

Environmental Management System

The environmental management system was set up to carry out tasks relating to water quality, air quality, waste and odor and to objectively manage environmental performance, The system is used to manage data on environmental loads in order to minimize environmental risks related to facility operation. The production management office in the head office collects the data in real time to enable prompt response if a problem should arise.

Environmental Communication Activities

External activities:
Recognizing the need for an internal and external network for environmental management, KT&G takes part in various environmental expos including the International Exhibition on Environmental Technologies and Products and maintains cooperative ties with NGOs and local governments.

Cooperation with local governing bodies:
The Shintanjin factory has a green e-mail system to share information with Daejeon city hall. Through the system, environmental policy staff at city hall provides the factory's environmental engineers and related personnel with information on Daejeon's environmental policy.

Ties with local communities:
KT&G holds meetings to exchange information with local residents on odor detected in their surroundings and to seek ways to engage the residents in odor monitoring. We also provide financial aid to install new and alternative energy (solar energy) facilities in welfare centers in communities with energy needs as part of efforts to fulfill our obligation to society.

Environmental expos, cooperation with NGOs, etc.:
The head office and manufacturing factories take part in environmental expos to exchange information. The printing factories has joined an NGO and is pursuing related activities.

Environmental protection activities:
In line with companywide initiatives, the manufacturing, leaf tobacco processing and printing factory engage in various environmental protection activities. These include garbage collection, preservation activities, "one company-one mountain" campaign, "one-company-one-river" campaign, and efforts to protect cultural assets.

SAFETY CARE

Industrial Safety and Health System

KT&G has adopted measures and conducts training so that employees maintain safety awareness levels that are in step with the changing business environment and landscape. In accordance with the Industrial Safety and Health Act, we have appointed workplace safety managers. We have also formulated the "safety and health management guidelines" and "accident-free movement guidelines". Each worksite holds the "safety inspection day" as a way to prevent fires and accidents. Each site has an industrial safety and health committee that oversees training and inspections in accordance with the safety and health management guidelines and engages in fire-prevention activities. The regular safety inspection team is responsible for maintaining firefighting facilities and fire prevention equipment and checks on emergency response measures and related training.

Training

As part of efforts to prevent industrial accidents, KT&G communicates safety regulations and information to employees through diverse channels. If an accident arises, KT&G has measures to effectively deal with the situation and prepares an analysis of the cause and countermeasures taken. The analysis is used in safety training to prevent damage from a repeat incident.

Industrial Accident Casebook

KT&G published the industrial accident casebook to prevent industrial accidents and increase employees' safety awareness. The casebook analyzes accidents that occurred over a five-year period. We will continue to upgrade and publish the casebook to prevent similar accidents from recurring and enhance workplace safety while keeping up efforts to increase overall productivity.

Social Standard

SOCIAL CONTRIBUTION

Long-term Social Contribution Strategy

Fulfilling our role as a corporate citizen in local communities across the globe, KT&G carries out a wide range of social contribution activities in return for the trust and support given by customers and other stakeholders. Recognizing the need for activities related to our business and for long-term programs as opposed to one-time events, we have drawn up a long-term social contribution strategy.

The strategy encompasses basic activities related to our business, initiatives unique to KT&G, and continuing programs based on partnerships with NGOs and other external stakeholders. Through the KT&G Welfare Foundation, we are able to extend our reach to a wider range of areas including research, scholarships, arts and culture, and sports. Moreover, this spirit of sharing prevails in a large number of KT&G employees who participate in diverse volunteer activities.

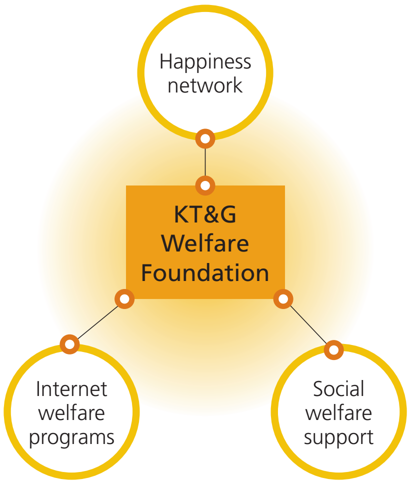
Social Contribution Related to Core Business

- Youth smoking prevention: KT&G recognizes teen smoking as a serious social problem and has taken concrete steps to prevent underage smoking. To restrict youth access to cigarettes, we made 50,000 copies of promotional materials on the "age limit and carding tips" and distributed them to cigarette vendors. We will continue to provide information to vendors by training salespeople. Currently, we are developing a youth smoking prevention program and plan to form cooperative ties with NGOs for its implementation.

- Smoking etiquette and culture: As part of the smoking etiquette campaign, KT&G has been hosting the "Let's make a better tomorrow contents festival" every year since 2007. Various contents on smoking etiquette and culture are submitted for a contest. These include images, photographs, designs and ideas which are displayed during the festival.

- Improving the environment for nonsmokers: KT&G is trying to find ways to eliminate the inconvenience or discomfort felt by both smokers and nonsmokers. We have installed smoking rooms in public places like airports and public waste baskets in places like highway rest areas. We also distributed portable ashtrays and created ads on smoking etiquette. Our future plans include a public campaign using banners on Internet portals and joint initiatives with local governing bodies and civic groups.

KT&G Welfare Foundation

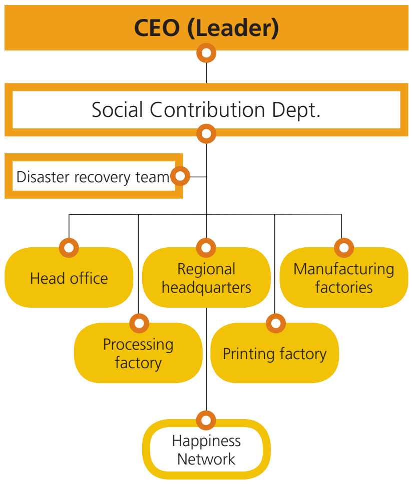


- Happiness Network Welfare Center: Under the concept of protecting local communities, the Happiness Network Welfare Center is networking with diverse local welfare systems to assist our neighbors in need who desperately require social welfare services.

- Internet welfare programs: The KT&G Welfare Foundation operates diverse online programs, such as Internet fundraising to help the heads and guardians of low-income families needing medical treatment.

- Social welfare support: As a way to provide mobile welfare services, KT&G has been donating 100 vehicles every year under the "Social Welfare Compact Car Support Project" since 2004. So far, we have provided 600 compact cars that are being used by social welfare workers.

Employee Volunteer Groups



KT&G encourages participation in volunteer activities and instills the spirit of giving across the company through employee community involvement programs. Employees at each business site and office take part in 182 volunteer groups and visit social welfare facilities or engage in environmental protection work.

KT&G Scholarship Foundation

Creative and high-caliber human resources are vital for sustainable development in the information-based society and age of unlimited competition that characterizes the 21st century. With that in mind, we established the KT&G Scholarship Foundation in 2008. The foundation offers scholarships for foreign undergraduate students in Korea and Korean graduate students pursuing studies in Korea and overseas, along with support for research. The KT&G Scholarship Foundation will fulfill its responsibility to society by nurturing the development of competent and well-rounded people who will shape the future.

Sangsang Madang

Sangsang Madang represents a multicultural community that gives artists an opportunity to pursue their artistic endeavors while allowing the public to enjoy the arts and culture. Its online programs nurture creative pursuits by discovering and nurturing young amateur artists in the fields of films, cartoons, photography and literature. They are complemented by a multi-cultural space comprising a performance hall, cinema for short films, art square, gallery, academy and studio.

KGC Sports Teams

KGC has a professional basketball team, a professional volleyball team, a table tennis team, and a badminton team. These teams discover and foster rising sports stars while contributing to the development of sports in Korea. They work to promote sports among the general public to create a harmonious society that highlights physical and mental well-being. In particular, the basketball team raises funds at each game through a matching grant system which are subsequently directed toward social welfare centers and underprivileged youth in Anyang, the team's home ground.

CUSTOMER SATISFACTION

KT&G has set up diverse communication channels to enhance customer access to information on our business and products. In addition to fair and transparent information disclosure, we carry out numerous activities to maximize customer satisfaction.

Improving Customer Satisfaction

- Communication with customers: The KT&G website features a Q&A corner where customers can pose questions about products, propose ideas, and access information on product purchasing. Customers can also post suggestions and opinions through the ombudsman section.

- Customer counseling and product claim process: The CS-Center prepares weekly and monthly reports on the contents of counseling, reinforces communication with brand managers (BM) and continuously communicates with customers to improve quality. The counseling process is monitored on a real-time basis, and problems identified in this process and solutions thereto are covered in discussions and training programs.

- Customer satisfaction survey: KT&G conducts a customer satisfaction index (CSI) survey among adult smokers and dealer satisfaction index (DSI) survey for domestic retailers and salespersons.

  The results of the surveys which rate product quality, company image (credibility), attitude of salespersons, and sales support are actively reflected in our operations.

  As a result of efforts to improve upon shortcomings, KT&G has enjoyed satisfaction levels on par with rivals since 2003 and the survey results have continued to improve.

MARKETING STANDARD

Framework for Marketing

KT&G provides ongoing education for salespeople on legal sales activities, prohibition of unfair practices, and fair market order. We established a new framework for marketing with the formulation of our marketing guidelines.

Disclosing Product Information to Customers

KT&G prints warnings on the packaging and advertisements for domestically sold cigarettes according to the Tobacco Business Act and the National Health Promotion Act. For exported products, warnings are printed in compliance with laws of the importing countries.

Warnings are also printed in countries where that is not required by law to respect the consumers' right to information. For expressions likely to cause confusion among consumers, KT&G complies with international standards. To inform consumers of the health risks of smoking, KT&G plans to print warnings in a way that does not impair the product identity or packaging design. Currently, KT&G discloses tar and nicotine contents to guarantee customers' right to know.

Research to Reduce the Harm of Smoking

Conducting research to develop products that minimize the harm of smoking is an obligation of all tobacco companies including KT&G. To this end, we carry out research to develop new products such as cigarettes that reduce overall and individual smoke components and those with enhanced filters that remove specific harmful substances.

Win-win Partnership

KT&G has raised funds and continued to support farmers following privatization. While raising the funds, KT&G entered into an agreement with the Federation of Leaf Tobacco Production Cooperatives and provided KRW20 billion annually for farmers and cooperatives. Since fundraising was completed in 2007, KT&G has been trying to provide a stable sales channel for existing farmers. Domestic leaf tobacco has a higher price than imported leaf tobacco. Even so, KT&G maintains contracts with domestic farmers as the sole buyer of tobacco leaf in Korea. Going forward, we will continue to support the development of new varieties of tobacco leaf and cultivation technology.

Policies to Prevent Impediments to Fair Competition

In 2002, we adopted the Compliance Program (CP) at the KT&G CP Declaration Ceremony. This program promotes sound market order through compliance with the Fair Trade Act and is contributing to preventing tangible and intangible losses that would arise in the case of violations.

Independent Auditors' Report

Based on a report originally issued in Korean

KPMG SAMJONG

KPMG SAMJONG Accounting Corp.
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The Board of Directors and Shareholders
KT&G Corporation:

We have audited the accompanying statements of financial position of KT&G Corporation (the "Company") as of December 31, 2010 and 2009, and the related statements of comprehensive income, changes in equity and cash flows for the years then ended. Management is responsible for the preparation and fair presentation of these financial statements. 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, 2010 and 2009 and the results of its operations, the changes in its equity and its cash flows for the years then ended in conformity with Korean International Financial Reporting Standards.

The accompanying financial statements as of and for the year ended December 31, 2010 have been translated into United States dollars solely for the convenience of the reader. We have audited the translation and, in our opinion, the financial statements expressed in Korean won have been translated into dollars on the basis set forth in note 4 to the financial statements.

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

As discussed in note 29 to the financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩584 million for the effects of smoking. The final outcome of these lawsuits cannot be predicted. Accordingly, no provisions have been made in the accompanying financial statements.

KPMG Samjong Accounting Corp.

KPMG Samjong Accounting Corp.
Seoul, Korea
February 22, 2011

This report is effective as of February 22, 2011, 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 a possibility that the above audit report may have to be revised to reflect the impact of such subsequent events or circumstances, if any.

Statements of Financial Position

As of December 31, 2010 and 2009

[In millions of Won and thousands of U.S. dollars]

	Note	2010 Korean won	2010 U.S.dollars (note 4)	2009 Korean won
Assets				
Property, plant and equipment	5	₩ 1,196,126	$ 1,050,247	₩ 1,210,426
Intangible assets	6	48,564	42,641	45,041
Investment property	7	98,143	86,174	101,900
Investments in associates	8	2,830	2,485	2,830
Investments in subsidiaries	9	840,121	737,660	720,330
Available-for-sale financial assets	10, 28	313,937	275,649	441,843
Long-term deposits in MSA Escrow Fund	11,28,29	132,414	116,264	118,121
Long-term prepaid expenses		4,401	3,864	4,927
Long-term trade and other receivables	12,28	84,595	74,278	106,567
Total non-current assets		2,721,131	2,389,262	2,751,985
Inventories	13	990,333	869,552	1,054,321
Trade and other receivables	12,27,28	527,827	463,453	505,731
Prepaid tobacco excise and other taxes		177,043	155,451	169,440
Advance payments		5,783	5,079	10,776
Prepaid expenses		1,707	1,498	1,395
Current available-for-sale financial assets	10,28	1,000	878	1,957
Cash and cash equivalents	14,28	828,951	727,852	268,954
		2,532,644	2,223,763	2,012,574
Assets held for sale	30	-	-	23,246
Total current assets		2,532,644	2,223,763	2,035,820
Total assets		₩ 5,253,775	$ 4,613,025	₩ 4,787,805
Equity				
Ordinary shares	1,15	₩ 954,959	$ 838,493	₩ 954,959
Other capital surplus	15	3,582	3,145	2,632
Treasury shares	16	(216,827)	(190,383)	(226,945)
Gain on reissuance of treasury shares	16	482,129	423,328	468,274
Reserve	17	2,184,703	1,918,257	2,074,108
Retained earnings	18,19	929,140	815,822	579,963
Total equity	28	4,337,686	3,808,662	3,852,991
Liabilities				
Long-term trade and other payables	21,28	22,902	20,109	24,042
Long-term advance receipts		515	452	535
Defined benefit liabilities	22	28,774	25,265	18,295
Deferred income tax liabilities	25	93,310	81,930	122,372
Total non-current liabilities		145,501	127,756	165,244
Short-term borrowings	20,28	8,618	7,567	19,338
Trade and other payables	21,27,28	238,587	209,489	277,616
Advance receipts		7,712	6,771	22,528
Income taxes payable	25	190,815	167,543	100,038
Tobacco excise and other taxes payable		324,856	285,237	350,050
Total current liabilities		770,588	676,607	769,570
Total liabilities		916,089	804,363	934,814
Total equity and liabilities		₩ 5,253,77	$ 4,613,025	₩ 4,787,805

See accompanying notes to the financial statments.

Statements of Comprehensive Income

For the years ended December 31, 2010 and 2009

[In millions of Won and thousands of U.S. dollars, except earnings per share]

	Note	2010 Korean won	2010 U.S.dollars (note 4)	2009 Korean won
Sales:	27			
Manufacture of tobacco		₩ 2,366,230	$ 2,077,645	₩ 2,472,054
Real estate		100,521	88,262	258,033
Exports of leaf tobacco and others		33,180	29,133	46,316
		2,499,931	2,195,040	2,776,403
Cost of sales:	27			
Manufacture of tobacco		(925,850)	(812,933)	(960,187)
Real estate		(56,435)	(49,552)	(165,811)
Exports of leaf tobacco and others		(19,900)	(17,474)	(28,946)
		(1,002,185)	(879,959)	(1,154,944)
Gross profit		1,497,746	1,315,081	1,621,459
Other income	23	130,197	114,319	51,395
Selling expenses	23	(411,108)	(360,970)	(460,792)
General and administrative expenses	23	(220,041)	(193,205)	(150,432)
Employee welfare fund		(9,465)	(8,311)	(10,000)
Other expense	8,23	(62,313)	(54,713)	(105,083)
Profit from operations		925,016	812,201	946,547
Finance income	24	296,857	260,653	41,607
Finance costs	24	(1,767)	(1,552)	(2,806)
Net finance income	24	295,090	259,101	38,801
Profit before income taxes		1,220,106	1,071,302	985,348
Income tax expense	25	(288,979)	(253,735)	(240,406)
Profit for the period		₩ 931,127	$ 817,567	₩ 744,942
Other comprehensive income:				
Available-for-sale financial assets, net of tax	10,24,25	₩ (110,759)	$ 97,251)	₩ 101,055
Actuarial gains (losses), net of tax	22,25	(4,439)	(3,899)	16,924
Other comprehensive income (expense) for the period, net of tax		(115,198)	(101,150)	117,979
Total comprehensive income for the period		₩ 815,929	$ 716,417	₩ 862,921
Earnings per share in won and U.S. dollars:				
Basic and diluted	26	₩ 7,317	$ 6.42	₩ 5,803

See accompanying notes to the financial statments.

Statements of Changes in Equity

For the year ended December 31, 2010

[In millions of Won]

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total equity
Balance at January 1, 2010	₩ 954,959	2,632	(226,945)	468,274	2,074,108	579,963	3,852,991
Total comprehensive income for the period:							
Profit for the period	-	-	-	-	-	931,127	931,127
Other comprehensive income:							
Available-for-sale financial assets, net of tax	-	-	-	-	(110,759)	-	(110,759)
Actuarial losses, net of tax	-	-	-	-	-	(4,439)	(4,439)
Total other comprehensive income (expense)	-	-	-	-	(110,759)	(4,439)	(115,198)
Total comprehensive income (expense) for the period	-	-	-	-	(110,759)	926,688	815,929
Transactions with owners, recorded directly in equity:							
Dividends	-	-	-	-	-	(356,157)	(356,157)
Disposal of treasury shares	-	-	10,118	13,855	-	-	23,973
Transfer from reserve for research and human resource development	-	-	-	-	(15,000)	15,000	-
Transfer from reserve for loss on reissuance of treasury shares	-	-	-	-	(26,646)	26,646	-
Transfer to reserve for research and human resource development	-	-	-	-	60,000	(60,000)	-
Transfer to unconditional reserve	-	-	-	-	203,000	(203,000)	-
Transfer of a business operation from / to the subsidiaries	-	950	-	-	-	-	950
Total transactions with owners	-	950	10,118	13,855	221,354	(577,511)	(331,234)
Balance at December 31, 2010	₩ 954,959	3,582	(216,827)	482,129	2,184,703	929,140	4,337,686

See accompanying notes to the financial statments.

[In thousands of U.S. dollars]

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	Total equity
Balance at January 1, 2010	$ 838,493	2,311	(199,267)	411,164	1,821,150	509,232	3,383,083
Total comprehensive income for the period:							
Profit for the period	-	-	-	-	-	817,567	817,567
Other comprehensive income:							
Available-for-sale financial assets, net of tax	-	-	-	-	(97,251)	-	(97,251)
Actuarial losses, net of tax	-	-	-	-	-	(3,899)	(3,899)
Total other comprehensive income (expense)	-	-	-	-	(97,251)	(3,899)	(101,150)
Total comprehensive income (expense) for the period	-	-	-	-	(97,251)	813,668	716,417
Transactions with owners, recorded directly in equity:							
Dividends	-	-	-	-	-	(312,720)	(312,720)
Disposal of treasury shares	-	-	8,884	12,164	-	-	21,048
Transfer from reserve for research and human resource development	-	-	-	-	(13,170)	13,170	-
Transfer from reserve for loss on reissuance of treasury shares	-	-	-	-	(23,396)	23,396	-
Transfer to reserve for research and human resource development	-	-	-	-	52,682	(52,682)	-
Transfer to unconditional reserve	-	-	-	-	178,242	(178,242)	-
Transfer of a business operation from/to the subsidiaries	-	834	-	-	-	-	834
Total transactions with owners	-	834	8,884	12,164	194,358	(507,078)	(290,838)
Balance at December 31, 2010	$ 838,493	3,145	(190,383)	423,328	1,918,257	815,822	3,808,662

See accompanying notes to the financial statments.

Statements of Changes in Equity

For the years ended December 31, 2009

[In millions of Won]

	Ordinary shares	Other capital surplus	Treasury shares	Gain on reissuance of treasury shares	Reserve	Retained earnings	**Total equity**
Balance at January 1, 2009	₩ 954,959	337	(226,945)	468,274	1,821,348	436,453	3,454,426
Total comprehensive income for the period:							
Profit for the period	-	-	-	-	-	744,942	744,942
Other comprehensive income:							
Available-for-sale financial assets, net of tax	-	-	-	-	101,055	-	101,055
Actuarial gains, net of tax	-	-	-	-	-	16,924	16,924
Total other comprehensive income	-	-	-	-	101,055	16,924	117,979
Total comprehensive income for the period	-	-	-	-	101,055	761,866	862,921
Transactions with owners, recorded directly in equity:							
Dividends	-	-	-	-	-	(360,357)	(360,357)
Reacquisition of treasury shares	-	-	(103,999)	-	-	-	(103,999)
Retirement of treasury shares	-	-	103,999	-	-	(103,999)	-
Transfer to unconditional reserve	-	-	-	-	169,000	(169,000)	-
Transfer from reserve for research and human resource development	-	-	-	-	(15,000)	15,000	-
Expiration of employee share options	-	2,295	-	-	(2,295)	-	-
Total transactions with owners	-	2,295	-	-	151,705	(618,356)	(464,356)
Balance at December 31, 2009	₩ 954,959	2,632	(226,945)	468,274	2,074,108	579,963	3,852,991

See accompanying notes to the financial statments.

Statements of Cash Flows

For the years ended December 31, 2010 and 2009

[In millions of Won and thousands of U.S. dollars]

	Note	2010 Korean won	2010 U.S.dollars (note 4)	2009 Korean won
Cash flows from operating activities				
Cash generated from operations	31	₩ 916,063	$ 804,340	₩ 1,034,124
Income tax paid		(200,595)	(176,130)	(286,450)
Net cash from operating activities		715,468	628,210	747,674
Cash flows from investing activities				
Interest received		17,547	15,407	9,468
Investment income received from long-term deposits in MSA Escrow Fund		1,244	1,092	-
Dividends received		32,056	28,147	30,215
Proceeds from investments in associates		-	-	1
Proceeds from sale of available-for-sale financial assets		265,678	233,276	1,648
Collection of loans		43,509	38,202	23,967
Proceeds from sale of property, plant and equipment		35,088	30,809	17,972
Proceeds from sale of intangible assets		633	556	64
Proceeds from sale of assets held for sale		100,830	88,533	-
Proceeds from transfer of a business operation		8,566	7,521	-
Purchases of investments in associates		-	-	(500)
Purchases of investments in subsidiaries		(123,225)	(108,197)	(34,233)
Purchases of available-for-sale financial assets		(39,923)	(35,054)	(11,222)
Increase in loans		(20,587)	(18,076)	(15,461)
Payments of long-term deposits in MSA Escrow Fund		(13,625)	(11,963)	(18,055)
Purchases of property, plant and equipment		(124,478)	(109,297)	(96,400)
Acquisition of intangible assets		(7,787)	(6,837)	(4,769)
Acquisition of investment property		-	-	(323)
Settlement of financial derivatives		-	-	(4,410)
Cash flows from other investing activities		(2,036)	(1,788)	284
Net cash provided by (used in) investing activities		173,490	152,331	(101,754)
Cash flows from financing activities				
Interest paid		(5)	(4)	(585)
Dividends paid		(356,157)	(312,720)	(360,357)
Reacquisition of treasury shares		-	-	(103,999)
Disposal of treasury shares		28,395	24,932	-
Cash flows from other financing activities		(1,158)	(1,018)	(347)
Net cash used in financing activities		(328,925)	(288,810)	(465,288)
Net increase in cash and cash equivalents		560,033	491,731	180,632
Cash and cash equivalents at beginning of year		268,954	236,152	88,352
Effect of exchange rate fluctuation on cash held		(36)	(31)	(30)
Cash and cash equivalents at end of year		₩ 828,951	$ 727,852	₩ 268,954

See accompanying notes to the financial statments.

Notes to the Financial Statements

December 31, 2010 and 2009

1. ORGANIZATION AND DESCRIPTION OF BUSINESS

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 enterprise 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 shares on the Korea Exchange (formerly, 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 and Ginseng Corporation.

As of December 31, 2010, the Company has four manufacturing plants, including the Shintanjin plant, and 14 local head quarters and 137 branches for the sale of tobacco throughout the country. Also, the Company has the Gimcheon plant for fabrication of leaf tobacco and the Cheonan printing plant for the manufacturing of packaging. The head office of the Company is located in Pyeongchon-dong, Daedeok-gu, Daejeon.

Pursuant to the Korean government's privatization program and management reorganization plan, on December 28, 1998, the shareholders approved a plan to separate the Company 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, Korea Ginseng Corporation.

On October 17, 2002 and October 31, 2001, the Company listed 35,816,658 and 45,400,000 Global Depositary Receipts ("GDR") (each GDR representing the right to receive one-half share of an ordinary share of the Company), respectively, on the Luxembourg Stock Exchange pursuant to the Korean government's privatization program. Also, on June 25, 2009, the market of the Company's GDR was changed from the BdL market to the Euro MTF in the Luxembourg Stock Exchange.

The ownership of the Company's issued ordinary shares as of December 31, 2010 is held as follows:

Shareholder	Number of shares	Percentage of ownership
Industrial Bank of Korea	9,510,485	6.93%
Employee Share Ownership Association	3,970,401	2.89%
Treasury shares	9,643,697	7.02%
Others	114,167,914	83.16%
	137,292,497	100.00%

2. BASIS OF PREPARATION

(a) Statement of Compliance

The financial statements have been prepared in accordance with Korean International Financial Reporting Standards (“K-IFRS”), as prescribed in the Act on External Audit of Corporations. K-IFRS is effective from the fiscal year beginning on or after January 1, 2011 and the Company early-adopted K-IFRS from 2009.

These financial statements are separate financial statements which are those presented by a parent or an investor in an associate, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investee in accordance with K-IFRS No.1027 Consolidated and Separate Financial Statements.

(b) Basis of Measurement

The financial statements have been prepared under the historical cost basis except as described in the accounting policy below on financial instruments, inventories valued at net realizable value and share-based payments.

(c) Use of Estimates and Judgments

The preparation of the financial statements in conformity with K-IFRS requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Information about critical judgements in applying accounting policies that have the most significant effect on the amounts recognized in the financial statements is included in the following notes:

• Classification of investment property - Note 7.

Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next financial year is included in the following notes:

• Measurement of defined benefit obligations - Note 22.
• Provisions and contingencies - Note 29.

Notes to the Financial Statements

December 31, 2010 and 2009

3. SIGNIFICANT ACCOUNTING POLICIES

(a) Investments in Subsidiaries and Associates in the Separate Financial Statements

These financial statements are separate financial statements which are those presented by a parent or an investor in an associate in accordance with K-IFRS No.1027, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees. The Company accounts for investments in subsidiaries and associates at cost. The Company measures an investment in Korea Ginseng Corporation at the deemed cost which is previous GAAP carrying amount at the date of transition in accordance with K-IFRS No.1101 *First-time Adoption of Korean International Financial Reporting Standards.* Dividends on investments in subsidiaries and associates are recognized in profit or loss when the Company's right to receive payment is established.

(b) Foreign Currencies

These financial statements are presented in Korean won, which is the Company's functional currency that is the currency of the primary economic environment in which the Company operates.

Foreign currency transactions are initially recorded using the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. At the end of each reporting period, foreign currency monetary items are translated using the closing rate. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary items that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements are recognized in profit or loss in the period in which they arise. When gains or losses on non-monetary items are recognized in other coprehensive income, exchange components of those gains or losses are recognized in other comprehensive income. Conversely, when gains or losses on non-monetary items are recognized in profit or loss, exchange components of those gains or losses are recognized in profit or loss.

(c) Property, Plant and Equipment

Property, plant and equipment are measured initially at cost and after initial recognition, are carried at cost less accumulated depreciation and accumulated impairment losses. The cost of property, plant and equipment includes expenditure arising directly from the construction or acquisition of the asset, any costs directly attributable to bringing the asset to the location and condition necessary for them to be capable of operating in the manner intended by management and the initial estimate of the costs of dismantling and removing the item and restoring the site on which they are located.

Subsequent costs are recognized in the carrying amount of property, plant and equipment at cost or, if appropriate, as separate items if it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. The costs of the day-to-day servicing are recognized in profit or loss as incurred.

Property, plant and equipment, except for land and other tangible fixed assets, are depreciated on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment. The estimated useful lives were as follows:

[Useful live (years)]

Buildings and structures	10 ~ 60
Machinery and vehicles	4 ~ 12
Tools, furniture and fixtures	4

Each part of property, plant and equipment with a cost that is significant in relation to the total cost are depreciated separately.

Depreciation methods, useful lives and residual values are reviewed at each financial year-end and adjusted if appropriate. The change is accounted for as a change in an accounting estimate.

(d) Intangible Assets

Intangible assets are measured initially at cost and after initial recognition, are carried at cost less accumulated amortization and accumulated impairment losses. Intangible assets consist of industrial property rights, rights to facility usage and other intangible assets. Intangible assets are amortized on a straight-line basis over the estimated useful lives of intangible assets from the date that they are available for use. The residual value of intangible assets is assumed to be zero. However, as there are no foreseeable limits to the periods over which rights to facility usage and some of industrial property right are expected to be available for use, these intangible assets are regarded as having indefinite useful lives and not amortized.

The estimated useful lives were as follows:

[Useful live (years)]

Industrial property rights	10 ~ 20 or indefinite
Rights to facility usage	indefinite
Other intangible assets	15

The amortization period and the amortization method for intangible assets with a finite useful life are reviewed at each financial year-end. The useful lives of intangible assets that are not being amortized are reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for those assets. If it is appropriate to change, such a change is accounted for as a change in an accounting estimate.

Notes to the Financial Statements

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(e) Investment Property

Properties held to earn rentals or for capital appreciation are classified as investment properties. Investment properties are measured initially at its cost including transaction costs and after initial recognition, are carried at cost less accumulated depreciation and accumulated impairment losses.

Subsequent costs are recognized in the carrying amount of investment property at cost or, if appropriate, as separate items if it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. The costs of the day-to-day servicing are recognized in profit or loss as incurred.

Investment properties, except for land, are depreciated on a straight-line basis over 10 ~ 60 years, the estimated useful lives. Depreciation methods, useful lives and residual values are reviewed at each financial year-end and adjusted if appropriate. The change is accounted for as a change in an accounting estimate.

(f) Inventories

Inventories are measured at the lower of cost and net realizable value. The cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

The cost of inventories is determined by the weighted-average method for finished goods, by-products, work-in-progress and tobacco leaf in raw materials, by the moving-average method for raw materials and supplies; and by the specific identification method for all other inventories.

When inventories are sold, the carrying amount of those inventories is recognized as an expense in the period in which the related revenue is recognized. The amount of any write-down of inventories to net realizable value and all losses of inventories are recognized as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value, is recognized as a reduction in the amount of inventories and recognized as an expense in the period in which the reversal occurs.

Tobacco leaf inventories which have an operating cycle that exceeds 12 months are classified as current assets, consistent with recognized industry practice. The estimated amounts of inventories in current assets which are not expected to be realized within 12 months are ₩403,082 million and ₩362,594 million, respectively, as of December 31, 2010 and 2009.

(g) Non-derivative Financial Assets

The Company classifies a non-derivative financial asset into the following four categories: financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables or available-for-sale financial assets, relating to recognition and measurement of financial assets. The Company recognizes financial assets in the statement of financial position when the Company becomes a party to the contractual provisions of the financial asset. The Company derecognizes financial assets from the statement of financial position when the contractual rights to the cash flows from the financial asset expire or the Company transfers the contractual rights to receive the cash flows on the financial asset in a transaction in which all the risks and rewards of ownership of the financial asset are substantially transferred. If the Company retains substantially all the risks and rewards of ownership of the transferred financial assets, the Company continues to recognize the transferred financial asset and recognizes financial liabilities for the consideration received.

Non-derivative financial assets comprise investments in equity and debt securities, long-term deposits in MSA Escrow Fund, trade and other receivables and cash and cash equivalents. When non-derivative financial assets are recognized initially, the Company measures it at its fair value plus, in the case of financial assets not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset.

Financial Assets at Fair Value through Profit or Loss
Financial assets are classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Upon initial recognition transaction costs are recognized in profit or loss when incurred. Financial assets at fair value through profit or loss are measured at fair value, and changes therein are recognized in profit or loss.

Held-to-maturity Investments
Non-derivative financial assets with fixed or determinable payments and fixed maturity that the Company has the positive intention and ability to hold to maturity are classified as held-to-maturity investments. After initial recognition, held-to-maturity investments are measured at amortized cost using the effective interest method.

Loans and Receivables
Loans and receivables are trade receivables, loans and other receivables with fixed or determinable payments that are not quoted in an active market. After initial recognition, loans and receivables are measured at amortized cost using the effective interest method except for short-term receivables of which the effect of discounting is immaterial.

Available-for-sale Financial Assets
Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as financial assets at fair value through profit or loss, held-to-maturity investments or loans and receivables. Subsequent to initial recognition, they are measured at fair value and changes therein are recognized directly in other comprehensive income, except for impairment losses and foreign exchange gains and losses on monetary available-for-sale financial asset. Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are measured at cost. When the financial asset is derecognized or impairment losses is recognized, the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit or loss. Dividends on an available-for-sale equity instrument are recognized in profit or loss when the Company's right to receive payment is established.

Cash and Cash Equivalents
Cash and cash equivalents comprise cash on hand, demand deposits and short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date. Bank overdrafts are included as a component of cash and cash equivalents for the purpose of the statement of cash flows.

(h) Non-derivative Financial Liabilities

The Company classifies non-derivative financial liabilities into financial liabilities at fair value through profit or loss or other financial liabilities in accordance with the substance of the contractual arrangement and the definitions of financial liabilities. The Company recognizes financial liabilities in the statement of financial position when the Company becomes a party to the contractual provisions of the financial liability and removes financial liabilities from the statement of financial position when the financial liability is extinguished.

Non-derivative financial liabilities comprise borrowings and trade and other payables. When non-derivative financial liabilities are recognized initially, the Company measures it at its fair value minus, in the case of financial liabilities not at fair value through profit or loss, transaction costs that are directly attributable to the issue of the financial liability.

Financial Liabilities at Fair Value through Profit or Loss
Financial liabilities are classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Upon initial recognition transaction costs are recognized in profit or loss when incurred. Financial liabilities at fair value through profit or loss are measured at fair value, and changes therein are recognized in profit or loss.

Notes to the Financial Statements

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Other Financial Liabilities

Other financial liabilities are those non-derivative financial liabilities that are not classified as financial liabilities at fair value through profit or loss. After initial recognition, other financial liabilities are measured at amortized cost using the effective interest method except for short-term liabilities of which the effect of discounting is immaterial.

(i) Derivative Financial Instruments

Derivatives are recognized initially at fair value. Attributable transaction costs are recognized in profit or loss when incurred.

A hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment that is attributable to a particular risk is accounted for as a fair value hedge. A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognized asset or liability or a highly probable forecast transaction is accounted for as a cash flow hedge.

At the inception of the hedge, the Company formally designates the hedging relationship and the Company's risk management objective and strategy for undertaking the hedge and documents identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the Company will assess the hedging instrument's effectiveness. The Company assesses the hedge effectiveness on an ongoing basis throughout the financial reporting periods for which the hedge was designated.

Subsequent to initial recognition, derivatives are measured at fair value, and changes therein are accounted for as described below.

Fair Value Hedges

The gain or loss from remeasuring the hedging instrument designated as a fair value hedge at fair value and the gain or loss on the hedged item attributable to the hedged risk is recognized in profit or loss.

Cash Flow Hedges

The portion of the gain or loss on the hedging instrument designated as a cash value hedge that is determined to be an effective hedge is recognized in other comprehensive income and the ineffective portion of the gain or loss on the hedging instrument is recognized in profit or loss. The associated gains or losses that were recognized in other comprehensive income is reclassified from equity to profit or loss in the same period or periods during which the hedged forecast transaction affects profit or loss. If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, the associated gains and losses that were recognized in other comprehensive income are removed and included in the initial cost or other carrying amount of the asset or liability.

If the hedging instrument expires or is sold, terminated or exercised or the hedge no longer meets the criteria for hedge accounting or the Company revokes the designation, the hedge accounting is discontinued prospectively. The cumulative gain or loss on the hedging instrument that has been recognized in other comprehensive income is reclassified from equity to profit or loss when the forecast transaction occurs. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognized in other comprehensive income is immediately reclassified from equity to profit or loss.

Changes in the fair value of derivatives that are not designated as hedging instrument or do not meet the criteria for hedge accounting are recognized immediately in profit or loss.

As of December 31, 2010, the Company does not have derivative financial instruments.

(j) Non-current Assets Held for Sale

The Company classifies a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use, and measures it at the lower of its carrying amount and fair value less costs to sell.

A non-current asset which is classified as held for sale or which is part of a disposal group classified as held for sale is not depreciated.

The Company recognizes an impairment loss for write-down of the asset (or disposal group) to fair value less costs to sell and a gain for increase in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognized previously in accordance with K-IFRS No.1036 Impairment of Assets.

(k) Revenue Recognition

The Company's revenue categories consist of goods sold, services and other income.

Revenue from sale of goods is measured at the fair value of the consideration received or receivable, net of tobacco excise and other taxes, trade discounts and volume rebates. Revenue from the sale of goods is recognized when the Company has transferred to the buyer the significant risks and rewards of ownership of the goods, the Company retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold, the amount of revenue can be measured reliably, it is probable that the economic benefits associated with the transaction will flow to the Company and the costs incurred or to be incurred in respect of the transaction can be measured reliably. Tobacco excise and other taxes deducted from revenue for the years ended December 31, 2010 and 2009 were ₩3,363,885 million and ₩3,772,203 million, respectively.

Revenue from the building lotting-out construction contracts is recognized upon delivery when the significant risks and rewards of ownership of the goods are transferred to the buyer.

Revenue associated with the transaction involving the rendering of services is recognized by reference to the stage of completion of the transaction at the end of the reporting period when the amount of revenue can be measured reliably, it is probable that the economic benefits associated with the transaction will flow to the Company, the stage of completion of the transaction at the end of the reporting period can be measured reliably and the costs incurred for the transaction and the costs to complete the transaction can be measured reliably. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue is recognized only to the extent of the expenses recognized that are recoverable.

Revenue arising from the use by others of the Company assets yielding interest, royalties and dividends is recognized when it is probable that the economic benefits associated with the transaction will flow to the Company and the amount of the revenue can be measured reliably.

In addition, interest is recognized using the effective interest method, royalties are recognized on an accrual basis in accordance with the substance of the relevant agreement and dividends are recognized when the shareholders' right to receive is established.

Notes to the Financial Statements

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(l) Impairment of Non-financial Assets

The Company assesses at the end of each reporting period whether there is any indication that an asset may be impaired except for inventories, deferred tax assets, assets arising from employee benefits and non-current assets (or disposal groups) classified as held for sale. If any such indication exists, the Company estimates the recoverable amount of the asset. Intangible assets with indefinite useful lives and intangible assets not yet available for use are tested for impairment annually, irrespective of whether there is any indication that it may be impaired. If there is any indication that an asset may be impaired, recoverable amount is estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, the Company determines the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

The recoverable amount is measured as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. If the recoverable amount of an asset or cash-generating unit is less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. That reduction is recognized in profit or loss.

(m) Impairment of Financial Assets

The Company assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired, except a financial asset at fair value through profit or loss. A financial asset or group of financial assets is considered to be impaired if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset and that loss event has an impact on the estimated future cash flows of the financial asset. For specific financial assets such as trade receivables, if the Company determines that no objective evidence of impairment exists for an individually assessed financial asset, it collectively assesses them for impairment. The objective evidence that the group of loans and receivables is impaired includes an increased number of delayed payments and an adverse change in national or local economic conditions that correlate with defaults on the assets in the group.

The amount of the impairment loss on financial assets carried at amortized cost is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced either directly or through use of an allowance account. The amount of the loss is recognized in profit or loss. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed. The reversal does not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal is recognized in profit or loss.

The amount of the impairment loss on financial assets carried at cost is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses are not reversed.

When a decline in the fair value of an available-for-sale financial asset has been recognized in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment even though the financial asset has not been derecognized. Impairment losses recognized in profit or loss for an investment in an equity instrument classified as available for sale are not reversed through profit or loss. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in profit or loss, the impairment loss is reversed, with the amount of the reversal recognized in profit or loss.

(n) Income Taxes

Income tax expense comprises current tax expense and deferred tax expense. Current and deferred taxes are recognized as an expense included in profit or loss for the period, except to the extent that the tax arises from a transaction which is recognized in other comprehensive income or directly in equity.

Current tax expense is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. Current tax liabilities (assets) for the current and prior periods are measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates that have been enacted or substantively enacted by the end of the reporting period.

Deferred tax assets and liabilities are recognized for temporary differences which are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base, the carryforward of unused tax losses and unused tax credits. Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates that have been enacted or substantively enacted by the end of the reporting period.

The Company recognizes a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries and associates, except to the extent that the parent or investor is able to control the timing of the reversal of the temporary difference; and it is probable that the temporary difference will not reverse in the foreseeable future.

The Company recognizes a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries and associates, to the extent that, and only to the extent that it is probable that the temporary difference will reverse in the foreseeable future; and taxable profit will be available against which the temporary difference can be utilized.

The carrying amount of a deferred tax asset is reviewed at the end of each reporting period. The Company reduces the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of these deferred tax assets to be utilized. Such reduction is reversed to the extent that it becomes probable that sufficient taxable profit will be available.

Income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

(o) Dividends

The dividends declared to holders of equity instruments after the reporting period are not recognized as a liability at the end of the reporting period.

(p) Equity Capital

Ordinary shares are classified as equity. Incremental costs directly attributable to the equity transaction are recognized as a deduction from equity, net of any tax effects.

If the Company reacquires its own equity instruments, those instruments (“treasury shares”) are presented as a deduction from total equity. The gain or loss on the purchase, sale, issue or cancellation of treasury shares is not recognized in profit or loss but recognized directly in equity.

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(q) Provisions, Contingent Assets and Contingent Liabilities

Provisions are recognized when the Company has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

The amount recognized as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The risks and uncertainties that inevitably surround many events and circumstances are taken into account in reaching the best estimate of a provision. Where the effect of the time value of money is material, the amount of a provision is the present value of the expenditures expected to be required to settle the obligation.

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement is recognized when, and only when, it is virtually certain that reimbursement will be received if the Company settles the obligation. The reimbursement is treated as a separate asset.

Provisions are reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision is reversed.

(r) Employee Benefits

Short-term Employee Benefits
Short-term employee benefits are employee benefits that are due to be settled within 12 months after the end of the period in which the employees render the related service. When an employee has rendered service to the Company during an accounting period, the Company recognizes the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service.

The Company recognizes the expected cost of profit-sharing and bonus payments if the Company has a present legal or constructive obligation to make such payments as a result of past events; and a reliable estimate of the obligation can be made.

Retirement Benefits: Defined Contribution Plans
With regard to the defined contribution plan, when an employee has rendered service to the Company during a period, the Company recognizes the contribution payable to a defined contribution plan in exchange for that service as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, the Company recognizes that excess as an asset (prepaid expense) to the extent that the prepayment will lead to a reduction in future payments or a cash refund.

Retirement Benefits: Defined Benefit Plans
The Company classifies retirement benefits plans other than defined contribution plans as defined benefit plans. The defined benefit liabilities are calculated at the present value of the defined benefit obligations less the fair value of the plan assets at the end of the reporting period.

In determining the present value of its defined benefit obligations and the related current service cost, the Company uses the projected unit credit method.

With regard to actuarial gains and losses which arise from application of actuarial assumptions, the Company recognizes all actuarial gains and losses in other comprehensive income. Actuarial gains and losses recognized in other comprehensive income are recognized immediately in retained earnings and are not reclassified to profit or loss in a subsequent period.

Termination Benefits
The Company recognizes termination benefits as a liability and an expense when, and only when, the Company is demonstrably committed to terminating the employment of an employee or group of employees before the normal retirement date or providing termination benefits as a result of an offer made in order to encourage voluntary redundancy.

(s) Share-based Payment Transactions

For equity-settled share-based payment transactions, the Company measures the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the Company cannot estimate reliably the fair value of the goods or services received, the Company measures their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

For cash-settled share-based payment transactions, the Company measures the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the Company remeasures the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognized in profit or loss for the period.

For share-based payment transactions in which the terms of the arrangement provide either the Company or the counterparty with the choice of whether the Company settles the transaction in cash or by issuing equity instruments, the Company accounts for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the Company has incurred a liability to settle in cash, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

(t) Earnings per Share

The Company presents basic and diluted earnings per share ("EPS") data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss for the period attributable to owners of the Company by the weighted-average number of shares outstanding during the period.

Diluted EPS is determined by adjusting the profit or loss for the period attributable to owners of the Company and the weighted-average number of shares outstanding for the effects of all dilutive potential shares, which comprise employee share options.

(u) Operating Segments

Operating segment disclosures are included in the consolidated financial statements in accordance with K-IFRS No.1108 Operating Segments.

(v) New Standards and Interpretations Not Yet Adopted

The new and amended standards and interpretations that have been issued but are not yet effective as of December 31, 2010 have not been applied in preparing the financial statements. None of these is expected to have a significant effect on the financial statement of the Company, except for K-IFRS No. 1109 Financial Instruments. The extent of the impact of adopting this standard on the financial statements has not been determined.

4. BASIS OF TRANSLATING FINANCIAL STATEMENTS

The financial statements are expressed in Korean won and have been translated into U.S. dollars at the rate of ₩1,138.90 to $1, the basic exchange rate on December 31, 2010 posted by Seoul Money Brokerage Services, solely for the convenience of the reader. 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.

Notes to the Financial Statements

December 31, 2010 and 2009

5. PROPERTY, PLANT AND EQUIPMENT

(a) Changes in property, plant and equipment for the year ended December 31, 2010 were as follows:

[In millions of Won]

	Land, buildings and structures	Machinery and vehicles	Tools, furniture, fixtures and other	Construction-in-progress	Total
Cost:					
Balance at January 1, 2010	₩ 1,022,347	835,754	232,769	45,447	2,136,317
Additions	4,593	10,500	18,205	91,180	124,478
Disposals	(6,493)	(44,178)	(63,456)	(123)	(114,250)
Other	16,626	25,970	1,376	(54,029)	(10,057)
Balance at December 31, 2010	₩ 1,037,073	828,046	188,894	82,475	2,136,488
Accumulated depreciation and impairment:					
Balance at January 1, 2010	(229,226)	(523,569)	(173,096)	-	(925,891)
Disposals	1,936	36,525	61,866	-	100,327
Depreciation	(25,004)	(60,039)	(29,652)	-	(114,695)
Other	(103)	-	-	-	(103)
Balance at December 31, 2010	₩ (252,397)	(547,083)	(140,882)	-	(940,362)
Carrying amount:	-	-	-	-	(15,000)
Balance at January 1, 2010	₩ 793,121	312,185	59,673	45,447	1,210,426
Balance at December 31, 2010	₩ 784,676	280,963	48,012	82,475	1,196,126

Other changes for the year ended December 31, 2010 include the carrying amount of construction-in-progress transferred to operating expenditures and inventories amounting to ₩957 million and ₩9,449 million, respectively, and the carrying amount of investment property transferred to land and buildings amounting to ₩247 million.

(b) Changes in property, plant and equipment for the year ended December 31, 2009 were as follows:

[In millions of Won]

	Land, buildings and structures	Machinery and vehicles	Tools, furniture, fixtures and other	Construction-in-progress	Total
Cost:					
Balance at January 1, 2009	₩ 1,022,851	837,278	212,724	41,380	2,114,233
Additions	12,100	13,349	17,464	53,487	96,400
Disposals	(13,579)	(17,402)	(2,242)	-	(33,223)
Other	975	2,529	4,823	(49,420)	(41,093)
Balance at December 31, 2009	₩ 1,022,347	835,754	232,769	45,447	2,136,317
Accumulated depreciation and impairment:					
Balance at January 1, 2009	(206,967)	(492,017)	(139,713)	-	(838,697)
Disposals	2,918	14,756	2,151	-	19,825
Depreciation	(25,177)	(61,811)	(35,535)	-	(122,523)
Other	-	15,503	1	-	15,504
Balance at December 31, 2009	₩ (229,226)	(523,569)	(173,096)	-	(925,891)
Carrying amount:					
Balance at January 1, 2009	₩ 815,884	345,261	73,011	41,380	1,275,536
Balance at December 31, 2009	₩ 793,121	312,185	59,673	45,447	1,210,426

Other changes for the year ended December 31, 2009 include the carrying amount of machinery, furniture and fixtures provided as an investment in kind in KT&G Pars amounting to ₩2,343 million and the amount transferred to non-current assets held for sale amounting to ₩23,246 million.

6. INTANGIBLE ASSETS

(a) Changes in intangible assets for the year ended December 31, 2010 were as follows:

[In millions of Won]

		Industrial property rights	Rights to facility usage	Other intangible assets	Intangible assets under development	Total
Cost:						
Balance at January 1, 2010	₩	6,175	15,316	658	29,419	51,568
Additions		3	1,711	3,416	2,657	7,787
Disposals		(200)	(513)	-	(171)	(884)
Others		288	-	-	(288)	-
Balance at December 31, 2010	₩	6,266	16,514	4,074	31,617	58,471
Accumulated amortization and impairment:						
Balance at January 1, 2010	₩	(5,233)	-	(647)	(647)	(6,527)
Disposals		94	-	-	-	94
Amortization		(48)	-	(11)	-	(59)
Impairment		-	-	(3,415)	-	(3,415)
Balance at December 31, 2010	₩	(5,187)	-	(4,073)	(647)	(9,907)
Carrying amount:						
Balance at January 1, 2010	₩	942	15,316	11	28,772	45,041
Balance at JDecember 31, 2010	₩	1,079	16,514	1	30,970	48,564

The Company recognized ₩3,415 million of impairment loss on the intangible assets relating to the acquisition of the sales network in the United States for the year ended December 31, 2010.

(b) Changes in intangible assets for the year ended December 31, 2009 were as follows:

[In millions of Won]

		Industrial property rights	Rights to facility usage	Other intangible assets	Intangible assets under development	Total
Cost:						
Balance at January 1, 2009	₩	6,133	14,616	658	25,456	46,863
Additions		42	764	-	3,963	4,769
Disposals		-	(64)	-	-	(64)
Balance at December 31, 2009	₩	6,175	15,316	658	29,419	51,568
Accumulated amortization and impairment:						
Balance at January 1, 2009	₩	(5,028)	-	(575)	-	(5,603)
Amortization		(205)	-	(72)	-	(277)
Impairment		-	-	-	(647)	(647)
Balance at December 31, 2009	₩	(5,233)	-	(647)	(647)	(6,527)
Carrying amount:						
Balance at January 1, 2009	₩	1,105	14,616	83	25,456	41,260
Balance at JDecember 31, 2009	₩	942	15,316	11	28,772	45,041

The Company recognized ₩647 million of impairment loss on the intangible assets under development due to the relinquishment of the industrial property rights for the year ended December 31, 2009.

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(c) Expenditures not capitalized for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Cost of sales	₩	252	182
Selling expenses		630	403
General and administrative expenses		9,898	12,815
	₩	10,780	13,400

7. INVESTMENT PROPERTY

(a) Changes in investment property for the year ended December 31, 2010 were as follows:

[In millions of Won]

		Land	Buildings	Total
Cost:				
Balance at January 1, 2010	₩	13,919	117,010	130,929
Transfer to property, plant and equipment		-	(350)	(350)
Balance at December 31, 2010		13,919	116,660	130,579
Accumulated depreciation and impairment:				
Balance at January 1, 2010	₩	-	(29,029)	(29,029)
Depreciation		-	(3,510)	(3,510)
Transfer to property, plant and equipment		-	103	103
Balance at December 31, 2010	₩	-	(32,436)	(32,436)
Carrying amount:				
Balance at January 1, 2010		13,919	87,981	101,900
Balance at December 31, 2010	₩	13,919	84,224	98,143

(b) Changes in investment property for the year ended December 31, 2009 were as follows:

[In millions of Won]

		Land	Buildings	Total
Cost:				
Balance at January 1, 2009	₩	3,919	116,687	130,606
Subsequent expenditure		-	323	323
Balance at December 31, 2009	₩	3,919	117,010	130,929
Accumulated depreciation and impairment:				
Balance at January 1, 2009	₩	-	(25,531)	(25,531)
Depreciation		-	(3,498)	(3,498)
Balance at December 31, 2009	₩	-	(29,029)	(29,029)
Carrying amount:				
Balance at January 1, 2009	₩	13,919	91,156	105,075
Balance at December 31, 2009	₩	13,919	87,981	101,900

(c) The amounts recognized in profit or loss from investment property for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Rental income	₩	17,039	16,739
Direct operating expense		(3,510)	(3,498)
	₩	13,529	13,241

(d) The carrying amount and the fair value of investment property as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010		2009	
		Fair value	Carrying amount	Fair value	Carrying amount
Land	₩	204,383	13,919	204,383	13,919
Buildings		109,235	84,224	109,235	87,981
	₩	313,618	98,143	313,618	101,900

(e) Investment property pledged as collateral to Korea Life Insurance Co., Ltd. and others as of December 31, 2010 and 2009 was as follows:

[In millions of Won]

Asset		Carrying amount	Type		Received amount	Collateral-ized amount	Leaseholder
Investment property	₩	98,143	Leasehold de-posits received	₩	2,583	3,429	Korea Life Insurance Co., Ltd. and others

(f) Investment property pledged as collateral as of December 31, 2009 was as follows:

[In millions of Won]

Asset		Carrying amount	Type		Received amount	Collateral-ized amount	Leaseholder
Investment property	₩	101,900	Leasehold de-posits received	₩	2,496	3,445	Korea Life Insurance Co., Ltd. and others

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8. INVESTMENTS IN ASSOCIATES

Investments in associates as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won, except percentage of ownership]

Associate	Location	Principal operation	2010 Percentage of owneship	2010 Carrying amount	2009 Percentage of owneship	2009 Carrying amount
Cosmo Tabacco Co., Ltd.	Mongolia	Manufacturing and selling tobacco	40.00%	₩ -	40.00%	₩ -
Lite Pharm Tech, Inc.	Korea	Manufacturing medical supplies	25.34%	1,830	29.46%	1,830
Korean Carbon Finance, Inc.	Korea	Emissions trading	20.00%	1,000	20.00%	1,000
				₩ 2,830		₩ 2,830

In 2010, Lite Pharm Tech, Inc. exercised asymmetric paid-in capital increase and consequently, the Company's percentage of ownership decreased from 29.46% to 25.34%.

In 2009, the Company disposed of its entire stake in Korea Islet Transplantation, Inc. and recognized ₩1,999 million of loss on sale of investments in associates as other expense in the statement of comprehensive income for the year ended December 31, 2009.

The Company recognized ₩2,947 million of impairment loss on the investment in Cosmo Tabacco Co., Ltd. for the year ended December 31, 2009 and this impairment loss is recognized as other expense in the statement of comprehensive income.

9. INVESTMENTS IN SUBSIDIARIES

Investments in subsidiaries as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won, except percentage of ownership]

Subsidiary	Location	Principal operation	2010		2009	
			Percentage of owneship	Carrying amount	Percentage of owneship	Carrying amount
Korea Ginseng Corporation	Korea	Manufacturing and selling ginseng	100.00%	₩ 559,882	100.00%	₩ 559,882
Yungjin Pharm. Ind. Co., Ltd.(*1)	Korea	Manufacturing and selling pharmaceutical	53.00%	66,355	55.50%	50,691
Tae-a Industry Co., Ltd.	Korea	Manufacturing tobacco materials	100.00%	14,198	100.00%	14,198
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.(*2)	Turkey	Manufacturing and selling tobacco	99.99%	54,049	99.99%	54,049
Korea Tabacos do Brasil Ltda.	Brazil	Processing leaf tobacco	99.90%	394	99.90%	394
KT&G Pars(*3)	Iran	Manufacturing and selling tobacco	99.99%	5,733	99.99%	5,733
KT&G Rus L.L.C.(*4)	Russia	Manufacturing and selling tobacco	100.00%	110,297	100.00%	34,483
KGC Life & Gin Co., Ltd. (formerly, KGC Sales Co., Ltd.)(*5)	Korea	Selling ginseng door-to-door	100.00%	22,500	-	-
KT&G Bio Corp.(*6)	Korea	Manufacturing and selling pharmaceutical	100.00%	900	100.00%	900
Global Trading, Inc.(*7)	USA	Selling tobacco	100.00%	4,913	-	-
Purpleland Development Co., Ltd.(*8)	Korea	Real estate	100.00%	900	-	-
				₩ 840,121		₩ 720,330

(*1) Yungjin Pharm. Ind. Co., Ltd. increased paid-in capital by way of Employee Share Ownership Association and shareholder allocation and the Company's investments in subsidiaries increased by ₩15,664 million for the year ended December 31, 2010.

(*2) KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. increased paid-in capital by way of shareholder allocation and the Company's investments in subsidiaries increased by ₩19,044 million for the year ended December 31, 2009.

(*3) KT&G Pars increased paid-in capital by way of investment in kind and the Company's investments in subsidiaries increased by ₩4,037 million for the year ended December 31, 2009.

(*4) KT&G Rus L.L.C. increased paid-in capital by way of shareholder allocation and the Company's investments in subsidiaries increased by ₩75,814 million for the year ended December 31, 2010.

(*5) In 2010, the Company acquired all the shares of KGC Life & Gin Co., Ltd. (formerly, KGC Sales Co., Ltd.) for ₩4,934 million from Korea Ginseng Corporation, which is a subsidiary of the Company. The Company recognized investments in subsidiaries at the carrying amount of ₩1,500 million in the financial statements of Korea Ginseng Corporation. Accordingly, the Company recognized a decrease in other capital surplus amounting to ₩3,434 million. After the acquisition, KGC Life & Gin Co., Ltd. increased paid-in capital by way of shareholder allocation and the Company's investments in subsidiaries increased by ₩21,000 million for the year ended December 31, 2010.

(*6) The Company established KT&G Bio Corp. for the year ended December 31, 2009.

(*7) The Company acquired all the shares of Global Trading, Inc. and increased paid-in capital for the year ended December 31, 2010.

(*8) The Company established Purpleland Development Co., Ltd. for the year ended December 31, 2010.

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10. AVAILABLE-FOR-SALE FINANCIAL ASSETS

(a) Changes in available-for-sale financial assets for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Balance at beginning of year	₩	443,800	304,105
Acquisitions		39,923	11,222
Net changes in fair value before tax		(141,998)	129,558
Disposals		(26,788)	(1,085)
Balance at end of year	₩	314,937	443,800
Statements of financial position:			
- Current	₩	1,000	1,957
- Non-current		313,937	441,843
	₩	314,937	443,800

(b) Available-for-sale financial assets as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010	2009
Available-for-sale debt instruments:			
- Government and municipal bonds	₩	44	2,001
- Corporate bonds		20,300	2,000
Total available-for-sale debt instruments		20,344	4,001
Available-for-sale equity instruments:			
Listed			
- Yonhap Television News (YTN)		30,839	38,967
- Crystal Genomics Co., Ltd.		-	1,748
- Oscotech, Inc.		1,022	780
- Shinhan Financial Group Co., Ltd.		212,042	173,161
- Rexahn Pharmaceuticals, Inc.		8,152	4,878
- Celltrion, Inc.		-	195,462
- Genematrix, Inc.		-	708
		252,055	415,704
Unlisted			
- Dream Hub PFV Co., Ltd.		12,732	15,975
- Migami, Inc.		3,988	3,365
- Other unlisted available-for-sale equity instruments		25,818	4,755
		42,538	24,095
Total available-for-sale equity instruments		294,593	439,799
Total available-for-sale financial assets	₩	314,937	443,800

(c) The fair value of listed available-for-sale equity instruments is principally based on quoted prices in an active market.

The Company disposed of all of its interest in Celltrion, Inc. and recognized ₩239,748 million of gain on sale of available-for-sale financial assets as other income in the statement of comprehensive income for the year ended December 31, 2010.

The fair value of Dream Hub PFV Co., Ltd. which does not have a market price in an active market is measured at the value per share determined by the net asset valuation model.

The other unlisted available-for-sale equity instruments that do not have a market price in an active market and whose fair value cannot be reliably measured and available-for-sale debt instruments whose fair value is similar to their carrying amount, are measured at cost.

11. LONG-TERM DEPOSITS IN MSA ESCROW FUND

(a) Long-term deposits in MSA Escrow Fund as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010	2009
MMF	₩	74,167	4,874
T-Bill		-	57,287
T-Note		58,247	55,960
	₩	132,414	118,121

(b) As discussed in notes 29 to financial statements, long-term deposits in MSA Escrow Fund are deposited to the Unite States government related to the export of tobacco to the United States. The payments of long-term deposits in MSA Escrow Fund for the years ended December 31, 2010 and 2009 are ₩13,625 million and ₩18,055 million, respectively.

(c) Investment income on long-term deposits in MSA Escrow Fund for the years ended December 31, 2010 and 2009 are ₩4,637 million and ₩23 million, respectively.

(d) Long-term deposits in MSA Escrow Fund are measured at quoted prices in an active market.

12. TRADE AND OTHER RECEIVABLES

(a) Trade and other receivables as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010		2009	
		Current	Non-current	Current	Non-current
Loans to employees	₩	19,287	42,972	23,985	68,067
Loans		14,942	7,374	9,870	5,861
Other receivables		70,822	-	53,775	-
Guarantee deposits		-	34,249	-	32,639
Accrued income		2,989	-	981	-
Trade receivables		419,787	-	417,120	-
	₩	527,827	84,595	505,731	106,567

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(b) Trade and other receivables as of December 31, 2010 and 2009 have been reported in the statements of financial position net of allowances as follows:

[In millions of Won]

		2010		2009	
		Current	Non-current	Current	Non-current
Gross trade and other receivables	₩	533,011	84,595	511,138	106,567
Allowance account:		14,942	7,374	9,870	5,861
- Other receivables		(1,917)	-	(2,161)	-
- Trade receivables		(3,267)	-	(3,246)	-
		(5,184)	-	(5,407)	-
Net trade and other receivables	₩	527,827	84,595	505,731	106,567

(c) Changes in the allowance account for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Balance at beginning of year	₩	5,407	4,867
Impairment loss		63	540
Write-off		(286)	-
Balance at end of year	₩	5,184	5,407

Impairment loss on trade and other receivables is included as part of other expense in the statements of comprehensive income.

(d) The aging schedule of trade and other receivables which were past due but not impaired as of December 31, 2010 and 2009 is as follows:

[In millions of Won]

		2010	2009
Within 1 month	₩	46,679	58,419
Between 1 and 2 months		64,212	71,366
Beyond 2 months		7,226	15,243
	₩	118,117	145,028

There is no significant concentration of credit risk with respect to trade and other receivables since trade and other receivables, excluding export trade receivables, are widely dispersed amongst a number of customers. The Company holds bank guarantees, other guarantees and credit insurance in respect of some of the past due debtor balances.

(e) Details of trade and other receivables that are measured at amortized cost as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

	2010				2009			
	Effective interest rate		Current	Non-current	Effective interest rate		Current	Non-current
Loans to employees	3.00~5.68%	₩	19,287	42,972	3.00~5.68%	₩	23,985	68,067
Guarantee deposits	3.00~5.68%		-	34,249	3.00~5.68%		-	32,639
		₩	19,287	77,221		₩	23,985	100,706

There is no material difference between the carrying amount and their fair value except the above trade and other receivables, due to the short-term duration of the majority of trade and other receivables.

13. INVENTORIES

(a) Inventories as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010	2009
Finished goods, net of loss on the write-down of inventories	₩	70,770	86,318
Work-in-progress		14,401	12,633
Raw materials		843,286	858,373
Supplies		23,400	23,895
By-products		7,467	5,547
Completed buildings		-	53,816
Buildings under construction		381	-
Sites for building lotting-out construction		9,449	-
Goods-in-transit		21,179	13,739
	₩	990,333	1,054,321

(b) The amount of inventories recognized as an expense for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Cost of sales:			
- Loss on the write-down of inventories	₩	82	-
- Reversal of loss on the write-down of inventories		-	(189)
Other expense:			
- Loss on retirement of inventories		4,036	2,473
	₩	4,118	2,284

14. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010	2009
Cash on hand	₩	4,956	6,681
Demand deposits		53,995	62,273
Short-term investment assets		770,000	200,000
	₩	828,951	268,954

Cash equivalents mainly include short-term deposits with an original maturity of three months or less. The carrying amount of cash and cash equivalents approximates their fair value.

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15. SHARE CAPITAL

(a) Details of share capital as of December 31, 2010 and 2009 were as follows:

[In Won, except number of shares]

		2010	2009
Number of ordinary shares:			
- Authorized		800,000,000	800,000,000
- Issued		137,292,497	137,292,497
- Outstanding		127,648,800	127,198,800
Par value	₩	5,000	5,000

The Company has, thus far, reacquired and retired 53,699,400 shares of treasury share. Accordingly, as of December 31, 2010, the Company's ordinary share differs from the aggregate par value of issued shares by ₩268,497 million.

(b) Changes in the number of shares for the years ended December 31, 2010 and 2009 were as follows:

[Number of shares]

	2010			2009		
	Ordinary shares	Treasury shares	Total	Ordinary shares	Treasury shares	Total
Beginning of year	137,292,497	(10,093,697)	127,198,800	138,792,497	(10,093,697)	128,698,800
Reacquisition of treasury shares	-	-	-	-	(1,500,000)	(1,500,000)
Retirement of treasury shares	-	-	-	(1,500,000)	1,500,000	-
Disposal of treasury shares	-	450,000	450,000	-	-	-
End of year	137,292,497	(9,643,697)	127,648,800	137,292,497	(10,093,697)	127,198,800

(c) Changes in the other capital surplus for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Balance at beginning of year	₩	2,632	337
Acquisition of KGC Life & Gin Co., Ltd.		(3,434)	-
Transfer of the sports department		4,384	-
Expiration of employee share options		-	2,295
Balance at end of year	₩	3,582	2,632

In 2010, the Company acquired all the shares of KGC Life & Gin Co., Ltd. for ₩4,934 million from Korea Ginseng Corporation, which is a subsidiary of the Company. The Company recognized investments in subsidiaries at the carrying amount of ₩1,500 million in the financial statements of Korea Ginseng Corporation. Accordingly, the Company recognized a decrease in other capital surplus amounting to ₩3,434 million.

In 2010, the Company disposed of its sports department to Korea Ginseng Corporation, which is a subsidiary of the Company for ₩8,565 million. The Company recognized the difference of ₩4,384 million between the net disposal proceeds and the carrying amount of the sports department as an increase in other capital surplus.

The employee share options were settled in cash and terminated for the year ended December 31, 2009. Consequently, the employee share option reserve was reclassified to the other capital surplus.

16. TREASURY SHARES

(a) Changes in the treasury shares for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won, except number of shares]

	2010			2009		
	Number of shares		Carrying amount	Number of shares		Carrying amount
Balance at beginning of year	10,093,697	₩	226,945	10,093,697	₩	226,945
Reacquisition of treasury shares	-		-	1,500,000		103,999
Retirement of treasury shares	-		-	(1,500,000)		(103,999)
Disposal of treasury shares	(450,000)		(10,118)	-		-
Balance at end of year	9,643,697	₩	216,827	10,093,697	₩	226,945

(b) Changes in gain on reissuance of treasury shares for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Balance at beginning of year	₩	468,274	468,274
Gain on reissuance of treasury shares before tax		18,278	-
Less: tax at 24.2%		(4,423)	-
Gain of reissuance of treasury shares, net of tax		13,855	-
Balance at end of year	₩	482,129	468,274

17. RESERVES

(a) Details of reserves as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Available-for-sale financial assets reserve	₩	18,034	128,793
Legal reserve		602,937	602,937
Voluntary reserve		1,563,732	1,342,378
	₩	2,184,703	2,074,108

(b) Available-for-sale financial assets reserve as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010	2009
Available-for-sale financial assets reserve before tax	₩	23,120	165,119
Tax effect		(5,086)	(36,326)
	₩	18,034	128,793

(c) Legal Reserve

The Korean Commercial Code requires the Company to appropriate a legal reserve in 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 may be transferred to ordinary shares in connection with a free issue of shares.

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(d) Details of voluntary reserve as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Reserve for business rationalization	₩	12,851	12,851
Reserve for research and human resource development		60,000	15,000
Reserve for loss on reissuance of treasury shares		-	26,646
Reserve for business expansion		698,881	698,881
Unconditional reserve		792,000	589,000
	₩	1,563,732	1,342,378

Reserve for Business Rationalization

Until December 10, 2002 under the Special Tax Treatment Control Law, investment tax credits were allowed for certain investments. The Company was, however, required to appropriate from retained earnings, the amount of tax benefits received, and transfer such amount into a reserve for business rationalization.

Effective December 11, 2002, the Company was 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.

Reserve for Business Expansion

Reserve for business expansion was a legal reserve under the Korea Tobacco and Ginseng Corporation Act, which was abrogated on September 1, 1997, consequently, the existing balance has been regarded as a voluntary reserve since then.

Other Reserves

Reserves for research and human resource development and loss on reissuance of treasury shares were appropriated in order to utilize certain tax deduction 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 shareholders.

18. RETAINED EARNINGS

Changes in retained earnings for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Balance at beginning of year	₩	579,963	436,453
Transfer from reserve for research and human resource development		15,000	15,000
Transfer from reserve for loss on reissuance of treasury shares		26,646	-
Transfer to reserve for research and human resource development		(60,000)	-
Transfer to unconditional reserve		(203,000)	(169,000)
Dividends		(356,157)	(360,357)
Profit for the period		931,127	744,942
Actuarial gains (losses), net of tax		(4,439)	16,924
Retirement of treasury shares		-	(103,999)
Balance at end of year	₩	929,140	579,963

19. STATEMENTS OF APPROPRIATION OF RETAINED EARNINGS

Statements of appropriation of retained earnings for the years ended December 31, 2010 and 2009 are as follows:

Date of appropriation for 2010: March 4, 2011
Date of appropriation for 2009: February 26, 2010

[In millions of Won]

	2010	2009
Unappropriated retained earnings:		
Balance at beginning of year	₩ 2,452	(77,904)
Retirement of treasury shares	-	(103,999)
Profit for the period	931,127	744,942
Actuarial gains (losses), net of tax	(4,439)	16,924
Balance at end of year before appropriation	929,140	579,963
Transfer from voluntary reserves:		
Reserve for research and human resource development	-	15,000
Reserve for loss on reissuance of treasury shares	-	26,646
	-	41,646
Unappropriated retained earnings available for appropriation	929,140	621,609
Appropriation of retained earnings:		
Dividends (note 32)	(382,946)	(356,157)
Reserve for research and human resource development	-	(60,000)
Unconditional reserve	(544,000)	(203,000)
	(926,946)	(619,157)
Unappropriated retained earnings to be carried over to subsequent year	₩ 2,194	2,452

20. SHORT-TERM BORROWINGS

Short-term borrowings as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

	2010	2009
Customer credit contracts	₩ 8,618	19,338

The Company has entered into a customer credit contract with the National Agricultural Cooperative Federation ("NACF") and other financial institutions, the financial institutions pay past-due trade receivables for customers and the Company has provided guarantees to the financial institutions for customers. The amount paid by the financial institutions is recognized as short-term borrowings in the statements of financial position.

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21. TRADE AND OTHER PAYABLES

(a) Trade and other payables as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010		2009	
		Current	Non-current	Current	Non-current
Leasehold deposits received	₩	-	22,902	-	24,042
Trade payables		21,669	-	35,019	-
Withholdings		2,725	-	3,504	-
Withholdings taxes		114,727	-	121,217	-
Accrued expenses		86,548	-	87,024	-
Other payables		12,918	-	30,852	-
	₩	238,587	22,902	277,616	24,042

(b) Details of trade and other payables that are measured at amortized cost as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

	2010			2009		
	Effective interest rate		Amortized cost	Effective interest rate		Amortized cost
Leasehold deposits received	3.00~5.68%	₩	22,902	3.00~5.68%	₩	24,042

There is no material difference between the carrying amount and their fair value except the above trade and other payables, due to the short-term duration of the majority of trade and other payables.

22. RETIREMENT BENEFITS PLAN

The Company operates both defined benefit and defined contribution plans. According to these plans, the Company pays retirement benefits calculated under the plan's benefit formula at the time employees leave the Company. The defined benefit obligations are calculated annually by independent actuaries using the projected unit credit method.

(a) The components of retirement benefits for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Defined benefit costs:			
Current service costs	₩	26,895	32,676
Interest costs		6,978	5,550
Expected returns on plan assets		(6,434)	(5,412)
Gains on the settlement of the plan		286	(279)
	₩	27,725	32,535
Defined contribution costs:			
Contributions recognized as expense	₩	960	365
	₩	28,685	32,900

The Company recognized contributions payable amounting to ₩ 83 million and ₩ 74 million as trade and other payables (accrued expenses) in the statements of financial position as of December 31, 2010 and 2009, respectively.

The Company recognized termination benefits amounting to ₩ 47,301 million as an expense for the year ended December 31, 2010. with regard to the termination benefits, the Company recognized trade and other payables (accrued expenses) amounting to ₩ 1,695 in the statements of financial position as of December 31, 2010.

(b) Changes in defined benefit liabilities for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

	2010	2009
Balance at beginning of year	₩ 18,295	48,336
Retirement benefits	27,725	32,535
Actuarial gains (losses) before tax	5,692	(21,698)
Payments into plan assets	(10,758)	(29,127)
Transfer of the sports department	(451)	-
Payments, including the amount transferred to the defined contribution plan	(11,258)	(11,751)
Changes in accrued expenses	(471)	-
Balance at end of year	₩ 28,774	18,295
Statements of financial position:		
- Present value of retirement benefit obligations	₩ 133,114	129,813
- Fair value of plan assets	(104,340)	(111,518)
Defined benefit liabilities	₩ 28,774	18,295

(c) Changes in defined benefit obligations for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

	2010	2009
Balance at beginning of year	₩ 129,813	133,459
Current service costs	26,895	32,676
Interest costs	6,978	5,550
Gains (losses) on the settlement of the plan	286	(279)
Actuarial gains (losses) before tax	5,033	(20,937)
Transfer of the sports department	(599)	-
Payments, including the amount transferred to the defined contribution plan	(33,798)	(20,656)
Changes in accrued expenses	(1,494)	-
Balance at end of year	₩ 133,114	129,813

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(d) Changes in plan assets for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Balance at beginning of year	₩	111,518	85,123
Expected return on plan assets		6,434	5,412
Actuarial gains (losses) before tax		(659)	761
Payments into plan assets		10,758	29,127
Transfer of the sports department		(148)	-
Payments, including the amount transferred to the defined contribution plan		(22,540)	(8,905)
Changes in accrued expenses		(1,023)	-
Balance at end of year	₩	104,340	111,518

Actual returns on plan assets for the years ended December 31, 2010 and 2009 are ₩5,775 million and ₩6,173 million, respectively.

Expected rates of return are determined taking into account the current level of expected returns on risk-free investments, the historical level of risk premium associated with other invested assets, and the expectations for future returns on such assets.

(e) The amount of actuarial gains (losses) for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Actuarial gains (losses) before tax	₩	(5,692)	21,698
Tax effect		1,253	(4,774)
	₩	(4,439)	16,924

(f) The components of plan assets as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Cash and cash equivalents	₩	17,532	43,713
Short-term trading financial assets		58,942	61,917
Available-for-sale financial assets		27,866	5,888
	₩	104,340	111,518

As of December 31, 2010 and 2009, short-term trading financial assets include severance insurance of ₩65 million and ₩63 million, respectively, which continues to be covered by the existing retirement benefits plan.

(g) The principal actuarial assumptions as of December 31, 2010 and 2009 were as follows:

[Percentage]

	2010	2009
Rate of salary increases	5.00%	5.00%
Discount rate	4.70%	5.80%
Expected rate of return on plan assets	4.40%	6.00%

For the purpose of calculating present value of the defined benefit obligations, the Company used the discount rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds consistent with the currency and estimated term of the defined benefit obligations.

(h) Sensitivities in respect of the key assumptions used to measure the defined benefit plan were as follows:

[In millions of Won]

	1 percentage point increase	1 percentage point decrease
Rate of salary increases:		
- Increase (decrease) in defined benefit obligations	₩ 13,373	(11,755)
- Increase (decrease) in retirement benefits before tax	3,445	(2,247)
Discount rate:		
- Increase (decrease) in defined benefit obligations	(12,444)	14,494
- Increase (decrease) in retirement benefits before tax	(1,027)	2,006
Expected rate of return on plan assets:		
- Increase (decrease) in retirement benefits before tax	(1,017)	1,017

The effect on defined benefit obligations is as of December 31, 2010. The effect on retirement benefits before tax is for the year ended December 31, 2010.

23. PROFIT FROM OPERATIONS

(a) Employee benefit costs for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

	2010	2009
Salaries	₩ 272,505	316,006
Retirement benefits	28,685	32,900
Termination benefits	47,301	-
Employee welfare	29,405	32,983
	₩ 377,896	381,889

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(b) Depreciation and amortization for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Depreciation	₩	118,204	126,021
Amortization		59	277
	₩	118,263	126,298

(c) Details of other income for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Foreign currency transaction gain	₩	15,068	26,854
Foreign currency translation gain		44	178
Gain on sale of property, plant and equipment		101,522	12,100
Gain on sale of intangible assets		2	-
Others		13,561	12,263
	₩	130,197	51,395

(d) Details of selling expenses for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Salaries	₩	125,520	146,695
Retirement and termination benefits		33,133	12,340
Employee welfare		14,895	15,839
Travel		3,771	3,606
Communications		1,698	1,668
Utilities		5,195	4,641
Taxes and dues		13,877	13,939
Supplies		929	1,271
Rent		10,969	3,881
Depreciation		29,161	32,832
Amortization		-	41
Repairs and maintenance		5,336	3,097
Vehicles		6,515	6,630
Insurance		103	75
Commissions		27,019	31,690
Freight and custody		26,283	24,139
Conferences		1,387	2,232
Advertising		100,978	154,337
Training		2,237	912
Prizes and rewards		1,472	524
Normal research and development		630	403
	₩	411,108	460,792

(e) Details of general and administrative expenses for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Salaries	₩	47,927	49,175
Retirement and termination benefits		15,528	10,221
Employee welfare		4,373	5,790
Travel		2,438	2,012
Communications		2,275	2,449
Utilities		1,642	1,788
Taxes and dues		1,652	2,274
Supplies		1,212	2,301
Rent		1,193	6,797
Depreciation		10,738	15,172
Amortization		59	231
Repairs and maintenance		1,914	1,525
Vehicles		1,513	1,443
Insurance		288	369
Commissions		33,431	28,222
Freight and custody		1,013	-
Conferences		1,414	1,864
Advertising		74,613	-
Training		5,799	5,058
Prizes and rewards		1,121	926
Normal research and development		9,898	12,815
	₩	220,041	150,432

(f) Details of other expenses for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Foreign currency transaction loss	₩	17,428	35,784
Foreign currency translation loss		5,085	16,048
Impairment loss on trade and other receivables		63	540
Donations		29,392	32,557
Loss on sale of property, plant and equipment		2,191	5,831
Loss on sale of intangible assets		159	-
Impairment loss on intangible assets		3,415	647
Impairment loss on investments in associates		-	2,947
Loss on sale of investments in associates		-	1,999
Others		4,580	8,730
	₩	62,313	105,083

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24. NET FINANCE COSTS

(a) Details of net finance costs (income) for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Finance cost:			
- Interest costs	₩	553	1,095
- Loss on sale of available-for-sale financial assets		1,214	-
- Loss on transaction of financial derivatives		-	1,711
		1,767	2,806
Finance income:			
- Interest income		(20,060)	(10,806)
- Dividend income		(32,056)	(30,215)
- Investment income on long-term deposits in MSA Escrow Fund		(4,637)	(23)
- Gain on sale of available-for-sale financial assets		(240,104)	(563)
		(296,857)	(41,607)
Net finance costs (income)	₩	(295,090)	(38,801)

(b) Details of interest costs for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Related financial liabilities:			
- Short-term borrowings	₩	-	561
- Trade and other payables		548	510
- Others		5	24
	₩	553	1,095

(c) Details of interest income for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Related financial assets:			
- Deposits	₩	17,199	6,483
- Available-for-sale financial assets		361	245
- Trade and other receivables		2,500	4,078
	₩	20,060	10,806

(d) Details of finance income recognized in other comprehensive income for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010				2009		
		Before tax	Tax effect	Net of tax		Before tax	Tax effect	Net of tax
Gains (losses) on available-for-sale financial assets:								
Net change in fair value	₩	96,892	(21,317)	75,575	₩	130,121	(28,627)	101,494
Less: reclassified to profit or loss		(238,890)	52,556	(186,334)		(563)	124	(439)
	₩	(141,998)	31,239	(110,759)	₩	129,558	(28,503)	101,055

25. INCOME TAXES

(a) The Company was subject to income taxes on taxable income at the following normal tax rates.

Taxable income			Tax rate
2009 and thereafter	2009	2010 & 2011	Thereafter
Up to ₩ 200 million	12.1%	11.0%	11.0%
Over ₩ 200 million	24.2%	24.2%	22.0%

In December 2009, the Korean government postponed the reduction of the corporate income tax rate (including resident tax) from 24.2% to 22%, until 2012.

(b) The components of income tax expense (benefit) for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Current income tax expense	₩	291,735	219,928
Adjustments recognized in the period for current tax of prior periods		(363)	13,074
Changes in temporary difference		(29,062)	40,681
Total income tax expense		262,310	273,683
Tax expense (benefit) recognized outside profit or loss		26,669	(33,277)
Income tax expense	₩	288,979	240,406

(c) Current and deferred tax expense that were recognized outside profit or loss for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Current:			
- Other capital surplus	₩	(1,400)	-
- Gain on reissuance of treasury shares		(4,423)	-
- Actuarial gains (losses)		1,253	(4,774)
		(4,570)	(4,774)
Deferred:			
- Net changes in fair value of available-for-sale financial assets		31,239	(28,503)
Tax expense (benefit) recognized outside profit or loss	₩	26,669	(33,277)

The Company recognized tax expense related to other capital surplus and gain on reissuance of treasury shares directly in equity and tax expense related to actuarial gains (losses) and gain (loss) on valuation of available-for-sale assets in other comprehensive income.

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(d) The income tax expense calculated by applying statutory tax rates to the Company's profit before tax for the period differs from the actual tax expense in the statements of comprehensive income for the years ended December 31, 2010 and 2009 for the following reasons:

[In millions of Won, except tax rate information]

		2010	2009
Profit before tax	₩	1,220,106	985,348
Normal tax rate		24.2%	24.2%
Expense for income taxes at normal tax rate	₩	295,239	238,430
Adjustment:			
- Tax effects of permanent differences	₩	2,414	2,928
- Non-inclusion of proceeds-dividend earned		(7,394)	(7,275)
- Investment tax credits		(981)	(1,724)
- Additional income taxes (tax return) for prior period		(299)	8,047
Income tax expense	₩	288,979	240,406
Effective tax rate		23.7%	24.4%

(e) Deferred tax expense (benefit) relating to the origination and reversal of temporary differences for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Deferred tax liabilities at end of year	₩	(93,310)	(122,372)
Deferred tax liabilities at beginning of year		(122,372)	(81,691)
Deferred tax expense (benefit)	₩	(29,062)	40,681

(f) Deferred tax assets and liabilities are measured using the tax rate to be applied for the period in which temporary differences are expected to be realized.

(g) The net deferred tax liabilities are reflected in the statements of financial position after offsetting assets and liabilities where there is a legally enforceable right to offset current tax assets and liabilities and where the deferred income taxes relate to the same fiscal authority.

(h) Changes in deferred tax assets and liabilities for the year ended December 31, 2010 were as follows:

[In millions of Won]

		Balance at beginning of period	Creited to profit (charged to loss)	Charged to other comprehensive income	Balance at end of period
Available-for-sale financial assets	₩	9,449	412	-	9,861
Accrued expense		20,411	(2,548)	-	17,863
Donations in excess of tax limit		89	(89)	-	-
Defined benefit liabilities		(1,894)	2,073	-	179
Depreciation		4,169	(274)	-	3,895
Investments in subsidiaries		(95,884)	-	-	(95,884)
Foreign currency translations		3,841	(2,621)	-	1,220
Treasury shares		(8,565)	382	-	(8,183)
Unrealized gain on valuation of available-for-sale financial assets		(36,326)	-	31,239	(5,087)
Voluntary reserve		(13,200)	-	-	(13,200)
Provision for advanced depreciation		(4,722)	-	-	(4,722)
Others		260	488	-	748
	₩	(122,372)	(2,177)	31,239	(93,310)

(i) Changes in deferred tax assets and liabilities for the year ended December 31, 2009 were as follows:

[In millions of Won]

		Balance at beginning of period	Creited to profit (charged to loss)	Charged to other compre-hensive income	Balance at end of period
Available-for-sale financial assets	₩	8,800	649	-	9,449
Accrued expense		20,101	310	-	20,411
Sales		7,157	(7,157)	-	-
Donations in excess of tax limit		8,606	(8,517)	-	89
Defined benefit liabilities		4,986	(6,880)	-	(1,894)
Depreciation		1,978	2,191	-	4,169
Investments in subsidiaries		(95,884)	-	-	(95,884)
Foreign currency translations		(6,130)	9,971	-	3,841
Treasury shares		(8,565)	-	-	(8,565)
Unrealized gain on valuation of available-for-sale financial assets		(7,823)	-	(28,503)	(36,326)
Voluntary reserve		(10,078)	(3,122)	-	(13,200)
Provision for advanced depreciation		(4,722)	-	-	(4,722)
Others		(117)	377	-	260
	₩	(81,691)	(12,178)	(28,503)	(122,372)

(j) The income taxes payable and income taxes refund before offsetting as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Income taxes payable	₩	291,736	221,139
Income taxes refund		(100,921)	(121,101)
	₩	190,815	100,038

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26. EARNINGS PER SHARE

Basic and diluted earnings per share for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won, except share information]

		2010	2009
Profit for the period	₩	931,127	744,942
Weighted-average number of ordinary shares outstanding		127,251,814	128,372,302
Basic and diluted earnings per share in won	₩	7,317	5,803

27. TRANSACTIONS AND BALANCES WITH RELATED COMPANIES

(a) Details of parent and subsidiary relationships as of December 31, 2010 and 2009 were as follows:

[Percentage of ownership]

Subsidiary	Location	Next most senior parent	2010			2009		
			Parent	Sub-sidiary	Total	Parent	Sub-sidiary	Total
Korea Ginseng Corporation	Korea	The Company	100.00%	-	100.00%	100.00%	-	100.00%
Yungjin Pharm. Ind. Co., Ltd.	Korea	The Company	53.00%	-	53.00%	55.50%	-	55.50%
Tae-a Industry Co., Ltd.	Korea	The Company	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Turkey	The Company	99.99%	-	99.99%	99.99%	-	99.99%
Korea Tabacos do Brasil Ltda.	Brazil	The Company	99.90%	-	99.90%	99.90%	-	99.90%
KT&G Pars	Iran	The Company	99.99%	-	99.99%	99.99%	-	99.99%
KT&G Rus L.L.C.	Russia	The Company	100.00%	-	100.00%	100.00%	-	100.00%
KT&G Bio Corp.	Korea	The Company	100.00%	-	100.00%	100.00%	-	100.00%
KGC Life & Gin Co., Ltd.	Korea	The Company	100.00%	-	100.00%	-	100.00%	100.00%
Global Trading, Inc.	USA	The Company	100.00%	-	100.00%	-	-	-
Purpleland Development Co., Ltd.	Korea	The Company	100.00%	-	100.00%	-	-	-
Korea Ginseng HK, Ltd.	Hong Kong	Korea Ginseng Corporation	-	99.99%	99.99%	-	99.99%	99.99%
Cheong Kwan Jang Taiwan Corporation	Taiwan	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korean Red Ginseng Corp., Inc.	USA	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%
Korea Ginseng (China) Corp.	China	Korea Ginseng Corporation	-	100.00%	100.00%	-	100.00%	100.00%

(b) Significant transactions which occurred in the normal course of business with related companies for the years ended December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

Relationship	Related Company		2010	2009
Revenue from sales and other income:				
Subsidiary	Korea Ginseng Corporation	₩	4,670	12,790
	Yungjin Pharm. Ind. Co., Ltd.		225	174
	Tae-a Industry Co., Ltd.		14	1
	KGC Life & Gin Co., Ltd.		22	2
	Purpleland Development Co., Ltd.		4	-
	KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.		4,176	7,943
	KT&G Pars		2,590	6,825
	KT&G Rus L.L.C.		6,557	485
	Global Trading, Inc.		6,545	-
		₩	24,803	28,220
Purchases and other expenses:				
Subsidiary	Korea Ginseng Corporation	₩	1,702	2,096
	Yungjin Pharm. Ind. Co., Ltd.		-	43
	Tae-a Industry Co., Ltd.		13,312	13,616
	Korea Tabacos do Brasil Ltda.		-	191
		₩	15,014	15,946

The Company recognized dividends from Korea Ginseng Corporation amounting to ₩30,000 million and ₩30,000 million as finance income for the years ended December 31, 2010 and 2009, respectively.

(c) Account balances with related companies as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

Relationship	Related Company		2010	2009
Receivables:				
Subsidiary	KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	₩	17,642	13,437
	KT&G Pars		22,114	18,883
	KT&G Rus L.L.C.		8,159	5,487
	Global Trading, Inc.		11,248	-
		₩	59,163	37,807
Payables:				
Subsidiary	Korea Ginseng Corporation	₩	2,289	2,238

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(d) Details of guarantees provided for related companies as of December 31, 2010 and 2009 were as follows:

[In thousands of Euro]

Relationship	Type of guarantee	Guarantee recipient	2010			2009	
				Limit	Exercise	Limit	Exercise
Subsidiary	Guarantee on foreign currency letter of credit opened	KT&G Rus L.L.C.	€	2,063	2,063	€ 7,267	-

(e) Details of key management personnel compensation for the years ended December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010	2009
Short-term employee benefits	₩	1,911	6,896
Post-employment benefits		709	5,838
	₩	12,620	12,734

28. RISK MANAGEMENT

(a) Overview

The Company has exposure to the following risks from its use of financial instruments:

- Credit risk
- Liquidity risk
- Currency risk
- Interest rate risk
- Other market price risk.

This note presents information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk and the Company's management of capital including quantitative disclosures.

(b) Risk Management Framework

The purpose of managing financial risks is to identify the potential risk factors that may affect the Company's financial performance, and minimize, eliminate and avoid it to the extent that is acceptable. One of the principal responsibilities of the treasury department is to manage the financial risks arising from the Company's underlying operations. The treasury department monitors and manages the financial risk arising from the Company's underlying operations in accordance with the risk management policies and procedures authorized by the board of directors. Also, the treasury department provides an internal report analyzing the nature and exposure level on financial risks to Risk Management Committee of the Company. The Risk Management Committee prepares the overall strategy for financial risk management, and evaluates the effectiveness of the financial risk management. In addition, the internal auditor consistently observes the compliance of the risk management policy and procedure, and reviews the risk exposure limit of the Company. The Company applied the same financial risk management strategy that was applied in the previous period.

(c) Management of Financial Risks

Credit Risk

The Company has exposure to the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. The Company has transacted with customers with high credit ratings to manage credit risk, and has implemented and operated policies and procedures for credit enhancements of the financial assets. Counterparty credit risk is managed by evaluating its credit rating and limiting the aggregate amount and duration of exposure before sales commence, and the Company has been provided collateral and guarantees. The credit ratings of all counterparties and the level of collateral and guarantees are reviewed regularly. Analysis of financial assets past due has been reported quarterly and appropriate measures have been taken to secure the Company's assets.

The carrying amount of financial assets is maximum exposure to credit risk. The maximum exposure to credit risk as of December 31, 2010 and 2009 is as follows:

[In millions of Won]

		2010	2009
Available-for-sale financial assets	₩	314,937	443,800
Long-term deposits in MSA Escrow Fund		132,414	118,121
Trade and other receivables		612,422	612,298
Cash and cash equivalents		828,951	268,954

Export trade receivables to overseas clients, including Alokozay International Limited are ₩235,636 million, ₩229,096 million, and equal to 56.1% and 54.9% of the aggregate trade receivables, respectively, as of December 31, 2010 and 2009. The Company's trade receivables mentioned above were insured against non-payment up to USD 38,525 thousand and USD 36,200 thousand by export guarantee insurance with the Korea Export Insurance Corporation, respectively, as of December 31, 2010 and 2009. The Company has no significant concentration of customer credit risk since trade and other receivables, excluding the above export trade receivables, are widely dispersed amongst a large number of customers.

The Company has made deposits on cash, cash equivalents and long-term deposits in NACF and several financial institutions with high credit ratings, thus the credit risks from these financial institutions are very limited.

Liquidity Risk

The Company has exposure to the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. The Company's management has established short-term and long-term financial management plans to manage the liquidity risk, and analyzed cash outflows occurred and cash outflows budgeted, so as to match the maturity structure of financial assets and financial liabilities. The Company's management determines whether or not the financial liabilities are repayable with the operating cash flows and cash inflows from financial assets. The Company entered into an overdraft agreement with the NACF to manage the temporary liquidity risk.

Notes to the Financial Statements

December 31, 2010 and 2009

The maturity analysis with a residual contractual maturity of financial liabilities as of December 31, 2010 and 2009 is as follows:

[In millions of Won]

		Carrying amount	Contractual cash flow	Residual contractual maturity: Within 3 months	Between 3 months and 1 year	Between 1 and 5 years	Beyond 5 years
As of December 31, 2010:							
Derivative financial liabilities	₩	-	-	-	-	-	-
Non-derivative financial liabilities		152,655	153,199	68,202	75,105	9,892	-
	₩	152,655	153,199	68,202	75,105	9,892	-
As of December 31, 2009:							
Derivative financial liabilities	₩	-	-	-	-	-	-
Non-derivative financial liabilities	₩	196,275	196,838	92,772	93,707	8,359	2,000
	₩	196,275	196,838	92,772	93,707	8,359	2,000

The above financial liabilities are presented at the nominal value of undiscounted future cash flows as of the earliest period at which the Company can be required to pay.

Currency Risk

The Company has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates arising from the export and import of tobacco. The Company's management has measured the currency risk internally and regularly, and has entered into foreign currency option contracts to hedge foreign currency risk in case of need.

The carrying amounts of monetary assets and liabilities denominated in a currency other than the functional currency as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010		2009	
		USD	EUR	USD	EUR
Assets:					
Cash and cash equivalents	₩	6,228	1,227	3,887	44
Trade and other receivables		277,055	9,883	258,943	8,390
Long-term deposits in MSA Escrow Fund		132,414	-	118,121	-
	₩	415,697	11,110	380,951	8,434
Liabilities:					
Trade and other payables	₩	1,448	2,434	3,624	4,045

As of December 31, 2010 and 2009, the effects of a 10% strengthening or weakening of functional currency against foreign currencies other than functional currency on profit before tax were as follows:

[In millions of Won]

		2010		2009	
		10% strengtheing	10% weakening	10% strengtheing	10% weakening
USD	₩	41,425	(41,425)	37,733	(37,733)
EUR		868	(868)	439	(439)
	₩	42,293	(42,293)	38,172	(38,172)

The above sensitivity analysis was applied to monetary assets and liabilities denominated in foreign currencies other than the functional currency at the end of the reporting period.

Interest Rate Risk

The Company has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company's management has monitored the level of interest rates regularly and has maintained the balance of borrowings at variable rates and fixed rates. As of December 31, 2010, there is no significant effect on cash flows or the fair value of financial liabilities from the interest rate fluctuation, considering the amounts of interest bearing liabilities.

Other Market Price Risk

The Company has exposure to the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Other market price risk arises from available-for-sale equity instruments held for investments. The Company's management has monitored the mix of debt and equity instruments in its investment portfolio based on market indices. Material investments within the portfolio are managed on an individual basis and all buy and sell decisions are approved by the Company's management.

As of December 31, 2010 and 2009, the effects of a 5% fluctuation of the price index of stocks on other comprehensive income were as follows:

[In millions of Won]

	2010		2009	
	5% increase	5% decrease	5% increase	5% decrease
Other comprehensive income before tax	₩ 13,338	(13,338)	25,536	(25,536)
Tax effect	(2,934)	2,934	(5,618)	5,618
Other comprehensive income after tax	₩ 10,404	(10,404)	19,918	(19,918)

(d) Management of Capital Risk

The fundamental goal of capital management is the maximization of shareholders' value by means of the stable dividend policy and the retirement of treasury shares. The capital structure of the Company consists of equity and net debt deducting cash and cash equivalents and current financial instruments from borrowings. The Company applied the same capital risk management strategy that was applied in the previous period.

As of December 31, 2010 and 2009, the Company defines net debt and equity as follows:

[In millions of Won]

	2010	2009
Net debt:		
Debts (borrowings)	₩ 8,618	19,338
Less:		
- Cash and cash equivalents	(828,951)	(268,954)
- Current available-for-sale financial assets	(1,000)	(1,957)
	₩ (821,333)	(251,573)
Equity	₩ 4,337,686	3,852,991

Notes to the Financial Statements

December 31, 2010 and 2009

(e) Fair Value of Financial Instruments

The carrying amount and the fair value of financial instruments as of December 31, 2010 and 2009 are summarized as follows:

[In millions of Won]

		2010		2009	
		Carrying amount	Fair value	Carrying amount	Fair value
Assets:					
Financial assets measured at fair value					
- Available-for-sale financial assets	₩	314,937	314,937	443,800	443,800
- Long-term deposits in MSA Escrow Fund		132,414	132,414	118,121	118,121
- Cash and cash equivalents		828,951	828,951	268,954	268,954
	₩	1,276,302	1,276,302	830,875	830,875
Financial assets measured at amortized cost					
- Trade and other receivables	₩	612,422	612,422	612,298	612,298
	₩	1,888,724	1,888,724	1,443,173	1,443,173
Liabilities:					
Financial liabilities measured at fair value	₩	-	-	-	-
Financial liabilities measured at amortized cost					
- Trade and other payables	₩	(144,037)	(144,037)	(176,937)	(176,937)
- Short-term borrowings		(8,618)	(8,618)	(19,338)	(19,338)
	₩	(152,655)	(152,655)	(196,275)	(196,275)
	₩	(152,655)	(152,655)	(196,275)	(196,275)

The Fair Value Hierarchy

The Company classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The level of fair value hierarchy is as follows:

- Level Ⅰ The quoted prices in active markets for identical assets or liabilities
- Level Ⅱ The inputs that are observable for the asset or liability, either directly or indirectly
- Level Ⅲ The inputs for the asset or liability that are not based on observable market data

The fair value measurements classified by fair value hierarchy as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

		Level Ⅰ	Level Ⅱ	Level Ⅲ	Total
As of December 31, 2010:					
Financial assets					
- Available-for-sale financial assets	₩	252,099	40,363	22,475	314,937
- Long-term deposits in MSA Escrow Fund		132,414	-	-	132,414
- Cash and cash equivalents		828,951	-	-	828,951
	₩	1,213,464	40,363	22,475	1,276,302
As of December 31, 2009:					
Financial assets					
- Available-for-sale financial assets	₩	417,705	2,000	24,095	443,800
- Long-term deposits in MSA Escrow Fund		118,121	-	-	118,121
- Cash and cash equivalents		268,954	-	-	268,954
	₩	804,780	2,000	24,095	830,875

As Genematrix, Inc. was listed on KOSDAQ in the year ended December 31, 2009, available-for-sale equity instruments in Genematrix, Inc. were transferred from Level Ⅲ to Level Ⅰ.

29. CONTINGENT LIABILITIES AND FINANCIAL COMMITMENTS

(a) The Company deposited some proportion of sales in accordance with the Tobacco Master Settlement Agreement ("MSA") under the Escrow Statute of the United States government, related to the export of tobacco to the United States. The MSA Escrow Funds are maintained to pay the medical expenses of tobacco purchasers who have suffered health effects as a result of smoking. The unused portion of this fund will be refunded to the Company 25 years from the date that the fund was established. The Company recorded as long-term deposits the amounts paid into the MSA Escrow Funds of State governments in the United States against potential litigation and damages related to the export of tobacco into the United States.

(b) As of December 31, 2010, tobacco lawsuits claiming damages of ₩584 million were filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligations to notify smokers of the potential health hazards of smoking. Additionally, as of December 31, 2010, the Company is involved in three lawsuits as a defendant for alleged damages totalling ₩4,069 million. The amount of the liability the Company may ultimately be liable for with respect to the litigation cannot be reasonably estimated as of December 31, 2010.

After the reporting period, the Company won two tobacco lawsuits claiming damages of ₩484 million in the second trial on February 15, 2011.

(c) As of December 31, 2010, the Company has entered into letter of credit agreements with Korea Exchange Bank and other banks with a limit set at USD 48,000 thousand.

(d) As of December 31, 2010, the Company's trade receivables from the export of cigarettes were insured against non-payment up to USD 38,525 thousand by an export guarantee insurance with the Korea Export Insurance Corporation.

(e) As of December 31, 2010, the Company has been provided with a foreign currency payment guarantee for local dealers in Russia and other countries up to USD 70,000 thousand by Korea Exchange Bank and others.

(f) As of December 31, 2010, the Company and 28 other companies, which form the Samsung Corporation National Pension Service Joint Consortium, were guaranteed ₩240,000 million by Seoul Guarantee Insurance Co., Ltd. related to the Yongsan International Commercial Development Project.

(g) The Company has provided KT&G Rus L.L.C. with payment guarantee on a foreign currency letter of credit opened in relation with acquisition of tobacco manufacturing machinery up to EUR 2,063 thousand to Korea Exchange Bank as of December 31, 2010.

(h) The Company entered into an overdraft agreement with a limit of ₩10,000 million with the NACF as of December 31, 2010.

30. NON-CURRENT ASSETS HELD FOR SALE

The Company entered into a contract to sell land located in Yongsan and Eulji-ro, Seoul for the year ended December 31, 2009. The Company recognized non-current assets held for sale at the lower of its carrying amount and fair value less costs to sell. Non-current assets held for sale as of December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Land located in Yongsan, Seoul	₩	-	2,521
Land located in Eulji-ro, Seoul		-	20,725
	₩	-	23,246

The Company disposed of the above non-current assets held for sale and recognized a ₩77,585 million gain on sale of property, plant and equipment for the year ended December 31, 2010.

Notes to the Financial Statements

December 31, 2010 and 2009

31. CASH FLOWS FROM OPERATING ACTIVITIES

Details of cash generated from operations for the years ended December 31, 2010 and 2009 were as follows:

[In millions of Won]

		2010	2009
Profit for the years	₩	931,127	744,942
Adjustments for:			
- Income tax expense		288,979	240,406
- Finance costs		1,767	2,806
- Finance income		(296,857)	(41,607)
- Depreciation		118,204	126,021
- Amortization		59	277
- Retirement benefits		28,685	32,900
- Termination benefits		47,301	-
- Foreign currency translations loss		5,085	16,048
- Loss on the write-down of inventories		82	-
- Impairment loss on trade and other receivables		63	540
- Loss on sale of property, plant and equipment		2,191	5,831
- Loss on sale of intangible assets		159	-
- Impairment loss on intangible assets		3,415	647
- Impairment loss on investments in associates		-	2,947
- Loss on sale of investments in associates		-	1,999
- Other expense		4,994	2,473
- Reversal of loss on the write-down of inventories		-	(189)
- Foreign currency translations gain		(44)	(178)
- Gain on sale of property, plant and equipment		(101,522)	(12,100)
- Gain on sale of intangible assets		(2)	-
		1,033,686	1,123,763
Changes in working capital:			
- Trade and other receivables		(32,200)	19,766
- Advance payments		4,993	(8,871)
- Prepaid expenses		(2,256)	1,590
- Prepaid tobacco excise and other taxes		(7,603)	32,333
- Inventories		69,318	90,492
- Trade and other payables		(41,291)	(114,865)
- Advance receipts		(14,817)	(48,768)
- Tobacco excise and other taxes payable		(25,193)	(20,147)
- Payment of retirement benefits		(68,574)	(41,169)
Cash generated from operations	₩	916,063	1,034,124

32. DIVIDENDS

Dividends and dividends per share proposed or declared before the financial statements were authorized for issue but not recognized as a distribution to owners during the years ended December 31, 2010 and 2009 are as follows:

[In millions of Won, except share information and dividends per share]

		2010	2009
Number of shares receivable dividend		127,648,800	127,198,800
Dividends per share in won	₩	3,000	2,800
Total Dividends		382,946	356,157

33. DATE OF AUTHORIZATION FOR ISSUE

The financial statements were authorized for issue on January 19, 2011, at the Board of Directors meeting.

Independent Accountants' Review Report on Internal Accounting Control System

English Translation of a Report Originally Issued in Korean

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To the President of
KT&G Corporation:

We have reviewed the accompanying Report on the Operations of Internal Accounting Control System ("IACS") of KT&G Corporation (the "Company") as of December 31, 2010. The Company's management is responsible for designing and maintaining an effective IACS and for its assessment of the effectiveness of the IACS. Our responsibility is to review management's assessment and issue a report based on our review. In the accompanying report of management's assessment of IACS, the Company's management stated: "Based on the assessment on the operations of the IACS, the Company's IACS has been effectively designed and is operating as of December 31, 2010, in all material respects, in accordance with the IACS Framework issued by the Internal Accounting Control System Operation Committee."

We conducted our review in accordance with IACS Review Standards, issued by the Korean Institute of Certified Public Accountants. Those Standards require that we plan and perform the review to obtain assurance of a level less than that of an audit as to whether the Report on the Operations of Internal Accounting Control System is free of material misstatement. Our review consists principally of obtaining an understanding of the Company's IACS, inquiries of company personnel about the details of the report, and tracing to related documents we considered necessary in the circumstances. We have not performed an audit and, accordingly, we do not express an audit opinion.

A company's IACS is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Because of its inherent limitations, however, IACS may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on our review, nothing has come to our attention that the Report on the Operations of Internal Accounting Control System as of December 31, 2010 is not prepared in all material respects, in accordance with IACS Framework issued by the Internal Accounting Control System Operation Committee.

This report applies to the Company's IACS in existence as of December 31, 2010. We did not review the Company's IACS subsequent to December 31, 2010. This report has been prepared for Korean regulatory purposes, pursuant to the External Audit Law, and may not be appropriate for other purposes or for other users.

KPMG Samjong Accounting Corp.

Seoul, Korea
February 22, 2011

This report is annexed in relation to the audit of the financial statements as of December 31, 2010 and the review of internal accounting control system pursuant to Article 2-3 of the Act on External Audit for Stock Companies of the Republic of Korea.

Report on the Operations of Internal Accounting Control System

To the Board of Directors and Internal Audit Committee of KT&G Corporation:

I, as the Internal Accounting Control Officer ("IACO") of KT&G Corporation (the "Company"), have assessed the status of the design and operations of the Company's internal accounting control system ("IACS") for the year ended December 31, 2010.

The Company's management including the IACO is responsible for the design and operations of its IACS. I, as the IACO, have assessed whether the IACS has been effectively designed and is operating to prevent and detect any error or fraud which may cause any misstatement of the financial statements, for the purpose of establishing the reliability of financial reporting and the preparation of financial statements for external purposes. I, as the IACO, applied the IACS Framework for the assessment of design and operations of the IACS.

Based on the assessment of the operations of the IACS, the Company's IACS has been effectively designed and is operating as of December 31, 2010, in all material respects, in accordance with the IACS Framework issued by the Internal Accounting Control System Operation Committee.

January 19, 2011

Baik, Cheol Man, Internal Accounting Control Officer

Min, Young Jin, Chief Executive Officer

Corporate Governance

Min, Young Jin
Chief Executive Officer

An, Yong Chan
Chairman of BOD
Independent Non-executive Director

Lee, Yoon Jae
Independent Non-executive Director

Kim, Won Yong
Independent Non-executive Director

Kim, Duk Hwi
Independent Non-executive Director

Jee, Seung Lim
Independent Non-executive Director

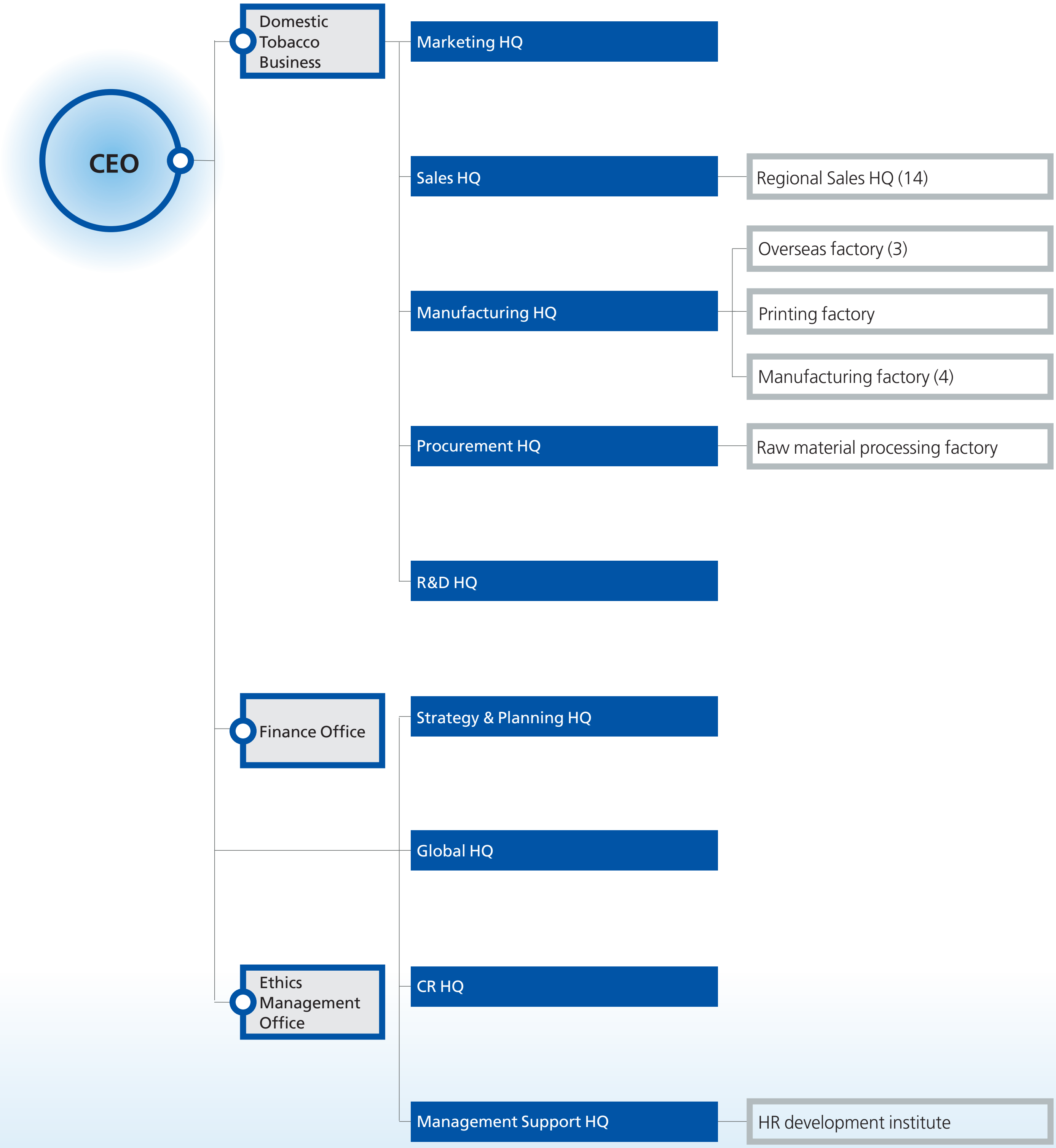
Cho, Kyu Ha
Independent Non-executive Director

Chung, Young Kee
Independent Non-executive Director

Lee, Wang Jae
Independent Non-executive Director

Kim, Jung Sik
Independent Non-executive Director

Organization Chart



Manufacturing Factory & Investor Information

Tobacco Manufacturing

- Shintanjin Factory
- Wonju Factory
- Gwangju Factory
- Yeongju Factory

Leaf Tobacco Processing

- Gimcheon Factory

Printing Factory

- Cheonan Factory

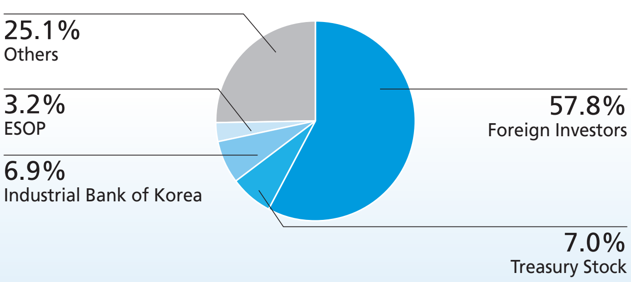
Sales

- Regional Headquarters: 14
- Branch Offices: 137

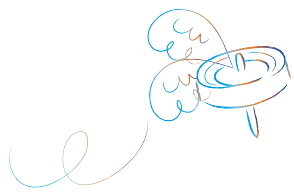
Overseas Factiories

- KT&G Turkey
- KT&G Pars (Iran)
- KT&G Russia

Ownership Structure



• Capital Strock	KRW 955 billion
• Number of Authorized Shares	800,000,000
• Number of Shares Issued	137,292,497
• Shareholders' Equity	KRW 4,338 billion (End of 2010)



INQUIRIES

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  20F, KOSMO Tower, 1002 Daechi-dong, Gangnam-gu, Seoul,
  135-280, Korea
- **Tel.** (82-2) 3404-4522~4, 4535, 4537 **Fax.** (82-2) 3404-4278

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