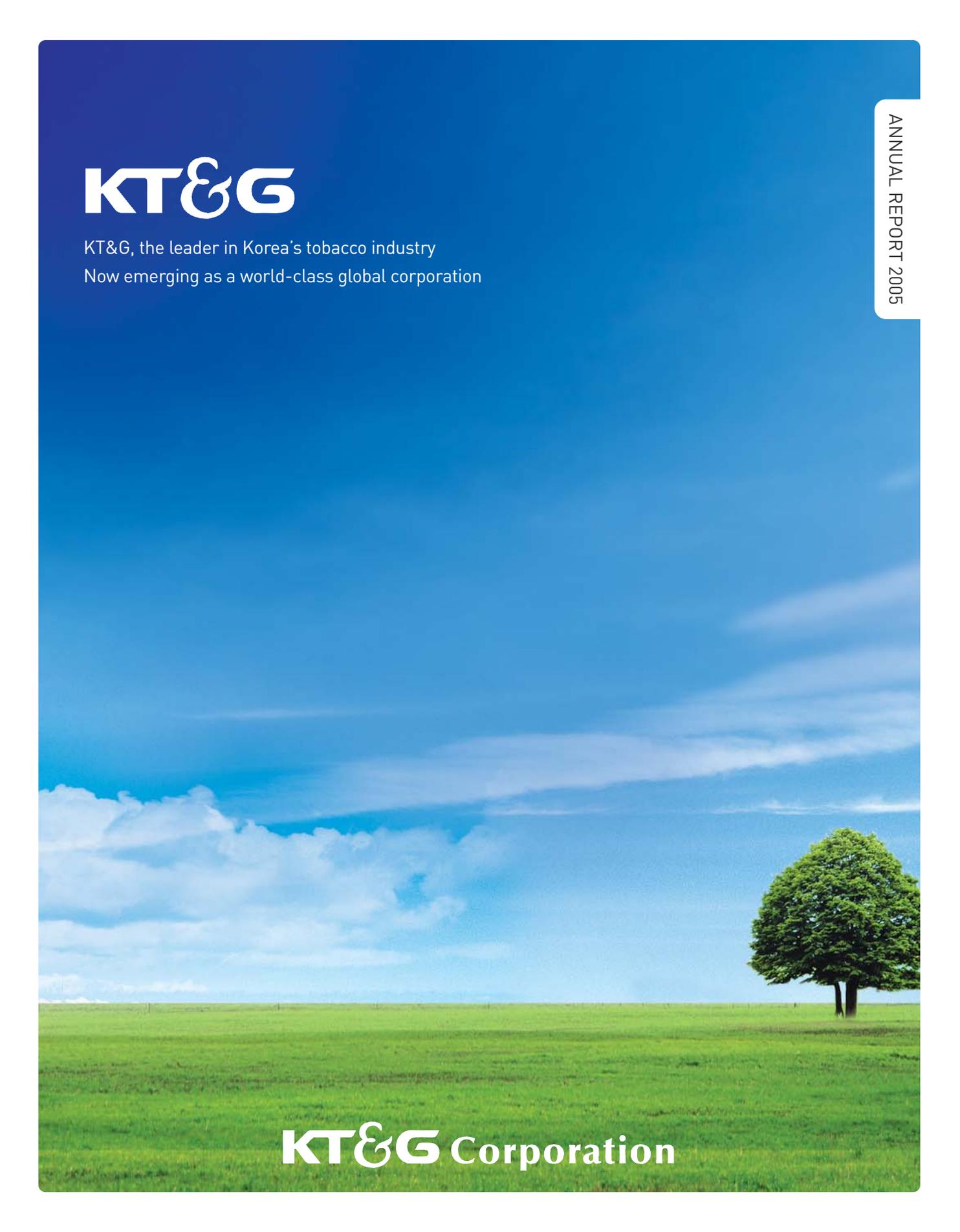


KT&G

KT&G, the leader in Korea's tobacco industry
Now emerging as a world-class global corporation

ANNUAL REPORT 2005



KT&G Corporation

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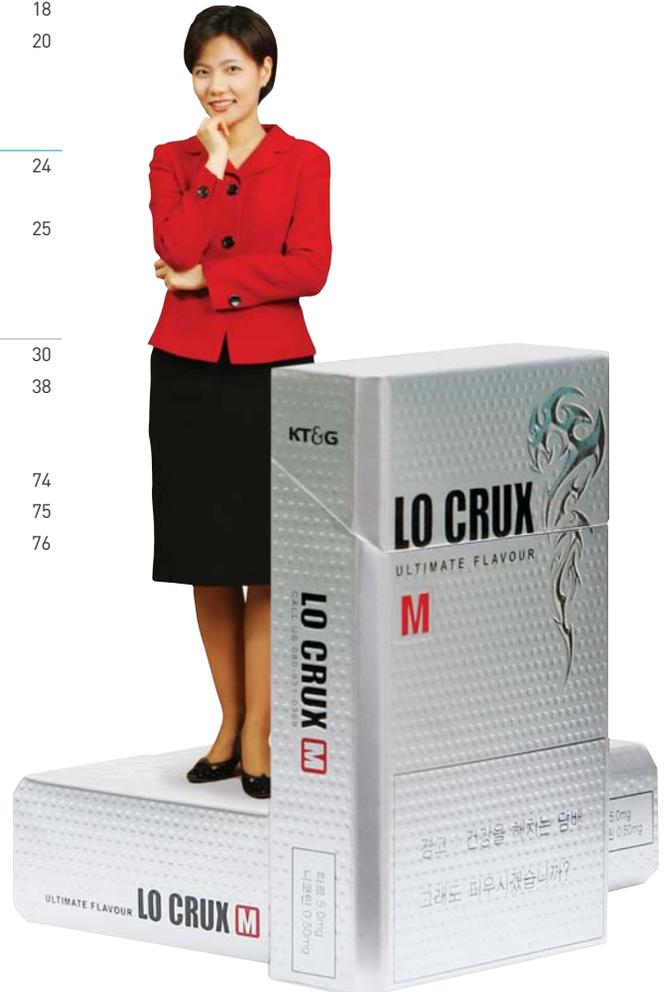
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KT&G, the leader in Korea's tobacco industry Now emerging as a world-class global corporation

004_01

KT&G
ANNUAL REPORT 2005

KT&G, formerly known as Korea Tobacco and Ginseng Corporation, ushered in a new era following complete privatization at the end of 2002.

KT&G's management philosophy is rooted in three beliefs-righteousness, enlightenment, and companionship. Based on these values, we have grown and continued to strive forward in various ways such as the rationalization of management, the modernization of production facilities, workforce rationalization. Focusing on our core business of cigarettes and ginseng, we have worked to secure other profit base such as real estate business.

The head office consists of six headquarters-marketing, overseas business, management/administration, manufacturing, procurement, and business development-and five divisions. Under 14 regional sales headquarters, there are 168 branch offices across the nation. We operate from advanced manufacturing facilities including 4 cigarette manufacturing factories, 2 raw material processing factories, and 1 printing factory. In addition, KT&G has a human resources center and a central research institute.

KT&G has been competing in a fierce domestic market following privatization and localization of foreign tobacco companies. Nevertheless, KT&G still holds a dominant 70% market share of the domestic tobacco market through continuous technological advancements to produce globally competitive products.

While strengthening our position as the dominant tobacco company in Korea, we are also emerging as a world-class global corporation. KT&G is expanding its presence in fast growing overseas markets such as Russia, China, and Southeast Asia, as well as the main markets of Middle East and CIS. We are paving the way toward sustainable growth as we continue to reinforce our core businesses and nurture future growth drivers.



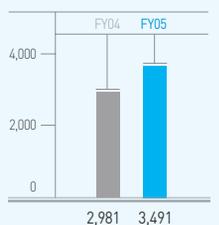
Through the quality of our products, our commitment to ethical corporate governance, and our progressive corporate culture, at KT&G we are forging trusting partnerships with customers, shareholders, and employees.

// FINANCIAL HIGHLIGHTS ///

● DILUTED EPS (won)

3,491

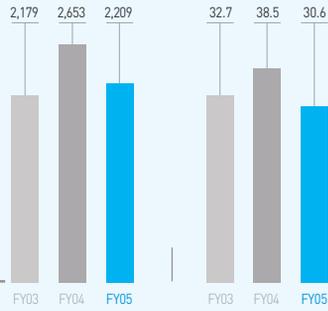
up 17% YoY.



	2003	2004	2005
<u>(In billions of Korean won)</u>			
Net sales	2,178.9	2,653.4	2,209.3
Gross profit	1,207.4	1,548.2	1,224.6
Operating profit	711.5	1,021.6	676.9
Net profit	459.7	472.3	515.9
<u>(In billions of Korean won)</u>			
Total assets	3,887.0	3,885.0	3,964.4
Current assets	1,746.8	2,002.0	2,032.9
Fixed assets	2,140.3	1,883.0	1,931.2
Total liabilities	1,071.7	670.8	516.4
Current liabilities	487.0	535.3	301.1
Long-term liabilities	584.7	135.5	215.3
Total shareholders' equity	2,815.3	3,214.2	3,448.0
<u>(% YoY)</u>			
Net sales growth	20.6	21.8	-16.7
Gross profit growth	33.9	28.2	-20.9
Operating profit growth	35.0	43.6	-33.7
Net profit growth	32.3	2.7	9.2
<u>(%)</u>			
Gross profit margin	55.4	58.3	55.4
Operating profit margin	32.7	38.5	30.6
Net profit margin	21.1	17.8	23.4
<u>(Per share data)</u>			
Diluted EPS (won)	3,307.0	2,981.0	3,491.0
Diluted PER (x)	6.3	10.4	12.9
Year-end stock price (won)	20,700.0	30,950.0	45,050.0

● NET SALES

(In billions of KRW)



● OPERATING MARGIN

(%)



● NET PROFIT

(In billions of KRW)

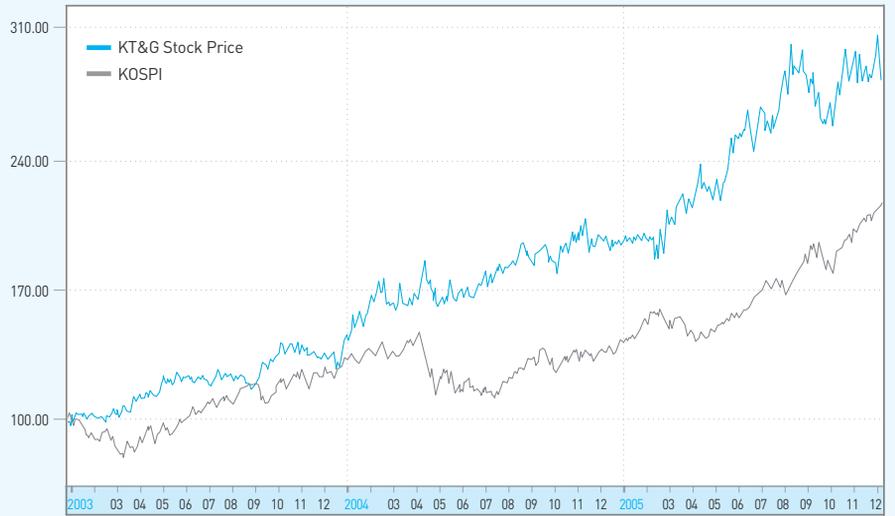


● TOTAL ASSETS

(In billions of KRW)



● CHART OF KT&G STOCK PRICE



(January 1, 2003 = 100)

// MESSAGE FROM CEO ///

Dear Shareholders,



Year 2005 was a challenging year for KT&G amid a weak domestic economy, tighter smoking regulations, and severe competition. On volume basis, the domestic tobacco market decreased by 22.7% to 82.3 billion sticks compared to 2004, the year of high stockpiling ahead of tobacco tax hike. KT&G's net sales fell 16.7% to KRW2,209.3 billion as the competitors stepped up their marketing efforts including new brand launch. Nevertheless, we could achieve higher net profit increased by 9.2% to KRW515.9 billion, thanks to ongoing efforts to improve non-operating profits.



“We believe our success is rooted in transparent management, sound corporate governance, and the trust of our shareholders.”

Over the last few years, we have strived for the growth in profitability as well as volume. As a mark of our progress, our bottom line profits rose from the previous year, despite the downturn in the domestic tobacco market, as sales of premium cigarettes increased.



For overseas sales, we strengthened our presence abroad and worked hard to meet the rapidly changing tastes of the export markets by bolstering sales of premium brand cigarettes, which in turn raised our export unit price. In particular, sales of the KT&G’s flagship brand, Esse, have already recorded 2 billion sticks in Russia.



We believe our success is rooted in transparent management, sound corporate governance, and the trust of our shareholders. To enhance transparency, we have given greater authority to the committees under the board of directors. We also adopted an evaluation and implementation system to strengthen ethical management practices.



KT&G also plays an active role in contributing to its communities. In line with our pursuit of a “Society where everyone shares”, we have participated in a variety of social contribution activities.

KT&G is committed to creating value for all of KT&G’s shareholders. We respect the views of all of our shareholders and welcome their thoughtful input regarding our company. As we did in the past, we will continue to focus on maximization of shareholder and corporate value for the best interest of our shareholders.



We look forward to continuing to deliver outstanding shareholder returns, leadership in corporate governance, and superior long-term value.



Thank you.

Chairman & CEO_Young-kyoon Kwak

// SNAPSHOTS IN 2005 ///

- (BEST CORPORATE GOVERNANCE AWARD FOR SECOND YEAR IN A ROW)**

JUN 2005 KT&G received the Best Corporate Governance Award for the second year in a row on June 22 at the 2005 Corporate Governance Awards Ceremony held at the Korea Exchange.
- (CORPORATE SOCIAL CONTRIBUTION AWARD IN THE CATEGORY FOR "WELFARE OF THE ELDERLY")**

AUG 2005 KT&G was awarded the Corporate Social Contribution Award for its contribution to the welfare of the elderly people.
- (LAUNCH OF LO CRUX, A PRODUCT MADE OF NATURALLY MATURED TOBACCO)**

AUG 2005 Lo Crux is a new product that took three years to develop based on KT&G's new VR technology, which produces cigarettes using top quality tobacco leaves that are matured naturally. The result is a cigarette with a rich yet mild flavor.
- (LAUNCH OF INDIGO, A NEW 1MG TAR CIGARETTE)**

OCT 2005 Indigo is an ultra low tar cigarette developed to capture the 1mg tar cigarette market. First released last May, Indigo was KT&G's first new product in a year since Zest. Its launch was followed by the subsequent release of Indigo Episode 1 in October.



- OCT 2005** [CELEBRATED EXPORTS OF 1 BILLION STICKS OF ESSE TO RUSSIA]

KT&G CEO and executives visited Moscow, Russia, on October 6 for "Esse Global Brand Strategy and 1 Billion Sticks Export Ceremony."
- NOV 2005** [OUTSTANDING IR COMPANY AWARD]

On November 25, KT&G received the Korea Investor Relations Association's Outstanding IR Company Award at the Fifth Korea IR Awards ceremony held at the Korea Exchange. The award was based on a wide range of recommendations, including institutional investors.
- [PRESIDENT'S AWARD FOR BEST COMPANY FOR HUMAN RESOURCES DEVELOPMENT]

In recognition of steady efforts to enhance employees' potential, KT&G received the President's Award for Best Company for Developing Employees' Talent presented by the Ministry of Labor.
- FEB 2006** [BEST KOREA ETHICAL MANAGEMENT AWARD]

KT&G received Best Korea Ethical Management Award from New Industry Management Center early this year.



Flavor of Culture

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We are building a value-oriented corporate culture, implementing a result-oriented management system and reinforcing our internal capabilities.

”



● **Arirang:** Arirang was reborn by upgrading in design and technology. The brand name and package design represent the very traditional Korean culture.



〔 Since 1994, KT&G has engaged in a variety of activities to promote social welfare, public health, education and culture, environment protection, and youth guidance. ● 〕



KT&G is committed to increasing civic activities and becoming a trustworthy corporation through proactive involvement with its communities.

// CORPORATE VISION ///

● VISION: BECOME A LEADING GLOBAL ENTERPRISE BY MAXIMIZING THE CORPORATE AND SHAREHOLDER VALUE

(VISION & STRATEGY) • KT&G's management principle is rooted in autonomy and creativity. We pursue 'righteousness' as a future-oriented company that values fairness; 'enlightenment' as a company that believes in ongoing evolution to build a progressive and creative corporate culture; and 'companionship' as a company that serves the best interest of our shareholders, customers, and employees, and takes its social responsibilities by contributing to the communities.

To become a global enterprise, we are focusing on the following business strategies: maintaining our dominant presence in the domestic market, expanding overseas sales, strengthening ginseng business, and securing other profit base. For these purposes, we are building a value-oriented corporate culture, implementing a result-oriented management system and reinforcing our internal capabilities.

KT&G is the dominant leader in Korea with a 73% market share in 2005. To uphold our leadership, we have adopted a brand-oriented management system and upgraded our facilities. This allows us to increase productivity and develop high-quality cigarettes to better compete with the foreign competitors.

Turning to our overseas business, we export cigarettes to about 30 countries around the world. Efforts have been made to strengthen marketing in our main export markets, the Middle East and Central Asia. KT&G is also working to make further inroads in bigger markets such as Russia, and China. Building on our achievements to date, we will use our premium brands to enhance our position as a global enterprise, increase profitability, and secure greater overseas market share.

Through its wholly owned subsidiary, Korea Ginseng Corp., KT&G has pursued several key initiatives for the ginseng business to further improve its financial performance and strengthen its brand equity. Korea Ginseng Corp. is expanding its sales network not only in the domestic market but also in its main export region including China, Taiwan, Japan, and more.

Since 1994, KT&G has engaged in a variety of activities to promote social welfare, public health, education and culture, environment protection, and youth guidance. That is in line with our pursuit of a "Society Where Everyone Shares," which places public services as an important part of the KT&G corporate culture. KT&G is committed to increasing civic activities and becoming a trustworthy corporation through proactive involvement with its communities.

Domestic tobacco
(Foundation for growth)

Overseas tobacco
(Core strategic business)

Red ginseng
(Leading growth driver)



// CORPORATE GOVERNANCE ///

(BOARD OF DIRECTORS)



● Young-kyoon Kwak
Chairman & CEO



● Kwang-youl Lee
Senior Managing Director



● Young-jin Min
Senior Managing Director



● Jin-hyun Kim
Outside Director



● Choong-sup Kim
Outside Director



● Soon-moo Soh
Outside Director



● Kyung-jae Lee
Outside Director



● Sun-gak Cha
Outside Director



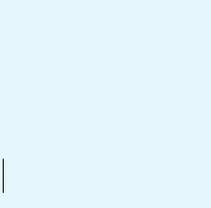
● Yoon-jae Lee
Outside Director



● Chang-woo Lee
Outside Director



● Yong-chan An
Outside Director



● Warren G. Lichtenstein
Outside Director

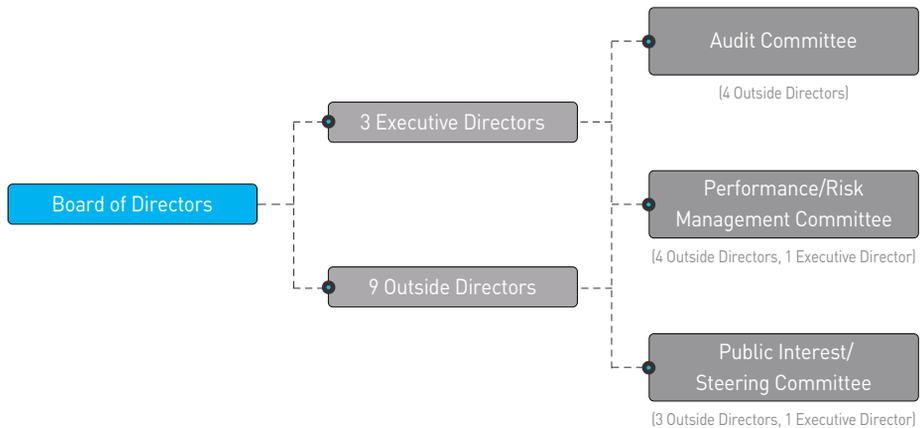
// CORPORATE GOVERNANCE ///

(BOARD OF DIRECTORS & MANAGEMENT)

• The Board of Directors (BOD) has an important role in upholding sound corporate governance. There are 12 seats on the KT&G's board, three of which are filled by executive directors and nine by outside directors (equivalent to 75% of the total). There are three committees, consisting of the audit committee, the performance/risk management committee, and the public interest/steering committee, all of which are composed of experts in the relevant field. In particular, executive directors are restricted from participating in the audit committee and agenda for which there is potential conflict of interests.



KT&G'S BOD STRUCTURE



(TRANSPARENCY)

• KT&G aims to become a globally renowned company by maximizing corporate value with transparent management and the commitment of all employees. We have in place a sound corporate governance system led by a Board that is predominantly composed of outside directors, while operations are overseen by professional managers who are accountable for their actions. This framework allows for balanced distribution of profits between shareholders and other parties with a vested interest. In July 2003, we became the first company in Korea to formulate and proclaim a Corporate Governance Charter, which includes the rights of shareholders, the Board of directors, audit, interested parties and public disclosure. The adoption of the Charter has installed an advanced corporate governance structure that separates ownership and management.



“The adoption of the Charter has installed an advanced corporate governance structure that separates ownership and management.”

As a result of the numerous efforts, KT&G was honored with the Best Corporate Governance Award given by the Korea Corporate Governance Service in 2005, second year in a row.

KT&G has realigned internal disclosure guidelines and established a more systematic disclosure control procedure to reflect changes in the Financial Supervisory Services' regulations on disclosures and disclosed contents. Based on the revised procedures, all annual and quarterly business reports are subject to internal review to promote accuracy in the disclosed information.

Furthermore, KT&G fully understands the importance of investors' rights to access information of the company. We have therefore make our best efforts to make accurate, timely, and fair disclosures to existing and potential shareholders. In 2005, we have made numerous disclosures. We also make disclosures in English as foreign investors are more interested in the company.



(INVESTOR RELATIONS) • Every year, KT&G has strived to return profits to shareholders through high dividends and share buyback. In 2005, we repurchased and cancelled 3 million shares worth KRW115 billion and decided to pay KRW1,700 per share in cash dividends. KT&G focuses on generating high profits via enhanced competitiveness, returning profits to shareholders and improving corporate governance. We will continue to return profits to shareholders through dividends considering cash flow and market conditions.

KT&G is working to gain the trust of investors by accurately conveying operating results to shareholders and prospective investors. Along with overseas non-deal roadshows, quarterly earnings presentation, and other IR meetings with domestic/international investors, we have made efforts to communicate with the investors. Moreover, KT&G was presented with the Outstanding Shareholder Value Award by Money Today and the Outstanding IR Award by Korea Investor Relations Association.

Every quarter, KT&G holds a conference to disclose and discuss our operating activities and quarterly performance with domestic and overseas institutional investors. KT&G also conducts frequent one-on-one meetings and conference calls to update investors on corporate activities and industry trends and to listen to the opinions and advice of our valued investors.



Scent of Growth

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More active communication with affiliates and adoption of a performance-based system will allow them to more efficiently operate.

”



● **Esse:** Esse is the KT&G's best selling brand. The popularity of Esse is growing fast both in Korea and overseas.



[• For improved efficiency, we implemented a new human resources evaluation system in 2005.]



• • •
KT&G is striving to strengthen our foothold in the domestic tobacco and ginseng industry, and increase volume and profit in the export market.

// BUSINESS STRUCTURE //

(BUSINESS EFFICIENCY) • In line with our mid-term business strategy, KT&G is striving to strengthen our foothold in the domestic tobacco and ginseng industry, increase volume and profit in the export market, and exploit opportunities as future growth engines to become a global company.

Ginseng business will grow as a key revenue source in the future. Enhanced value could be achieved as the company expands and secures ginseng supply base and further strengthen the brand equity of Jung-Kwan-Jang. Jung-Kwan-Jang will continue to lead the market as the world's best quality.

KT&G has formulated guidelines for managing companies in which it has invested and has set mid- to long-term strategy in regards to its affiliates. We have taken steps to promote sharing of strategy and vision at the Group level and to reinforce operations of Korea Ginseng Corp. More active communication with affiliates and adoption of a performance-based system will allow them to more efficiently operate. We also expect to achieve greater progress in technology as we have adopted a more effective R&D management system.

For improved efficiency, we implemented a new human resources evaluation system in 2005. Under the new system, all employees are evaluated based on their capability and performance, which is boosting their work ability and productivity. In particular, labor-management relations have improved on the basis of trust, and the selective benefits system has been expanded to better meet the needs of our employees.



(TECHNOLOGY) • A vital element for enhancing our corporate value is to develop technologies that comply with the Framework Convention on Tobacco Control (FCTC) and meet customers' demands, and to strengthen the link between our R&D objectives and business strategy. With consideration to both the theoretical and practical aspects, we have a systematic framework that facilitates quick progression from R&D to commercialization. We are maximizing efficiency in our research endeavors with a goal-oriented approach, while performance review and compensation depend on the level of risk and difficulty of the research undertaking. Ongoing monitoring is one way in which we continue to enhance our R&D capacity. Additionally, we have adopted a mentor system to foster succession of technology and introduced various measures to protect our technological know-how.

In 2005, with efficient R&D, we launched several new premium brands to meet our customer needs. We will also keep launching top quality products to the market going forward.



THE
ONE
LIFE SAVED, LIFE IMPROVED

“KT&G has formulated guidelines for managing companies in which it has invested and has set mid- to long-term strategy in regards to its affiliates.”

NEW PRODUCT DEVELOPMENT

- (AUGUST 2005 LAUNCH OF 'LO CRUX')

Rich and mild flavor using VR technology



- (SEPTEMBER 2005 LAUNCH OF 'FRESH ONE')

Menthol cigarette with premium natural flavor



- (OCTOBER 2005 LAUNCH OF 'INDIGO')

Ultra low tar



- (NOVEMBER 2005 LAUNCH OF 'ESSE SPECIAL')

Supreme quality and best blending



- (NOVEMBER 2005 LAUNCH OF 'ESSE GOLD')

Supreme quality and best blending



- (NOVEMBER 2005 LAUNCH OF 'LO CRUX M')

Smooth and abundant flavor using charcoal dual filter



- (DECEMBER 2005 LAUNCH OF 'ENTZ')

World's first compact, regular type cigarette



- (MARCH 2006 LAUNCH OF 'ARIRANG')

Oxygen-reinforced filter product



//KT&G SUBSIDIARY COMPANIES ///

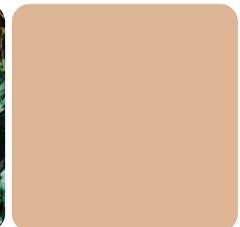
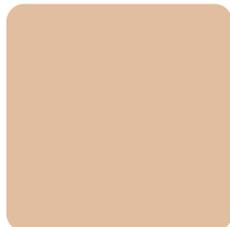
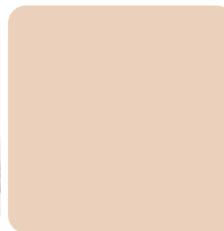
KT&G SUBSIDIARY COMPANIES



KOREA GINSENG CORPORATION



- ESTABLISHED: January 1, 1999
- KEY BUSINESS:
 - Manufacturing and sales of ginseng and ginseng-derived products
 - Sales of food and beverages
 - Manufacturing and sales of pharmaceutical and health supplement products
 - R&D and trading related to the above
- KEY FINANCIALS (as of end-2005): Paid-in capital of KRW64.9 billion, sales of KRW332.0 billion, total assets of KRW394.8 billion



“We are maximizing efficiency in our research endeavors with a goal-oriented approach.”

YUNGJIN PHARMACEUTICALS



- ESTABLISHED: July 16, 1962
- KEY BUSINESS:
 - Manufacturing and sales of pharmaceutical and related materials, chemical engineering products
 - Manufacturing and sales of food & beverage, food additive, ginseng-derived products and cosmetics
 - Manufacturing and sales of medical supplementary products, medical equipment and sanitation products
- KEY FINANCIALS (as of end-2005): Paid-in capital of KRW46.6 billion, sales of KRW101.8 billion, total assets of KRW134.3 billion



TAE-A INDUSTRY



- ESTABLISHED: December 20, 1972
- KEY BUSINESS: Reconstituted tobacco leaves manufacturing
- KEY FINANCIALS (as of end-2005): Paid-in capital of KRW750 million, sales of KRW10.3 billion, total assets of KRW7.6 billion



[Reconstituted Tobacco Leaves]

// OPERATIONS ///

- KT&G'S DOMESTIC MARKET SHARE

73.0%

- KT&G'S LOW TAR (% OF TOTAL SALES VOLUME)

35.3%

- KT&G'S EXPORT (% OF TOTAL SALES VOLUME)

32.1%

(DOMESTIC SALES) • KT&G maintained its solid position with 73% market share in the domestic market in 2005 with better product quality and enhanced marketing. These efforts also minimized the negative impact from the unfavorable turn in regulatory measures over the cigarette industry. With a forward-looking view, we prepared for anticipated changes in the operating climate brought on by ratification of the Framework Convention on Tobacco Control (FCTC) and for the possibility of additional hikes in tobacco excise tax.

Triggered by stockpiling towards the end of 2004 prior to the tobacco tax hike and heightened health awareness, the Korean cigarette market in 2005 contracted by 22.7% from a year earlier to 82.3 billion sticks. On revenue basis, the market shrank by 1.9% to KRW8,552.3 billion. While the market declined overall, cigarette sales did recover to normal levels in the second half of the year.

The extent of decline in revenue was lower than the reduction in volume thanks to the growing preference for premium brand cigarettes. As a portion of the domestic cigarette market, the premium brand segment expanded by 1.7%p to 68.5% in 2005.

Another notable trend is the rising popularity of low tar cigarettes. As a percentage of total cigarette sales in Korea, low tar products went up 6.0%p to 35.3% in 2005. As Koreans become increasingly health-conscious, competition is growing fiercer in this market segment. With KT&G at the forefront, tobacco companies are aggressively launching new products and stepping up marketing to capture a greater share of this growing market.

KT&G recorded sales volume of 60.1 billion sticks (down 27.0% year-on-year) and net sales of KRW1,790.4 billion (down 21.6%) in the domestic market. Market share went down 4.3%p from 77.3% in 2004 to 73.0% in 2005.

As a percentage of KT&G's total revenue, premium brands accounted for 62%, maintaining an upward trend. In low tar cigarettes, KT&G upheld its leadership position with a dominant 73% market share. Low tar products also continue to generate a growing portion of KT&G's revenue.

The change in our product portfolio drove up net revenue per pack by 1.5%, from KRW555.2 in 2004 to KRW563.3 in 2005. The shift in our sales mix toward premium and low tar cigarettes is the outcome of careful analysis of consumer and social trends.



“KT&G maintained its solid position with 73% market share in the domestic market in 2011 with better product quality and enhanced marketing.”

(OVERSEAS SALES) • We have drawn up business objectives and brand strategies for each export region based on thorough analysis of its growth and earnings prospects. Special emphasis is being given to maintain our foothold in the Middle East and Central Asia, our key export markets. We have also made our efforts to improve profitability through product mix and cost saving.

After an extensive review of our brand portfolio, we have worked hard to expand exports of premium brands in 2011. The shift in focus from volume growth to profitability has steadily raised the net revenue per pack. Based on systematic market research, we have been nurturing “Esse” into a global brand. The Esse brand has already sold more than 2 billion sticks in Russia, and Esse as a portion of total exports ballooned from 4.4% in 2009 to 10.3% in 2010 and 18.6% in 2011.

• • •

(MANUFACTURING) • To improve product competitiveness, we are focused on enhancing product quality and rationalizing the procurement system for raw materials. We have adopted an action plan for global quality strategy so that quality control is an important feature at all levels of operations. Timely application of new technologies to the manufacturing process helps us respond promptly to the unique and diverse demands of our customers. We have also upgraded the filter material and packaging system.

KT&G will continue to invest to improve product quality, production efficiency and technology to retain our competitive edge. We will exploit our know-how and facilities to enhance profitability while satisfying the diverse needs of our customers.



Zest for Sharing

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KT&G conducts all economic and social activities based on the company's Code of Ethics.

”



● **RAISON:** Raison, one of top quality premium brands, has gained popularity from urban youth for its clean and neat taste since 2002.

[KT&G received the 2005 New Industry Management Academy's "Best Korea Ethical Management Award." ●]



● ● ●
In line with our pursuit of a "Society Where Everyone Shares," KT&G has carried out a variety of social contribution activities since 1994.

// ETHICAL MANAGEMENT ///

(**CODE OF CORPORATE ETHICS**) • KT&G conducts all economic and social activities based on the company's Code of Corporate Ethics. Our ethical management system was established in February 2003, when we formulated regulations and guidelines on ethical conduct. This system is made up of four components-Code of Corporate Ethics, Code of Ethics for Directors, Declaration of Compliance with Fair Trade Standards, and Customer Service Code.

● ● ● ETHICAL MANAGEMENT SYSTEM AT KT&G



The Code of Corporate Ethics is a direct reflection of KT&G's commitment to high ethical standards.

The Code of Corporate Ethics for Directors stresses the importance for KT&G's board of directors to carry pride, maximize the company and shareholders' value, and fulfill their responsibilities based on the highest standard of ethics.

The Declaration of Compliance with Fair Trade Standards requires all employees to willingly comply with fair trade regulations and compete honestly through innovative business activities and high quality products.

The Customer Service Code reiterates KT&G's strong commitment to place customer satisfaction as the highest value, always working to please customers first under the understanding that KT&G exists because of our customers.

With respect to ethical management, KT&G introduced an evaluation scheme in 2005 to more vigorously incorporate our ethics code into our business practices. Recognized for its high ethical standards, KT&G received the 2005 New Industry Management Academy's "Best Korea Ethical Management Award," which is also sponsored by Ministry of Industry, Energy, and Trade.



(CORPORATE CITIZENSHIP)

• In line with our pursuit of a "Society Where Everyone Shares," KT&G has carried out a variety of social contribution activities since 1994, which eventually led to the establishment of KT&G Social Welfare Foundation in July 2003. With the main focus on social welfare, the foundation has opened a home welfare center that provides at-home support including hospice care, thus expanding the scope of our activities. Other projects include



assistance for low-income families, children, the elderly, the disabled, educational and research support for social welfare, and medical support for the underprivileged.

In 2005, we selected welfare for the elderly as our main target, which is one of the weakest areas in terms of social welfare amid Korea's rapidly aging population. We plan to establish and operate social centers for senior citizens in cooperation with local government bodies. In addition, we are involved in other activities such as funding medical research and medical expenses for rare diseases, running a volunteer center, providing support to weak social welfare areas, and running an Internet-based welfare project.

Within KT&G, there are various volunteer groups which participate in charitable work. Rather than relying only on the KT&G Social Welfare Foundation, we have raised funding from third parties and enlisted support from a variety of other organizations, expanding the scale of our social work and making our work more meaningful.

Our commitment to social responsibilities has been recognized by society. We received the 2005 Corporate Social Contribution Award in the welfare of the elderly category, jointly given by the Korea Economic Daily and the Open Management Research Institute. The award acknowledges various



efforts by KT&G including the opening of four Seoul Welfare Foundation 'Happiness Network' centers (in Guro, Gangbuk, Jungrang, and Mapo districts in Seoul) that provide at-home assistance, support for professionals who treat Alzheimer's disease, and assisting with programs that promote at-home support for the elderly.



// CORPORATE SOCIAL RESPONSIBILITY ///

VOLUNTEER WORK

• True social welfare requires the attention and support towards neglected areas of society. KT&G is participating in a wide range of activities in line with our motto of 'Co-existing with Society.'



• Kimchee Sharing Campaign • Silver Kindness for the Elderly Campaign • At-home Support Promotion • Automobile Assistance for Social Welfare Organizations • KT&G Social Welfare Foundation's

'Mobile Bank Neighborly Love' • 'Partnerships with Universities Volunteer Organizations' • Medical Support for Children Suffering from Leukemia and Cancer • Free Legal Assistance, and others



PUBLIC HEALTH SUPPORT

• KT&G believes the value of people's lives is enriched by happiness and health. That is behind our drive to realize a healthy society free of illness.



• Helping North Koreans Fight Leukemia • Building Seoul National University's Clinical Research Center • Sponsor of Children's Day Life and Love Festival to Cure Children with Cancer



• Research on National Health • Nurturing Professionals who Treat Alzheimer's Disease • 'Love with Wings' Campaign for Patients with Rare and Incurable Diseases • Orthodontic Treatment

for Disabled Children • Opening of a Cornea Bank • Rehabilitation Equipment for Cerebral Palsy Patients • Wheelchairs for the Poor and Disabled, and others



EDUCATIONAL/CULTURAL ACTIVITIES

• Children hold the key to a brighter and healthier future. With that in mind, KT&G is committed to educating children about the importance of history through various programs.

“In 2005, we selected welfare for the elderly as our main target, which is one of the weakest areas in terms of social welfare amid Korea’s rapidly aging population.”



- Creative Writing Contest
- KT&G Cultural Discovery for Students
- Organized ACS (Asia Collaborative Study) International Co-research Conference
- Sponsored the Bolshoi Ballet & Seoul Performing Arts Festival
- Support for World Peace Forum and Seoul Arts Center
- Support for Non-Governmental Inter-Korean Exchanges
- KT&G Agricultural Biotechnology Center
- Assistance for Overseas Koreans to Study the Korean Language, and others



ENVIRONMENTAL PRESERVATION

• Mankind has always coexisted with nature. KT&G is committed to protecting the environment, which we are temporarily borrowing from our future generations.

- Established a Wild Animal Nature Study Center
- Campaign to Improve Public Facilities
- Installed a Sewage Purification Facility in Gyeryong Mountain
- Campaign for Food Waste Composting
- Promotion to Reduce Waste and Increase Recycling
- Provision of Disposable Ash Trays
- Production of Environmental Awareness Education CD-ROM



YOUTH PROTECTION

• Our dreams for the future depend on our children. KT&G helps boys and girls develop sound values and enjoy new experiences. Through various activities, we enrich the imagination of our children and encourage them to pursue their dreams.

- Donation of Birthday Presents to Neglected Children
- Employment Funds for the Young
- Youth Anti-Smoking Campaign
- Initial Funding for Korea Juvenile Protection Association
- Youth Nationalism Training Center
- Abused Children and Youth Protection Campaign
- Children’s After-School Studies Centers
- Campaign to Help Children from Unemployed Families
- Education for Youth Volunteer Activity Leaders
- Safe School Movement



// CORPORATE SOCIAL RESPONSIBILITY ///

(HUMAN RESOURCES MANAGEMENT)

• In 2005, KT&G drew up a mid-term strategy to manage our human resources more productively and efficiently. Our goal is to secure a stable growth base and pursue business operations with an optimal organizational structure. The main focus of the strategy consists of adopting a new human resources system, strengthening employees' scope of influence, and improving labor management.



A new performance-oriented human resources system has been set up so as to enable all employees to fully develop their work potential and be compensated accordingly. First, KT&G improved its evaluation system based on employees capacity, incorporating and utilizing factors such as leadership, workload system, and e-HR. In addition, to manage CDP (Career Development Planning), KT&G conducted an employee survey to gather information about the standard work experience brought to each job position, thus reevaluating employees' work performance capacity



and disposition. KT&G has also made improvements to the basic infrastructure through the operation of HOPES (Human Resources Management on Performance Evaluation System).

For our employees to contribute to the best of their ability, KT&G's management believes in the importance of working together and sharing our corporate vision. Through our corporate value of "To the Future, to the World," we have communicated and shared our management philosophy and corporate vision with our entire workforce.



Financial Information

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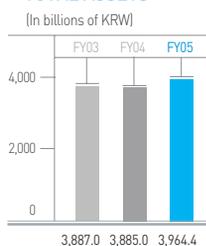
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KT&G is targeting to sell 97 billion sticks in 2006, including overseas sales, for year-on-year volume growth of 9.6%. We are aiming for operating income of KRW731 billion and net income of KRW525 billion.

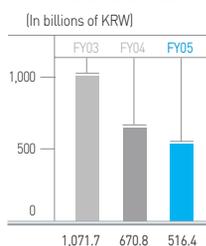
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// MANAGEMENT'S DISCUSSION & ANALYSIS ///

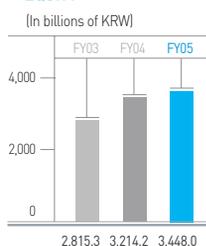
● TOTAL ASSETS



● TOTAL LIABILITIES



● TOTAL SHAREHOLDERS' EQUITY



SELECTED FINANCIAL DATA

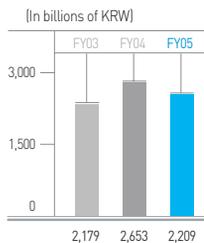
(In billions of Korean won)	2003	2004	2005	Change
Net sales	2,178.9	2,653.4	2,209.3	-16.7%
Operating profit	711.5	1,021.6	676.9	-33.7%
Net profit	459.7	472.3	515.9	9.2%
Total assets	3,887.0	3,885.0	3,964.4	2.0%
Total liabilities	1,071.7	670.8	516.4	-23.0%
Total shareholders' equity	2,815.3	3,214.2	3,448.0	7.3%
Operating profit margin (%)	32.7	38.5	30.6	-7.9%p
Return on equity (%)	18.5	15.7	15.5	-0.2%p
Interest-bearing debt to equity (%)	17.4	0.6	0.0	-0.6%p
Earnings per share (won)	3,724	3,183	3,497	9.9%
Weighted-average number of outstanding shares, (000's)	123,428	148,391	147,536	-0.6%
Diluted earnings per share (won)	3,307	2,981	3,491	17.1%
Weighted-average number of outstanding shares, (000's)	146,925	161,077	147,823	-8.2%
Average dividend per share (won)	1,600	1,600	1,700	6.3%
Year-end stock price (won)	20,700	30,950	45,050	45.6%
Average net selling price (won/pack of 20 cigarettes)	505.6	555.2	563.3	1.5%
Domestic sales volume (in billions of cigarettes)	74.4	82.3	60.1	-27.0%
Exports volume (in billions of cigarettes)	30.9	31.1	28.5	-8.5%
Number of employees	4,564	4,264	4,335	1.7%



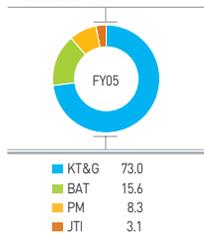
EXECUTIVE SUMMARY

Year 2005 was a difficult year for the cigarette business, the core business for KT&G. Uncertainty about the industry's future growth and fierce competition became more intense despite improvements in the overall world economy. In particular, sales decreased by such factors as stockpiling in 2004 ahead of tobacco tax hike, stricter smoking regulation, a declining smoking rate, and appreciation of the Korean currency. Although revenue decreased, 2005 was still a meaningful and valuable year for KT&G as the company worked hard in various ways to secure a stable foundation for future growth and important structural improvements were made.

● NET SALES



● DOMESTIC MARKET SHARE (%)



To better meet our customers' needs, we launched new brands such as "Indigo" and "Lo Crux." We also received a positive response to "Entz", another new brand from KT&G which is also the first compact type cigarette. Although sales volume dropped 27% compared to the previous year due to unusually high demand in 2004 and fierce competition, the decrease in revenue was a relatively moderate 21.6%, as sales of premium brands returned to the normal level.

In our overseas business, as we reduced exports of non-profitable brands, the total export volume went down 8.4% to 28.5 billion sticks. We worked hard to minimize the impact of unfavorable currency movements, which reduced our income, and to strengthen our business structure. Such measures helped KT&G increase its export unit price, despite the reduction in export volume. In particular, the exports of "Esse", thanks to persistent brand management and marketing, rose 65.9% year-on-year to 5.3 billion sticks, highlighting Esse's potential to become a global brand. We extended our export markets, which used to be concentrated in the Middle East and Central Asia, to Southeast Asia, China and Russia.

ANALYSIS OF BUSINESS RESULTS

Summary Income Statement

(In billions of Korean won)

	FY03	FY04	FY05
Net sales	2,179	2,653	2,209
Operating profit	712	1,022	677
Net profit	460	472	516
Earnings per share (won)	3,724	3,183	3,497

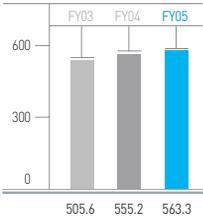
In 2005, KT&G's net operating revenues suffered a decline of 16.7% to KRW2,209 billion due to an unusually high demand in 2004 ahead of an increase in tobacco taxes. Nevertheless, strong marketing efforts and launch of new products allowed sales to recover to normal levels in the second half of the year. As fixed cost ratio increased due to the sales decline, operating profit also decreased by 33.7% to KRW677 billion. However, net profit grew 9.2% to KRW516 billion, thanks to improved non-operating income.

KT&G's domestic market share slipped by 4.0%p to 73%, dampened by the previous year's stockpiling and aggressive marketing by the competitors. We will make our efforts to protect our market and strengthen our future market position by differentiating ourselves through high-quality brands and proactive marketing.

// MANAGEMENT'S DISCUSSION & ANALYSIS ///

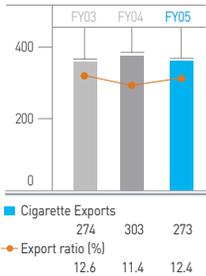
● AVERAGE NET SELLING PRICE

(Korean won per pack)



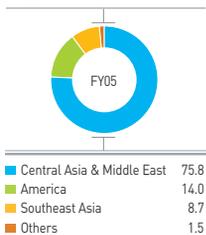
● CIGARETTE EXPORTS

(In billions of Korean won)



● EXPORTS BY REGION

(%)



KT&G at the low-tar segment

(Million sticks, %)	FY03	FY04	FY05
Low-tar market	11,656	31,219	29,024
KT&G's low-tar cigarette sales	9,570	24,515	21,227
KT&G's low-tar sales growth	665%	156%	-13%
KT&G's low-tar ratio to total sales volume	12%	29%	35%

While the overall domestic cigarette market shrank 22.7% last year, the low-tar segment only decreased 7.0%. As a result, low-tar products accounted for 35.3% of the domestic market, a 6.0%p year-on-year rise compared to 2004's 29.3%. That is an indication of the market's ongoing shift towards low-tar cigarettes. KT&G has led the low tar cigarette market with brands such as "The One", "Raison" and the ultra slim market with the "ESSE" family brands.

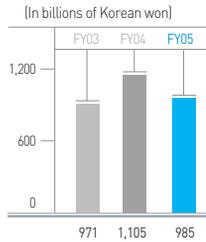
Smokers' preference for low tar cigarettes continued to grow in 2005, accelerating the growth in demand for premium products. KT&G led the low tar and premium cigarette market in 2005 with prominent brands such as "Lo Crux", "Entz", "Indigo", "ESSE", "Raison" and "The One." In 2005, premium cigarettes as a percentage of KT&G's overall sales increased up 1.0%p year-on-year to 58.0%. As a result, our weighted average net selling price continued to rise, climbing to KRW563.3 in 2005 from KRW555.2 in 2004.

Exports by Region

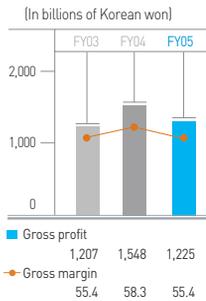
(%)	FY03	FY04	FY05
Central Asia & Middle East	84.1	78.2	75.8
America	12.7	14.5	14.0
Southeast Asia	2.8	6.1	8.7
Others	0.5	1.1	1.5

To overcome the limitation of domestic cigarette market growth and evolve into a global company, we are reinforcing our overseas business. We made visible progress as we re-organized our overseas sales mix towards more profitable brands. In 2005, export revenues dwindled by KRW30 billion to KRW273 billion compared to a year earlier. The decline in overseas revenues was the result of KT&G's strategic decision to reduce the export of unprofitable brands in order to minimize the loss caused by the sudden appreciation of Korean currency and to better adjust to the rapidly changing overseas market environment.

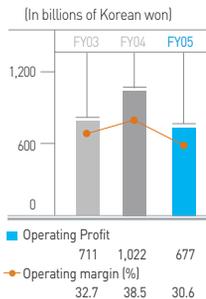
COGS



GROSS PROFIT



OPERATING PROFIT



To secure a foundation for sustainable growth overseas and to diversify our export markets, we carefully analyzed the growth and profitability prospects of each market. Consequently, our overseas sales, which were heavily dependent on Central Asia and the Middle East, started to increase to other areas such as Russia, Southeast Asia and China.

Our export net selling price increased by an average 9% per annum over the past five years.

(Operating Cost)

Cost of goods sold fell 10.9% to KRW985 billion in 2005 compared to the previous year. Gross profit declined 20.9% to KRW1,225 billion, primarily due to lower sales and an increase in usage of domestic leaf tobacco by 4.0%p to 74.0%. Despite efforts to increase our average selling price through new premium brands and higher priced products, gross margin declined 2.9%p to 55.4%, resulting in increased burden to fixed costs.

SG&A Expenses

(In billions of Korean won)	FY03	FY04	FY05
Salaries	169	182	191
Employee welfare	31	28	13
Advertising	135	153	147
Commissions	37	37	47
Depreciation	32	38	42
Others	91	89	109

Selling, general and administrative expenses rose 4.0% to KRW547 billion from KRW526 billion in 2004. As a result, SG&A expenses as a percentage of sales increased 5.0%p from the previous year's 19.8%.

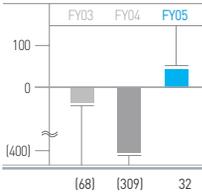
Labor costs, including salaries and welfare costs, dropped 3.0% to KRW204 billion from KRW210 billion in 2004 through tighter cost control, even though the number of employees increased. Commission expense went up amid a change in the accounting treatment for sample and promotional-use cigarettes.

In summary, operating profit dropped 33.7% to KRW677 billion in 2005 compared to KRW1,022 billion in 2004. The operating margin declined 7.9%p to 30.6%.

// MANAGEMENT'S DISCUSSION & ANALYSIS ///

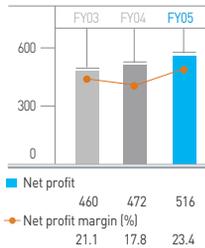
● NON-OPERATING BALANCE

(In billions of Korean won)



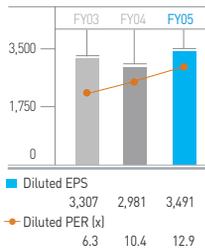
● NET PROFIT MARGIN

(In billions of Korean won)



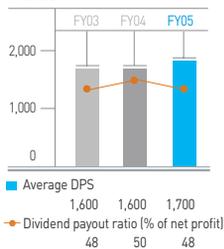
● DILUTED EPS AND DILUTED PER

(won)



● DIVIDEND PER SHARE

(won)



Note: Based on the year-end closing stock price.

(Non-operating items)

Non-operating income fell 9.8% to KRW153 billion and non-operating expense dropped 74.7% to KRW121 billion, leading to a net non-operating income of KRW32 billion. The notable improvement from 2004 is ascribed to a KRW142 billion reduction in conversion loss of CB and a KRW85 billion reduction in penalty taxes. KT&G will continue its efforts to lower non-operating expenses to improve the bottom line.

(Earnings and dividends)

Net profit before taxes was KRW709 billion in 2005, edging down 0.6% from the previous year, but net profit stood at a record high of KRW516 billion, growing 9.2%, mainly thanks to a reduction in corporate tax expenses. The net profit margin went up 5.6%p to 23.4%, from 17.8%.

The decrease in number of outstanding shares following cancellation of treasury stock combined with increased net income lifted diluted EPS by 17.1% year-on-year to KRW3,491 from 2004's KRW2,981. However, as our stock price surged 45.6% to KRW45,050 at the end of 2005 compared with KRW30,950 at the end of 2004, the diluted P/E ratio rose to 12.9 from 10.4.

Since IPO we have done our best efforts to return profits in the form of dividend and share repurchase to our shareholders. Moving forward, KT&G will maintain its policy of maximizing shareholder value for its shareholders, with measures such as share repurchase and cancellation and high dividend payout, considering market conditions and cash flow.

ANALYSIS OF FINANCIALS

Summary Balance Sheet

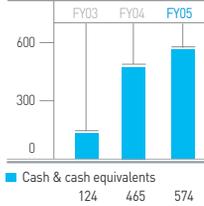
(In billions of Korean won)

	FY03	FY04	FY05
Assets	3,887	3,885	3,964
Liabilities	1,072	671	516
Shareholders' equity	2,815	3,214	3,448

In 2005, our total assets expanded 2.0% to KRW3,964 billion, increased by a KRW115 billion in short-term financial instruments under current assets and valuation gains on investment assets. Total liabilities decreased to KRW516 billion, down by KRW155 billion from KRW671 billion in 2004, as income tax payable fell by KRW128 billion.

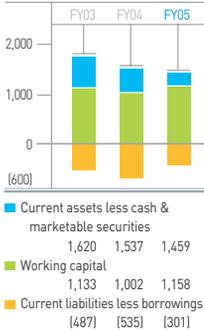
● CASH & CASH EQUIVALENTS

(In billions of Korean won)



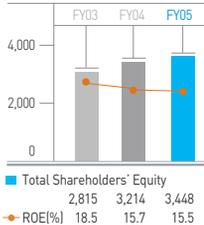
● WORKING CAPITAL

(In billions of Korean won)



● SHAREHOLDERS' EQUITY

(In billions of Korean won)



While accounts receivables increased by KRW16 billion, inventory assets went down by KRW136 billion. KT&G decreased excess inventory of tobacco leaves while reducing the area of cultivation and output. That should ease the future working capital burden.

Fixed Assets

(In billions of Korean won)

	FY03	FY04	FY05
Investment assets	972	666	692
Property, plant & equipment	1,166	1,215	1,237
Intangible assets	2	2	2

Fixed assets expanded by 2.6% from a year earlier to KRW1,932 billion. Investment assets increased 3.9% to KRW692 billion while tangible assets rose 1.8% to KRW1,237 billion. The boost in investment assets resulted from KRW27 billion in valuation gains on investment securities subject to equity method accounting.

Borrowings

(In billions of Korean won)

	FY03	FY04	FY05
Short-term borrowings	0	0	0
Exchangeable bonds	489	20	0
Interest-bearing debt to equity ratio	17.4	0.6	0.0

Following our no-debt financing policy, KT&G realized no interest-bearing debt.

In 2005, there was no change in capital stock but gains from the sale of treasury shares increased KRW22.7 billion, which led to a capital surplus of KRW300 billion. Retained earnings, following an increase in net income, grew by KRW163 billion compared to the previous year, which raised total shareholders' equity to KRW3,448 billion, up by 7.3% from KRW3,214 billion in 2004.

ANALYSIS OF CASH FLOW

Summary Cash Flow Statement

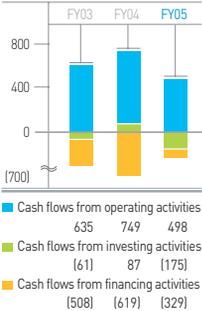
(In billions of Korean won)

	FY03	FY04	FY05
Cash flows from operating activities	635	749	498
Cash flows from investing activities	(61)	87	(175)
Cash flows from financing activities	(508)	(619)	(329)

// MANAGEMENT'S DISCUSSION & ANALYSIS ///

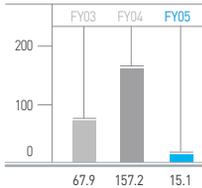
● SUMMARY CASH FLOW STATEMENT

(In billions of Korean won)



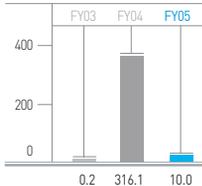
● LOSS ON REDEMPTION OF EXCHANGEABLE BONDS, NET

(In billions of Korean won)



● DISPOSAL OF AVAILABLE-FOR-SALE SECURITIES

(In billions of Korean won)



Over the last few years, KT&G has continuously generated stable cash flow from operations.

Cash flows from operating activities

(In billions of Korean won)	FY03	FY04	FY05
Net profit	459.7	472.3	515.9
Depreciation and amortization	87.4	103.4	110.9
Loss on redemption of exchangeable bonds, net	67.9	157.2	15.1
Others	20.0	15.7	(143.7)

Despite increases in net income, depreciation and amortization, our cash flow from operating activities fell to KRW498 billion in 2005 from KRW749 billion in 2004.

Cash flows from investing activities

(In billions of Korean won)	FY03	FY04	FY05
Net capital expenditure	(126.5)	(148.1)	167.0
Disposal of available-for-sale securities	0.2	316.1	10.0
Others	65.8	(80.6)	(351.8)

Our cash flow from investing activities recorded a KRW175 billion net outflow while a KRW87 billion net inflow in 2004. Cash inflow shrank to KRW121 billion from KRW604 billion, down by about KRW500 billion, of which over KRW300 billion stemmed from a reduction in disposal of available-for-sale securities, while the rest mostly came from a reduction in disposal of tangible assets. Due to a tightening policy overall, cash outflow from investing activities decreased to KRW296 billion in 2005 from KRW517 billion in 2004.

Cash flows from financing activities

(In billions of Korean won)	FY03	FY04	FY05
Borrowings & debentures	(289.6)	3.4	(1.5)
Reissuance of treasury stock	16.2	100.2	27.0
Dividend	(167.4)	(221.5)	(237.3)
Others	(67.1)	(501.1)	(117.1)

Cash outflow from financing activities tumbled to KRW329 billion from KRW619 billion in the previous year. There were no borrowings in 2005, while we saw a KRW27 billion inflow from reissuance of treasury shares.

2006 BUSINESS OUTLOOK & MANAGEMENT ISSUES

Our domestic cigarette business may continue to encounter hurdles in 2006 as the government tightens price and non-price regulatory constraints in connection with the Framework Convention on Tobacco Control. We also expect more intense competition due to aggressive marketing by the competitors. Even so, we are confident KT&G will remain as the dominant market leader in Korea. We are actively developing high quality brands that will satisfy the varying needs of our customers. We will strengthen our customer-oriented marketing communications and solidify our sales network to gain more market share.

We also anticipate to make further headway overseas in terms of profits and brand recognition in 2006, following last year's realignment towards a profit-oriented business structure. We will work to improve profits by increasing sales of mid- to high-priced brands and penetrate into the ultra slim market with the "Esse" brands.

KT&G will continue to strengthen its profit base in the long-term basis. In the year ahead, we will reinforce ginseng business which will grow as a key revenue source to the company in the future by securing ginseng supply base, increasing international presence, and strengthening the brand equity of Jung-Kwan-Jang.

KT&G is targeting to sell 97 billion sticks in 2006, including overseas sales, for year-on-year volume growth of 9.6%. We are aiming for operating income of KRW731 billion and net income of KRW525 billion, for an 8.0% and 1.8% year-on-year increase respectively. KT&G will do its best to grow as a global enterprise by heightening transparency, strengthening our governance structure, and maximizing shareholders value.

// INDEPENDENT AUDITORS' REPORT ///



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The Board of Directors and Stockholders

KT&G Corporation:

We have audited the accompanying balance sheets of KT&G Corporation (the "Company") as of December 31, 2005 and 2004, and the related statements of income, appropriation of retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of KT&G Corporation as of December 31, 2005 and 2004, and the results of its operations, the changes in its retained earnings, and its cash flows for the years then ended in conformity with accounting principles generally accepted in the Republic of Korea.

The accompanying financial statements as of and for the year ended December 31, 2005 have been translated into United States dollars solely for the convenience of the reader and have been translated on the basis set forth in note 2 to the financial statements.

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

As discussed in note 1(b) to the financial statements, accounting principles and auditing standards and their application in practice vary among countries. The accompanying financial statements are not intended to present the financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in countries other than the Republic of Korea. In addition, the procedures and practices utilized in the Republic of Korea to audit such financial statements may differ from those generally accepted and applied in other countries. Accordingly, this report and the accompanying financial statements are for use by those knowledgeable about Korean accounting procedures and auditing standards and their application in practice.

As discussed in note 1(b) to the financial statements, effective January 1, 2005, the Company adopted Statements of Korea Accounting Standards No. 15, No. 16 and No. 17. Certain prior year amounts in the accompanying financial statements have been reclassified to conform to the current year's presentation.

As discussed in note 21, the Company entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise a fund with the target set at ₩410 billion by 2008 to stabilize tobacco production. Under the agreement, the Company is to make up for the deficiency, should the fund fall short of the target. The Company annually provides for a provision for the deficiency to fully fund tobacco production stabilization target by 2008. The provision for the fund made by the Company amounted to ₩18,082 million in each year of 2005 and 2004, and the reserve for the fund as of December 31, 2005 and 2004 amounted to ₩55,753 million and ₩37,671 million, respectively.

As discussed in note 21, the Company and the Korean government are defendants in lawsuits claiming damages of ₩1,282 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.

As discussed in note 18, the Company reacquired and subsequently retired 3,000,000 shares of treasury stock in 2005. Accordingly, as of December 31, 2005, the number of the Company's shares issued decreased to 162,442,497 shares. Also, as discussed in note 28, on January 25, 2006, the board of directors of the Company decided to retire additional 3,000,000 shares of treasury stock and, if the additional retirement is completed, the number of the Company's shares issued will decrease to 159,442,497 shares.

KPMG Samjong Accounting Corp.

Seoul, Korea

January 13, 2006

This report is effective as of January 13, 2006, 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.

// BALANCE SHEETS ///

December 31, 2005 and 2004

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

	Korean Won	U.S. dollars [note 2]	Korean Won
	2005		2004
(Assets)			
Current assets:			
Cash and cash equivalents [notes 3 and 17]	₩ 333,107	\$ 328,832	₩ 338,542
Short-term financial instruments	241,000	237,907	126,000
Accounts receivable, net of allowance for doubtful accounts of ₩2,495 in 2005 and ₩2,275 in 2004 [notes 8 and 17]	241,281	238,185	225,196
Inventories [notes 4 and 12]	1,125,791	1,111,343	1,261,567
Current portion of deferred income tax assets [note 23]	10,970	10,829	-
Other current assets [notes 5 and 17]	80,749	79,714	50,694
Total current assets	2,032,898	2,006,810	2,001,999
Available-for-sale securities [note 6]	74,086	73,135	52,496
Equity method investment securities [note 7]	421,317	415,910	401,340
Long-term loans, net of allowance for doubtful accounts of ₩885 in 2005 and ₩809 in 2004 and present value discount of ₩22,916 in 2005 and ₩33,514 in 2004 [note 9]	87,600	86,475	80,077
Long-term loans to employees	62,899	62,092	84,967
Guarantee deposits paid	25,934	25,601	25,358
Long-term deposits in escrow fund, net of allowance for doubtful accounts of ₩28,720 in 2005 and ₩19,817 in 2004 [note 17]	-	-	-
Property, plant and equipment, at cost [notes 10, 11 and 12]	1,883,435	1,859,265	1,808,734
Less accumulated depreciation	(646,740)	(638,440)	(593,909)
Net property, plant and equipment	1,236,695	1,220,825	1,214,825
Intangible assets	2,458	2,426	2,132
Other assets [note 13]	20,527	20,264	21,818
Total assets	₩ 3,964,414	\$ 3,913,538	₩ 3,885,012

(Continued)

// BALANCE SHEETS ///

December 31, 2005 and 2004

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

	Korean Won	U.S. dollars (note 2)	Korean Won
	2005		2004
(Liabilities and Stockholders' Equity)			
Current liabilities:			
Accounts payable (notes 8 and 17)	₩ 12,130	\$ 11,974	₩ 13,846
Value added tax payable	141,146	139,336	157,306
Accrued expenses	28,309	27,946	27,514
Other payables	13,191	13,022	38,828
Tobacco excise taxes and dues payable	18,925	18,682	42,140
Income taxes payable	64,220	63,396	192,584
Current portion of exchangeable bonds (note 15)	-	-	20,142
Other current liabilities (note 14)	23,140	22,844	42,938
Total current liabilities	301,061	297,200	535,298
Retirement and severance benefits (note 16)	55,713	54,998	46,399
Guarantee deposits received (note 8)	26,126	25,788	27,623
Deferred income tax liabilities (note 23)	77,722	76,725	23,804
Reserve for tobacco production stabilization fund (note 21)	55,753	55,038	37,671
Total liabilities	516,375	509,749	670,795
Stockholders' equity (note 18):			
Common stock of ₩5,000 par value (note 1):			
Authorized-800,000,000 shares			
Issued-162,442,497 shares			
Outstanding-146,883,932 shares	954,959	942,704	954,959
Capital surplus	300,043	296,193	277,331
Retained earnings (note 19)	2,519,321	2,486,989	2,355,656
Capital adjustments (note 20)	(326,284)	(322,097)	(373,729)
Total stockholders' equity	3,448,039	3,403,789	3,214,217
Commitments and contingencies (note 21)			
Total liabilities and stockholders' equity	₩ 3,964,414	\$ 3,913,538	₩ 3,885,012

See accompanying notes to financial statements.

// STATEMENTS OF INCOME ///

Years ended December 31, 2005 and 2004

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

	Korean Won	U.S. dollars [note 2]	Korean Won
	2005		2004
Sales:			
Tobacco	₩ 2,063,312	\$ 2,036,833	₩ 2,587,519
Lotting-out (note 22)	95,315	94,092	49,209
Other	50,665	50,015	16,657
	<u>2,209,292</u>	<u>2,180,940</u>	<u>2,653,385</u>
Cost of sales (notes 22 and 26)	984,655	972,018	1,105,231
Gross profit	<u>1,224,637</u>	<u>1,208,922</u>	<u>1,548,154</u>
Selling and administrative expenses (notes 26 and 27)	547,708	540,680	526,578
Operating income	<u>676,929</u>	<u>668,242</u>	<u>1,021,576</u>
Other income (expense):			
Interest income	30,562	30,170	38,373
Interest expense	(304)	(301)	(11,566)
Other bad debts expense	(21,413)	(21,138)	(28,317)
Loss on foreign currency transactions, net	(3,087)	(3,048)	(26,292)
Donations	(32,166)	(31,753)	(87,164)
Contribution to Tobacco Production Stabilization Fund (note 21)	(18,082)	(17,850)	(18,082)
Gain on valuation of equity method investments (note 7)	72,160	71,234	73,297
Loss on valuation of equity method investments (note 7)	(3,195)	(3,154)	-
Loss on redemption of exchangeable bonds, net	(15,077)	(14,884)	(157,244)
Loss on prior period adjustments	-	-	(13,908)
Additional income taxes for prior years	(1,136)	(1,121)	(86,337)
Other, net	23,643	23,340	8,734
	<u>31,905</u>	<u>31,495</u>	<u>(308,506)</u>
Income before income taxes	<u>708,834</u>	<u>699,737</u>	<u>713,070</u>
Income taxes (note 23)	192,909	190,433	240,770
Net income	<u>₩ 515,925</u>	<u>\$ 509,304</u>	<u>₩ 472,300</u>
Basic earnings per share			
in Korean Won and U.S. dollars (note 24)	<u>₩ 3,497</u>	<u>\$ 3.45</u>	<u>₩ 3,183</u>
Diluted earnings per share			
in Korean Won and U.S. dollars (note 24)	<u>₩ 3,491</u>	<u>\$ 3.45</u>	<u>₩ 2,981</u>

See accompanying notes to financial statements.

// STATEMENTS OF APPROPRIATION OF RETAINED EARNINGS ///

Years ended December 31, 2005 and 2004

Date of Appropriation for 2005: March 17, 2006

Date of Appropriation for 2004: March 18, 2005

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

	Korean Won	U.S. dollars (note 2)	Korean Won
	2005		2004
Unappropriated retained earnings:			
Balance at beginning of year	₩ 3,811	\$ 3,762	₩ 230,219
Retirement of treasury stock	(114,998)	(113,523)	(412,160)
Net income	515,925	509,304	472,300
Balance at end of year before appropriation	404,738	399,543	290,359
Transfer from voluntary reserves:			
Reserve for research and manpower development	6,269	6,189	12,038
Unconditional reserve	-	-	10,320
	6,269	6,189	22,358
Unappropriated retained earnings available for appropriation	411,007	405,732	312,717
Appropriation of retained earnings:			
Dividends-34% on par value			
at 1,700 Korean Won per share (note 25)	249,703	246,498	237,260
Reserve for research and manpower development	-	-	45,000
Reserve for losses on reissuance of treasury stock	-	-	26,646
Unconditional reserve	158,000	155,972	-
	407,703	402,470	308,906
Unappropriated retained earnings to be carried over to subsequent year	₩ 3,304	\$ 3,262	₩ 3,811

See accompanying notes to financial statements.

// STATEMENTS OF CASH FLOWS ///

Years ended December 31, 2005 and 2004

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

	Korean Won	U.S. dollars [note 2]	Korean Won
	2005		2004
Cash flows from operating activities:			
Net income	₩ 515,925	\$ 509,304	₩ 472,300
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	110,939	109,516	103,415
(Gain) loss on valuation of inventories	(4,341)	(4,285)	8,877
Bad debts expense	220	217	730
Amortization of discount on exchangeable bonds	167	165	8,003
Gain on valuation of equity method investments	(72,160)	(71,234)	(73,297)
Loss on valuation of equity method investments	3,195	3,154	-
Loss on foreign currency transactions, net	1,620	1,600	5,846
Other bad debts expense	21,413	21,138	28,317
Provision for retirement and severance benefits	30,442	30,051	52,629
Loss (gain) on sale of property, plant and equipment	635	627	(4,917)
Impairment losses on intangible assets	3,950	3,899	-
Amortization of present value discounts	(10,607)	(10,470)	(9,902)
Loss on transactions of interest rate swaps	-	-	698
Loss on transactions of currency swaps	-	-	9,051
Provision for Tobacco Production Stabilization Fund	18,082	17,850	18,082
Loss on redemption of exchangeable bonds, net	15,077	14,884	157,244
Loss on prior-period adjustments	-	-	13,908
Deferred income tax liabilities	34,444	34,002	18,069
Payments of retirement and severance benefits	(6,938)	(6,847)	(38,128)
Increase in deposit for severance benefit insurance	(14,190)	(14,008)	(8,699)
Decrease (increase) in assets:			
Accounts receivable	(17,590)	(17,364)	(76,509)
Other receivables	(22,740)	(22,448)	9,933
Accrued income	(719)	(709)	(711)
Advance payments	(13,782)	(13,605)	3,270
Prepaid expenses	(621)	(613)	(81)
Inventories	139,539	137,748	128,686
Increase (decrease) in liabilities:			
Accounts payable	(1,612)	(1,592)	3,418
Other payables	(25,636)	(25,307)	16,392
Advance receipts	(32,256)	(31,842)	(4,130)
Withholdings	12,601	12,439	(404)
Value added tax payable	(16,160)	(15,953)	44,498
Accrued expenses	2,860	2,823	(247)
Tobacco excise taxes and dues payable	(23,215)	(22,918)	(110,479)
Income taxes payable	(136,979)	(135,221)	(14,338)
Unearned income	(143)	(141)	283
Other, net	(13,180)	(13,014)	(13,137)
Net cash provided by operating activities	₩ 498,240	\$ 491,846	₩ 748,670

(Continued)

	Korean Won	U.S. dollars (note 2)	Korean Won
	2005		2004
Cash flows from investing activities:			
Proceeds from sale of available-for-sale securities	₩ 9,960	\$ 9,832	₩ 316,099
Proceeds from sale of trading securities	-	-	198
Proceeds from sale of equity method investments	50,000	49,358	50,000
Decrease in long-term interest receivable	-	-	473
Decrease in long-term loans to employees	11,141	10,998	27,661
Proceeds from sale of property, plant and equipment	9,002	8,885	18,953
Decrease in short-term deposits	(115,000)	(113,524)	(123,905)
Purchases of available-for-sale securities	(10,111)	(9,981)	(3,617)
Purchases of equity method investments	-	-	(40,284)
Settlement of currency swaps	-	-	(9,697)
Settlement of interest rate swaps	-	-	13,819
Increase in guarantee deposits	(577)	(569)	(28,889)
Increase in long-term deposits in escrow fund	(9,342)	(9,222)	(5,077)
Purchases of property, plant & equipment	(141,433)	(139,616)	(166,008)
Purchases of intangible assets	(5,287)	(5,220)	(267)
Increase in other investments	(752)	(741)	(3,295)
Other, net	27,532	27,177	41,311
Net cash (used in) provided by investing activities	(174,867)	(172,623)	87,475
Cash flows from financing activities:			
(Decrease) increase in guarantee deposits received	(1,498)	(1,481)	3,350
Reissuance of treasury stock	27,029	26,682	100,168
Reacquisition of treasury stock	(114,998)	(113,523)	(501,075)
Redemption of exchangeable bonds	(1,917)	(1,892)	(4)
Payment of long-term interest payables	(162)	(160)	-
Payment of dividends	(237,262)	(234,215)	(221,528)
Net cash used in financing activities	(328,808)	(324,589)	(619,089)
Net (decrease) increase in cash and cash equivalents	(5,435)	(5,366)	217,056
Cash and cash equivalents at beginning of year	338,542	334,198	121,486
Cash and cash equivalents at end of year	₩ 333,107	\$ 328,832	₩ 338,542

See accompanying notes to financial statements.

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND BASIS OF PRESENTING FINANCIAL STATEMENTS

[a] 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 stock on the Korea Stock Exchange on October 8, 1999. On December 27, 2002, the Company changed its name again to KT&G Corporation from Korea Tobacco & Ginseng Corporation.

As of December 31, 2005, the Company has four manufacturing plants, including the Shin Tan Jin plant, and 14 local headquarters and 168 branches for the sale of tobacco throughout the country. Also, the Company has two plants for fabrication of leaf tobacco, including the Nam Won plant, and the Chun Ahn printing plant for the manufacturing of wrapping paper.

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

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

The ownership of the Company's issued common stock at December 31, 2005 is held as follows:

Stockholder	Number of shares	Percentage of ownership
Industrial Bank of Korea	9,510,485	5.9%
Employee Stock Ownership Association	9,334,632	5.7%
Treasury stock	15,558,565	9.6%
Others	128,038,815	78.8%
	162,442,497	100.0%

[\(b\) Basis of Presenting Financial Statements](#)

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

Certain information attached to the Korean language financial statements, but not required for a fair presentation of the Company's financial position, results of operations or cash flows, is not presented in the accompanying financial statements.

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

The Company adopted Statements of Korea Accounting Standards ("SKAS") No. 15, "The Equity Method," No. 16, "Income Taxes," and No. 17, "Provisions and Contingent Liabilities & Assets," effective January 1, 2005. Certain accounts of prior year's financial statements were reclassified to conform to the current year's presentation.

[\(c\) Cash Equivalents](#)

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

[\(d\) Financial Instruments](#)

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

[\(e\) Allowance for Doubtful Accounts](#)

Allowance for doubtful accounts is estimated based on an analysis of individual accounts and past experience of collection. However, when principals of trade accounts and notes receivable, interest rate or repayment period are changed unfavorably for the creditor by a court imposition, such as on commencement of reorganization, or by mutual agreements and the difference between nominal value and present value is material, the difference is recognized as bad debt expense.

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

(f) Inventories

Inventories are stated at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling cost. The cost of inventories is determined by the weighted-average method for finished goods, by-products and work-in-process; using the moving-average method for raw materials and supplies; and using the specific identification method for materials-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. The Company recognized reversal of loss on valuation of inventories amounted to ₩4,341 for the year ended December 31, 2005.

(g) Investment in Securities

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

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

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

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

(h) Investment Securities under the Equity Method of Accounting

Investments in affiliated companies of which the Company owns 20% or more of the voting stock or over which the Company has a significant management control, are stated at an amount as determined using the equity method.

Under the equity method of accounting, the Company's initial investment is recorded at cost and is subsequently increased to reflect the Company's share of the investee income and reduced to reflect the Company's share of the investee losses or dividends received. Any excess in the Company's acquisition cost over the Company's share of the investee's identifiable net assets is generally recorded as goodwill or other intangibles and amortized by the straight-line method over the estimated useful life. The amortization of investor-level goodwill is recorded against the equity income (losses) of affiliates. When events or changes in circumstances indicate that the carrying amount may not be recoverable, the Company reviews goodwill for any impairment. The Company does not record its share of losses of affiliate companies when such losses would make the Company's investment in such entity less than zero. However, if the Company holds preferred stock or long-term debt issued by the affiliate, the Company's share of loss of the affiliate remains recorded until such investment is reduced to zero.

Prior to January 1, 2005, investments in affiliated companies were deducted when dividends from its affiliated companies were paid. Additionally, bad debt expense on receivables from its subsidiaries was not eliminated in the financial statements. Effective January 1, 2005, the Company adopted SKAS No. 15, "The Equity Method." In accordance with SKAS No. 15, investments in affiliated companies are reduced when dividends from its affiliated companies are declared by shareholders' meeting of its affiliated companies and bad debt expense on receivables from subsidiaries is eliminated.

(i) Property, Plant and Equipment

Property, plant and equipment are stated at cost, except in the case of revaluation made in accordance with the old Asset Revaluation Law. Plant and equipment under capital leases are stated at an amount equal to the lower of their fair value or the present value of minimum lease payments at inception of lease. Significant additions or improvements extending useful lives of assets are capitalized. However, normal maintenance and repairs are charged to expense as incurred.

Depreciation is computed by the straight-line method using rates based on estimated useful lives of the respective assets as follows:

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

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

The Company recognizes interest cost and other financial charges on borrowings associated with the manufacture, purchase, or construction of property, plant and equipment as an expense in the period in which they are incurred.

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

(j) Goodwill

Goodwill, which represents the excess of the acquisition cost over the fair value of net identifiable assets acquired, is amortized on a straight-line basis over the expected periods to be benefited but generally less than 20 years. In cases where goodwill is no longer probable of being recovered from the expected future economic benefit, it is expensed immediately.

(k) Intangible Assets

Intangible assets are stated at cost less accumulated amortization, as described below.

(i) Research and Development Costs

Expenditure on research activities undertaken with the prospects of gaining new scientific or technical knowledge and understanding, is recognized in the statement of income as an expense as incurred.

Expenditure on development incurred in conjunction with new products or technologies in which the elements of costs can be identified and future economic benefits are clearly expected, is capitalized and amortized on a straight-line basis over the expected periods to be benefited. The expenditure capitalized includes the cost of materials, direct labor and an appropriate proportion of overheads.

(ii) Other Intangible Assets

Other intangible assets, which are acquired by the Company, are stated at cost less accumulated amortization and impairment losses. Such intangible assets are amortized using the straight-line method over a reasonable period based on the nature of the asset.

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

(l) Valuation of Receivables and Payables at Present Value

Receivables and payables arising from long-term installment transactions, long-term cash loans/borrowings and other similar loan/borrowing transactions are stated at present value.

The difference between nominal value and present value is deducted directly from the nominal value of related receivables or payables and is amortized using the effective interest method. The amount amortized is included in interest expense or interest income.

(m) Retirement and Severance Benefits

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

(n) Exchangeable Bonds

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

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

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

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

[\[o\] Foreign Currency Translation](#)

Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at the balance sheet date, with the resulting gains and losses recognized in current results of operations. Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at ₩1,013.00 to USD 1, the rate of exchange on December 31, 2005 that is permitted by the Financial Accounting Standards. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated into Korean Won at the foreign exchange rate ruling at the date of the transaction.

[\[p\] Discount on Debentures](#)

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

[\[q\] Revenue Recognition](#)

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

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

[\[r\] Income Taxes](#)

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

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

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

[\(s\) Prior Period Adjustments](#)

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

[\(t\) Earnings Per Share](#)

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

[\(u\) Provisions, Contingent Assets and Contingent Liabilities](#)

Provisions are recognized when all of the following are met: (1) an entity has a present obligation as a result of a past event, (2) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and (3) a reliable estimate can be made of the amount of the obligation. In cases where an obligation is settled, the Company recognizes the amount reimbursable from a third party as income when it is virtually certain that the reimbursement will be received.

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

[\(v\) Use of Estimates](#)

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

2. BASIS OF TRANSLATING FINANCIAL STATEMENTS

The financial statements are expressed in Korean Won and, solely for the convenience of the reader, have been translated into U.S. dollars at the rate of ₩1,013.00 to USD 1, the basic exchange rate on December 31, 2005. 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 FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

3. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Cash on hand	₩ 6,777	3,901
Passbook accounts	116,330	74,641
Bonds sold on repurchase agreement	30,000	70,000
Call loans	80,000	-
Money market fund accounts	100,000	190,000
	₩ 333,107	338,542

4. INVENTORIES

Inventories as of December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Merchandise	₩ 133	-
Finished goods, net of valuation loss reserve	75,026	86,046
Work-in-process	9,005	6,772
Raw materials, net of valuation loss reserve	999,498	1,132,872
Supplies	16,347	17,249
By-products	3,399	2,872
Completed buildings	8,187	1,450
Sites for building lotting-out construction	966	4,406
Goods-in-transit	13,230	9,900
	₩ 1,125,791	1,261,567

5. OTHER CURRENT ASSETS

Other current assets as of December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Accrued income	₩ 4,625	3,907
Other receivables	31,241	9,753
Prepaid expenses	1,584	963
Short-term loans to employees	11,814	22,955
Advance payments	23,777	9,995
Current portion of long-term loans	2,711	3,121
Available-for-sale securities (note 6)	4,997	-
	₩ 80,749	50,694

6. AVAILABLE-FOR-SALE SECURITIES

Available-for-sale securities as of December 31, 2005 and 2004 are summarized as follows:

(a) Equity securities

Company	Number of shares	Percentage of ownership	Acquisition cost	Fair value	Book value	
					2005	2004
Yonhap Television News (YTN)	8,380,000	19.95%	₩ 5,102	35,028	35,028	10,098
Celltrion, Inc.	3,791,368	14.62%	21,245	21,245	21,245	18,866
Nexgen Biotechnologies, Inc.	100,000	13.27%	2,150	2,150	2,150	2,150
KT&G USA	100,000	100.00%	584	584	584	584
Cosmo Tobacco Co., Ltd.	480,000	40.00%	2,540	763	763	763
Innodis	110,000	19.64%	55	55	55	55
Oscotech, Inc.	230,770	5.18%	2,250	2,250	2,250	2,250
REXAHN Pharmaceuticals, Inc.	2,500,000	5.47%	2,359	2,359	2,359	2,359
Leifenza	29,047	13.01%	1,600	1,600	1,600	1,600
Korea Islet Transplantation Institute, Inc.	60,500	33.80%	1,000	1,000	1,000	-
KT&G Mongolia LLC	40,000	100.00%	201	201	201	-
Korea Tabacos do Brasil Ltda.	(*)	99.90%	203	203	203	-
Bioheart Korea Co., Ltd.	15,873	4.84%	1,000	1,000	1,000	-
KT&G Hanbit Hyang Ryo, Inc.	-	-	-	-	-	2,829
			₩ 40,289	68,438	68,438	41,554

(*) Stock certificates are not issued.

(b) Debt securities

Description	Interest rate per annum	Acquisition cost	Fair value	Book value	
				2005	2004
Current assets:					
Government and municipal bonds (note 5)	3.0 ~ 9.7%	₩ 4,997	4,997	4,997	-
Non-current assets:					
Government and municipal bonds	3.0 ~ 9.7%	3,050	3,050	3,050	9,343
Crystal Genomics Co., Ltd.	3.0%	999	1,998	1,998	999
MD Bioalpha Co., Ltd.	5.5%	600	600	600	600
		₩ 9,646	10,645	10,645	10,942

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

(c) Changes in unrealized gain for the year ended December 31, 2005 are summarized as follows:

	Amount
Beginning balance	₩ 4,996
Changes in unrealized gain	25,931
Ending balance before tax effect	30,927
Less: Intra-period tax allocation	(8,506)
Ending balance	₩ 22,421

7. AFFILIATES' EQUITY SECURITIES ACCOUNTED FOR USING EQUITY METHOD

(a) Affiliates' equity securities accounted for using the equity method as of December 31, 2005 and 2004 are summarized as follows:

Affiliate	Number of shares	Percentage of ownership	2005		2004
			₩		
Korea Ginseng Corporation	12,985,851	100.00%	₩ 353,411		331,133
Buytheway Co., Ltd.	4,034,935	43.67%	22,719		22,744
Yungjin Pharm. Ind. Co., Ltd.	53,148,564	56.97%	32,496		33,153
Tae-a Industry Co., Ltd.	150,000	100.00%	11,823		13,442
KT&G Turkey	9,900	99.00%	868		868
			₩ 421,317		401,340

(b) Details of the difference between the acquisition cost and the Company's share of the investees' identifiable net assets as of December 31, 2005 are as follows:

Affiliate	Beginning balance	Amortized amount	Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩ 3,650	909	2,741
Tae-a Industry Co., Ltd.	9,331	2,074	7,257
	₩ 12,981	2,983	9,998

(c) Details of changes in affiliates' equity securities accounted for using the equity method after acquisition as of December 31, 2005 are as follows:

Affiliate	Acquisition cost	Adjustment to Retained earnings		Capital adjustment	Principally dividends	December 31, 2005
		Prior to 2005	2005			
Korea Ginseng Co.	₩ 214,929	255,076	72,160	146	(188,900)	353,411
Buytheway Co., Ltd.	26,419	(3,675)	(25)	-	-	22,719
Yungjin Pharm. Ind. Co., Ltd.	32,682	330	(1,551)	1,035	-	32,496
Tae-a industry Co., Ltd.	14,198	(756)	(1,619)	-	-	11,823
KT&G Turkey	2,203	-	-	-	(1,335)	868
	₩ 290,431	250,975	68,965	1,181	(190,235)	421,317

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

Affiliate	Acquisition cost	Adjustment to Retained earnings		Capital adjustment	Principally dividends	December 31, 2004
		Prior to 2004	2004			
Korea Ginseng Co.	₩ 214,929	180,954	74,122	28	(138,900)	331,133
Buytheway Co., Ltd.	26,419	(3,275)	(400)	-	-	22,744
Yungjin Pharm. Ind. Co., Ltd.	32,682	-	330	141	-	33,153
Tae-a industry Co., Ltd.	2,203	-	-	-	(1,335)	868
KT&G Turkey	14,198	-	(756)	-	-	13,442
	₩ 290,431	177,679	73,296	169	(140,235)	401,340

(e) Summarized financial information of affiliates as of and for the year ended December 31, 2005 is as follows:

Affiliate	Total assets	Total liabilities	Sales	Net income
Korea Ginseng Co.	₩ 406,728	53,317	332,017	72,160
Buytheway Co., Ltd.	180,667	128,640	418,997	218
Yungjin Pharm. Ind. Co., Ltd.	134,185	80,418	101,098	194
Tae-a industry Co., Ltd.	7,554	2,525	10,308	842

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

(f) Market price of equity investments in listed affiliated companies as of December 31, 2005 is as follows:

Affiliate	Market price	Book value
Yungjin Pharm. Ind. Co., Ltd.	₩ 238,637	32,496

8. TRANSACTIONS AND BALANCES WITH RELATED COMPANIES

Significant transactions and account balances which occurred in the normal course of business with related companies as of and for the years ended December 31, 2005 and 2004 are summarized as follows:

(a) Revenue from sales and others

	2005			2004		
	Sales	Other income	Total	Sales	Other income	Total
Buytheway Co., Ltd.	₩ 79,997	-	79,997	102,178	-	102,178
Korea Ginseng Corporation	-	7,196	7,196	-	5,995	5,995
Yungjin Pharm. Ind. Co., Ltd.	-	2,641	2,641	-	14	14
KT&G USA	25,316	-	25,316	3,119	-	3,119
KT&G Mongolia LLC	199	-	199	-	-	-
	₩ 105,512	9,837	115,349	105,297	6,009	111,306

(b) Purchases and other expenses

	2005			2004		
	Purchases	Other expenses	Total	Purchases	Other expenses	Total
Buytheway Co., Ltd.	₩ -	3,618	3,618	-	4,070	4,070
Korea Ginseng Corporation	1,365	-	1,365	1,802	-	1,802
Tae-a Industry Co., Ltd.	10,310	-	10,310	11,181	-	11,181
Yungjin Pharm. Ind. Co., Ltd.	123	-	123	-	-	-
Korea Tabacos do Brasil Ltda.	-	45	45	-	-	-
	₩ 11,798	3,663	15,461	12,983	4,070	17,053

(c) Due from affiliates

	December 31, 2005		December 31, 2004		
	Accounts receivable	Long-term loans	Accounts receivable	Long-term loans	Other
Korea Ginseng Corporation	₩ -	-	-	-	15
Buytheway Co., Ltd.	4,534	-	14,979	-	-
KT&G USA	20,781	-	-	205	-
Yungjin Pharm. Ind. Co., Ltd.	-	8	-	-	-
KT&G Turkey	-	1,249	-	1,249	-
KT&G Mongolia LLC	112	238	-	-	-
	₩ 25,427	1,495	14,979	1,454	15

(d) Due to affiliates

	December 31, 2005			December 31, 2004		
	Account payable	Guarantee deposits received	Other	Account payable	Guarantee deposits received	Other
Korea Ginseng Corporation	₩ 12	1,684	532	14	1,190	197
Buytheway Co., Ltd.	-	-	356	-	-	434
	₩ 12	1,684	888	14	1,190	631

9. LONG-TERM LOANS RECEIVABLE

Long-term loans receivable as of December 31, 2005 and 2004 are as follows:

Classification	Interest rate per annum	Maturity date	2005	2004
Loan to National Leaf Tobacco Growers Cooperative Federation in support of leaf tobacco cultivation (*)	0.7%	2007.11.20.	₩ 110,000	110,000
Loan to Korea Ginseng Cooperative Federation in support of ginseng cultivation	1.5%	2002.12.21. ~ 2007.12.21.	4,400	7,800
			114,400	117,800
Less: Present value discount account (**)			[23,177]	[33,761]
Total present value			91,223	84,039
Less: Current portion			[2,738]	[3,153]
Allowance for doubtful accounts			[885]	[809]
			₩ 87,600	80,077

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December 31, 2005 and 2004

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

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

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

10. PROPERTY, PLANT AND EQUIPMENT

[a] Changes in property, plant and equipment for the year ended December 31, 2005 are as follows:

	January 1, 2005	Acquisition	Disposal	Depreciation	Others	December 31, 2005
Land	₩ 299,854	8,897	(2,339)	-	25,338	331,750
Buildings	437,482	7,497	(1,129)	(19,178)	11,097	435,769
Structures	24,608	797	(303)	(1,900)	280	23,482
Machinery and equipment	317,381	2,208	(1,231)	(56,590)	17,873	279,641
Vehicles and other						
transportation equipment	8,561	1,673	(253)	(3,472)	2,003	8,512
Tools	7,900	1,066	(19)	(4,027)	4,993	9,913
Furniture and fixtures	63,424	33,288	(4,362)	(24,760)	4,754	72,344
Construction-in-progress	55,249	85,916	-	-	(66,338)	74,827
Other tangible fixed assets	366	91	-	-	-	457
	₩1,214,825	141,433	(9,636)	(109,927)	-	1,236,695

[b] Changes in property, plant and equipment for the year ended December 31, 2004 are as follows:

	January 1, 2004	Acquisition	Disposal	Depreciation	Others	December 31, 2004
Land	₩ 301,909	258	(4,082)	-	1,769	299,854
Buildings	448,959	4,196	(1,812)	(19,029)	5,168	437,482
Structures	25,799	546	(194)	(1,946)	403	24,608
Machinery and equipment	317,497	2,097	(7,488)	(54,708)	59,983	317,381
Vehicles and other						
transportation equipment	8,030	3,717	(82)	(3,104)	-	8,561
Tools	7,813	830	(209)	(3,495)	2,961	7,900
Furniture and fixtures	45,499	38,564	(165)	(20,500)	26	63,424
Construction-in-progress	9,806	115,795	-	-	(70,352)	55,249
Other tangible fixed assets	362	4	-	-	-	366
	₩1,165,674	166,007	(14,032)	(102,782)	(42)	1,214,825

11. OFFICIALLY DECLARED VALUE OF LAND

The officially declared value of land at December 31, 2005, as announced by the Minister of Construction and Transportation, is ₩1,106,742. The officially declared value, which is used for government purposes, is not intended to represent fair value.

12. INSURANCE

Buildings, structures, machinery and inventories were insured against fire damage up to ₩778,390 as of December 31, 2005 with DongBu Insurance Co., Ltd. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

13. OTHER ASSETS

Other assets as of December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Long-term accrued interest	₩ 46	23
Long-term loans to affiliates	1,487	1,454
Other investment assets	18,994	20,341
	₩ 20,527	21,818

14. Other Current Liabilities

Other current liabilities as of December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Withholdings	₩ 20,286	7,685
Advance receipts	2,062	34,318
Unearned income	792	935
	₩ 23,140	42,938

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

15. EXCHANGEABLE BONDS

The details of exchangeable bonds as of December 31, 2005 and 2004 are as follows:

Issue date	Maturity date	Interest rate per annum	2005	2004
June 29, 2002	June 29, 2005	3%	₩ -	18,807
	Plus: long-term accrued expenses		-	1,347
	Less: discount upon issuance		-	(12)
			-	20,142
	Less: Current portion		-	(20,142)
			₩ -	-

For the year ended December 31, 2005, exchangeable bonds amounting to ₩16,890 were exchanged for 947,809 shares of treasury stock. In relation to the above transactions, the Company recognized a loss on redemption of exchangeable bonds of ₩15,077 and a gain on reissuance of treasury stock (a component of capital surplus) of ₩13,014 (note 18).

16. RETIREMENT AND SEVERANCE BENEFITS

Changes in the retirement and severance benefits for the years ended December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Estimated severance liability at beginning of year	₩ 109,386	94,885
Provision for retirement and severance benefits	30,442	52,629
Payments	(6,938)	(38,128)
Estimated severance liability at end of year	132,890	109,386
Severance benefits insurance deposit	(77,177)	(62,987)
Net balance at end of year	₩ 55,713	46,399

17. ASSETS AND LIABILITIES DENOMINATED IN FOREIGN CURRENCIES

Details of assets and liabilities denominated in foreign currencies as of December 31, 2005 and 2004 are as follows:
(In thousands of USD, JPY, HKD and EUR)

		Foreign currency		Won equivalent	
		2005	2004	2005	2004
Assets:					
Cash and cash equivalents	USD	7,639	1,014	₩ 7,738	1,058
	JPY	-	1,829	-	19
	HKD	-	1,460	-	196
Accounts receivable	USD	69,071	61,150	69,969	63,829
	JPY	5,228	-	45	-
	HKD	707	-	92	-
Other receivables	USD	46	563	46	587
Long-term deposits in escrow fund	USD	28,351	18,986	28,720	19,817
Total	USD	105,107	81,713		
	JPY	5,228	1,829		
	HKD	707	1,460	₩ 106,610	85,506
Liabilities:					
Accounts payable	USD	5,438	4,801		
	EUR	1,069	1,128	₩ 6,791	6,616

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

18. STOCKHOLDERS' EQUITY

Transactions in stockholders' equity accounts for the years ended December 31, 2005 and 2004 are summarized as follows:

	Common stock	Capital surplus	Retained earnings	Capital adjustments	Total
Balance at January 1, 2004	₩ 954,959	81,140	2,517,044	(737,810)	₩2,815,333
Net income	-	-	472,300	-	472,300
Unrealized gain on valuation of available-for-sale securities	-	-	-	(1,969)	(1,969)
Unrealized gain on valuation of equity method investments	-	-	-	169	169
Exchangeable bonds exchanged for treasury stock	-	173,878	-	386,368	560,246
Reissuance of treasury stock	-	22,313	-	68,428	90,741
Reacquisition of treasury stock	-	-	-	(501,075)	(501,075)
Retirement of treasury stock	-	-	(412,160)	412,160	-
Dividends	-	-	(221,528)	-	(221,528)
Balance at December 31, 2004	954,959	277,331	2,355,656	(373,729)	3,214,217
Net income	-	-	515,925	-	515,925
Unrealized gain on valuation of available-for-sale securities	-	-	-	17,425	17,425
Unrealized gain on valuation of equity method investments	-	-	-	1,011	1,011
Exchangeable bonds exchanged for treasury stock	-	13,014	-	15,356	28,370
Reissuance of treasury stock	-	9,698	-	13,653	23,351
Retirement of treasury stock	-	-	(114,998)	-	(114,998)
Dividends	-	-	(237,260)	-	(237,260)
Balance at December 31, 2005	₩ 954,959	300,043	2,519,321	(326,284)	₩ 3,448,039

In 2005, the Company reacquired 3,000,000 shares of treasury stock for ₩114,998 and retired those shares. Accordingly, as of December 31, 2005, the number of Company's shares issued decreased to 162,442,497 shares.

19. RETAINED EARNINGS

Retained earnings as of December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Legal reserve	₩ 602,937	602,937
Reserve for business expansion	698,881	698,881
Reserve for business rationalization	12,851	12,851
Reserve for research and manpower development	51,269	18,308
Reserve for loss on reissuance of treasury stock	26,646	-
Unconditional reserve	722,000	732,320
Unappropriated retained earnings at end of year	404,737	290,359
	<u>₩ 2,519,321</u>	<u>2,355,656</u>

(a) Legal Reserve

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

(b) Reserve for Business Expansion

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

(c) Reserve for Business Rationalization

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

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

(d) Other Reserves

Reserves for research and manpower development and loss on reissuance of treasury stock 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 stockholders.

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December 31, 2005 and 2004

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

20. CAPITAL ADJUSTMENTS

Capital adjustments as of December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Treasury stock	₩ (349,885)	(378,894)
Unrealized gain on valuation of available-for-sale securities	22,421	4,996
Unrealized gain on valuation of equity method investments	1,180	169
	₩ (326,284)	(373,729)

21. COMMITMENTS AND CONTINGENCIES

The Company has entered into a purchase contract with the National Leaf Tobacco Growers Cooperative Federation (the "Federation"), which has been given powers of attorney from tobacco cultivators for sales of their leaf tobacco. In addition, the Company has committed to the Federation to provide training programs to leaf tobacco growers and bear the cost for compensations to the Federation's employees.

Additionally, the Company entered into an agreement with the Federation to raise a fund with the target set at ₩410,000 by 2008 for the purpose of stabilizing tobacco production. Under the agreement, the Company is obligated to make up for the deficiency, should the fund fall short of the target. The Company estimates the deficiency at the end of each year and provides for a provision to fully fund the tobacco production stabilization target by 2008. The provision for the fund deficiency for each of the years ended December 31, 2005 and 2004 amounted to ₩18,082 and the reserve for the fund as of December 31, 2005 and 2004 amounted to ₩55,753 and ₩37,671, respectively. In addition, effective December 30, 2004, the levy per pack of cigarettes, which was imposed for the purpose of raising the fund, was increased to 15 Korean Won from 10 Korean Won. However, due to uncertainty as to the use of the 5 Korean Won increase per pack of cigarettes, the Company did not take into account the effect of this increase in estimating the deficiency.

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

As of December 31, 2005, tobacco lawsuits claiming damages of ₩1,282 were filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligation to notify smokers of the potential health hazards of smoking. The final outcome of the litigation cannot be predicted as of this audit report date. The amount of the liability the Company may ultimately have with respect to the litigation cannot be reasonably estimated as of December 31, 2005.

As of December 31, 2005, the Company has provided to the National Agricultural Cooperative Federation ("NACF") guarantees in the amount of ₩21,306 for the customers who made a financing agreement with the NACF.

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

As of December 31, 2005, the Company's accounts receivable arisen from export of cigarettes was insured against dishonor up to USD 28,500 by an export guaranty insurance with the Export-Import Bank of Korea.

22. BUILDING LOTTING-OUT CONSTRUCTION CONTRACTS

(a) Building lotting-out construction contracts as of December 31, 2005 are summarized as follows:

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

(b) Details of installment sales as of December 31, 2005 are summarized as follows:

	Expected contract amount	Confirmed contract amount	Recognized revenue		Unrecognized revenue
			Prior to 2005	2005	
Multi-purpose buildings in Dongdaemoon area	₩ 164,233	159,589	65,479	78,313	₩ 20,441
Apartment buildings in Suwon	26,700	17,002	-	17,002	9,698
	₩ 190,933	176,591	65,479	95,315	₩ 30,139

(c) Cost of installment sales of store units for years ended December 31, 2005 and 2004 are as follows:

	2005	2004
Outsourcing cost	₩ 40,835	16,361
Land and completed buildings:		
Beginning of the year	5,856	,453
End of the year	(9,153)	(5,856)
Cost of sales of buildings	₩ 37,538	15,958

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

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

	Provider	Amount
Multi-purpose buildings in Dongdaemoon area	Seoul Guarantee Insurance Co., Ltd.	₩ 13,222
Apartment buildings in Suwon	Korea Specialty Constructor Financial Cooperative	871

23. INCOME TAXES

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

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

The Korean government reduced the corporate income tax rate from 29.7% to 27.5% beginning in 2005.

(b) The components of income tax expense for the years ended December 31, 2005 and 2004 are summarized as follows:

	2005	2004
Current income tax expense	₩ 182,343	289,596
Deferred income tax expense	27,685	34,060
Income tax expense charged directly to the stockholders' equity	(17,119)	(82,886)
	₩ 192,909	240,770

(c) The provision for income taxes calculated using the normal tax rates differs from the actual provision for the years ended December 31, 2005 and 2004 for the following reasons:

	2005	2004
Provision for income taxes at normal tax rate	₩ 194,916	211,768
Tax effects of permanent differences, primarily		
Additional income taxes for prior years	1,209	33,516
Tax credit	(4,513)	(8,116)
Other	1,297	3,602
Actual provision for income taxes	₩ 192,909	240,770

The effective tax rates, after adjustments for certain differences between amounts reported for financial accounting and income tax purposes, were approximately 27.2% and 33.8% for the years ended December 31, 2005 and 2004, respectively.

(d) The tax effects of temporary differences that result in significant portions of the deferred income tax assets and liabilities as December 31, 2005 and 2004 are presented below:

	2005	2004
Deferred income tax assets:		
Provision for severance and retirement benefits	₩ 22,413	22,016
Loss on valuation of inventories	3,460	4,654
Depreciation	5,703	5,609
Bad debts	8,690	5,827
Impairment losses on property, plant and equipment	1,650	2,589
Present value discounts	6,374	9,284
Provision for Tobacco Production Stabilization Fund	15,332	10,360
Long-term deposits in escrow fund	6,035	6,603
Other	3,448	1,868
Total deferred tax assets	<u>73,105</u>	<u>68,810</u>
Deferred income tax liabilities:		
Accrued income	1,269	1,070
Deposit for severance and retirement benefits insurance	21,224	17,321
Reserve for research and manpower development	12,375	14,099
Equity-method investment securities	72,568	52,736
Reserve for losses on reissuance of treasury stock	7,328	7,328
Available-for-sale securities	8,506	-
Treasury stock	16,521	-
Other	66	60
Total deferred tax liabilities	<u>139,857</u>	<u>92,614</u>
Net deferred tax liabilities	(66,752)	(23,804)
Less: Current portion	<u>10,970</u>	<u>-</u>
Deferred tax liabilities	<u>₩ (77,722)</u>	<u>(23,804)</u>

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

(e) Effective January 1, 2005, the Company adopted SKAS No. 16, "Income Taxes". In accordance with SKAS No. 16, deferred taxes are recognized on the temporary differences related to unrealized gains and losses that were reported as a separate component of stockholders' equity and the tax effect of the changes in these accounts is charged directly to the separate component of stockholders' equity. Income taxes charged directly to the separate component of stockholders' equity for the year ended December, 31, 2005 are as follows:

	Amount
Gain on reissuance of treasury stock	₩ (8,613)
Unrealized gain on valuation of available-for-sale securities	(8,506)
	₩ (17,119)

24. EARNINGS PER SHARE

(a) Basic earnings per share

Basic earnings per share for the years ended December 31, 2005 and 2004 are as follows:

	2005	2004
Net income per accompanying statements of income	₩ 515,925	472,300
Weighted-average number of shares outstanding	147,535,658	148,391,341
Basic earnings per share in Korean Won	₩ 3,497	3,183

(b) Diluted earnings per share

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

	2005	2004
Net income per accompanying statements of income	₩ 515,925	472,300
Add: interest on exchangeable bonds, net of tax	172	7,808
Diluted net income	516,097	480,108
Weighted-average number of outstanding shares	47,823,188	161,077,325
Diluted net earnings per share in Korean Won	₩ 3,491	2,981

25. DIVIDENDS

Details of dividends for the years ended December 31, 2005 and 2004 are as follows:

	2005	2004
Cash dividends, planned but not declared	₩ 249,703	237,260
Net income	515,925	472,300
Dividends as a percentage of net income	48.40%	50.24%

26. ADDED VALUE

The components of manufacturing costs and selling and administrative expenses which are necessary in calculating added value for the years ended December 31, 2005 and 2004 are as follows:

	2005	2004
Wages and salaries	₩ 293,666	286,317
Provision for severance benefits	30,442	52,628
Employee welfare	23,890	50,149
Rent	11,133	7,621
Depreciation	110,939	103,414
Taxes and dues	26,002	13,375
	₩ 496,072	513,504

// NOTES TO FINANCIAL STATEMENTS ///

December 31, 2005 and 2004

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

27. SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

The details of selling and administrative expenses for the years ended December 31, 2005 and 2004 are as follows:

	2005	2004
Salaries	₩ 172,618	164,150
Provision for severance benefits	18,309	17,792
Welfare	13,124	28,265
Travel	4,532	3,998
Communications	3,718	3,471
Utilities	5,230	3,280
Taxes and dues	23,795	11,080
Supplies	2,768	2,847
Uniforms	220	88
Rent	3,720	2,953
Depreciation	41,504	37,741
Amortization	993	614
Repairs and maintenance	4,747	4,260
Vehicles	6,580	5,088
Insurance	582	474
Commissions	46,921	37,241
Transportation and warehousing	22,561	25,528
Entertainment	620	532
Conferences	2,717	1,862
Advertising	146,850	152,550
Training	7,804	6,597
Prizes and rewards	2,772	1,829
Cooperation	475	274
Normal research and development	12,932	9,634
Sample	799	2,911
Bad debts	220	730
Miscellaneous	597	789
	₩ 547,708	526,578

28. SUBSEQUENT EVENTS

On January 25, 2006, the board of directors of the Company decided to retire 3,000,000 shares of treasury stock and, if the retirement is completed, the number of the Company's shares issued will decrease to 159,442,497 shares.

// INTERNAL ACCOUNTING CONTROL SYSTEM REVIEW REPORT ///



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The Board of Directors and Stockholders

KT&G Corporation:

We have reviewed the report of management's assessment of internal accounting control system ("IACS") of KT&G Corporation (the "Company") as of December 31, 2005. In accordance with Article 2-2 of the Act on External Audit for Stock Companies (the "External Audit Law") of the Republic of Korea, the Company's management is responsible for assessing the design and operating effectiveness of its IACS. Our responsibility is to review management's assessment and issue a report based on our review.

We conducted our review in accordance with Article 2-3 of the External Audit Law. Our review included inquiries of management and employees, inspection of related documents and evaluation of the operating effectiveness of the Company's IACS. We did not perform an audit of the Company's IACS and accordingly, we do not express an audit opinion.

As this report is based on Interim Guidelines on Auditors' Review and Report on Management's Assessment of IACS, issued by the Korean Audit Standards Committee on March 29, 2005, it applies only from that date until the date the Final Standard for Management's Assessment of IACS and Final Standard for Auditors' Review and Report on Management Assessment of IACS become effective. A review performed based on the final standards may have different results and accordingly, the content of our report may be different.

Based on our review, no material weakness in the design or operating effectiveness of the Company's IACS under Article 2-2 of the External Audit Law as of December 31, 2005 has come to our attention.

This report applies to the Company's IACS in existence as of December 31, 2005. We did not review the Company's IACS subsequent to December 31, 2005. 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.

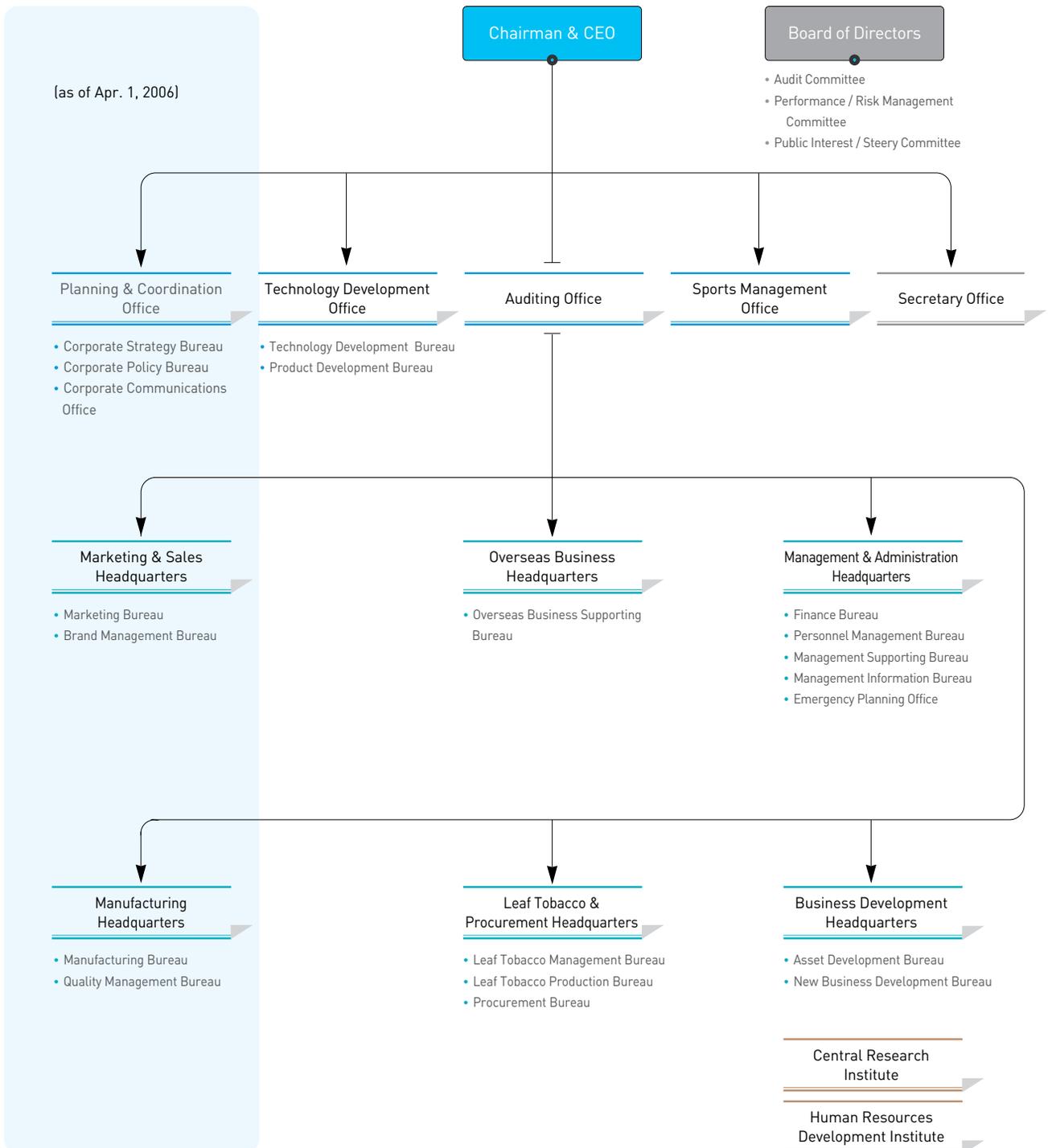
KPMG Samjong Accounting Corp.

Seoul, Korea
January 13, 2006

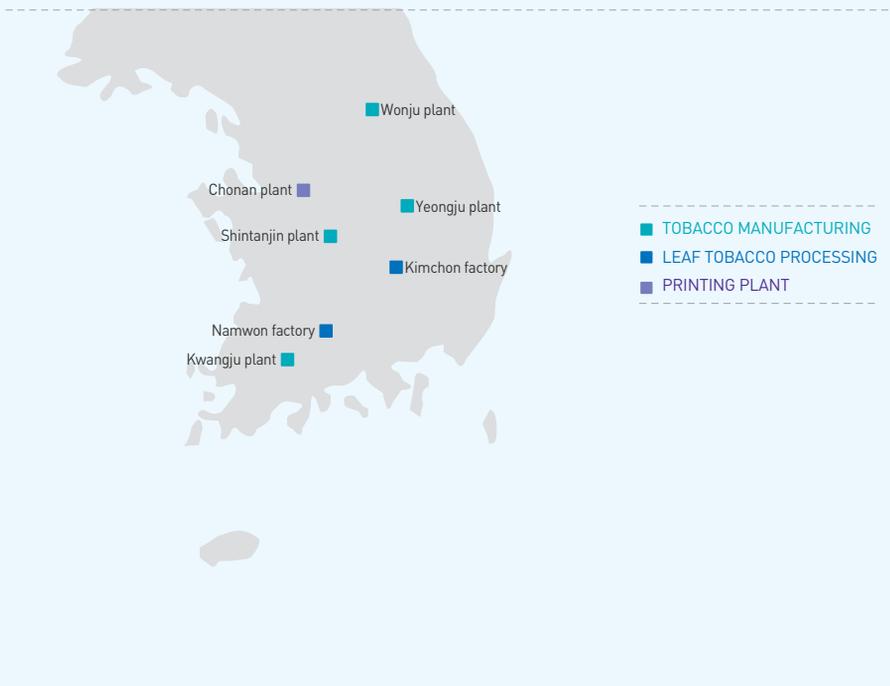
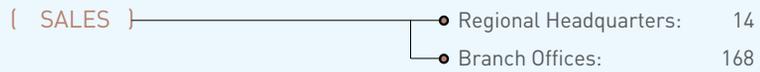
Notice to Readers

This report is annexed in relation to the audit of the financial statements as of December 31, 2005 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.

// ORGANIZATION CHART ///



// MANUFACTURING & SALES NETWORK ///



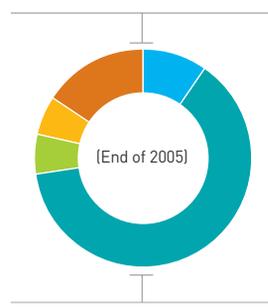
// INVESTOR INFORMATION ///

• Capital Stock	KRW955 billion
• Number of Authorized Shares	800,000,000
• Number of Shares Issued	162,442,497
• Shareholders' Equity	KRW3,214 billion

(End of 2005)

(OWNERSHIP STRUCTURE (%))

■ Treasury Stocks	9.6%
■ Foreign Investors	63.1%
■ Industrial Bank of Korea	5.9%
■ ESOP	5.8%
■ Others	15.7%



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● FORWARD-LOOKING STATEMENTS ●

KT&G Annual Report 2005 contains forward-looking statements about the Company, including descriptions of plans or objectives of its management for future operations, products or services, and forecasts of its revenues, earnings or other measures of economic performance.

Forward-looking statements, by their nature, are subject to risks and uncertainties. A number of factors-many of which are beyond the Company's control-could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. Some of these factors include certain credit, market, operational, liquidity and interest rate risks associated with KT&G business and operations.

Forward-looking statements speak only as of the date they are made. KT&G does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events.



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