This is KT&G

2007 ANNUAL REPORT

KT&G Corporation

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KT&G's 2007 Annual Report contains forward-looking statements to assist in the understanding of future financial performance and business plans. Discussion or implication of future management plans in this report incorporates the known and unknown risk factors. However, it should be noted that actual results may differ materially from those expressed in forward-looking statements due to factors beyond the Company's control.

Statements on the past and future in this section cannot be construed as the Company's promise or claims, and estimations and projection can alter due to the operating environment. Therefore, users of this report should take reasonable care when relying on the information contained in this report. KT&G does not assume responsibility on the accuracy or completeness of information contained or implied in this report. Estimations, plans and projections are based on conditions as of the day this report was prepared. We do not bear responsibility of providing additional information on future events. The term 'Company' used herein without any other qualifying description refers to 'KT&G.'

KT&G is building a leading global company through sustainable management

KT&G has implemented bold reforms and innovation activities since the privatization in 2002 and these efforts, in turn, have resulted in business model diversification and solid performance. KT&G promotes active communication with stakeholders and practices sustainable management as it pursues its vision of growing into a leading global company.

All business activities at KT&G are guided by the core beliefs of righteousness, enlightenment and companionship which serve as the basis of its corporate philosophy. Adherence to the core beliefs is a key reason that KT&G has been acknowledged for sound corporate governance, integrity, transparency and business innovation. As a responsible corporate citizen, KT&G has a firm commitment of sharing created value with customers, shareholders, employees and society.

KT&G remains the undisputed leader in the domestic tobacco market. For fiscal 2007, the company recorded net sales of KRW 2,412.7 billion and net profit of KRW 661.2 billion on sales volume of 100.9 billion sticks. To face up to the competition from foreign tobacco companies operating in Korea, KT&G has continued to enhance product quality and upgrade production facilities. With ongoing technological innovation and new product development, KT&G has upheld its domestic leadership. Moreover, the company has reinforced its growth potential through overseas expansion centered on its flagship brand, Esse. KT&G products are now exported to more than 40 countries including Russia, CIS nations, Middle East, Central Asia, China and Southeast Asia.

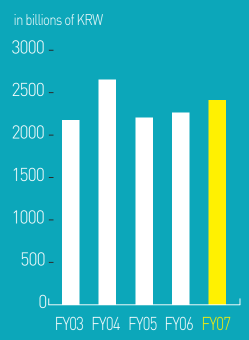
Driven by the goal of increasing corporate value through growth, KT&G constantly strives for change and innovation to strengthen core competencies and to discover and cultivate future growth engines. With a balanced business portfolio, KT&G is growing into a global enterprise via growth, profitability, stability and sustainability.

Financial Highlights

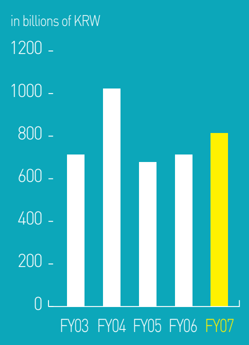
	FY03	FY04	FY05	FY06	FY07
in billions of KRW					
Net sales	2,179	2,653	2,209	2,263	2,413
Operating profit	712	1,022	677	714	814
Net profit	460	472	516	650	661
Total assets	3,887	3,885	3,964	3,668	3,978
Total liabilities	1,072	671	516	623	836
Total shareholders' equity	2,815	3,214	3,448	3,046	3,142

	FY03	FY04	FY05	FY06	FY07
%, KRW					
ROA	11.6	12.2	13.0	17.7	17.3
ROE	18.5	15.7	15.0	21.3	21.4
Operating profit margin	32.7	38.5	30.6	31.5	33.8
EBITDA margin	36.7	39.9	35.7	36.9	39.4
EPS	3,728	3,180	3,497	4,608	4,992
Payout ratio	48.2	50.2	48.4	49.2	51.5
DPS	1,600	1,600	1,700	2,479	2,600
Liabilities-to-equity ratio	38.1	20.9	15.0	20.4	26.6
Net debt-to-equity ratio	17.4	0.6	-	-	-

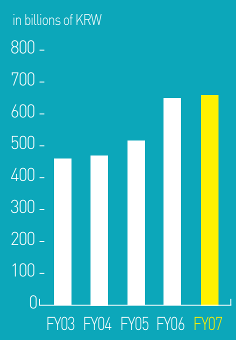
■ NET SALES



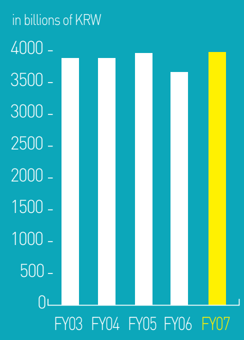
■ OPERATING PROFIT

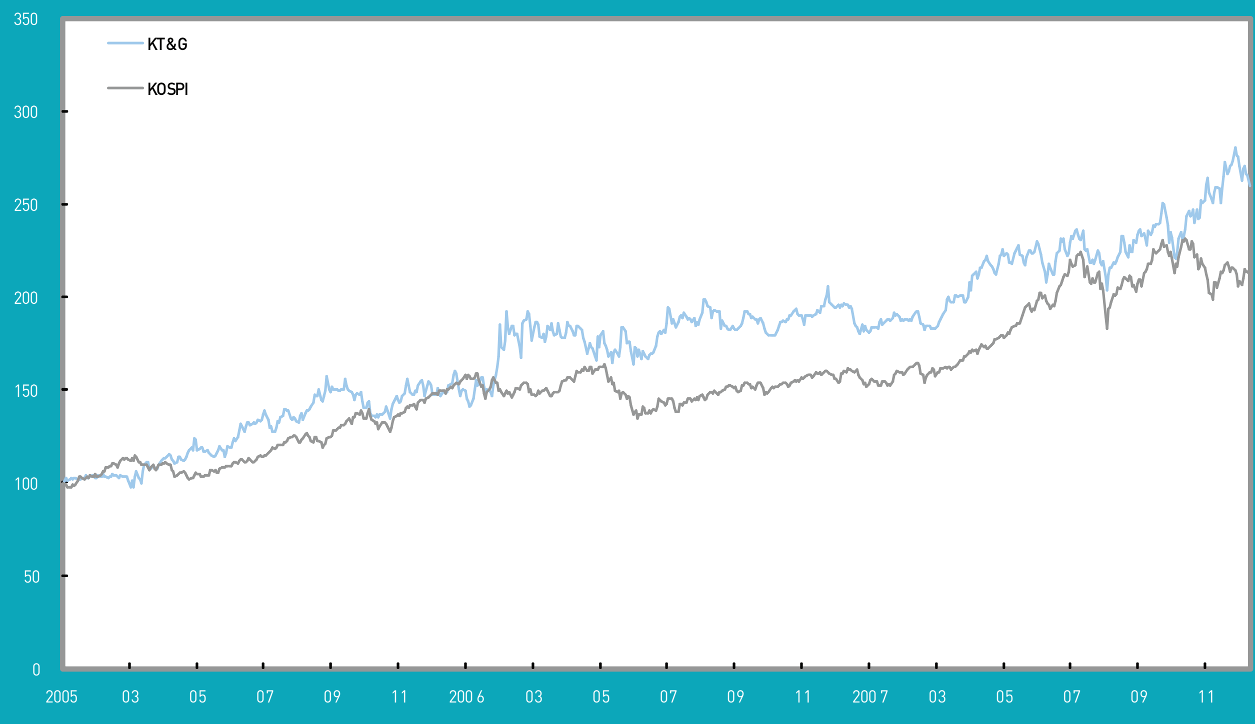


■ NET PROFIT



■ TOTAL ASSETS





(January 1, 2005=100)

Korea Tomorrow & Global

Guided by a clearly defined vision, KT&G continues to embrace challenge to grow into a global company that creates a better future for Korea and the rest of the world.

Korea Tobacco & Ginseng

KT&G aspires to global excellence in the tobacco and ginseng sectors which represent the core competencies of the company.

Korea Trust & Goodwill

KT&G fulfills its responsibilities
to society to gain the trust of
stakeholders and promote sustainability

Korea Transparency & Growth

KT&G practices fair and transparent management to achieve growth and enhance intrinsic value.

Letter to the Stakeholders

With a view to propelling growth of the overall KT&G Group, we will pursue a bold expansion strategy centered on the core businesses. Our objective is to increase value for our shareholders through sustained growth.

Over the course of 2007, KT&G made further strides towards its vision of growing into a leading global tobacco company as it pursued management objectives aimed at maximizing corporate value.

In the cigarette business, we are building on the success of our core brands, Esse, Raison and The One, and carving out a new market for super premium products to sustain sales and earnings growth in our domestic operations. Turning to overseas, our manufacturing plants in Turkey and Iran are scheduled for completion in the first half of 2008. These facilities will provide added impetus to our overseas expansion drive and help us make greater inroads in the growing markets of Russia and Eastern Europe.

Our ginseng business continues to produce robust sales and profits driven by the launch of high value-added products and more aggressive marketing. Standing on firmer financial ground, the pharmaceutical business has been overhauled to serve as the platform for our bio business.

Based on our mid to long term master-plan, we repurchased and cancelled 4 million shares in June 2007. Subsequently, we went ahead with the repurchase and retirement of another 2.7 million shares. Moreover, we have reinforced our ability to execute our mid to long term strategy by innovating our organizational and personnel structure and by fostering a performance-based corporate culture.

For fiscal 2007, KT&G recorded net sales of KRW 2,412.7 billion, operating income of KRW 814.4 billion, and net income of KRW 661.2 billion. During the year, KT&G shares appreciated by 41% in value and market capitalization exceeded the KRW 11 trillion mark for the first since listing.

Looking beyond its success to date, KT&G constantly strives to create a brighter and stronger future. In tandem with this approach, we have decided on the following action plans for 2008 under the theme of "maximizing corporate value through dynamic growth."

For the domestic cigarette business, we have reformulated our business objectives to promote strategic brands and target the high-end market. Our emphasis will be on enhancing sales and profitability and ensuring efficient resource allocation. As for our overseas business, we aim to reinforce earnings growth in the Middle East and Central Asia. With the plants in Turkey and Iran set to commence production this year, we plan to launch relevant brands tailored to the preference of local customers. We will also pursue volume growth by building a market management system and by discovering new markets.

In the ginseng segment, we will promote the sale of high-end products and expand our distribution network in key markets with respect to our domestic operations. Turning to overseas, we will extend our distribution channels in China, Taiwan and Japan, and set up a product portfolio optimized for local consumer trends.

With a view to propelling growth of the overall KT&G Group, we will pursue a bold expansion strategy centered on the core businesses. Our objective is to increase value for our shareholders through sustained growth.

Guided by the vision of growing into a leading global enterprise, KT&G will build management systems that satisfy globally recognized standards and secure a foothold in key markets around the world.

KT&G is committed to serving shareholders by ensuring the ultimate in corporate value and continued growth. We look forward to another year of progress for KT&G and all of our stakeholders.

Thank you.

Chairman & CEO
Young-kyoon Kwak

2007 At a Glance

KT&G RECOGNIZED FOR OUTSTANDING IR AT THE 7TH KOREA IR AWARDS

On November 23, KT&G received the Outstanding IR Company Award presented by the Korea IR Association at the 7th Korea IR Awards. This was the third consecutive year the company received the honor. The award winners are selected by a committee comprising experts from various fields based on an objective and rigorous evaluation process. The award shows that KT&G is being recognized for its professional and systematic IR activities aimed at promoting benefits for the company, shareholders and investors.

CORESTA STUDY GROUP MEETING

KT&G hosted the CORESTA Study Group Meeting held on Jeju Island from September 30 to October 4. CORESTA stands for "Centre de Cooperation pour les Recherches Scientifiques Relatives au Tabac (Cooperation Center for Scientific Research Relative to Tobacco)." Founded in 1956, CORESTA promote international cooperation in scientific research related to tobacco and currently has 196 member companies from 52 nations. Hosting the CORESTA Study Group Meeting presented an opportunity for KT&G to reinforce its presence in the global tobacco market and foster closer ties with related international organizations.

TFWA WORLD EXHIBITION

KT&G took part in the TFWA (Tax Free World Association) World Exhibition held in Cannes, France. The company decided to participate in the event for the second time after its success in the previous year. After the 2006 exhibition, KT&G managed to export 120 million sticks of the Esse brand to five Eastern European nations, Turkey, Malaysia and Africa. TFWA 2007 gave KT&G a chance to seek new markets and clients. CEO Young-kyoon Kwak was on hand to personally meet with buyers during the exhibition.

CARS DONATED TO SOCIAL WELFARE ORGANIZATIONS

KT&G Social Welfare Foundation, which introduced a new trend in corporate social contribution with the "Happiness Network," donated 100 mini cars (worth KRW 1 billion in total) to 100 social welfare organizations across Korea. The foundation will continue the mini car donation drive which was launched in 2004 after studying the extent of such support provided by other entities and the needs of social welfare organizations.

OPENING OF CULTURE PLANET SANGSANGMADANG

KT&G opened the Culture Planet Sangsangmadang on September 7. The multidisciplinary arts center includes a performance hall, movie theater, art square and gallery. Located on Picasso Street near Hongik University, an area widely regarded as the artistic center of Seoul, the complex is expected to serve as a new "cultural playground" promoting diverse arts and cultural exchanges.

KGC SIGNS ENDORSEMENT DEAL WITH

PRO-GOLFER K.J. CHOI

Korea Ginseng Corp. (KGC) signed a one-year endorsement deal with pro-golfer K.J. Choi. Also known as the "Tank," Choi is making a name for himself on the world stage with his success on the PGA tour. His image as a family man and the total concentration and enduring stamina he demonstrates on the golf course is deemed to be the perfect fit for KGC's Cheong-Kwan-Jang brand.

KT&G INDUCTED INTO KCGS HALL OF FAME FOR EXCELLENCE IN CORPORATE GOVERNANCE

On June 22, KT&G was inducted into the Hall of Fame for good corporate governance co-sponsored by the Korea Exchange (KRX) and The Korea Corporate Governance Service (KCGS). The honor is bestowed on a company that receives the Award of Excellence for corporate governance for three consecutive years. KT&G was a winner of the award from 2004 to 2006. Outstanding governance has played a major role in enhancing the value of KT&G.

UNVEILING OF SOCIAL CONTRIBUTION SYMBOL

KT&G unveiled a new symbol representing the company's unique identity for social contribution. The release is in line with the company's move to consolidate all social contribution activities. Signifying hope and dream, the symbol is a visual representation of imagination soaring into the sky. The symbol, which was designed to be used in conjunction with the existing Sangsangmadang image, will be utilized in all media related to social contribution.

KGC WINS GRAND PRIZE AT 2007 KOREA CONSUMER TRUST AWARDS

On May 10, Korea Ginseng Corp. (KGC) received the Grand Prize at the 2007 Korea Consumer Trust Awards jointly sponsored by the Korea Customers' Forum and Korea Economic Daily. The winners were chosen from among 407 companies providing consumer goods, durable goods and services based on consumer polls. KGC received the highest score among health supplement producers.

SIGNING OF KOREA-CHINA MEMORANDUM

KT&G signed a memorandum with the China National Tobacco Corporation(CNTC) to maintain mutual cooperation and exchanges. The two sides have upheld close ties and have been signing the "Korea-China memorandum" every year since 2001. KT&G expanded into China, the world's largest tobacco market, seven years ago.

KT&G SETS UP ITS FIRST OVERSEAS PLANT IN TURKEY

KT&G decided to set up a plant in Turkey, a strategic center of Europe, as part of its strategy for overseas direct investment aimed at strengthening its presence in global markets. As KT&G's first factory outside of Korea, the plant will be equipped with ultra-modern facilities and have annual production capacity of 2 billion sticks. Construction is set to be completed by April 2008.

VISION & ZEST

KT&G pursues to build a globally competitive business

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Vision & Strategy

CORPORATE VISION

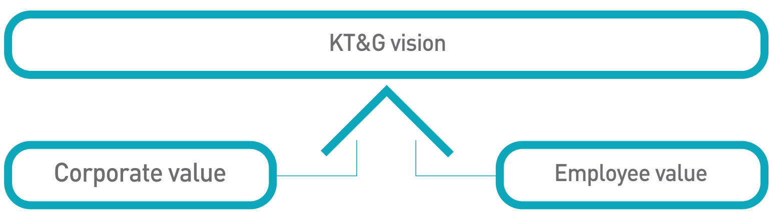
Vision
Emerge as a leading global company by maximizing corporate value

KT&G aims to grow into a leading global company by maximizing corporate value.

In the tobacco business, which serves as the "value base," KT&G will invest in R&D, brand development and marketing while pursuing quantitative and qualitative growth in overseas operations. The ginseng business (Korea Ginseng Corp.) will be nurtured as the "value grower" to propel the growth of KT&G. For pharmaceuticals (Yungjin Pharm.), KT&G will pursue bold restructuring and synergy creation with affiliates to foster this business as the "value catalyst."

The efforts of each individual to realize their full potential and systems that support such efforts are pivotal for "employee value." KT&G will nurture people who meet the needs of the globalization era and practice human-oriented management. Along with management accountability, we will focus on shaping a corporate culture that promotes creativity and innovation among all employees.

KT&G will build a balanced business portfolio spanning tobacco, health/functional foods and pharmaceuticals with the vision of growing into a global leader boasting growth, profitability, stability and sustainability by the year 2010.



Vision & Strategy

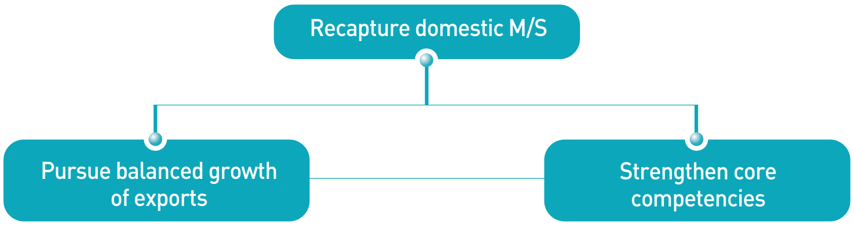
BUSINESS STRATEGY

Under our mid to long term master plan of growing into a global leader, KT&G has adopted three key strategies: rebuilding the business portfolio, maximizing the value of each business segment, and returning wealth to shareholders. The action plans to maximize the value of each segment of the business portfolio, namely tobacco, health/functional foods and pharmaceuticals, are explained below.

In the tobacco business, KT&G will invest in R&D, brand development and marketing while pursuing quantitative and qualitative growth overseas. The tobacco segment will serve as our "value base" as we uphold our dominance in the domestic market while pursuing growth as a profitable global tobacco company. Our operating targets are sales of KRW 3,200 billion and operating income of KRW 970 billion by 2010. Specifically, domestic tobacco operations will serve as our foundation, with targeted sales of KRW 2,100 billion and operating income of KRW 700 billion on sales volume of 60 billion sticks. We are aiming for a domestic market share of 76%. From the overseas business, which we are cultivating as a strategic growth engine, we are targeting sales of KRW 700 billion and operating income of KRW 200 billion on sales volume of 50 billion sticks.

To achieve these targets, KT&G will implement aggressive sales and marketing to recapture lost share in the domestic market. At the same time, we will pursue both growth and profitability in overseas markets and make bold investments to secure key competencies.

KT&G will nurture health/functional foods (ginseng) as the "value grower." We plan to aggressively expand this business through R&D on red ginseng and new materials and M&A in order to capitalize on the fast growing demand for health supplements. Our goal is to emerge as a leading provider of health/functional foods in the global marketplace. Our operating targets for 2010 are set at sales of KRW 1,000 billion and operating income of KRW 260 billion. Our objectives in this segment are aggressive expansion, domestic leadership in red ginseng, and promoting overseas sales of red ginseng products.



I STRATEGY TO MAXIMIZE VALUE IN TOBACCO BUSINESS I

The pharmaceutical business will serve the role of "value catalyst." KT&G will implement rigorous business and asset restructuring to overhaul the business model and maximize economic value. Key tasks include boosting sales productivity and creating synergies with KGC and other affiliates to increase competitiveness. Our target sales and operating income in the pharmaceutical business are respectively KRW 230 billion and KRW 23 billion by the year 2010. Our sights are on joining the top-10 pharmaceutical companies in Korea through the promotion of core products.

Lastly, the company has formulated several principles and strategies to return wealth to shareholders. Over the next 2~3 years, we will concentrate on enhancing our organizational strength and economic value. We will continue to create value over the long run to meet the expectations of our shareholders by seeking an optimal balance between reinvesting for future growth and returning wealth to shareholders. While pursuing sustainable growth and shareholder value, we will also give balanced consideration to all stakeholder groups and fulfill our responsibilities to our communities.

We will faithfully execute our mid to long term plan to increase economic value in each business sector while maintaining our shareholder-oriented policy. Our drive to discover and nurture future growth engines will persist to ensure continued creation of value amid uncertainties in the operating environment. In addition, we will carry out more organized and vigorous IR activities so that the value of subsidiaries such as KGC is adequately reflected in KT&G's share price. We are also mindful to our role as responsible corporate citizen. Approximately 2% of revenues will be channeled toward social contribution activities through the KT&G Social Welfare Foundation and the company's in-house programs based on our pursuit of "companionship," one of the three core beliefs shaping our corporate philosophy.

Pursue aggressive expansion

Execute strategy to strengthen leadership position

Build the platform for overseas expansion

STRATEGY TO MAXIMIZE VALUE IN HEALTH/FUNCTIONAL FOOD BUSINESS

Vision & Strategy

BUSINESS STRATEGIES ON THE WAY

Rebuilding our business portfolio holds the key to sustainable management as we strive to achieve continued growth and value creation in the face of stagnation of the tobacco market. Stricter smoking regulations, health-consciousness and heated competition with global peers have somewhat weakened our dominant market position in the domestic cigarette business. Meanwhile, our new emerging business of health/functional foods is enjoying robust growth, driven by the same trend for better health and well-being. To actively and efficiently respond to the changing business conditions, KT&G is reorganizing its business structure and pursuing diverse strategy roadmaps to maximize competitiveness in each segments. Our achievements in 2007 were as follows.

KT&G defines the tobacco business as its "value base." In order to maximize value and increase/maintain domestic market share, the company is striving to upgrade product quality through R&D, develop next-generation products, differentiate its brand, nurture brands to compete against major global makers, and diversify distribution channels. Regarding its overseas tobacco business which has established itself as an important growth segment, KT&G has prepared various growth strategies that include forging ahead strategic alliances with local companies, nurturing global brands, building a brand portfolio to satisfy local tastes, and expanding marketing resources and distribution channels.

STRATEGY ROADMAP FOR TOBACCO BUSINESS

'06 to early '07

Strengthen core competencies
- Prepare foundation for organizational reforms and for boosting capabilities of human resources
- Increase profits by improving overseas performance
- Enhance work efficiency through process improvements

Early '07 to '09

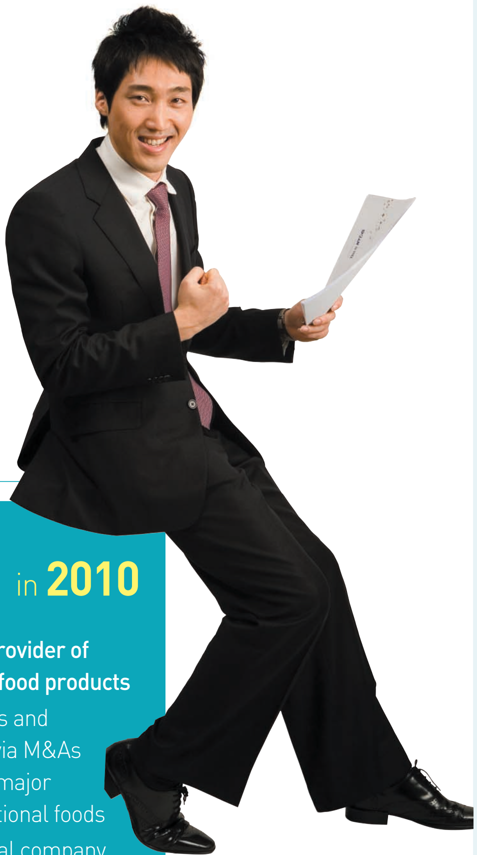
Actively pursue recovery of market share and qualitative reform in overseas business
- Implement domestic cigarette brand/marketing strategy (build channel management system and boost brand management in accordance to market changes)
- Induce qualitative change for balanced growth and profits in international tobacco business
- Execute major facility investments to boost product quality
- Increase R&D investments and strengthen competencies

KT&G in 2010

Global tobacco company
- Achieve domestic market share of 76% and strengthen market position through pro-active marketing
- Become a global company through balanced growth from overseas OEM, strategic alliances and joint ventures

- Generate steady cash flow by securing optimal profitability

With the health/functional food business making rapid strides as the "value grower," KT&G is maintaining its leadership position by boosting marketing capabilities and going forward with bold investments to secure a stable supply of raw ginseng. In particular, KT&G has adopted a strategy spanning the development, distribution and marketing of its red ginseng products. The strategy includes developing a diverse range of products, leading the specialty market for highly functional, efficient products, expanding R&D outsourcing, setting up an R&D center devoted to health/functional foods, and securing various distribution channels and franchise-type multi-purpose stores. Additionally, KT&G has mapped out an aggressive strategy for the international markets which involves establishing tailored strategy for each overseas markets and may consider building a one-stop system in China for cultivation, production, manufacturing and sales.



STRATEGY ROADMAP FOR HEALTH/FUNCTIONAL FOOD BUSINESS

'06 to early '07

Build foundation and strengthen core competencies

- Build organizational and work capabilities and R&D infrastructure
- Step up marketing of red ginseng products
- Concentrate investments on domestic/overseas ads and promotions, rebuild product portfolio

Early '07 to '09

Expand business and target international markets

- Secure distribution channels and increase marketing activities
- Establish/operate multi-purpose stores
- Strengthen market dominance by increasing overseas sales
- Execute bold investments to boost R&D capabilities

KT&G in 2010

Comprehensive provider of health/functional food products

- Expand business and pursue growth via M&As to emerge as a major provider of functional foods
- Emerge as global company by expanding international ginseng business

- Lead value growth of KT&G

Business Review

TOBACCO

Product Portfolio

KT&G is continuing to launch new products while upgrading the quality of existing products to satisfy the ever-changing tastes of consumers. We recognize that in addition to the taste and flavor of cigarettes, product concept and design weigh significantly with the customer satisfaction. With that in mind, KT&G is providing diverse products of superior quality featuring unique concepts and designs to deliver maximized satisfaction to customers.

NEW PRODUCTS

Raison Red "Raison Red" is a 5.5mg high-tar brand, an extension of the existing Raison line comprising 1mg and 3mg tar products. High quality tobacco leaves were selected to produce a deep yet clean cut taste. The package design features the colors of pearl red and wine to express its smooth and sophisticated taste, in addition to distinguishing it from previous product packaging using blue, green and black. The launch of Raison Red completes a strong brand portfolio in the regular cigarette market, and is expected to boost KT&G's competitiveness and market share.

Esse Soun 0.5 Consumers continue to show a preference for ultra low-tar, super-slim cigarettes. In response, KT&G introduced "Esse Soun 0.5" on May 2, 2007, as an extension of the Esse brand, which claims very strong brand power. Esse Soun 0.5 employs the existing bamboo design but uses a silver color to convey a smooth and sophisticated image. Vanilla flavor was added to heighten the smooth taste and aroma particular to Esse.

Esse Blend In 3 Esse, KT&G's representative brand, features 1, 2, 4, 5, and 6mg tar versions. A 3mg edition, "Esse Blend In 3," is the latest addition. Using soft colors, the new product realizes the characteristic mild and clean aftertaste of the Esse brand in a 3mg version which is expected to satisfy the diverse tastes of consumers.

Bohem Cigar No.1/No.6 Cigars remain largely unfamiliar to Korean consumers. KT&G launched the "Bohem Cigar," a "fusion" product which blends cigar leaves with regular cigarettes, to reinterpret cigars to better follow modern trends. The word "Bohem" is short for Bohemian which symbolizes freedom and passion. "Cigar + No" directly refers to product characteristics included in cigar leaves.

ESSE SOUN 0.5

Esse Golden Leaf (GL), Esse Golden Leaf Special Edition (SE) KT&G launched the "Esse GL" and "Esse GL SE" which employ the top quality leaf, "golden leaf," to provide premium value and rarity in the market. Containing 3.0mg tar, the Esse GL line offers a smooth and mild flavored cigarette in eye-catching black and silver packaging which includes the Korean calligraphy of poet Kim So-wol's famous work, "My Love, My Friend" for an individual look.

RENEWAL LAUNCH

The One 1mg KT&G re-released two new and improved versions of The One – "The One 1mg" and menthol "The One Fresh," on March 21. While using the same ring motif from "The One 0.5," The One 1mg employs a cool aqua blue and The One Fresh a crisp green to distinguish themselves while also conforming to the general look of The One brand.

This Plus First introduced in January 1991, "This Plus" remains a steady seller thanks to its appealing taste and price. However, the packaging required a facelift to keep up with the changing times. Through the design renewal, This Plus will continue to cement its reputation as a leading player in the 84mm, low to mid-priced cigarette segment.

Esse Family (Classic, Light, One, Menthol, SG) The Esse brand was first launched in 1996 and since 2003 has maintained its No.1 status in the domestic cigarette market. KT&G conducted a design renewal of the brand to update its image and keep it looking fresh. Of the eight Esse offerings, with the exception of Esse Soun and Esse Soun 0.5, the other six (Gold, Classic, Menthol, Light, Field and One) underwent an external transformation to unite their formerly different designs and distinguish them by color (blue, red, yellow, silver, etc).

Raison D'etre (limited edition) "Raison D'etre" was first introduced for a limited six-week run in December 2006. The cigarette was once again launched in 2007. Launched on December 5, the 2007 edition of Raison D'etre expresses cultural and innovation movements which rebelled against the established norms in arts, music, movies, culture and architecture, such as pop-art, funk-rock, nouvel vague, post-modernism and art nouveau, under the theme of "Legend of Revolution." Raison D'etre attempts to capture the spirit of 20-somethings who are able to freely communicate with the world through their individualism and talents.

RAISON RED

THE ONE 1mg

ESSE
GOLDEN LEAF

Business Review

Operation Review

2007 was a year in which KT&G focused on maximizing corporate and shareholder value by overcoming uncertainties in the business environment posed by increasing competition and the appreciating Korean won. KT&G managed to achieve net sales of KRW 2,412.7 billion and operating income of KRW 814.4 billion, representing year-on-year increases of 6.6% and 14% respectively. The sound results are credited to efforts to maximize performance in each business segment, as indicated below.

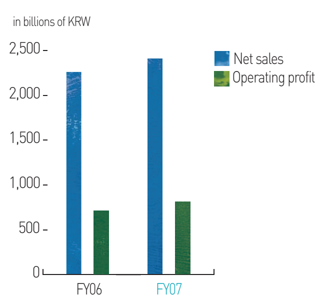
DOMESTIC SALES

KT&G continued to face challenges in the domestic market in the form of heated competition, not to mention the growing health trend which led to a falling smoking rate and expansion in smoke-free areas. To effectively respond to such market conditions, KT&G enforced a "restart-plus" strategy that stresses sales activities while adhering to basic principles. This means further strengthening relations with vendors, enforcing an active display/ad policy to enhance brand awareness, and efficiently allocating marketing resources to achieve effective and efficient sales activities.

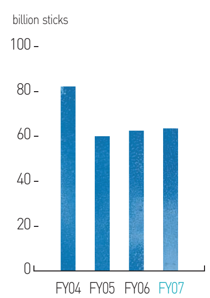
Additionally, to bolster brand competitiveness, KT&G launched new products: "Esse Soun 0.5," "Esse Blend In 3," "Bohem" and "Esse GL." Esse Soun 0.5 is Korea's first ultra-low tar cigarette, while Esse Blend In 3 harmonizes a smooth tasting cigarette in a stylish, super-slim design. Bohem is the first domestic cigarette to incorporate cigar leaves, while Esse GL targets the premium 1% of the Korean market. The diverse lineup of new and high-end products is in answer to increasingly segmented customer tastes, and the growing high-end market. Market response has been positive and a higher ratio of high-end products helped KT&G achieve an increase in net average selling price per pack. The renewal launch of main products, "The One," "Esse" and "This Plus," is also contributing to boosting brand loyalty among existing customers and enhance the company's image. KT&G reshuffled its organization and human resources to bring expert management to each distribution channel for greater efficiency in operations, not to mention increased competitiveness through better management of key markets. These efforts paid off in the form of sales volume increasing 1.6% year-on-year in 2007, while the net average selling price per pack rose 4.6% thanks to the greater sales proportion of high-priced, premium brand items.

OVERSEAS SALES

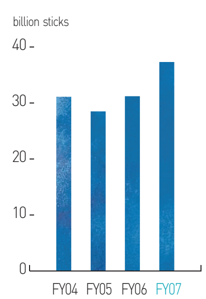
Overseas sales is a major growth driver and an area actively pursued by KT&G as it aims to become a profitable, global cigarette manufacturer. Overseas sales volume grew 19.6% to 37.3 billion sticks and sales rose 13.6% to KRW 379.3 billion. Responding swiftly to changes in external business conditions, KT&G boldly folded its low-profit products and adopted a profit-oriented approach that focuses on nurturing premium brands,



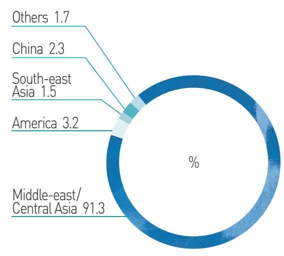
Operation Review



Domestic



Exports



Exports by region

actively expanding the high-end product market, and reducing costs. As a result, KT&G managed to grow operating income by 48.4% to KRW 82.2 billion despite unfavorable exchange rate movements. To ensure both profits and growth, KT&G is attempting to aggressively expand its overseas presence. We are moving to set up local offices in key regions such as Turkey and Iran to secure a platform for expansion in the Middle East and Central Asia. KT&G is examining strategic alliances with local companies and erecting an effective management system of wholesale dealers, in addition to boosting its incentives system to spur sales.

PRODUCTION & PROCUREMENT

In production, the emphasis has been on improving the quality assurance system and analytical abilities to manufacture top quality products. To answer quickly to customer needs, manufacturing infrastructure was upgraded through expanded facilities for producing super-slim products, improved printing facilities, streamlined processes, and expanded number of products for simultaneous manufacturing. Continued efforts to innovate and improve operations for enhanced quality and cost competitiveness produced a 5.2% fall in production costs while productivity rose 7.3%. KT&G also attempted to increase manufacturing competitiveness by building an e-production management system, re-designing the work process, and strengthening technical capabilities.

Turning to procurement, the aim was to efficiently manage tobacco leaf inventory. Accordingly, total cultivation area for tobacco leaf was cut back by 16.7%. KT&G is pursuing a procurement policy of leaf tobacco suiting the international standards to answer to customer tastes and regulations.

2008 Outlook

The domestic market in 2008 is predicted to see a further decline in consumption levels, rise in Net ASP, and preference for high-priced/low-tar cigarettes. The overseas market, meanwhile, is expected to sustain robust growth. KT&G will continue to follow its mid to long term master plan for management activities. This involves stepping up efforts to wrest domestic market share from big foreign companies, and increase the sales portion of high-end products which corresponds to market trends and improves profitability. Additionally, KT&G plans to update its portfolio of competitive brands and make new additions to satisfy the diverse needs of customers.

Exports to the Middle East and Central Asia are steadily rising, spurring the company to pursue building local plants, starting with Turkey in 2008 and another in Russia in 2010. KT&G's first overseas plant in Turkey is scheduled for completion in April of 2008, with full production possibly starting as early as the second half of the year. Annual capacity will be modest at 100 million packs, but considering that Turkey is the world's seventh largest tobacco market consuming 6 billion packs a year, the local production facility is expected to yield returns going forward. Meanwhile, as the world's largest market, China (accounting for 33% of world cigarette consumption) still maintains a quota system and hence the ratio of foreign cigarettes remains low. Once the quota system is eased however, KT&G should benefit greatly from its geographical proximity to the Chinese market and see greater market diversification and robust growth in its export business.

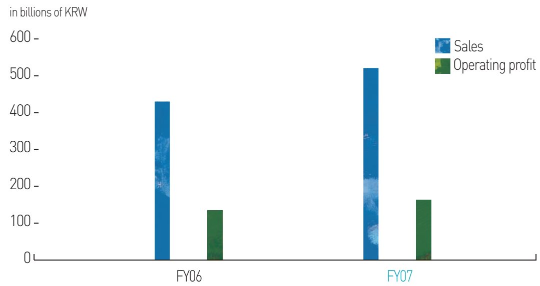
Business Review

HEALTH/FUNCTIONAL FOODS

Operation Review

Health/functional foods, led by the ginseng business, plays just as an important role in driving KT&G's growth as its international cigarette business. Operations in this segment are overseen by Korea Ginseng Corp. (KGC). Under the main "Cheong-Kwan-Jang" brand, KGC showcased a wide variety of products in 2007 to respond to consumer needs, including red ginseng roots, red ginseng products, drinks and gift sets. Brand exposure was maximized through a variety of media including terrestrial TV broadcasting, while distribution channels were diversified. Key distribution channels with high sales ratios, such as franchise stores, duty free shops and department stores, were strengthened along with continued promotional activities targeting different customer groups. As a result, KGC recorded sales of KRW 521.1 billion and operating income of KRW 162.5 billion, representing increases of 21.2% and 20.4% respectively.

Aside from volume growth, KGC enhanced its corporate image by receiving the Best Company Award at the 2007 Korea Communications Awards, while Cheong-Kwan-Jang received the Grand Prize in the 2008 Korea First Brand Awards. KGC was also selected No.1 in the ginseng category at the Korea Brand Prize Awards (K-BPI).



Operation Review

2008 Outlook

According to figures by the National Statistical Office, the 65 years old and older population will increase by more than 3% annually, growing from 4.81 million in 2007 to 5.42 million in 2010. That, in part, explains the heightening interest in health and well-being. Health/functional foods, in particular, ginseng products which enjoy a solid reputation for quality, efficacy and credibility, are expected to see greater demand. With major local food manufacturers set to enter the market, the health/functional food market is forecast to be worth approximately KRW 8 trillion by the year 2010.

To continue on its path of high growth, KGC has designated 2008 as the year of "expanding and securing distribution channels," "customer-focused marketing activities," and "actively penetrating Asian markets such as Hong Kong, China and Japan to raise awareness of the Cheong-Kwan-Jang brand."

PHARMACEUTICALS

Yungjin Pharm., a subsidiary of KT&G, oversees the pharmaceuticals business. Pharmaceuticals are considered the "value catalyst" to drive growth over the long term. Bold and swift restructuring of Yungjin Pharm.'s business portfolio until 2006 resulted in the withdrawal from non-core businesses, while asset restructuring eliminated inefficiencies. In 2007, R&D investment was increased to boost basic competitiveness and improve sales/marketing capabilities. Such measures helped to create more synergies with the affiliates. Yungjin Pharm. is expected to reap the benefits of such preparations and grow into a healthy pharmaceutical company with a focus on specialty drugs. Securing key strategic products and industry-leading sales and profitability will help Yungjin Pharm. achieve its goal of ranking among the top ten pharmaceutical companies in Korea by 2010, thereby fulfilling its role as a value catalyst for KT&G.

CARE & SHARE

KT&G shares success and happiness together

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Management Responsibility

OWNERSHIP STRUCTURE

KT&G carries out its business activities in accordance with decisions made by the Board of Directors and under the responsibility of the CEO. The management objective is to maximize value for the company and stakeholders to advance as a global leader. KT&G adheres to related regulations in regards to corporate governance, with a responsible management structure centering on independent directors who are experts in their respective fields. In this way, KT&G gives balanced consideration to its shareholders and other stakeholders.

Board of Directors

Executive/Non-executive	Name	Remarks
Executive directors	Young-kyoon Kwak	CEO & Chairman of Management Committee
	Kwang-youl Lee	Senior Managing Director/Chief Technology Officer(CTO) /Member of Public Interest & Steering Committee and Management Committee
	Young-jin Min	Senior Managing Director/Chief Production Officer(CPO) /Member of Performance & Risk Management Committee and Management Committee
Non-executive outside directors	Jin-hyun Kim	Chairman of Non-executive Board/Member of Audit Committee and Performance & Risk Management Committee
	Kyung-jae Lee	Member of Public Interest & Steering Committee and Performance & Risk Management Committee
	Yong-chan An	Member of Public Interest & Steering Committee
	Yoon-jae Lee	Member of Audit Committee and Performance & Risk Management Committee
	Chang-woo Lee	Member of Audit Committee and Performance & Risk Management Committee
	Kiu-won Kim	Member of Audit Committee
	Jong-hoon Kim	Member of Public Interest & Steering Committee
	Jin-moo Lee	Member of Performance & Risk Management Committee
	Jin-ho Chang	Member of Public Interest & Steering Committee

Management Responsibility

The Board of Directors (BOD) is comprised of nine independent non-executive outside directors and three executive directors to best serve its functions and raise efficiency. The BOD is the top decision-making body on important issues facing the company and other issues as stated in the Board statutes and regulations as well as KT&G's articles of incorporation.

The independent non-executive outside directors are experts from diverse fields including economics, management, law and environment. They attend the six annual regular meetings and extraordinary BOD meetings to perform reviews of management contracts, investments in other companies, investments in new facilities and other management activities. They are elected to the Board following an evaluation of candidates selected by the Independent Non-Executive Board Recommendation Committee and shareholders, and a subsequent recommendation/appointment process is conducted at the general shareholders' meeting to ensure independence and expertise. In December 2005, the non-executive outside directors adopted the Code of Conduct for Outside Directors which stipulates their roles and responsibilities as well as ethical standards.

BOD structure

The committees under the BOD, namely Public Interest & Steering, Performance & Risk Management, Management, and Audit, contribute to efficient BOD operations by facilitating rational and swift decision-making. To provide appropriate supervision and support to management, in addition to improving transparency and credibility of the company's financial information, the Audit Committee is wholly comprised of non-executive outside directors.

Shareholders' Meeting

The Annual General Shareholders' Meeting is held within three months of the end of each fiscal year, while the Extraordinary Shareholders' Meeting can be convened whenever the need arises following the resolution of the BOD and other regulations. For efficient operations of Shareholders' Meetings, a Shareholders' Council featuring no more than 15 shareholder representatives can be formed. The Shareholders' Council undertakes the role of offering opinions on agenda items as requested by the BOD.

ETHICS MANAGEMENT & PARTNERSHIP

Stronger foundation for ethical management

In 2001, KT&G established a comprehensive system for ethics management by formulating the Code of Ethics, Code of Ethics for Directors, and guidelines on ethical conduct. The system that governs KT&G's business conduct is comprised of four key components – Code of Conduct, Code of Ethics for Directors, Compliance Program, and Customer Service Code. All employees including irregular workers are required to honor the Code of Ethics and guidelines which set forth detailed practices with respect to customers, society, environment, employees, partners and shareholders. The audit office leads the ongoing effort to improve the ethical management system through follow-up evaluations.

Strategic ethics management

All new recruits to KT&G are asked to make a personal commitment to learn and uphold the company's Code of Ethics and guidelines. KT&G not only focuses on accountability and transparency in all aspects of operations but also endeavors to enhance the integrity of its leaders. As part of such efforts, the company's board of directors adopted the Code of Conduct for Outside Directors established by the Korea Listed Companies Association.

Internal control system

In January 2006, KT&G set up an internal control system to meet demands for greater accountability, including accountability on the part of the CEO and CFO under the Securities and Exchange Act and related regulations. The system also aims to protect the company from possible lawsuits with the introduction of class action suits in Korea as well as to satisfy internal accounting requirements and prepare for outside audits. KT&G is working to attain transparency through efficient internal controls. To this end, the company has made it mandatory for five internal control elements – control environment, risk evaluation, control activities, information and communication, and monitoring – to be reviewed by working level staffs, middle and upper level management.

Win-win partnership

KT&G offers technology support and training to partner firms to attain win-win partnership. The production management division is assisting partner firms with fair inspection and technology training, while the Gwangju plant is distributing eco-friendly manuals to partner firms to enhance their competitiveness and environmental management capabilities. Also, partner firms are encouraged to lodge their complaints and other requests for improvements through the procurement division.

Policy to prevent obstruction of fair competition

With the Declaration of Compliance with Fair Trade Standards in 2002, KT&G incorporated the compliance program (CP) into the fabric of its corporate culture. For efficient operation of the program, the company plans to conduct CP training and simulation inspections, publish a CP handbook and revise related internal regulations. These tasks are designed to enhance employee awareness and document related regulations. In 2007, we further promoted the compliance program by launching the first phase of CP and core elements and disclosed related documents. We intend to set up the second phase of the program in 2008. Meanwhile, the "2008 KT&G fair play" booklet was published in December 2007 to promote greater understanding of the CP among employees and encourage their participation.

Financial disclosure

To ensure greater access to information, KT&G has upgraded its financial disclosure system by expanding disclosure targets. KT&G has also reinforced customer accessibility and convenience by improving its customer Q&A bulletin board on the information disclosure website.

Management Responsibility

HR MANAGEMENT

Strategic human resources development

I 2007 BASIC DIRECTION FOR TRAINING I

- Reinforce employee engagement by creating foundation for companywide values
- Foster leaders and strengthen strategic business partner function for sustainable management
- Increase opportunities for individual growth and development by establishing/supporting field-centered training system

Value sharing

- Develop 2nd phase of "To the future, to the world" program
- Follow up on value sharing
- Pursue integration of companywide core values

Change and innovation

- Foster leaders for sustainable management
- Strengthen strategic partner functions

Learning

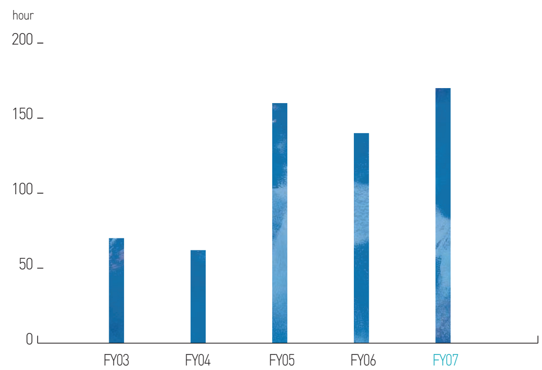
- Promote e-learning
- Set up field-centered training system
- Set up standard learning channels
- Continue with KISS system upgrade

Enforcement of value system through strengthened employee competencies

Carry out target performance counseling for employees
(71% of employees took part in counseling in 1H07)

KT&G invests in the development of its workforce to meet the changing global business environment and to attain its corporate vision. The company has set up detailed strategies on value sharing, change and innovation, and learning. Our training program is designed to achieve corporate goals throughout an employee's career by taking into account the company's strategic directions and individual aspirations. In particular, we seek a multitude of ways to incorporate training assessments, such as problem solving per training and rank, into daily work activities. For leadership training, we have set up clearly defined roles and required competencies according to each rank. The training also emphasizes "ownership," "mutual trust," "passion and proactiveness," "positive attitude," "commitment to self development" and "autonomy and responsibility." As of 2007, the annual average job training hours were 48 hours per employee and 63 hours for leadership training. The overall training hours were 169 hours per employee.

Strengthen cyber learning (e-learning system)



Training hours per person

KT&G's cyber training focuses on leadership, marketing and management to offer tailored learning solutions to employees to strengthen their professional competency and leadership ability. The online classes consist of a wide range of topics from basic accounting to language, business related laws, marketing, strategic management and a basic course on the tobacco business. They are designed to provide broader understanding of the company and foster work competency.

Design your life training program

KT&G's "Design your life" training program is aimed at fortifying organizational stability and competitiveness through professional development and to prepare employees for life after retirement. For prospective retirees, the program offers courses like financial and retirement planning. In addition, employees receive various learning experiences from on-the-job training to more recreational pursuits such as reading and computers.

Employee welfare

I MID TO LONG TERM WELFARE DIRECTION I

First phase	Introduce optional welfare system	Improve employee loan system
Second phase	Expand support for employee loans	Unify carry-over system
Third phase	Build mid to long term fund	Introduce new welfare projects

KT&G has set up a mid to long term welfare vision to raise the quality of life of its employees and maximize corporate value. All employees are eligible for a wide range of benefits. They include housing loans, congratulatory /condolence money and disaster funds, medical check-up, student loans, scholarship, kindergarten tuition, and use of resort facilities. The company also introduced the stock ownership system to promote partnership and mutual trust between labor and management. To enhance employee satisfaction, we offer an optional welfare program which allows employees to choose benefits according to their needs.

Win-win relationship between labor & management

The KT&G labor union has adopted the union shop system which requires all employees of ranks level three and below, seasonal employees at raw material plants, and delivery staff to join the union. As of the end of 2007, the union had 4,477 members. Major labor-management issues are resolved through the labor-management council and collective bargaining. By encouraging active employee involvement, KT&G has realized a labor dispute-free workplace for the past 10 years. For key issues that could affect employees, such as corporate restructuring or merger, the company gives advance notice through the collective bargaining process.

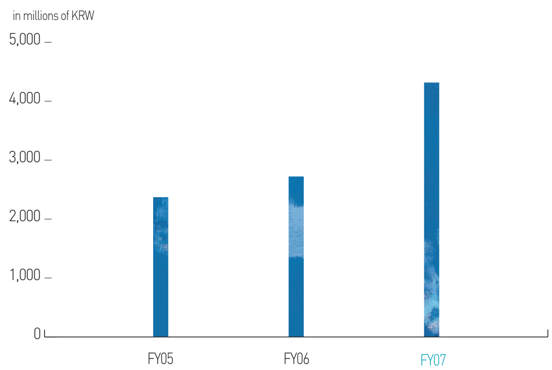
Environmental Responsibility

ENVIRONMENTAL CARE

KT&G is committed to sustainable management and corporate social reasonability. In order to pursue eco-friendly management, our focus is on carrying out green plant management, minimizing pollutants, reinforcing employee environmental awareness, and contributing to society. In addition, KT&G will define its organizational mission for environmental management and enforce practical strategies. KT&G headquarters is in charge of overseeing the environmental management system while individual worksites will concentrate on eliminating environmental risk factors and taking green action in everyday operation.

Performance based environmental management system

For greater efficiency and integration of environment-related activities, KT&G has deployed environmental management staff under the production group since 2000. The company also set up an environment division within each production plant in June 2005. Environmental staff workshops are held on a regular basis to ensure information sharing and to advance field-centered environmental management. As of now, the four tobacco manufacturing plants have obtained ISO14001 certification, with the leaf tobacco plant and printing plant aiming to acquire the certification in 2008.



Environmental investment

Environmental investment

To preserve air and water quality, KT&G invests in facility maintenance/repair such as replacing/upgrading cleaning machines, dust collectors and air ventilation units. Waste management spending includes payments to outside waste treatment companies and in-house treatment costs like reinforcing compressor sand repairing warehouses and waste storage units. The costs for air and water quality control are proportionally higher than waste treatment because KT&G is investing heavily on building new facilities and facility maintenance to reduce odor from raw material processing and waste water treatment and to minimize environmental accidents stemming from waste water leakage. We also upped spending on improving the working and living environment for employees last year.

Environmental management system

For effective environmental performance, KT&G has implemented the environmental management system. The system identifies and controls pollutant data to minimize impact of our operations on our natural surroundings. Environmental impacts of all plants are identified real time by the headquarters' production management division to ensure immediate action when necessary.

Environmental protection

For the second year in a row, the KT&G Social Welfare Foundation mobilized 300 volunteers to plant trees near Naksan Temple in Gangwon Province on March 31, 2007. The temple was devastated by a massive forest fire in 2005. Volunteers were invited to sign up for the tree planning event via the welfare foundation website from March 16 to 25. A total of 300 people including KT&G senior volunteer corps, college students and the general public turned up to plant 2,000 azalea tress after cleaning away burnt branches. In line with its commitment to the environment, KT&G plans to develop programs to protect biodiversity in our local communities.

Promoting external activities

KT&G understands the importance of building an internal and external network to attain successful environmental management. The company maintains a close partnership with NGOs and government agencies and participates in environmental expos and international environmental technology fairs. The Shintanjin Processing Plant is operating the Green E-mail System, designed to share environmental data with Daejeon city office. The plant is also engaged in promoting and visiting environment related facilities and strengthening ties with local communities by taking an active interest in regional environmental events and training.

SAFETY CARE

Employee health and safety

KT&G's goal is to continuously improve safety awareness and training for employees to keep abreast of global standards on safety. We have designated persons in charge of workplace safety in accordance with the Occupational Safety and Health Act. To prevent workplace accidents, the company also devised safety health management guidelines and accident free workplace guidelines. On the safety check day, each workplace conducts voluntary safety inspections to check for fire dangers and other hazards.

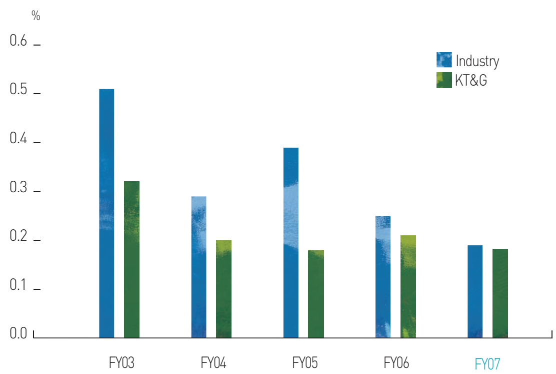
Each plant has an occupational safety health committee which oversees related activities including training, inspection, and fire control under the safety and health management guidelines. The safety inspection group comprised of the emergency planning team inspects fire facilities and equipments, emergency response measures and training at each affiliated organization on a routine basis.

Safety training

KT&G prevents worksite accidents by arming employees with safety guidelines and related information to ensure that safety awareness becomes a part of their everyday routine. When accidents do occur, they are immediately included in the safety training so that employees can learn from the experience.

Workplace injury casebook

KT&G collected workplace injuries of the past five years and published the data in a casebook to prevent future accidents and raise safety awareness. Classified by accident type, the casebook is intended to help prevent similar accidents and improve the company's productivity. Thanks to such preemptive efforts as establishing an occupational safety and health system, conducting safety training and publishing the workplace injury casebook, KT&G was able to achieve an injury rate of 0.16% in 2007, lower than the industry average of 0.19%. From October 2004 to 2007, 43 people were injured on the job at KT&G. In particular, no work-related death was recorded in 2007 which could result in a significant decrease in the number of lost work days.



Workplace injury casebook

Social Responsibility

SOCIAL CONTRIBUTION

Employees & social contribution

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 the 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 its activities.

To develop a more professional and streamlined approach to supporting community initiatives, KT&G created a social contribution department dedicated to such tasks as securing the necessary budget in April 2007. We are currently engaged in activities designed to make a positive impact on areas including social welfare, arts and culture and education. In 2007, we invested a total of KRW 21.8 billion in related programs.

KT&G Social Welfare Foundation

KT&G Social Welfare Foundation was established on the fundamental premise of improving people's welfare and bringing happiness to all. Working with public and private sectors, the foundation is striving to deliver tangible results, addressing a wide range of issues affecting our society. They include running the Happy Network and volunteer center, supporting social welfare centers, low income families and providing medical assistance to children and the elderly. Currently, 52% of its KRW 10 billion fund is used in programs committed to the betterment of elderly welfare.

Social welfare projects

KT&G is expanding the scale of our social work and making our work more meaningful by championing giving programs that benefit our underprivileged neighbors. Our charitable work includes providing vehicles to the country's social welfare centers to improve their mobility, developing and supporting programs for elderly and repairing unlicensed welfare facilities.

Online welfare programs

KT&G is leveraging the power of the Internet to pursue our mission to practice proactive philanthropy. We have three major online community involvement websites; 1004KT&G (www.1004ktng.com) dedicated to online fundraising for children-headed households and disabled and underprivileged children; Happy gift project (www.ktngwelfare.org), a website which delivers birthday gifts to children with disabilities from low-income families and in welfare facilities; and online sign language game site (www.ktngwelfare.org).

CUSTOMER SATISFACTION

Communication with customers

KT&G's corporate website serves as an effective communication channel between the company and its customers. The website is a place where customers can inquire about products, offer suggestions and gain access to various corporate and product information. It also features an ombudsperson section where customers can recommend exemplary KT&G employees and practices, report work-related irregularities or complaint mishandling, and post opinions or proposals regarding business operations.

Customer service & product claims

KT&G's customer service is divided into two main categories: general services on "health, tobacco policy, marketing, and company at large" and product claims related to "smoking, raw materials, packaging process and distribution." The CS Center, responsible for customer service, writes up weekly and monthly reports to share with the entire company. Moreover, strengthened communication with brand managers allows us to continue our efforts to enhance customer satisfaction. The real-time monitoring of customer calls also enables us to identify and address problems for quality customer care.

Research to develop less harmful products

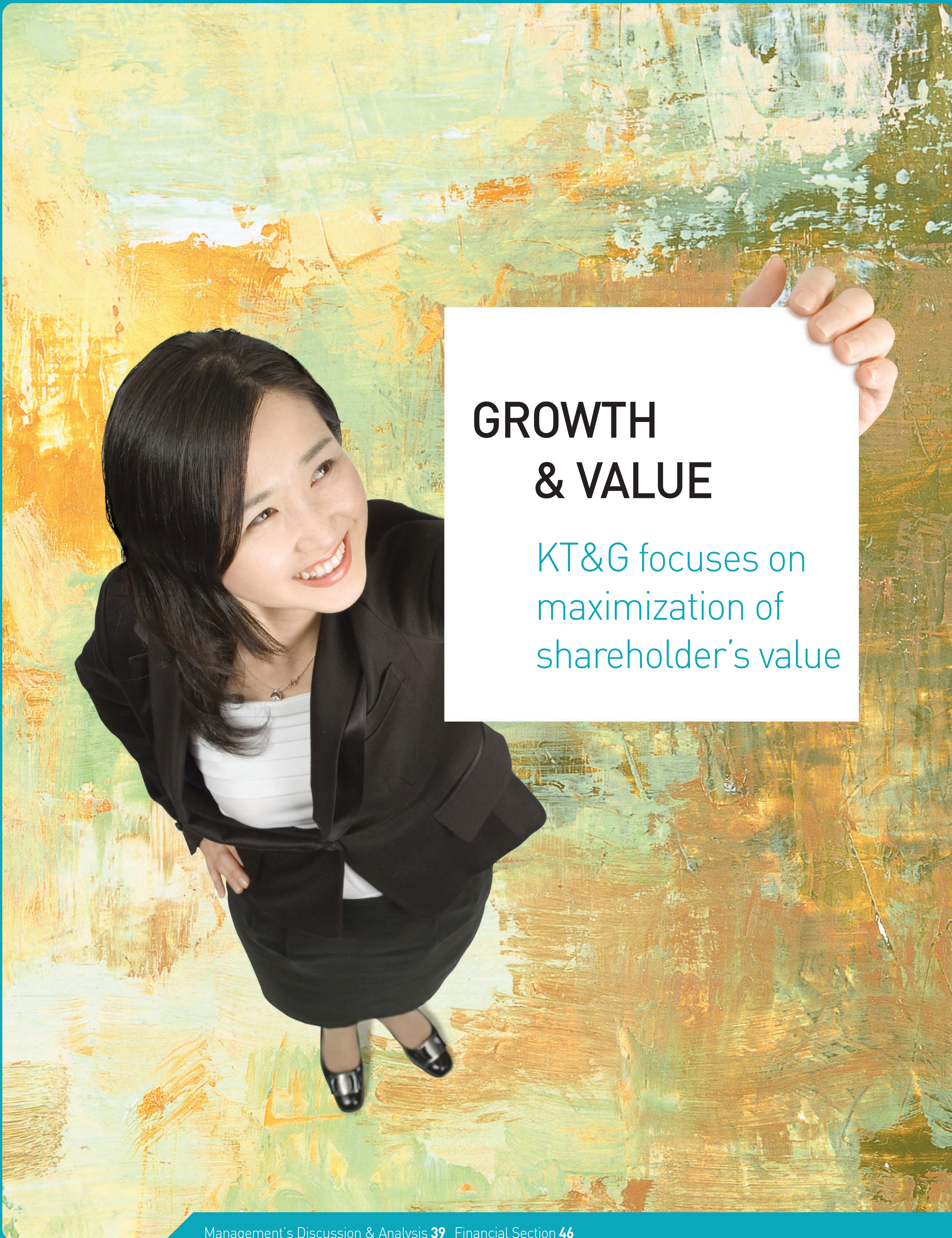
KT&G is committed to developing products that minimize the health risks of smoking. We are heavily invested in research into products that reduce the total smoke intake and development of alternative/innovative products. Starting in 2009, KT&G will disclose six major carcinogenic compounds in an effort to raise consumer awareness on health and actively comply with government policy.

Customer satisfaction management

KT&G conducts an annual consumer satisfaction (CSI) survey for the nation's adult smokers and dealer satisfaction (DSI) survey for our product retailers and salespeople. The survey rates product quality, corporate image (integrity), salespersons' manners, and sales support. The overall satisfaction level has been on the rise. The 2006 customer survey showed an increase in corporate image (integrity) and efforts to improve quality. In addition, the announcement of a planned price hike led to a sharp increase in the value for money category. Dealers' satisfaction level also went up in general, with high marks given in the salespeople's service category. We are pursuing improvement measures in conjunction with related departments such as marketing and R&D center for the categories that received relatively low points including intent to recommend KT&G brand to others, brand loyalty and sales/PR support.

MARKETING STANDARD

We project greater industry risks as tougher anti-smoking regulations worldwide are expected to contract the tobacco market and spur fiercer competition. Given the situation, KT&G is reviewing plans to devise marketing standards to meet the rapidly changing market environment. In addition, we are looking into creating systematic action plans to minimize risk and sharpen our competitive edge. In December 2006, we set up the basic framework for overall marketing activities by formulating marketing guidelines to minimize external and internal business risks.



GROWTH & VALUE

KT&G focuses on maximization of shareholder's value

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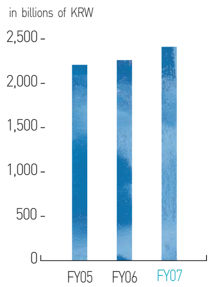
Management's Discussion & Analysis

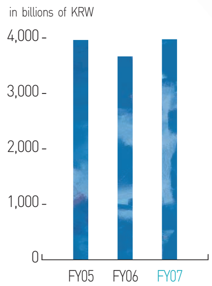
EXECUTIVE SUMMARY

KT&G faced numerous uncertainties in 2007 including fiercer competition and foreign exchange fluctuations. The primary focus throughout the year was on overcoming the various hurdles to enhance corporate value and shareholders' value. Underpinned by efforts to maximize performance across all business segments, KT&G generated net sales of KRW 2,412.7 billion and operating income of KRW 814.4 billion to post respective year-on-year growth rates of 6.6% and 14.1%.

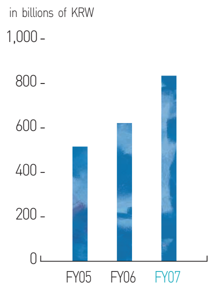
The smoking rate in Korea has continued to decline amid growing health awareness, along with an expansion of non-smoking areas. The domestic tobacco industry has also seen an increase in competitive pressure. Against this backdrop, KT&G adopted the "restart plus" strategy which emphasizes effective marketing activities based on basic principles. Under this strategy, the Company worked to strengthen relations with retailers, raise brand recognition through product displays, and efficiently allocate marketing resources. The objective was to maximize efficiency and effectiveness in our domestic operations.



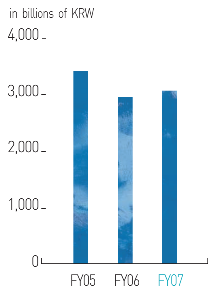
Net sales



Total assets



Total liabilities



Total shareholders' equity

Management's Discussion & Analysis

The launch of "Esse Soun 0.5," "Esse Blend In 3," "Bohem," and "Esse Golden Leaf" helped to reinforce brand power. KT&G has been introducing new products and premium brands to create a strong brand portfolio that meets diverse customer needs. In particular, KT&G products are drawing a favorable response in the growing market for premium brands. The Company's shift towards the premium brands has increased the net average selling price per pack. In addition, the renewal of "The One," "Esse," and "This Plus" has heightened loyalty among existing customers and enhanced the image of these brands.

With respect to distribution, KT&G made changes to the organizational and personnel structure for better management of each distribution channel. The Company has been placing greater emphasis on the key distribution channels to gain a stronger footing in the marketplace.

For fiscal 2007, KT&G posted 1.6% year-on-year growth in sales volume. Greater sales contribution from premium brands raised the net average selling price per pack by 4.6%.

The overseas business has surfaced as an important growth driver for KT&G, which has been exploring overseas markets to become a leading global tobacco company. Export sales volume in 2007 rose by 19.6% to 37.3 billion sticks and export revenue came to KRW 379.3 billion, up by 13.6%. Operating income from exports shot up 48.4% to KRW 82.2 billion. The robust performance in the face of adverse foreign exchange movements is ascribed to the Company's profitability-oriented approach. KT&G decreased the portion of low-margin product sales and concentrated on premium brands. The Company also raised export prices, aggressively expanded into the emerging premium market segment, and trimmed costs.

In terms of manufacturing, the Company upgraded its quality assurance system and analytical capabilities to offer products of the highest quality. Steps were taken to reinforce manufacturing infrastructure to promptly respond to customer demands. These include capacity expansion for superslim cigarettes, improved printing equipment, automation, and increasing the number of items for simultaneous production. Ongoing activities to uphold a competitive edge in terms of quality and cost lowered manufacturing costs by 5.2% and improved productivity by 7.3%. Redesigned work processes, e-production management, and technological enhancements also contributed to raising manufacturing competitiveness.

To rationalize tobacco leaf inventory, the contracted area of cultivation was reduced by 16.7% in 2007. KT&G observes standard cultivation procedure and purchasing policy to ensure competitive tobacco leaf production that satisfies customer needs. These measures are aimed at boosting leaf quality and usability.

ANALYSIS OF OPERATING RESULTS

Along with an increase in non-smoking areas, heightened health awareness further pulled down the smoking rate in 2007. Amid these trends, KT&G also faced greater pressure from competitors who pursued aggressive marketing and new product launches. Regardless of the challenges, KT&G continued to meet customer needs by developing and introducing new products and implemented a marketing strategy of selection and concentration. The Company also pushed ahead with unique innovation activities to reinforce its competencies, such as adoption of the market management system.

For fiscal 2007, the Company posted net sales of KRW 2,412.7 billion. That translates to year-on-year growth of 6.6%, implying top-line growth for two consecutive years. Operating income grew at a higher rate of 14.1% to reach KRW 814.4 billion due to the shift in sales mix towards the premium products. The Company also recorded net non-operating income for the year. Net income amounted to KRW 661.2 billion, rising by 1.8% over a year earlier.

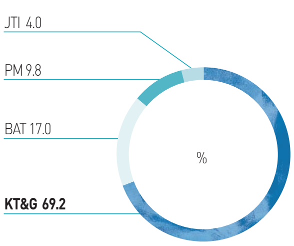
OPERATING REVENUES

The domestic cigarette market was expanded by 4.7% in 2007, with total sales volume reaching 91,847 million sticks. Particularly noteworthy is the growing preference for low-tar cigarettes as people become more health conscious, which led to a 14.3% growth in the market for low-tar products. As the supplier of three big name brands in Korea – Esse, Raison and The One – KT&G has also led the expansion of the domestic low-tar cigarette market. Low-tar products account for about 50% of the Company's total sales and the figure continues to rise. This trend has meaningful implications for profitability since many of the low-tar cigarettes carry higher prices than regular cigarettes.

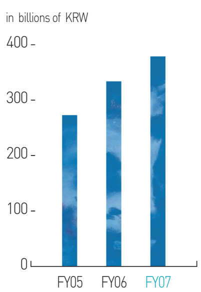
KT&G upholds a commanding share of the domestic market, although its market share slid by 2.2%p in 2007. With sound marketing activities and launching of high-quality, high value-added products, the Company is likely to retain its leadership in the domestic tobacco market.

Overseas expansion has been a key strategy for KT&G as it pursues the goal of becoming a leading global tobacco company. KT&G made meaningful progress in 2007 with respect to its overseas operations. Export revenue increased by 13.6% to KRW 379.3 billion and the export ratio to total sales climbed by 0.9%p to 15.7%. The Company also enjoyed enhanced profitability as it raised the sales proportion of higher-priced products through more aggressive marketing. In particular, the Esse brand began to establish itself as a global brand and accounted for 31.1% of total export revenue in 2007.

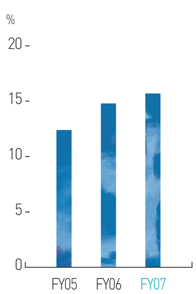
KT&G has continued to diversify its export markets. Currently, KT&G products are shipped to more than 40 countries including Russia, CIS nations, Middle East, Central Asia, China and Southeast Asia. The main export destination is Middle East/Central Asia, which accounted for 91.3% of total exports in 2007. To step up its overseas business, KT&G has been seeking strategic alliances with local companies and investing in local production facilities. Its plant in Turkey is set to be completed around April of 2008, while plans have been drawn up to build a plant in Russia by 2010. KT&G's global initiative also involves fostering brands tailored to the needs of local markets.



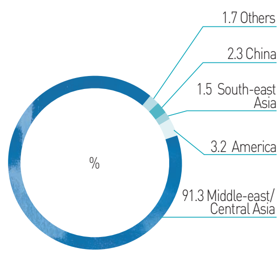
Domestic market share



Exports amount



Exports ratio to total sales



Exports by region

Management's Discussion & Analysis

OPERATING COST

Revenue growth and the rising sales contribution of premium brands lifted gross profit by 10.7% to KRW 1,420.2 billion. While net sales grew 6.6%, cost of sales edged up only 2%. The ratio of domestic leaf tobacco usage has a substantial impact on gross profit. In 2007, the ratio was 44%, falling by 10%p from the previous year. The decline is attributable to a 16.7% reduction in the area of cultivation, aimed at rationalizing the usage and inventory of domestic tobacco leaf. The boost in gross profit is also attributed to efforts to reinforce manufacturing competitiveness, such as process improvement, adoption of a cost control system, and ongoing infrastructure upgrades.

Selling, general and administrative (SG&A) expenses totaled KRW 605.8 billion. The rate of increase was 6.4%, similar to the rise in sales. As a percentage of sales, SG&A has stayed at around 25% since 2004, indicating that KT&G has managed to keep such expenses under tight control. In closer detail, salaries, employee welfare, advertising and commissions were largely unchanged from 2006, while depreciation and R&D expenses went up by 13.7% and 15.5%, respectively.

The increase in gross profit combined with the shift in sales mix towards the premium brands and effective control of SG&A expenses led to a 14.1% boost in operating income to KRW 814.4 billion. The operating profit margin improved by 2.3%p to 33.8%.

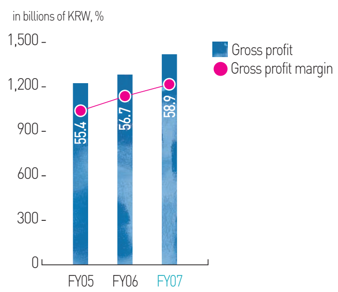
NON-OPERATING ITEMS

Non-operating income decreased by 31.7% to KRW 201.4 billion. Gains on valuation of equity method investments and gains on foreign currency translation increased by KRW 28.6 billion and KRW 2.5 billion, respectively. However, there were declines of KRW 2.3 billion in interest income, KRW 27.7 billion in reversal of allowance for doubtful accounts, and KRW 56.0 billion in income tax refund. Non-operating expenses fell by 29.2% to KRW 108.7 billion, primarily owing to a 74.7% reduction in donations to KRW 25.0 billion. In all, net non-operating income for the year amounted to KRW 92.7 billion.

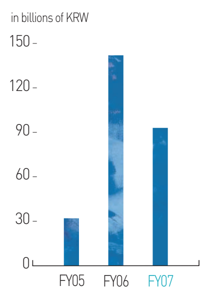
EARNINGS AND DIVIDENDS

Net income climbed to a new historic high buoyed by stable sales growth, effective cost control and net non-operating gains. The figure rose by 1.8% over 2006 to reach KRW 661.2 billion. However, the net profit margin narrowed by 1.3%p to 27.4% as the effective tax rate was normalized from 24.0% in 2006 to 27.1% in 2007. The effective tax rate in 2006 was affected by a one-off income tax refund.

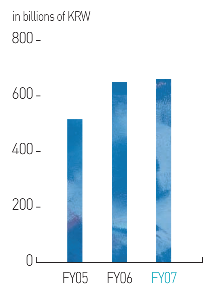
Earnings per share reached KRW 4,992, rising by 8.3% from KRW 4,608 in 2006. EPS growth was higher than net income growth due to a decrease in the weighted average number of common shares outstanding from 140.9 million in 2006 to 132.4 million in 2007 following share repurchase and cancellation. Backed by KT&G's healthy



Gross profit



Net non-operating income



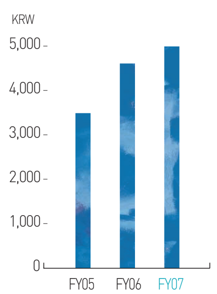
Net profit

earnings, strong growth potential and shareholder-friendly policy, the share price posted a 41.1% gain, soaring from KRW 56,500 at end-2006 to KRW 79,700 at end-2007. The price-earnings ratio increased to 16.0 times.

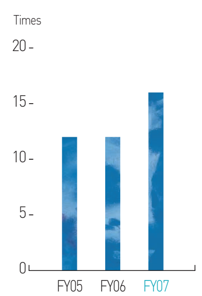
Staying true to its policy of maximizing shareholder value, KT&G distributed dividend per share(DPS) of KRW 2,600 for fiscal 2007. That translates to a dividend yield of 3.26% based on the 2007 closing share price. KT&G will continue to enhance shareholder value by faithfully implementing its mid to long term masterplan. The Company will also proceed with share repurchase and cancellation and distribute dividends, taking into account market conditions and cash flows.

ANALYSIS OF FINANCIAL CONDITIONS

KT&G maintains a healthy financial structure and flexible financial strategy and has the capability to generate stable operating cash flows. With its solid foundation, the Company has been focusing on raising efficiency in investment decision-making and working capital management.



EPS



PER

Total assets grew by 8.4% to KRW 3,977.8 billion, mainly due to the expansion in non-current assets. Investment assets swelled by more than KRW 350.0 billion and tangible assets, such as land and equipment, increased by KW 65.0 billion. Total shareholders' equity grew by 3.2% to KRW 3,142.0 billion as gains on the disposal of treasury stock pushed up capital surplus. Total liabilities went up 34.2% to KRW 835.8 billion owing to one-off factors (KRW 126.3 billion in tobacco excise payable, KRW 71.2 billion in income taxes payable).

Quick assets contracted by 17%. Accounts receivable inched up to KRW 303.6 billion in step with expanding sales. However, cash and cash equivalents decreased because of the share repurchase, acquisition of investment assets and tangible assets. Inventories declined by 3.6% to KRW 979.5 billion amid ongoing efforts to reduce tobacco leaf inventory and effective inventory management. As a result, current assets stood at KRW 1,467.1 billion as of end-2007, down by 8.5% from a year ago. Working capital shrank by 32.8% to KRW 844.4 billion. KT&G will maintain effective working capital management through sound business practices.

Investment assets swelled by 57.2% to KRW 980.6 billion due to a surge in available-for-sale securities and securities subject to the equity method of accounting. Property, plant and equipment increased by 4.8% to KRW 1,409.0 billion as acquisitions were made to enhance competitiveness.

Capital surplus rose by 38.4% to KRW 464.2 billion, buoyed by gains on disposal of treasury stock. While, retained earnings grew 3.5% to KRW 2,133.6 billion thanks to net income growth. In all, total shareholders' equity recorded KRW 3,142.0 billion, rising by 3.2% compared to the end of 2006, and in the meantime ROE improved by 1.4%p.

Management's Discussion & Analysis

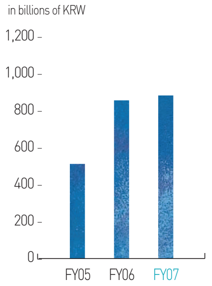
ANALYSIS OF CASH FLOW

KT&G pursues bold facility investments and product development to bolster product competitiveness and continues with efforts to discover and nurture future growth engines. In addition, the payout of dividends along with share repurchase and cancellation reflects the management policy of maximizing shareholder returns. KT&G is firmly committed to enhancing corporate value via efficient operations based on selection and concentration and stable generation of cash flows.

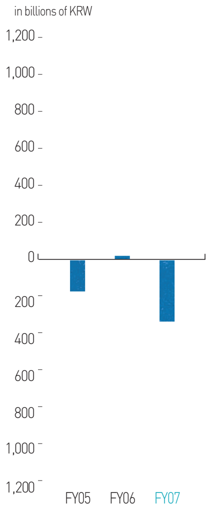
Cash flows from operating activities totaled KRW 865.7 billion in 2007, inching up 2.6% over the previous year. The slight increase stemmed from the growth in net income and depreciation, a cost item unaccompanied by cash outflow. Also, cash flows from change in working capital related to operating activities amounted to KRW 121.7 billion.

There was a cash outflow of KRW 49.9 billion related to facility modernization, which encompasses acquisition and disposal of land, buildings and equipment. Cash outflow from the acquisition of available-for-sale securities and securities subject to equity method of accounting reached KRW 258.6 billion. Consequently, KT&G recorded KRW 374.0 billion in net cash outflow from investing activities, as opposed to an inflow of KRW 16.1 billion in the previous year.

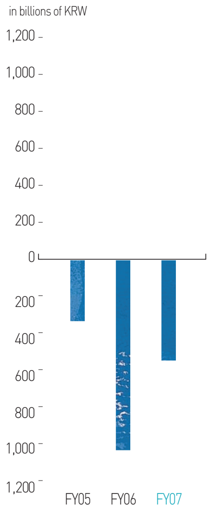
Cash outflow from financing activities fell sharply to KRW 542.5 billion in 2007, from KRW 1,027.1 billion in the previous year. There was no cash flow from external financing last year, and most of the cash flows were related to the acquisition or disposal of treasury stock. Cash outflow related to the acquisition and disposal of treasury stock decreased by 71.9% to KRW 219.8 billion. Cash dividends came to KRW 319.7 billion, rising by 28.1%.



Cash flow from operating



Cash flow from Investing



Cash flow from financing

2008 BUSINESS OUTLOOK & MANAGEMENT ISSUES

Uncertainties are expected to heighten in 2008. Along with foreign exchange fluctuations, inflation, and a slowdown of the domestic and global economies, the government is expected to impose tighter regulations on the tobacco industry. Moreover, competitors armed with global brands are predicted to make greater inroads into the Korean market.

KT&G has decided on the following strategies to pursue growth and profitability with the goal of maximizing corporate value and ensuring sustainable growth.

Reinforce existing businesses and pursue innovation for improved profitability

In the domestic tobacco market, KT&G will maintain strong dominance in market share while shifting to a brand and pricing strategy centered on sales growth and profitability. At the same time, measures will be taken to lower costs and raise efficiency. In the overseas markets, the Company will make greater inroads with the operation of its manufacturing plants in Turkey and Iran. In addition, high-end brands will be promoted to support profitability. In the ginseng business, the focus will be on expanding sales of high value-added products by highlighting quality and safety and by strengthening marketing and distribution channels. In pharmaceuticals, the main objectives are the early stabilization of operations and efficient liquidity management and resource allocation, in addition to fostering strategic products.

Reformulate financial and asset strategy for greater efficiency and future growth

To improve asset efficiency, KT&G will concentrate on development or disposal of idle property, reduction of tobacco leaf and other inventories, and efficiency of logistics. The Company will also revamp its financial strategy to maximize corporate value through growth, giving balanced consideration to investments for the future and shareholder return.

Cultivate growth engines for long-term corporate value

KT&G will expand direct investment in overseas facilities to sustain growth of the cigarette business. From a long-term perspective, the Company will study carefully the possibility of acquiring overseas tobacco makers and health/functional food companies. Moreover, KT&G will seek cooperation and strategic alliances in bio, pharmaceuticals and other related industries to create a stable business portfolio.

KT&G's target for fiscal 2008 is to grow net sales by 8.6% year-on-year to KRW 2,619.1 billion and operating income by 11.4% to KRW 907.0 billion.

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Independent Auditors' Report

Based on a report originally issued in Korean

The Board of Directors and Stockholders
KT&G Corporation:

We have audited the accompanying non-consolidated balance sheets of KT&G Corporation (the "Company") as of December 31, 2007 and 2006, and the related non-consolidated statements of income, appropriation of retained earnings, changes in equity and cash flows for the years then ended. These non-consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these non-consolidated 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 non-consolidated financial statements referred to above present fairly, in all material respects, the financial position of KT&G Corporation as of December 31, 2007 and 2006, and the results of its operations, the appropriation of its retained earnings, the changes in its equity and its cash flows for the years then ended in conformity with accounting principles generally accepted in the Republic of Korea.

The accompanying non-consolidated financial statements as of and for the year ended December 31, 2007 have been translated into United States dollars solely for the convenience of the reader. We have audited the translation and, in our opinion, the non-consolidated financial statements expressed in Korean Won have been translated into dollars on the basis set forth in note 2 to the non-consolidated financial statements.

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

As discussed in note 2(a) to the non-consolidated financial statements, accounting principles and auditing standards and their application in practice vary among countries. The accompanying non-consolidated 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 non-consolidated financial statements are for use by those knowledgeable in Korean accounting principles and auditing standards and their application in practice.

As discussed in note 21 to the non-consolidated financial statements, the Company and the Korean government are defendants in lawsuits claiming damages of ₩1,339 million for the effects of smoking. The final outcome of these lawsuits cannot be predicted. Accordingly, no provisions have been made in the accompanying non-consolidated financial statements.

As discussed in note 31 of the non-consolidated financial statements, the Company reacquired and subsequently retired 2,700,000 shares of common stock on January 15, 2008. Accordingly, the number of the Company' s issued shares and retained earnings decreased by 2,700,000 shares and ₩209,767 million respectively.

Seoul, Korea
January 24, 2008

This report is effective as of January 24, 2008, 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 non-consolidated 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.

Non-Consolidated Balance Sheets

As at December 31, 2007 and 2006

In millions of Won, and thousands of United States dollars	Note	2007 Korean Won	2007 U.S. dollars (note 3)	2006 Korean Won
Assets				
Cash and cash equivalents	17	₩ 115,126	$ 122,709	₩ 165,924
Short-term financial instruments		1,000	1,066	1,000
Trade accounts receivable, net of allowance for doubtful accounts of ₩8,723 in 2007 and ₩2,659 in 2006	8,17	294,895	314,320	263,164
Inventories	4,13	979,513	1,044,034	1,016,540
Current portion of long-term loans, net of allowance for doubtful accounts of ₩1,000 and present value discount of ₩11,416	9	-	-	98,984
Current deferred tax assets	23	16,026	17,082	7,760
Other current assets	5	60,585	64,576	49,377
Total current assets		1,467,145	1,563,787	1,602,749
Available-for-sale securities	6	257,089	274,024	69,779
Equity method investment securities	7	626,693	667,974	490,885
Other investments assets		677	722	395
Property, plant and equipment, net	10,11,13	1,408,958	1,501,767	1,344,156
Intangible assets	12	1,719	1,832	2,106
Long-term loans to employees	8	95,939	102,259	61,106
Guarantee deposits paid		30,521	32,531	29,579
Guarantee deposits for membership		21,197	22,593	20,499
Long-term deposits in Escrow Fund	17,21	66,633	71,022	45,611
Sundry non-current assets	14	1,256	1,339	1,514
Total non-current assets		2,510,682	2,676,063	2,065,632
Total assets		₩ 3,977,827	$ 4,239,850	₩ 3,668,381

Non-Consolidated Balance Sheets, Continued

As at December 31, 2007 and 2006

In millions of Won, and thousands of United States dollars except share data	Note	2007 Korean Won	2007 U.S. dollars (note 3)	2006 Korean Won
Liabilities				
Trade accounts payable	8,17	₩ 9,590	$ 10,222	₩ 9,176
Value added tax payable		128,866	137,355	128,878
Accrued expenses		12,320	13,132	6,845
Other payables		95,432	101,718	17,873
Income taxes payable		183,482	195,568	112,288
Tobacco excise and other taxes payable		181,734	193,705	55,388
Other current liabilities	15	11,299	12,043	15,399
Total current liabilities		622,723	663,743	345,847
Retirement and severance benefits	16	64,360	68,599	77,697
Guarantee deposits received	8	26,861	28,630	29,783
Deferred income tax liabilities	23	121,854	129,881	94,798
Reserve for Tobacco Production			-	
Stabilization Fund	21	-	-	74,484
Total non-current liabilities		213,075	227,110	276,762
Total liabilities		835,798	890,853	622,609
Equity				
Common stock of ₩5,000 par value				
Authorized – 800,000,000 shares				
Issued – 143,442,497 shares				
Outstanding – 130,839,907 shares in				
2007 and 133,213,315 shares in 2006	1	954,959	1,017,863	954,959
Capital surplus		464,237	494,817	335,414
Capital adjustments	18	(414,947)	(442,280)	(321,904)
Accumulated other comprehensive				
income	6, 19	4,189	4,465	15,784
Retained earnings	20	2,133,591	2,274,132	2,061,519
Total equity		3,142,029	3,348,997	3,045,772
Total equity and liabilities		₩ 3,977,827	$ 4,239,850	₩ 3,668,381

Non-Consolidated Statements of Income

For the years ended December 31, 2007 and 2006

In millions of Won and thousands of United States dollars, except earnings per share	Note	2007 Korean Won	2007 U.S. dollars (note 3)	2006 Korean Won
Sales				
Tobacco		₩ 2,342,411	$ 2,496,708	₩ 2,186,645
Lotting-out	22	50,463	53,787	26,845
Other		19,815	21,120	49,190
		2,412,689	2,571,615	2,262,680
Cost of sales	22,27,28	992,449	1,057,822	979,778
Gross profit		1,420,240	1,513,793	1,282,902
Selling, general and administrative expenses	27,28,29	605,839	645,746	569,173
Operating income		814,401	868,047	713,729
Other income (expense):				
Interest income		38,193	40,709	40,431
Interest expense		(101)	(108)	(115)
Other bad debts expense		(10)	(11)	(1,297)
Reversal of allowance for doubtful accounts		1,009	1,075	28,720
Loss on foreign currency transactions, net		(445)	(474)	(5,286)
Gain (loss) on foreign currency translation, net	17	2,361	2,517	(3,345)
Gain (loss) on sale of available-for sale securities, net		(724)	(772)	1,790
Gain on sale of property, plant and equipment, net		5,489	5,851	858
Provision to Tobacco Production Stabilization Fund	21	(35,516)	(37,855)	(18,730)
Gain on valuation of equity method investments	7	128,302	136,753	99,746
Loss on valuation of equity method investments	7	(24,999)	(26,646)	(5,882)
Gain on sale of equity method investments		-	-	17,428
Donations	28	(24,995)	(26,641)	(98,893)
Other, net		4,125	4,397	85,827
Other income		92,689	98,795	141,252
Income before income taxes		907,090	966,841	854,981
Income taxes	23	245,897	262,094	205,303
Net income		₩ 661,193	$ 704,747	₩ 649,678
Earnings per share				
Basic earnings per share	24	₩ 4,992	$ 5	₩ 4,608

Non-Consolidated Statements of Appropriation of Retained Earnings

For the years ended December 31, 2007 and 2006

Date of Appropriation for 2007: March 14, 2008

Date of Appropriation for 2006: March 14, 2007

In millions of Won and thousands of United States dollars	2007 Korean Won	2007 U.S. dollars (note 3)	2006 Korean Won
Unappropriated retained earnings			
Balance at beginning of year	₩ 5,492	$ 5,854	₩ 3,304
Retirement of treasury stock	(269,410)	(287,157)	(857,778)
Net income	661,193	704,747	649,678
Balance at end of year before appropriation	397,275	423,444	(204,796)
Transfer from voluntary reserves			
Reserve for research and manpower development	15,000	15,988	-
General reserve	-	-	530,000
Unappropriated retained earnings available for appropriation	412,275	439,432	325,204
Appropriation of retained earnings			
General reserve	70,000	74,611	-
Dividends – 52% on par value at 2,600 Won per share in 2007 and 48% on per value at 2,400 Won per share in 2006 (note 25)	340,449	362,875	319,712
	410,449	437,486	319,712
Unappropriated retained earnings to be carried over to subsequent year	₩ 1,826	$ 1,946	₩ 5,492

Non-Consolidated Statements of Changes in Equity

For the years ended December 31, 2007 and 2006

In millions of Won	Korean Won					
	Capital stock	Capital surplus	Capital adjust-ments	Accumu-lated other compre hensive income	Retained earnings	Total equity
Balance at January 1, 2006	₩ 954,959	300,043	(349,885)	23,601	2,519,322	3,448,040
Dividends	-	-	-	-	(249,703)	(249,703)
Net income	-	-	-		649,678	649,678
Decrease in unrealized gain on valuation of available-for-sale securities	-	-	-	(6,492)	-	(6,492)
Decrease in unrealized gain on valuation of equity method investments	-	-	-	(430)	-	(430)
Increase in unrealized loss on valuation of equity method investments	-	-	-	(895)	-	(895)
Reacquisition of treasury stock	-	-	(857,778)	-	-	(857,778)
Retirement of treasury stock	-	-	857,778	-	(857,778)	-
Compensation by treasury stock		35,371	27,981	-	-	63,352
Balance at December 31, 2006	₩ 954,959	335,414	(321,904)	15,784	2,061,519	3,045,772

In millions of Won, and thousands of United States dollars	Korean Won						U.S. dollars (note 3)
	Capital stock	Capital surplus	Capital adjust-ments	Accumu-lated other compre-hensive income	Retained earnings	Total equity	Total equity
Balance at January 1, 2007	₩ 954,959	335,414	(321,904)	15,784	2,061,519	3,045,772	$ 3,246,399
Dividends		-		-	(319,712)	(319,712)	(340,772)
Net income	-		-		661,193	661,193	704,747
Decrease in unrealized gain on valuation of available-for-sale securities	-	-		(13,829)	-	(13,829)	(14,738)
Increase in unrealized gain on valuation of equity method investments	-	-	-	1,978	-	1,978	2,108
Decrease in unrealized loss on valuation of equity method investments	-	-	-	256	-	256	273
Reacquisition of treasury stock	-	-	(455,035)	-	-	(455,035)	(485,009)
Retirement of treasury stock	-	-	269,409	-	(269,409)	-	
Compensation by treasury stock	-	128,823	92,583	-	-	221,406	235,990
Balance at December 31, 2007	₩ 954,959	464,237	(414,947)	4,189	2,133,591	3,142,029	$ 3,348,998

Non-Consolidated Statements of Cash Flows

For the years ended December 31, 2007 and 2006

In millions of Won, and thousands of United States dollars	2007				2006	
		Korean Won		U.S. dollars (note 3)		Korean Won
Cash flows from operating activities						
Net income	₩	661,193	$	704,747	₩	649,678
Adjustments for:						
Depreciation and amortization		135,503		144,429		121,181
Loss (gain) on valuation of inventories, net		(4,987)		(5,315)		6,993
Loss (gain) on sale of available-for-sale securities, net		724		772		(1,790)
Bad debts expense		6,064		6,463		164
Loss on impairment of available-for-sale securities		2,150		2,292		2,363
Gain on valuation of equity method investments, net		(103,303)		(110,108)		(93,864)
Gain on sale of equity method investments		-		-		(17,428)
Dividends from equity method investees		20,000		21,317		-
Loss (gain) on foreign currency translation, net		(2,361)		(2,517)		3,345
Other bad debts expense		10		11		1,297
Provision for retirement and severance benefits		31,014		33,057		47,765
Gain on sale of property, plant and equipment, net		(5,489)		(5,851)		(858)
Amortization of present value discounts		(11,416)		(12,168)		(11,808)
Provision for Tobacco Production Stabilization Fund		35,516		37,855		18,730
Deferred income taxes		24,540		26,156		9,299
Payments of retirement and severance benefits		(13,754)		(14,660)		(7,324)
Increase in deposit for severance benefits trust		(22,351)		(23,823)		(18,458)
		91,860		97,910		59,607
Change in trade accounts receivable		(35,891)		(38,255)		(22,422)
Change in other receivables		(9,623)		(10,257)		5,334
Change in accrued income		(77)		(82)		4,465
Change in advance payments		1,247		1,329		22,287
Change in prepaid expenses		(3,716)		(3,961)		(1,707)
Change in inventories		42,014		44,781		112,150
Change in trade accounts payable		286		305		(2,962)
Change in other payables		77,559		82,668		4,682
Change in advance receipts		(2,402)		(2,560)		5,050
Change in withholdings		(4,155)		(4,429)		(12,915)
Change in value added tax withholdings		(11)		(12)		(12,268)
Change in accrued expenses		9,940		10,595		(21,465)
Change in tobacco excise taxs and dues payable		126,346		134,669		36,463
Change in income taxes payable		22,330		23,801		48,068
Payments to Tobacco Production Stabilization Fund		(110,000)		(117,246)		-
Others, net		(1,233)		(1,314)		(28,391)
Net cash provided by operating activities	₩	865,667	$	922,689	₩	843,777

Non-Consolidated Statements of Cash Flows, Continued

For the years ended December 31, 2007 and 2006

In millions of Won, and thousands of United States dollars	2007 Korean Won	2007 U.S. dollars (note 3)	2006 Korean Won
Cash flows from investing activities			
Decrease in short-term financial instruments	₩ -	$ -	₩ 240,000
Proceeds from sale of available-for-sale securities	1,750	1,865	9,708
Proceeds from sale of equity method investment securities	-	-	40,148
Decrease in long-term loans	111,400	118,738	3,000
Decrease in guarantee deposits	17,226	18,361	18,738
Proceeds from sale of property, plant & equipment	26,617	28,370	21,601
Purchases of available-for-sale securities	(242,324)	(258,286)	(8,258)
Purchases of equity method investment securities	(18,009)	(19,195)	-
Increase in long-term loans to employees	(10,079)	(10,743)	(5,587)
Increase in guarantee deposits	(18,167)	(19,364)	(22,140)
Increase in long-term deposit in Escrow Fund	(20,415)	(21,760)	(19,841)
Purchases of property, plant & equipment	(220,962)	(235,517)	(259,041)
Purchases of intangible assets	(55)	(59)	(109)
Other, net	(1,012)	(1,078)	(2,126)
Net cash provided by (used in) investing activities	(374,030)	(398,668)	16,093
Cash flows from financing activities			
Increase (decrease) in guarantee deposits received, net	(2,921)	(3,113)	3,660
Reissuance of treasury stock	235,233	250,728	76,768
Reacquisition of treasury stock	(455,035)	(485,009)	(857,778)
Dividends paid	(319,712)	(340,772)	(249,703)
Net cash used in financing activities	(542,435)	(578,166)	(1,027,053)
Net decrease in cash and cash equivalents	(50,798)	(54,145)	(167,183)
Cash and cash equivalents at beginning of year	165,924	176,854	333,107
Cash and cash equivalents at end of year	₩ 115,126	$ 122,709	₩ 165,924

Notes to non-consolidated financial statements

December 31, 2007 and 2006

1 Organization and Description of Business

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

As of December 31, 2007, 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 Depositary Receipts ("GDR") (each GDR 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, 2007 is held as follows:

Stockholder	Number of shares of	Percentage ownership
Industrial Bank of Korea	9,510,485	6.63%
Employee Stock Ownership Association	8,784,209	6.12%
Treasury stock	12,602,590	8.79%
Others	112,545,213	78.46%
	143,442,497	100.00%

The Company has, thus far, reacquired and retired 47,549,400 shares of treasury stock. Accordingly, as of December 31, 2007, the Company's common stock differs from the aggregate par value of issued shares by ₩237,747 million.

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

(a) Basis of Presenting Financial Statements

The Company maintains its accounting records in Korean Won and prepares statutory nonconsolidated financial statements in the Korean language in conformity with 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 solely for use by only those who are informed about Korean accounting principles and practices. The accompanying non-consolidated financial statements have been condensed, restructured and translated into English from the Korean language nonconsolidated financial statements.

Certain information included in the Korean language non-consolidated 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 non-consolidated financial statements.

Effective January 1, 2007, the Company adopted Statements of Korea Accounting Standards ("SKAS") No. 21 (Preparation and Presentation of Financial Statements), No. 22 (Share-based Payment), and No. 23 (Earnings per Share). As allowed by these standards, prior year balances have not been reclassified to conform to the current year presentation. Certain accounts of prior year's non-consolidated financial statements have been reclassified to conform to the current year's presentation. These reclassifications have not resulted in any change to reported net income or stockholders' equity.

(b) Changes in Presentation of Financial Statements

According to SKAS No. 21, Preparation and Presentation of Financial Statements, a statement of changes in equity has been included in the financial statements and the capital adjustment account has been split into capital adjustments and accumulated other comprehensive income. In addition, earnings per share data are now presented as a separate item in the statement of income. A statement of comprehensive income has been included in the notes to the financial statements.

(c) Cash Equivalents

The Company considers short-term deposits with maturities of three months or less on acquisition date to be cash equivalents.

(d) Short-term Deposits

Short-term deposits, (including money market deposit accounts (MMDAs), time deposits, and installment savings deposits), are held for short-term cash management purposes, maturing within one year.

(e) Allowance for Doubtful Accounts

Allowance for doubtful accounts is estimated based on an analysis of individual accounts and past experience of collection and presented as a deduction from trade receivables.

2 Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued

(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 goods-in-transit. Also, the cost of construction-in-progress and land involved in pre-contracted sales are determined by the specific identification method. Amounts of inventory written down to net realizable value due to losses occurring in the normal course of business are recognized as cost of goods sold and are deducted as an allowance from the carrying value of inventories. The Company recognized loss and reversal of loss on valuation of inventories amounting to ₩30,014 million and ₩35,001 million, respectively, for the year ended December 31, 2007. Also, the estimated amounts of inventories in current assets, which will not be realized in a year or less, are ₩319,217 million and ₩411,239 million, respectively, as of December 31, 2007 and 2006.

The Company recognizes interest costs and other financial charges on borrowings associated with inventories that require a long period in the acquisition, construction or production as an expense in the period in which they are incurred.

(g) Investment in Securities (excluding investments in associates, subsidiaries and joint ventures)

Classification

Upon acquisition, the Company classifies debt and equity securities (excluding investments in subsidiaries, associates and joint ventures) into the following categories: held-to-maturity, availablefor-sale or trading securities. This classification is reassessed at each balance sheet date.

Investments in debt securities where the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity. Securities that are acquired principally for the purpose of selling in the short term are classified as trading securities. Investments not classified as either held to-maturity or trading securities are classified as available-for-sale securities.

Initial recognition

Investments in securities (excluding investments in subsidiaries, associates and joint ventures) are initially recognized at cost.

Subsequent measurement and income recognition

Trading securities are subsequently carried at fair value. Gains and losses arising from changes in the fair value of trading securities are included in the income statement in the period in which they arise. Available-for-sale securities are subsequently carried at fair value. Gains and losses arising from changes in the fair value of available-for-sale securities are recognized as accumulated other comprehensive income, net of tax, directly in equity. Investments in available-for-sale securities that do not have readily determinable fair values are recognized at cost less impairment, if any. Held-to-maturity investments are carried at amortized cost with interest income and expense recognized in the income statement using the effective interest method.

Fair value information

The fair value of marketable securities is determined using quoted market prices as of the period end. Non-marketable debt securities are fair valued by discounting cash flows using the prevailing market rates for debt with a similar credit risk and remaining maturity. Credit risk is determined using the Company' s credit rating as announced by accredited credit rating agencies in Korea. The fair value of investments in money market funds is determined by investment management companies.

2 Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued

(g) Investment in Securities (excluding investments in associates, subsidiaries and joint ventures), Continued

Presentation

Trading securities are presented as current assets. Available-for-sale securities, which mature within one year from the balance sheet date or where the likelihood of disposal within one year from the balance sheet date is probable, are presented as current assets. Held-to-maturity securities, which mature within one year from the balance sheet date, are presented as current assets. All other available-for-sale securities and held-to-maturity securities are presented as longterm investments.

Impairment

The Company reviews investments in securities whenever events or changes in circumstances indicate that the carrying amount of the investments may not be recoverable. Impairment losses are recognized when the reasonably estimated recoverable amounts are less than the carrying amount
and it is not obviously evidenced that impairment is unnecessary.

(h) Investment Securities under the Equity Method of Accounting

Associates are all entities over which the Company has the ability to significantly influence the financial and operating policies and procedures, generally accompanying a shareholding of over 20 per cent of the voting rights. Subsidiaries are entities controlled by the Company.

Investments in associates and subsidiaries are accounted for using the equity method of accounting and are initially recognized at cost.

The Company' s investments in associates and subsidiaries include goodwill identified on acquisition (net of any accumulated impairment loss). Goodwill is calculated as the excess of the acquisition cost of an investment in an associate or subsidiary over the Company' s share of the fair value of the identifiable net assets acquired. Goodwill is amortized using the straight-line method over its estimated useful life. Amortization of goodwill is recorded together with equity income (losses).

When events or circumstances indicate that the carrying value of goodwill may not be recoverable, the Company reviews goodwill for impairment and records any impairment loss immediately in the statement of income.

The Company' s share of its post-acquisition profits or losses in investments in associates and subsidiaries is recognized in the income statement, and its share of post-acquisition movements in equity is recognized in equity. The cumulative post-acquisition movements are adjusted against the carrying amount of each investment. Changes in the carrying amount of an investment resulting from dividends by an associate or subsidiary are recognized when the associate or subsidiary declares the dividend. When the Company' s share of losses in an associate or subsidiary equals or exceeds its interest in the associate or subsidiary, including preferred stock or other long term loans and receivables issued by the associate or subsidiary, the Company does not recognize further losses, unless it has incurred obligations or made payments on behalf of the associate or subsidiary. Unrealized gains on transactions between the Company and its ass sociate or subsidiary. ociates or subsidiaries are eliminated to the extent of the Company' s interest in each associate or subsidiary.

2 Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued

(i) Property, Plant and Equipment

Property, plant and equipment are stated at cost, except in the case of revaluations made in accordance with the Asset Revaluation Law which allowed for asset revaluation prior to the Law being revoked. Assets acquired through investment in kind or donation, are recorded at their fair value upon acquisition. For assets acquired in exchange for a non-monetary asset, the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

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 using the straight-line method over estimated useful lives of the respective assets as follows:

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

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

The Company reviews property, plant and equipment for impairment 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 the expected estimated undiscounted future net cash flows from the use of the asset and its eventual disposal are less than its carrying amount.

(j) Intangible Assets

An intangible asset is an asset where: (1) it is probable that future economic benefits that are attributable to the asset will flow into the entity and (2) the cost of the asset can be measured reliably.

Intangible assets are stated at cost less accumulated amortization and impairment losses, if any. Impairment losses are determined as the amount required to reduce the carrying amount of an intangible asset to its recoverable amount.

The criteria for determining whether an incurred cost qualifies as an intangible asset and the periods of amortization for each classification of intangible asset are described below.

2 Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued

(j) Intangible Assets, Continued

(i) Research and Development Costs

To assess whether an internally generated intangible asset meets the criteria for recognition, the Company classifies the expense generation process into a research phase and a development phase. All costs incurred during the research phase are expensed as incurred. Costs incurred during the development phase are recognized as assets only if the following criteria are met for recognition in SKAS No. 3, Intangible Assets: (1) Completion of the intangible asset is technically feasible so that it will be available for use or sale; (2) the Company has the intention and ability to complete the intangible asset and use or sell it; (3) there is evidence that the intangible asset will generate probable future economic benefit; (4) the Company has adequate technical, financial and other resources to complete the development of the intangible asset and the intangible asset will be available; and (5) the expenditures attributable to the intangible asset during its development can be reliably determined. If the costs incurred fail to satisfy these criteria, they are recorded as expenses as incurred.

(ii) Other Intangible Assets

Other intangible assets, which consist of industrial property rights, franchise rights and software, are amortized using the straight-line method over 5~15 years.

(k) 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 salary rates 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 non-consolidated 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 non-consolidated balance sheets as a reduction of the liability for retirement and severance benefits.

(l) 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 or losses recognized in current results of operations. Monetary assets and liabilities denominated in foreign currencies are translated into Korean Won at ₩938.9 to USD1, the rate of exchange on December 31, 2007 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 on the date of the transaction.

Foreign currency assets and liabilities of foreign-based operations and companies accounted for using the equity method are translated at current rate of exchange at the balance sheet date while profit and loss items in the statement of income are translated at average rate and capital account at historical rate. Translation gains and losses arising from collective translation of the foreign currency financial statements of foreign-based operations are recorded net as accumulated other comprehensive income. These gains and losses are subsequently recognized as income in the year the foreign operations or the companies are liquidated or sold.

2 Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued

(m) Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, the product has been delivered and title of the product has been transferred, the price is fixed or determinable, and collection of the resulting receivables is reasonably assured.

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.

(n) 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 in equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted.

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 tax 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.

Deferred tax assets and liabilities are classified as current or non-current based on the classification of the related asset or liability for financial reporting or the expected reversal date of the temporary difference for those with no related asset or liability such as loss carryforwards and tax credit carryforwards. The deferred tax amounts are presented as a net current asset or liability and a net non-current asset or liability.

Deferred taxes are recognized on the temporary differences related to unrealized gains and losses on investment securities that are reported as a separate component of capital adjustments.

(o) 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. Where the effect of the time value of money is material, a provision is recorded at the present value of the expenditures expected to be required to settle the obligation.

Where the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement is recognized as a separate asset when, and only when, it is virtually certain that reimbursement will be received if the Company settles the obligation. The expense relating to a provision is presented net of the amount recognized for a reimbursement.

2 Summary of Significant Accounting Policies and Basis of Presenting Financial Statements, Continued

(p) Earnings Per Share

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

(q) Share-based Payments

The Company has granted shares or share options to its employees and other parties. For equitysettled share-based payment transactions, the Company measures the goods or services received, and the corresponding increase in equity as a capital adjustment at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the Company measures their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. If the fair value of the equity instruments cannot be estimated reliably at the measurement date, the Company measures them at their intrinsic value and recognizes the goods or services received based on the number of equity instruments that ultimately vest. For cash-settled sharebased payment transactions, the Company measures the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the Company remeasures the fair value of the liability at each reporting date and at the date of settlement, with changes in fair value recognized in profit or loss for the period.

(r) Use of Estimates

The preparation of non-consolidated 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 non-consolidated financial statements and related notes to non-consolidated financial statements. Actual results could differ from those estimates.

3 Basis of Translating Financial Statements

The non-consolidated financial statements are expressed in Korean Won and have been translated into U.S. dollars at the rate of ₩938.2 to USD1, the basic exchange rate on December 31, 2007, solely for the convenience of the reader. This translation should not be construed as a representation that any or all of the amounts shown could be converted into United States dollars at this or any other rate.

Notes to non-consolidated financial statements

December 31, 2007 and 2006

4 Inventories

Inventories as of December 31, 2007 and 2006 are summarized as follows:

In millions of Won

		2007		2006
Finished goods, net of allowance for valuation losses	₩	80,680	₩	90,546
Work-in-process		10,100		9,758
Raw materials, net of allowance for valuation losses		792,561		866,445
Supplies		21,507		19,425
By-products		2,641		4,267
Completed buildings		52,150		2,745
Sites for building lotting-out construction		13,204		11,571
Goods-in-transit		6,670		11,783
	₩	979,513	₩	1,016,540

5 Other Current Assets

Other current assets as of December 31, 2007 and 2006 are summarized as follows:

In millions of Won

		2007		2006
Accrued income	₩	237	₩	160
Other receivables, net of allowance for doubtful accounts of ₩4,652 in 2007 and ₩4,661 in 2006 (note 17)		33,564		24,687
Prepaid expenses		7,006		3,291
Short-term loans to employees (note 8)		19,442		19,194
Advance payments		244		1,490
Available-for-sale securities (note 6)		92		555
	₩	60,585	₩	49,377

Notes to non-consolidated financial statements

December 31, 2007 and 2006

6 Available-for-sale Securities

Available-for-sale securities as of December 31, 2007 and 2006 are summarized as follows:

(a) Equity securities (non-current)

In millions of Won, except owned shares and percentage of ownership	Number of shares	Percentage of ownership	Acquisition cost	Fair value	Book value 2007	Book value 2006
Marketable securities:						
Yonhap Television News (YTN)	8,380,000	19.95%	₩ 5,102	₩ 28,366	₩ 28,366	₩ 28,366
Crystal Genomics Co., Ltd.	172,187	1.94%	3,022	1,79	1 1,791	1,582
Oscotech, Inc.	230,770	3.54%	2,250	1,396 1,	396	2,250
Shinhan Financial Group	3,500,000	0.92%	205,532	187,250	187,250	-
			215,906	218,803	218,803	32,198
Non-marketable securities:						
Celltrion, Inc.	37,913,680	13.89%	21,245	21,245	21,245	21,245
Nexgen Biotechnologies, Inc. (*1)	1,000,000	11.84%	2,150	-	-	2,150
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. (*4)	-	-	-	-	-	869
Cosmo Tobacco Co., Ltd. (*1)	480,000	40.00%	2,540	-	-	-
Innodis, Inc.	110,000	19.64%	55	55	55	55
REXAHN Pharmaceuticals, Inc.	4,642,858	8.41%	5,158	5,158	5,158	2,359
Lifenza, Inc. (*1)	29,047	13.01%	1,600	-	-	-
Korea Islet Transplantation Institute, Inc. (*2)	110,500	48.25%	2,000	2,000	2,000	2,000
KT&G Mongolia LLC (*2)	40,000	100.00%	201	201	201	201
Korea Tabacos do Brasil Ltda. (*2)	(*3)	99.90%	394	394	394	394
Genematrix, Inc.	300,000	10.49%	1,500	1,500	1,500	1,500
Litepharmtech, Inc. (*2)	77,667	29.41%	1,830	1,830	1,830	1,000
Hurum, Inc.	7,800	9.75%	39	39	39	39
MD Bioalpha Co., Ltd.	197,556	15.00%	733	733	733	667
OCT USA, Inc.	48,780	19.97%	927	927	927	927
Dream Hub PFV Co., Ltd.	15,000	1.50%	75	75	75	-
			40,447	34,157	34,157	33,406
Total			₩ 256,353	₩ 252,960	₩ 252,960	₩ 65,604

(*1) The Company wrote off the equity interest in Nexgen Biotechnologies, Inc. as its decline in value was judged to be other than temporary, and recorded a loss of ₩2,150 million charged to current results of operations for the year ended December 31, 2007. In the prior period, the Company also wrote off its investments in Lifenza, Inc., and Cosmo Tobacco Co., Ltd. for the same reason. Other than the above securities, non-marketable securities are recorded at cost since fair value is not available or readily determinable.

(*2) Investments in small affiliates are accounted for under the cost method of accounting for investments since the effect of applying the equity method on its financial statements is not material.

(*3) Stock certificates are not issued.

(*4) The Company reclassified its investment in KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. as an equity method accounted investment since the effect of applying the equity method was material due to an additional acquisition of shares in the investee given rise to by an increase in its paid-in capital in the year ended December 31, 2007.

Notes to non-consolidated financial statements

December 31, 2007 and 2006

6 Available-for-sale Securities, Continued

(b) Debt securities

In millions of Won	Interest rate per annum		Acquisition cost	Fair value	Book value 2007		Book value 2006
Current assets:							
Government and municipal bonds	3.0 ~ 4.0%	₩	92	92	92	₩	555
Non-current assets:							
Government and municipal bonds	2.5 ~ 4.0%		2,129	2,129	2,129		2,175
Oscotech, Inc.	10.0%		1,000	1,000	1,000		1,000
Litepharmtech, Inc.	8.0%		1,000	1,000	1,000		1,000
			4,129	4,1299	4,129		4,175
		₩	4,221	4,221	4,221	₩	4,730

(c) Changes in unrealized gains

(i) Changes in unrealized gains of valuation of available-for-sale securities for the year ended December 31, 2007 are summarized as follows:

In millions of Won		Amount including tax effect	Tax effect		Amount, net of tax effect
Beginning balance	₩	21,971	(6,042)	₩	15,929
Changes in unrealized gain		(19,074)	5,245		(13,829)
Ending balance	₩	2,897	(797)	₩	2,100

(ii) Changes in unrealized gains of valuation of available-for-sale securities for the year ended December 31, 2006 are summarized as follows:

In millions of Won		Amount including tax effect	Tax effect		Amount, net of tax effect
Beginning balance	₩	29,926	(8,230)	₩	21,696
Changes in unrealized gain		(7,955)	2,188		(5,767)
Ending balance	₩	21,971	(6,042)	₩	15,929

7 Equity Method Accounted Investments

(a) Investments in companies accounted for using the equity method as of December 31, 2007 were as follows:

In millions of Won, except owned shares and percentage of ownership

Company	Percentage of ownership		Cost	Market value or net assets		Balance at December 31, 2007
Listed						
Yungjin Pharm. Ind. Co., Ltd. (*1)	55.50%	₩	50,691	78,660	₩	23,966
Unlisted						
Korea Ginseng Corporation	100.00%		214,929	559,883		559,883
Tae-a Industry Co., Ltd.	100.00%		14,198	6,229		9,174
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. (*1,2)	99.99%		313,488	591,173		626,693
		₩	593,306	1,235,945	₩	1,219,716

(*1) The Company used unaudited financial statements of Yungjin Pharm. Ind. Co., Ltd. and KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. when applying the equity method of accounting. In the subsequent period, the Company adjusted the difference between the unaudited and audited results. Historically, the differences have been immaterial.

(*2) The Company reclassified its investment in KT&G Tutun Mamulleri Sanayi ve Ticaret A.S. as an equity method accounted investment since the effect of applying the equity method was material due to an additional acquisition of shares in the investee given rise to by an increase in its paid-in capital in the year ended December 31, 2007.

Investments in companies accounted for using the equity method as of December 31, 2006 were as follows:

In millions of Won, except owned shares and percentage of ownership

Company	Percentage of ownership		Cost	Market value or net assets		Balance at December 31, 2006
Listed						
Yungjin Pharm. Ind. Co., Ltd.	56.97%	₩	32,682	142,704	₩	27,909
Unlisted						
Korea Ginseng Corporation	100.00%		214,929	451,545		451,545
Tae-a Industry Co., Ltd.	100.00%		14,198	5,467		10,528
KT&G USA, Inc.	100.00%		584	903		903
		₩	262,393	600,619	₩	490,885

7 Equity Method Accounted Investments, Continued

(b) Details of the difference between the acquisition cost and the Company's share of the investees' identifiable net assets arisen in the years ended December 31, 2007 and 2006 were as follows:

	2007				
In millions of Won		Beginning balance	Amortized amount		Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩	1,832	(909)	₩	923
Tae-a Industry Co., Ltd.		5,183	(2,074)		3,109
	₩	7,015	(2,983)	₩	4,032

	2006				
In millions of Won		Beginning balance	Amortized amount		Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩	2,741	(909)	₩	1,832
Tae-a Industry Co., Ltd.		7,257	(2,074)		5,183
	₩	9,998	(2,983)	₩	7,015

(c) Details of unrealized gains from intercompany transactions for the years ended December 31, 2007 and 2006are summarized as follows:

	2007					
In millions of Won		Beginning balance	Increase	Realized amount		Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩	876	1,157	(16)	₩	2,017
Tae-a Industry Co., Ltd.		123	41	-		164
	₩	999	1,198	(16)	₩	2,181

	2006					
In millions of Won		Beginning balance	Increase	Realized amount		Ending balance
Yungjin Pharm. Ind. Co., Ltd.	₩	876	-	-	₩	876
Tae-a Industry Co., Ltd.		463	123	(463)		123
	₩	1,339	123	(463)	₩	999

7 Equity Method Accounted Investments, Continued

(d) Changes in the opening and closing balances of investments in companies accounted for using the equity method for the years ended December 31, 2007 and 2006 were as follows:

In millions of Won, except percentage of ownership

	2007							
Company	Percentage of ownership		Balance at January 1, 2007	Net income (loss)	Accumulated other comprehensive income	Other increase (decrease) (*1)		Balance December 31, 2007
Korea Ginseng Corporation	55.50%	₩	451,545	128,302	36	(20,000)	₩	559,883
Yungjin Pharm. Ind. Co., Ltd(*3).	100.00%		27,909	(23,645)	1,693	18,009		23,966
Tae-a Industry Co., Ltd.	100.00%		10,528	(1,354)	-	-		9,174
KT&G USA, Inc(*2)	-		903	-	-	(903)		-
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	99.99%		-	-	-	33,670		33,670
		₩	490,885	103,303	1,729	30,776	₩	626,693

(*1) The amount consists of ₩20,000 cash dividends, ₩51,679 paid-in capital increase and W903 reclassification.

(*2) In the first quarter of 2007, the Company reclassified its investment in KT&G USA, Inc. as available-for-sale securities since KT&G USA, Inc. was in the process of liquidation. The liquidation process was completed in the year ended December 31, 2007, and the Company recorded a ₩724 million gain on sale of available-for-sale securities.

(*3) Youngjin Pharm. Ind. Co., Ltd. amended its financial statements as of and for the year ended December 31, 2006 due to adjustments for the accounting error for the fiscal year 2006 and prior periods by which accumulated deficit increased by ₩20,959 million. However, as the effect of the adjustments on the financial statements was judged to be not material, a loss of ₩11,940 million has been charged to current results for the period ended December 31, 2007.

7 Equity Method Accounted Investments, Continued

In millions of Won, except percentage of ownership

	2006							
Company	Percent age of owner ship		Balance at January 1, 2006	Net income (loss)	Accumu-lated other compre-hensive income	Other increase (decrease)		Balance at December 31, 2006
Korea Ginseng Corporation	56.97%	₩	353,410	99,197	(1,062)	-	₩	451,545
Yungjin Pharm. Ind. Co., Ltd.	100.00%		32,496	(4,587)	-	-		27,909
Buytheway Co.,Ltd.(*)	-		22,719	-	-	(22,719)		-
KT&G Tutun MamulleriSanayi ve Ticaret A.S. 99.99%			868	-	-	(868)		-
Tae-a Industry Co., Ltd.	100.00%		11,823	(1,295)	-	-		10,528
KT&G USA, Inc	100.00%		-	549	(230)	584		903
		₩	421,316	93,864	(1,292)	(23,003)	₩	490,885

(*) The Company disposed of its investment in Buytheway Co.,Ltd. and recognized a gain on sale of equity method investments amounting to ₩17,428 million as other income in the year ended December 31, 2006.

(e) Summarized financial information of equity-accounted investments which represents 100% of the entities' balances as of December 31, 2007 was as follows:

In millions of Won		Total assets	Total liabilities	Sales		Net income (loss)
Korea Ginseng Corporation	₩	631,874	71,991	521,123	₩	128,302
Yungjin Pharm. Ind. Co., Ltd.		106,912	61,759	109,422		(16,575)
Tae-a Industry Co., Ltd.		10,298	4,070	13,419		767
KT&G Tutun MamulleriSanayi ve Ticaret A.S.	₩	37,973	4,303	-	₩	(1,608)

Notes to non-consolidated financial statements

December 31, 2007 and 2006

8 Transactions and Balances with Related Companies

(a) The Company's subsidiaries as of December 31, 2007 were as follows:

Controlled subsidiary (*)	Ownership (%)
Korea Ginseng Corporation	100.00%
Yungjin Pharm. Ind. Co., Ltd.	55.50%
Tae-a Industry Co., Ltd.	100.00%
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	99.99%
KT&G Mongolia LLC	100.00%
Cosmo Tabacco Co., Ltd.	40.00%
Korea Tabacos do Brasil Ltda.	99.90%
Korea Islet Transplantation Institute, Inc.	48.25%
Korea Ginseng HK, Ltd.	100.00%
KGC Sales Co., Ltd.	100.00%
Yungjin Distribution Co., Ltd.	

(*) Controlled subsidiaries represent majority-owned entities by either the Company or a controlled subsidiary and other entities where the Company or its controlled subsidiary owns more than 30% of total outstanding common stock and is the largest shareholder.

The Company's affiliation with KT&G USA, Inc. was terminated in the year ended December 31, 2007 on the completion of the latter's liquidation process.

(b) 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, 2007 and 2006 are summarized as follows:

(i) Revenue from sales and others

	2007			2006		
In millions of Won	Sales	Other income	Total	Sales	Other income	Total
Korea Ginseng Corporation	₩ 1,440	11,545	12,985	1,216	9,464	₩ 10,680
Yungjin Pharm. Ind. Co., Ltd.	202	1	203	307	45	352
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	1,186	680	1,866	-	-	-
KT&G USA	1,694	-	1,694	25,656	-	25,656
KT&G Mongolia LLC	1,457	-	1,457	232	-	232
	₩ 5,979	12,226	18,205	27,411	9,509	₩ 36,920

8 Transactions and Balances with Related Companies, Continued

(ii) Purchases and other expenses

In millions of Won	2007			2006		
	Purchases	Other expenses	Total	Purchases	Other expenses	Total
Korea Ginseng Corporation	₩ 2,223	-	2,223	2,149	-	₩ 2,149
Yungjin Pharm. Ind. Co., Ltd.	144	-	144	143	-	143
Tae-a Industry Co., Ltd.	13,419	-	13,419	9,959	-	9,959
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	1,092	494	1,586	-	-	-
Korea Tabacos do Brasil Ltda.	-	132	132	-	139	139
	₩ 16,878	626	1,586	12,251	139	₩ 12,390

(iii) Due from affiliates

In millions of Won	2007			2006		
	Trade accounts receivable	Other	Total	Trade accounts receivable	Other	Total
KT&G USA	₩ -	-	-	9,192	-	₩ 9,192
KT&G Tutun MamulleriSanayi ve Ticaret A.S.	1,127	-	1,127	-	1,249	1,249
KT&G Mongolia LLC	316	238	554	232	238	470
	₩ 1,443	238	1,681	9,424	1,487	₩ 10,911

(iv) Due to affiliates

In millions of Won	2007			2006		
	Trade accounts payable	Other	Total	Trade accounts payable	Other	Total
Korea Ginseng Corporation	₩ 270	2,379	2,649	13	2,820	₩ 2,833

(c) Due from stockholders, directors and employees as of December 31, 2007 and 2006 are summarized as follows:

In millions of Won	2007	2006
Loans for employee housing and education	₩ 31,713	₩ 33,075
Loans to Employee Stock Ownership Association	37,664	24,906
Other	46,004	22,319
	₩ 115,381	₩ 80,300

8 Transactions and Balances with Related Companies, Continued

(d) Key management personnel compensation in total and for each of the following categories for the year ended December 31, 2007 was summarized as follows:

In millions of Won		Amount
Short-term payroll	₩	11,609
Post-retirement pay		4,081
	₩	15,690

(e) The guarantee that the Company has provided for a related company as of December 31, 2007 was as follows:

Related company	Type of guarantee	Financial institution	Guaranteed amount
KT&G Tutun Mamulleri Sanayi ve Ticaret A.S.	Payment guarantee on foreign currency letter of redit opened in relation with acquisition of tobacco manufacturing machinery	Korea Exchange Bank (Deutschland) AG	10,000,000 Euros, plus incidental expenses and interest expense

9 Current Portion of Long-term Loans Receivable

Current portion of long-term loans to the National Leaf Tobacco Growers Cooperative Federation in support of Leaf Tobacco Cultivation and the Korea Ginseng Cooperative Federation in support of Ginseng Cultivation as of December 31, 2006 were collected in the period ended December 31, 2007.

10 Property, Plant and Equipment

Property, plant and equipment at December 31, 2007 and 2006 are summarized were follows:

In millions of Won		2007		2006
Property, plant and equipment at cost	₩	2,224,880	₩	2,040,833
Accumulated depreciation		(815,881)		(696,471)
Accumulated impairment losses		(41)		(206)
Property, plant and equipment, net	₩	1,408,958	₩	1,344,156

10 Property, Plant and Equipment, Continued

(a) Changes in property, plant and equipment for the year ended December 31, 2007 were as follows:

In millions of Won		January 1, 2007	Acquisition	Disposal	Depreciation	Others (*1)		December 31, 2007
Land	₩	353,865	21,961	(13,591)	-	41,110	₩	403,345
Buildings		460,511	6,088	(4,415)	(21,570)	30,117		470,731
Structures		23,194	1,076	(263)	(1,971)	1,304		23,340
Machinery and equipment		332,553	7,220	(2,478)	(67,408)	72,587		342,474
Vehicles and other transportation equipment		5,322	546	(225)	(2,883)	76		2,836
Tools		10,010	2,106	(28)	(4,497)	4,048		11,639
Furniture and fixtures		75,235	32,493	(128)	(36,443)	4,170		75,327
Construction-in-progress (*2)		83,002	149,333	-	-	(153,672)		78,663
Other tangible fixed assets		464	139	-	-	-		603
	₩	1,344,156	220,962	(21,128)	(134,772)	(260)	₩	1,408,958

(*1) Other changes in property, plant and equipment, except those transferred from construction-inprogress, for the year ended December 31, 2007 were as follows:

In millions of Won		Amount
Transferred to vehicles and other transportation equipment	₩	30
Transferred to intangible assets		(290)
	₩	(260)

(*2) Construction-in-progress as of December 31, 2007 included investment on development of new medicines amounting to ₩ 21,320 million.

(b) Changes in property, plant and equipment for the year ended December 31, 2006 were as follows:

In millions of Won		January 1, 2006	Acquisition	Disposal	Depreciation	Others (*1)		December 31, 2006
Land	₩	331,750	21,642	(3,286)	-	3,759	₩	353,865
Buildings		435,769	13,146	(15,128)	(20,199)	46,923		460,511
Structures		23,482	546	(360)	(1,967)	1,493		23,194
Machinery and equipment		279,641	4,342	(1,685)	(59,756)	110,011		332,553
Vehicles and other transportation equipment		8,512	498	(85)	(3,665)	62		5,322
Tools		9,913	1,777	(103)	(3,948)	2,371		10,010
Furniture and fixtures		72,344	31,929	(94)	(30,802)	1,858		75,235
Construction-in-progress (*2)		74,827	185,161	-	-	(176,986)		83,002
Other tangible fixed assets		457	-	-	-	7		464
	₩	1,236,695	259,041	(20,741)	(120,337)	(10,502)	₩	1,344,156

10 Property, Plant and Equipment, Continued

(*1) Other changes in property, plant and equipment except those transferred from construction-inprogress for the year ended December 31, 2006 were as follows:

In millions of Won		Amount
Impairment losses on property, plant and equipment	₩	(205)
Transferred to site for building lotting-out construction		(9,893)
Transferred to intangible assets		(404)
	₩	(10,502)

(*2) Construction-in-progress as of December 31, 2006 included investment on development of new medicines amounting to ₩14,155 million.

11 Officially Declared Value of Land

The officially declared value of land at December 31, 2007, as announced by the Minister of Construction and Transportation, is ₩1,304,163 million. The officially declared value, which is used for government purposes, is not intended to represent fair value.

12 Intangible Assets

(a) Changes in intangible assets for the year ended December 31, 2007 were as follows:

In millions of Won		Industrial property rights	Other intangible assets		Total
Beginning balance	₩	1,809	297	₩	2,106
Increases		345	-		345
Amortization		(634)	(98)		(732)
Net balance at end of period	₩	1,520	199	₩	1,719

(b) Changes in intangible assets for the year ended December 31, 2006 were as follows:

In millions of Won		Industrial rights	Other property assets		intangible Total
Beginning balance	₩	2,063	395	₩	2,458
Increases		512	-		512
Disposal		(20)	-		(20)
Amortization		(746)	(98)		(844)
Net balance at end of period	₩	1,809	297	₩	2,106

13 Insurance

Buildings, structures, machinery and inventories were insured against fire damage up to ₩811,628 million as of December 31, 2007 with DongBu Insurance Co., Ltd. In addition, the Company carries comprehensive automobile insurance, unemployment insurance and workers' accident compensation insurance.

14 Other Non-Current Assets

Other assets as of December 31, 2007 and 2006 are summarized as follows:

In millions of Won		2007		2006
Long-term accrued interest	₩	-	₩	27
Long-term loans to affiliates (note 8)		238		1,487
Long-term other receivables,				
net of allowance for doubtful accounts of ₩10 in 2007		1,018		-
	₩	1,256	₩	1,514

15 Other Current Liabilities

Other current liabilities as of December 31, 2007 and 2006 are summarized as follows:

In millions of Won		2007		2006
Withholdings	₩	6,244	₩	7,371
Advance receipts		4,709		7,113
Current portion of financial derivative liabilities		25		-
Unearned income		321		915
	₩	11,299	₩	15,399

16 Retirement and Severance Benefits

Changes in the retirement and severance benefits for the years ended December 31, 2007 and 2006 are summarized as follows:

In millions of Won		2007		2006
Estimated retirement and severance benefits accrual				
at beginning of year	₩	173,332	₩	132,890
Provision for retirement and severance benefits		31,014		47,765
Payments (*)		(22,001)		(7,324)
Estimated retirement and severance benefits accrual				
at end of year		182,345		173,332
Deposit for severance benefits trust		(117,985)		(95,635)
Net balance at end of year	₩	64,360	₩	77,697

The Company maintains an employees' severance benefit trust arrangement with Samsung Life Insurance Co., Ltd. and other. Under this arrangement, the Company has made a deposit in the amount equal to 64.7% and 55.2% of the reserve balances of retirement and severance benefits as of December 31, 2007 and 2006, respectively. This deposit is to be used to make the required payments to the retirees and accounted for as a reduction of the reserve balance.

(*) Compensations paid by treasury stock amounting to ₩8,247 million for the year ended December 31, 2007 were included.

17 Assets and Liabilities Denominated in Foreign Currencies

Details of assets and liabilities denominated in foreign currencies as of December 31, 2007 and 2006 were as follows:

In millions of Won, In thousands of USD, JPY, HKD, EUR and GBP	Foreign currency				Korean Won equivalent			
		2007		2006		2007		2006
Assets:								
Cash and cash equivalents	USD	9,107	USD	278	₩	8,544	₩	258
Trade accounts receivable	USD	159,875	USD	107,248		149,995		99,698
	EUR	816	EUR	-		1,127		-
	HKD	-	HKD	1,495		-		179
Other receivables	USD	259	USD	134		243		125
Long-term deposits in Escrow Fund	USD	71,022	USD	49,065		66,633		45,611
Total	USD	240,263	USD	156,725		225,415		145,692
	EUR	816	EUR	-		1,127		-
	HKD	-	HKD	1,495		-		179
					₩	226,542	₩	145,871
Liabilities:								
Trade accounts payable	USD	692	USD	5,320	₩	649	₩	4,963
	EUR	2,530	EUR	-		3,495		-
	GBP	-	GBP	96		-		157
					₩	4,144	₩	5,120

18 Capital Adjustments

Capital adjustments as of December 31, 2007 and 2006 are summarized as follows:

In millions of Won		2007		2006
Treasury stock	₩	(414,947)	₩	(321,904)

19 Accumulated Other Comprehensive Income

Other accumulated comprehensive income as of December 31, 2007 and 2006 are summarized as follows:

In millions of Won		2007		2006
Unrealized gain on valuation of available-for-sale securities (note 6)	₩	2,100	₩	15,929
Unrealized gain on valuation of equity method investments		2,728		750
Unrealized loss on valuation of equity method investments		(639)		(895)
	₩	4,189	₩	15,784

20 Retained Earnings

Retained earnings as of December 31, 2007 and 2006 are summarized as follows:

In millions of Won		**2007**		**2006**
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 human resource development		45,000		45,000
Reserve for loss on reissuance of treasury stock		26,646		26,646
Other appropriations		350,000		880,000
Unappropriated (undisposed) retained earnings (deficit) at end of year		397,276		(204,796)
	₩	2,133,591	₩	2,061,519

(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

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

(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 human resource 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, 2007 and 2006

21 Commitments and Contingencies

The Company has entered into an agreement with the National Leaf Tobacco Growers Cooperative Federation to raise a fund with the target set at ₩410,000 million by 2008 for the purpose of stabilizing tobacco production. Under the agreement, the Company is obligated to make up 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 program by 2008. However, the Tobacco Business Regulation is expected to be amended so as for the ₩410,000 fund to comprise ₩300,000 million to be raised and ₩110,000 million to be contributed by the Company. The Regulation is expected to be promulgated during January 2008. The ₩300,000 million goal was already reached by November 30, 2007 and the Company made its contribution of ₩110,000 million to the Federation on December 31, 2007. As the Company has made provision for the deficiency on an annual basis to fully fund the tobacco production stabilization program by 2008, ₩35,516 million, which is the difference between the ₩110,000 million and the 2007 beginning balance of ₩74,487 million, was recognized as provision to Tobacco Production Stabilization Fund in non-operating income as of December 31, 2007. The reserve for tobacco production stabilization program in the amount of ₩110,000 million was offset against the contribution the Company had made.

The Company recorded as a long-term deposit the amounts paid into the Escrow Fund of State governments in the United States against potential litigation and damages relative to the tobacco exportation into the United States. The Escrow Fund would be refunded, if the Company did not indemnify the State governments for damages for a specified number of years on the ground that the Company did not sell cigarettes illegally.

As of December 31, 2007, tobacco lawsuits claiming damages of ₩1,339 million were filed against the Company and the Korean government. The plaintiffs have asserted that the Company and the Korean government did not perform their obligation to notify smokers of the potential health hazards of smoking. Additionally, the Company is involved in 11 lawsuits and claims for alleged damages aggregating ₩971and ￥400 million as of December 31, 2007. The amount of the liability the Company may ultimately have with respect to the litigation cannot be reasonably estimated as of December 31, 2007.

As of December 31, 2007, the Company has provided to the National Agricultural Cooperative Federation ("NACF") and another bank guarantees in the aggregate of ₩11,910 million for the customers who made a financing agreement with these lenders.

The Company has entered into Letter of Credit agreements with the NACF and other banks on the aggregate limit set at USD134,000 thousand.

As of December 31, 2007, the Company's trade accounts receivable arisen from export of cigarettes was insured against dishonor up to USD34,900 thousand by an export guaranty insurance with the Korea Export Insurance Corporation.

As of December 31, 2007, the Company has been provided with a foreign currency payment guarantee for local dealers in Russia and other countries up to USD90,000 thousand by Korea Exchange Bank and other.

The Company made a currency forward contract with the Korea Exchange Bank up to the contractual limit of USD26,000 thousand and the balance outstanding of the contract is USD7,000 thousand as of December 31, 2007.

The Company provided KT&G Turkey with a payment guarantee on the foreign currency Letter of Credit (LC) with a limit of EUR 10,000,000, plus incidental expenses and interest expense, which LC was opened at Korea Exchange Bank AG in connection with the acquisition of tobacco manufacturing machinery.

The Company and 25 other companies, which form the Samsung Corporation-National Pension Service Joint Consortium, were guaranteed W80,000 million by Seoul Guarantee Insurance Co. in relation to the Yongsan International Commercial Development Project.

22 Building Lotting-out Construction Contracts

(a) Building lotting-out construction contracts as of December 31, 2007 are summarized as follows:

	Builder	Construction period	Location
Apartment buildings in Jeonju	SK Engineering & Construction . Co., Ltd	2006 ~ 2009	Jeonju
Apartment buildings in Daejeon	Kyeryong Construction Industrial . Co., Ltd	2008 ~ 2009	Daejeon

(b) Details of installment sales as of December 31, 2007 are summarized as follows:

In millions of Won				Recognized revenue		
		Expected contract amount	Confirmed contract amount	Prior to 2007	2007	Unrecognized revenue
Apartment buildings in Jeonju	₩	284,995	55,331	460	19,815	264,720
Apartment buildings in Daejeon		44,047	-	-	-	44,047
	₩	329,042	55,331	460	19,815	308,767

(c) Cost of installment sales of store units for the years ended December 31, 2007 and 2006 were as follows:

In millions of Won		2007		2006
Outsourcing cost	₩	64,304	₩	12,323
Land and completed buildings:				
Beginning of the year		14,316		9,153
End of the year		-		(14,316)
Transferred to land and buildings		-		(1,120)
Transferred from land		(65,354)		11,571
Cost of sales of buildings	₩	13,266	₩	17,611

23 Income Taxes

(a) The Company is subject to a number of income taxes on taxable income at the following normal tax rates:

Taxable income	Tax rate
Up to ₩ 100	14.3%
Over ₩ 100	27.5%

The components of income tax expense for the years ended December 31, 2007 and 2006 are summarized as follows:

In millions of Won		2007		2006
Current income tax expense	₩	270,497	₩	197,338
Deferred income tax expense		18,744		18,951
Income tax expense charged directly to stockholders' equity		(43,344)		(10,986)
Income tax charge	₩	245,897	₩	205,303

(b) The provision for income taxes calculated using the normal tax rates differs from the actual charge for the years ended December 31, 2007 and 2006 for the following reasons:

In millions of Won		2007		2006
Provision for income taxes at normal tax rates	₩	249,437	₩	235,107
Tax effects of permanent differences, primarily additional income taxes for prior years		(2,070)		(11,637)
Tax credit		(8,026)		(4,767)
Changes in valuation allowances for deferred income tax assets (liabilities) arisen from equity in income of affiliates		6,279		(13,400)
Others		277		-
Actual charge for income taxes	₩	245,897	₩	205,303

Notes to non-consolidated financial statements

December 31, 2007 and 2006

23 Income Taxes, Continued

(c) The tax effects of temporary differences that result in significant portions of the deferred income tax assets and liabilities as December 31, 2007 and 2006 are presented below:

In millions of Won		2007		2006
Deferred income tax assets:				
Provision for severance and retirement benefits	₩	32,594	₩	28,681
Loss on valuation of inventories		4,012		5,384
Depreciation		3,504		4,404
Bad debts		2,602		1,096
Impairment losses on property, plant and equipment		654		754
Present value discounts		-		3,140
Provision for Tobacco Production Stabilization Fund		-		20,483
Long-term deposits in escrow fund		-		-
Contributions		18,467		-
Other		8,358		4,342
Total deferred tax assets		70,191		68,284
Deferred income tax liabilities:				
Accrued income		(51)		(35)
Deposit for severance and retirement benefits insurance		(32,445)		(26,300)
Reserve for research and human resources development		(8,250)		(12,375)
Equity-method investment securities		(116,020)		(86,984)
Reserve for losses on reissuance of treasury stock		(7,328)		(7,328)
Available-for-sale securities		(797)		(6,042)
Treasury stock		(10,781)		(15,636)
Other		(347)		(622)
Total deferred tax liabilities		(176,019)		(155,322)
Net deferred tax liabilitiy		(105,828)		(87,038)
Less: current portion		16,026		7,760
Net deferred tax liability - non-current	₩	(121,854)	₩	(94,798)

(d) Effective January 1, 2006, the Company adopted SKAS No. 16, Income Taxes. In accordance with SKAS No. 16, deferred taxes were 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 was charged directly to the separate component of the stockholders' equity. Income taxes charged directly to the separate component of the stockholders' equity for the years ended December 31, 2007 and 2006 were as follows:

In millions of Won		2007		2006
Gain on reissuance of treasury stock	₩	(48,864)	₩	(13,416)
Unrealized gain on valuation of available-for-sale securities		5,245		2,462
Unrealized loss on valuation of equity method investments		275		(32)
	₩	(43,344)	₩	(10,986)

23 Income Taxes, Continued

(e) Deferred tax assets have been recognized because it is probable that future profit will be available against which the Company can utilize the related benefit.

(f) Under SKAS No. 16, the deferred tax amounts should be presented as a net current asset or liability and a net non-current asset or liability. In addition, the Company is required to disclose aggregate deferred tax assets (liabilities). As of December 31, 2007, details of aggregate deferred tax assets (liabilities) were as follows:

In millions of Won		Temporary differences at December 31, 2007	Deferred tax assets (liabilities)	
			Current	Non-current
Assets:				
Provision for severance and retirement benefits	₩	32,594	-	32,594
Loss on valuation of inventories		4,012	4,012	
Depreciation		3,504	-	3,504
Bad debts		2,602	2,602	-
Impairment losses on property, plant and equipment		654	-	654
Contributions		18,467	4,500	13,967
Other		8,358	4,963	3,395
		70,191	16,077	54,114
Liabilities:				
Accrued income		(51)	(51)	-
Deposit for severance and retirement benefits trust		(32,445)	-	(32,445)
Reserve for research and human resources development		(8,250)	-	(8,250)
Equity-method investment securities		(116,020)	-	(116,020)
Reserve for losses on reissuance of treasury stock		(7,328)	-	(7,328)
Available-for-sale securities		(797)	-	(797)
Treasury stock		(10,781)	-	(10,781)
Other		(347)	-	(347)
		(176,019)	(51)	(175,968)
	₩	(105,828)	16,026	(121,854)

Notes to non-consolidated financial statements

December 31, 2007 and 2006

24 Earnings Per Share

(a) Basic earnings per share

Basic earnings per share for the years ended December 31, 2007 and 2006 are as follows:

	2007	2006
Net income	₩661,193,095,540	₩649,678,194,741
Weighted-average number of shares outstanding	132,442,442	140,973,989
Basic earnings per share in Korean Won	₩ 4,992	₩ 4,608

(b) Potential dilutive securities which are not included in the calculation of diluted earnings per share for the year ended December 31, 2007 are summarized as follows:

Type	Par value in Korean Won	Maturity date	Issuable number of shares
Retirement and severance benefits (share-based payment)	₩ 5,000	February 28, 2010	13,781

25 Dividends

(a) Details of dividends for the years ended December 31, 2007 and 2006 were as follows:

In millions of Won	2007	2006
Cash dividends, but not declared	₩ 340,449	₩ 319,712
Net income	661,193	649,678
Dividends as a percentage of net income	51.49%	49.2%
Par value	₩ 654,710	₩ 666,067
Dividends as a percentage of par value	52.0%	48.0%

(b) The dividend yield ratios for the years ended December 31, 2007 and 2006 were as follows:

	2007	2006
Dividend per share in Korean Won	₩ 2,600	₩ 2,400
Market price as of year-end in Korean Won	₩ 79,700	₩ 56,500
Dividend yield ratio	3.3%	4.2%

Notes to non-consolidated financial statements

December 31, 2007 and 2006

26 Non-cash Investing and Financing Activities

Significant non-cash investing and financing activities for the years ended December 31, 2007 and 2006 are summarized as follows:

In millions of Won		2007		2006
Retirement of treasury stock	₩	269,410	₩	857,778

27 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, 2007 and 2006 are as follows:

In millions of Won		2007		2006
Wages and salaries	₩	306,787	₩	289,963
Provision for severance benefits		31,014		46,912
Employee welfare		43,830		33,308
Rent		13,322		11,777
Depreciation		134,772		120,337
Taxes and dues	₩	22,887	₩	22,593

28 Employee Welfare and Contributions to Society

For employee welfare, the Company maintains a refectory, an infirmary, athletic facilities, a scholarship fund, workmen's accident compensation insurance, unemployment insurance and medical insurance. The amounts of welfare spent for the years ended December 31, 2007 and 2006 were estimated at ₩43,830 million and ₩33,308 million, respectively.

The Company donated ₩24,995 million and ₩98,893 million to KT&G Social Welfare Foundation and others for the years ended December 31, 2007 and 2006, respectively.

29 Selling, General and Administrative Expenses

The details of selling, general and administrative expenses for the years ended December 31, 2007 and 2006 were as follows:

In millions of Won		2007		2006
Salaries	₩	183,268	₩	170,432
Provision for severance benefits		19,883		30,943
Welfare		25,050		18,729
Travel		5,889		4,412
Communications		4,188		3,906
Utilities		6,130		5,785
Taxes and dues		20,178		20,016
Supplies		2,948		2,634
Uniforms		65		82
Rent		5,840		4,294
Depreciation		53,847		47,295
Amortization		713		825
Repairs and maintenance		9,994		5,028
Vehicles		7,098		7,139
Insurance		561		601
Commissions		61,238		61,995
Transportation and warehousing		25,049		22,997
Entertainment		605		592
Conferences		2,634		2,551
Advertising		136,833		134,561
Training		8,111		6,533
Prizes and rewards		1,943		2,141
Cooperation		700		582
Normal research and development		16,402		14,249
Sample		4		4
Bad debts		6,064		164
Miscellaneous		604		683
	₩	605,839	₩	569,173

Notes to non-consolidated financial statements

December 31, 2007 and 2006

30 Share Based Payment

(a) Employees who have been with the Company for more than one year are entitled to severance payment which is based on employees' performance. Eligible employees have an option to choose the Company's shares for their severance payment. The details of the Company's stock compensation plan as of December 31, 2007 were as follows:

	Optional share-based payment	
	1st grant	2nd grant
Type	Severance payment based on performance by share grant	Severance payment based on performance by share grant
Grant date	March 1, 2007	March 14, 2007
Number of employees	5	3
Number of shares granted	5,695	8,086
Vesting condition	Service condition: 1~3 years Non-market, performance condition: Long-term evaluation results based on quantified and non-quantified indices	Service condition: 1~3 years Non-market, performance condition: Long-term evaluation results based on quantified and non-quantified indices

The number of shares that may be granted is subject to the level of performance and service period.

(b) Share-based payment expense for the year ended December 31, 2007 is summarized as follows:

In millions of Won		
Share-based payment expense (recognized)		
(Retirement and severance payment)	₩	1,370
The remainder		4,109
	₩	5,479

31 Comprehensive Income

Comprehensive income for the years ended December 31, 2007 and 2006 was as follows:

In thousands of Won		2007		2006
Net income	₩	661,193	₩	649,678
Change in fair value of available-for-sale securities, net of tax effect of ₩5,246 in 2007 and ₩2,462 in 2006		(13,829)		(6,492)
Increase of unrealized gain on valuation of equity method investments, net of tax effect of ₩285 in 2007 and ₩285 in 2006		1,978		(430)
Decrease of Unrealized loss on valuation of equity method investments, net of tax effect of ₩10 in 2007 and ₩253 in 2006		256		(895)
Comprehensive income	₩	649,598	₩	641,861

Non-Consolidated Balance Sheets, Continued

As at December 31, 2007 and 2006

32 Date of Authorization for Issue

The 2007 financial statements were authorized for issue on January 23, 2008, at the Board of Directors Meeting.

33 Results of Operations for the Last Interim Period

In thousands of Won, except earnings per share		2007 4th Quarter		2006 4th Quarter
Sales	₩	617,249	₩	589,216
Operating income		185,761		170,291
Net income for the period		135,012		205,053
Earnings per share	₩	1,023	₩	1,535

34 Post Balance Sheet Date Events

The Company reacquired and subsequently retired 2,700,000 shares of common stock on January 15, 2008. Accordingly, retained earnings and the number of Company's issued shares decreased by ₩209,767 million and 2,700,000 shares, respectively.

Notes to non-consolidated financial statements

December 31, 2007 and 2006

Independent Accountants' Review Report on Internal Accounting Control System
English Translation of a Report Originally Issued in Korean

To the President of
KT&G Corporation:

We have reviewed the accompanying Report on the Operations of Internal Accounting Control System ("IACS") of KT&G Corporation (the "Company") as of December 31, 2007. The Company's management is responsible for designing and maintaining effective IACS and for its assessment of the effectiveness of IACS. Our responsibility is to review management's assessment and issue a report based on our review. In the accompanying report of management's assessment of IACS, the Company's management stated: "Based on the assessment on the operations of the IACS, the Company's IACS has been effectively designed and is operating as of December 31, 2007, in all material respects, in accordance with the IACS Framework issued by the Internal Accounting Control System Operation Committee."

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

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

Based on our review, nothing has come to our attention that Report on the Operations of Internal Accounting Control System as of December 31, 2007 is not prepared in all material respects, in accordance with IACS Framework issued by the Internal Accounting Control System Operation Committee. This report applies to the Company's IACS in existence as of December 31, 2007. We did not review the Company's IACS subsequent to December 31, 2007. 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.

Seoul, Korea
January 24, 2008

KPMG Samjong Accounting Corp.

Notice to Readers

This report is annexed in relation to the audit of the (non-consolidated) financial statements as of December 31, 2007 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.

Notes to non-consolidated financial statements

December 31, 2007 and 2006

Report on the Operations of Internal Accounting Control System

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

I, as the Internal Accounting Control Officer ("IACO") of KT&G Corporation (the "Company"), have assessed the status of the design and operations of the Company's internal accounting control system ("IACS") for the year ended December 31, 2007.

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

Based on the assessment of the operations of the IACS, the Company's IACS has been effectively designed and is operating as of December 31, 2007, in all material respects, in accordance with the IACS Framework issued by the Internal Accounting Control System Operation Committee.

January 24, 2008

Kim, San Kyum, Internal Accounting Control Officer

Kwak, Young Kyoon, Chief Executive Officer

KPMG Samjong Accounting Corp.
10th Floor, Star Tower,
737 Yeoksam-dong,
Gangnam-gu, Seoul 135-948,
Republic of korea

Tel +82(2)2112 0100
Fax +82(2)2112 0101
www.kr.kpmg.com

Corporate Governance & Organization Chart

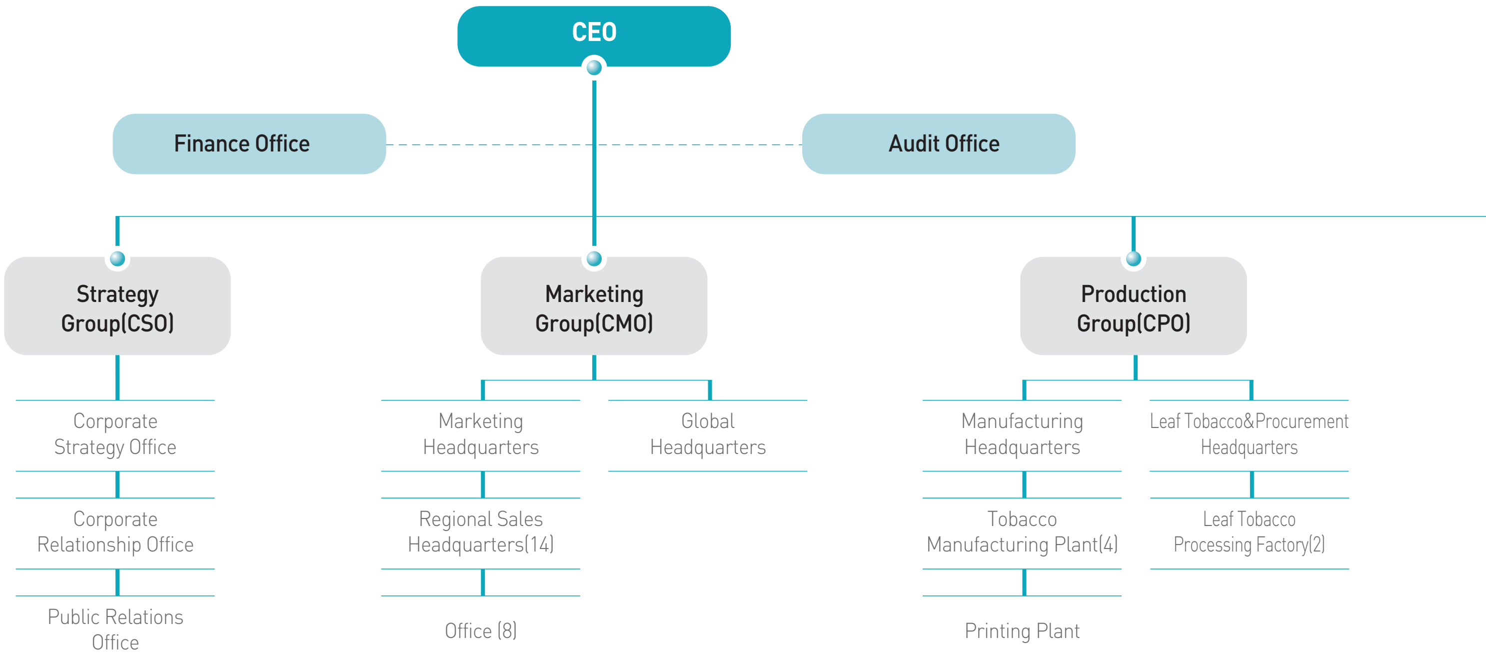
Young-kyoon Kwak
Chairman & CEO

Kyung-jae Lee
Independent non-executive Director

Yong-chan An
Independent non-executive Director

Yoon-jae Lee
Independent non-executive Director

Chang-woo Lee
Independent non-executive Director



Kwang-youl Lee
Senior Managing Director

Young-jin Min
Senior Managing Director

Jin-hyun Kim
Independent non-executive Director

Kiu-won Kim
Independent non-executive Director

Jong-hoon Kim
Independent non-executive Director

Jin-moo Lee
Independent non-executive Director

Jin-ho Chang
Independent non-executive Director

- R&D Group(CTO)
  - R&D Headquarters
  - Central Research Institute
- Growth Business Headquarters
- Management Support Headquarters
  - Human Resources Development Institute

Manufacturing & Sales Network

TOBACCO MANUFACTURING

Shintanjin plant
Wonju Plant
Gwangju Plant
Yeongju Plant

PRINTING PLANT

Cheonan plant

LEAF TOBACCO PROCESSING

Gimcheon factory
Namwon factory

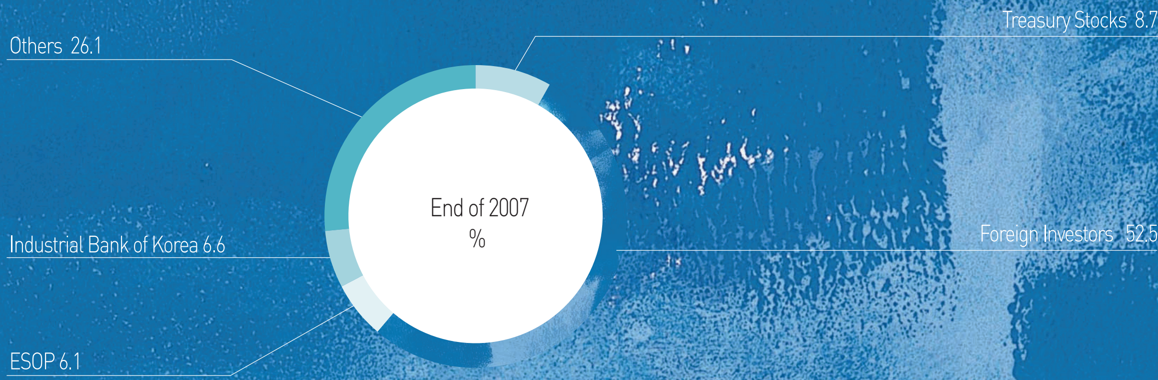
SALES

Regional Headquarters: 14
Branch Offices: 168

Investor Information

- Capital Stock KRW955 billion
- Number of Authorized Shares 800,000,000
- Number of Shares Issued 143,442,497
- Shareholders' Equity KRW3,046 billion

(End of 2007)



OWNERSHIP STRUCTURE

INQUIRIES

- INVESTOR RELATIONS DEPARTMENT
- KT&G Corporation

  19F, KOSMO Tower, 1002 Daechi-dong, Gangnam-gu, Seoul, 135-280, Korea
- Tel. (82-2)3404-4522~4, 4533~37 ■ Fax.(82-2)3404-4515

HEAD OFFICE

- KT&G Corporation

  100, Pyongchon-dong, Daedeok-gu, Daejon City, 306-130, Korea
- Tel. (82-42)939-5000 ■ Fax.(82-42)939-5001
- http://www.ktng.com

KT&G

100, Pyongchon-dong, Daedeok-gu,Daejon City, 306-130, Korea
Tel 82-42-939-5000 Fax 82-42-939-5001
www.ktng.com